UTTRAKHAND OPEN UNIVERSITY

LL.M.-104

SCHOOL OF SOCIAL SCIENCE

कॉर्पोरेट विधि

(CORPORATE LAW)

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UTTRAKHAND OPEN UNIVERSITY HALDWANI

CORPORATE LAW

LL.M.-104

कॉरपोरेट विधि

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Block 1 - Introduction
Unit 1 -History Of Company Legislation In England And India, And Meaning Of Company

STRUCTURE

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1.1. Introduction:

The roots of the present day human institutions lie deeply buried in the past. The same is true of a country's law and legal institution. The legal system of a country at a given time is not the creation of one man or of one day. It represents the cumulative fruit of the endeavor, experience, thoughtful planning a patient labour of a large number of people through generations. To comprehend, understand and appreciate the present company law adequately, it is necessary, therefore, to acquire background knowledge of the course of its growth and development. To explain why it is so, on e has to penetrate deep in to the past and make cognizance of the factors, stresses and strains which have moulded and shaped legal development. To understand, how it is so, one must appreciate the problems and the pitfalls which the administrators had to face in the past and the manner in which they sought to deal with them. If we were to confine our attention exclusively to the law as it is, our understanding of it is bound to be deficient as it is not possible to appreciate its present ordering without some familiarity with its past. We would have a distorted picture of the nature of modern company law if we were to the take the stand that it began only today, or the day before yesterday. The truth is that the traditions of the past were made our modern company law what it is, and still line on in it. Without a proper historical background, it may be difficult to appreciate as to why a particular feature of the system is as it is. The historical perspective throws light on the anomalies that exist here and there in the system. Hence, we may conclude that in order to understand the company law properly, knowledge of historical background is an essential condition.

1.2. Objective:

The objective of this lesson is to analysis historical development of Company Legislation in England and India along with meaning of company.

1.3. Presentation of Contents:

1.3.1 History of Company Law in England:

First Period-Prior to the Bubble Act of 1720:

In London, the earliest business associations during the 11th to 13th centuries were called the 'merchant guilds'. These guilds obtained charters from the Crown mainly to secure for their members, a monopoly in respect of particular trade or commodity. These associations were either formed as 'Commenda' or 'Societas'. 'Commenda' operated in the form of partnership, the financier being a sleeping partner with limited

liability. The liability was basically borne by the working partners. In 'Societies', on the other hand, all the members took part in the management of the trade and had unlimited liability, more in line with the present day partnership.

In the 14th century, the word 'Company' was adopted by certain merchants for trading overseas. This was, more or less an extension of the merchant guilds in foreign trade. By the end of 16th century Royal Charters granted monopoly of trade to members of the Company over a certain territory. These companies were called regulated companies. East India Company was one of such regulated companies established by a Charter in 1600. It had monopoly of trade in India; its members could carry on trade individually and had the option to subscribe to the joint fund or stock of the company. After each voyage, the profits made, together with the subscribed amount, were divided among the members. In 1653, however, a permanent subscribed fund was introduced, called joint fund or stock of the company. Accordingly, the term joint stock company came into use. In a simple way, the members contributed to the capital by providing the joint stock and were shareholders in respect of the profits earned by its use. The profits were, however, shared at the end of each voyage. By the end of 17th century all these companies or merchant guilds and many regulated companies which the Crown had incorporated, meanwhile had established permanent fixed capitals represented by shares which were freely saleable and transferable. The property with which the companies traded was recognized as being under the exclusive control of their governors or directors for the purpose of carrying on these undertakings and was not available for division between members at intervals of time.

At this time the only method of obtaining the incorporation of a company was by Royal Charter or by an Act of Parliament. These methods of incorporation were quite expensive and time consuming. Consequently, many companies were formed by agreement without incorporation. As a result, the first 20 years of 18th century witnessed a flood of speculative and often fraudulent schemes of company floatation of which the notorious scheme of the South Sea Company is the best known example. The South Sea Company had a scheme to acquire virtually the whole of the national debt [approx. £31,000,000] by purchasing the holdings or exchanging the holdings for the stocks of the company. The possession of interest-bearing loan owed by the State was a basis on which the company might raise vast sums to extend its trade. This theory was not necessarily unsound—it was indeed a logical extension of the principle upon which the Bank of England, and the South Sea Company itself, had been originally formed but unfortunately, the Company had very little trade

to expand. It had paid a huge sum of money for obtaining the charter in competition with the Bank of England.

Second Period-From 1720 to 1825:

In 1720 an Act, known as Bubble Act, was enacted to curb the development of unincorporated companies. The passage of the Bubble Act in 1720 marked the second period in the history of company law in England. The Bubble Act was made it a criminal offence to act as a corporate body without the sanction of an Act of Parliament of a royal Charter.[1] Since during this period the incorporation of a company was possible by a royal charter or an Act of Parliament, the Government had full control over the incorporation of the companies. The Government showed reluctance in granting incorporation and therefore, it became very difficult for an association of persons to get incorporated. Consequently, the businessmen were compelled to find out an alternative device and this they found in the unincorporated companies. Thus the Bubble Act caused a rebirth of the unincorporated companies which it had sought to destroy.[2] Thus The Bubble Act failed to achieve its object and, therefore, it was repealed by the Legislature in 1825.

Third Period-From 1825 to 1844:

The English Act of 1825 which repealed The Bubble Act provided that the members of a company should be liable for debts of the company to an extent the Charter might provide. It is notable that the repeal of The Bubble Act was followed by disastrous slumps. Because of the repeal of this Act the companies were once more left free to be formed by contracts and thereby the un-incorporated companies once more came into existence in huge quantity. In law an unincorporated company was treated as partnership and was not conferred on legal personality. Consequently, an unincorporated company was not entitled to sue or be sued in its own name. Thus it was very difficult to conduct a suit by or against an unincorporated company. Besides, the members of such companies could not limit their personal liability. These companies were large fluctuating bodies and, therefore, the persons dealing with them were unable to locate the persons responsible to discharge the liabilities of the company. Because of these defects it was felt necessary to check the formation of such companies. For this purpose, various steps were taken. The first step was the enactment of the Trading Companies Act of 1834 which required the public registration of its members and gave some of the privileges of incorporation of associations without their being actually incorporated. In 1837 a new Act was passed which contained certain regulations as to the formation and conduct of the business of companies. The Parliamentary

[1] The Bubble Act, S. 18

[2] See Gower, *The principles of Modern Company Law*, p. 31.

committee appointed to investigate the working of the Act found that the Act of 1837 could easily be used to form fraudulent companies because no provision was introduced in the Act for the periodical audit of the company and for holding directors and promoters liable for fraud. As a result of the Parliamentary Committee's report, two Acts were passed in 1844.

Fourth Period- From 1844 to the present day:

The first Joint Stock Company Act of 1844 provided that all the companies formed after the date of the Act with more than twenty-five members or with shares transferable without the consent of all members must be registered under it. The Act also provided compulsory registration for all insurance companies. The Act laid down that a company might be incorporated on compliance with certain regulations contained in the Act and thus it did away with necessity of special application to the Crown for Incorporation. Thus, after the enactment of this it was possible to form companies by mere registration under the Act without royal Charter or special Act of Parliament.

The second Act of 1844 dealt with the winding up of the companies. It also provided remedies for the abuses by the directors and promoters in the formation and management of the company.

In is notable that after 1844 a company could be incorporated by registration under Act of 1844 but the liability of the members was still unlimited. For this, the Act of 1844 was criticized much and ultimately the right to trade with limited liability was granted by the Limited Liability Act of 1855. The Limited Liability Act remained in force a few months as it was repealed by the Joint Stock Companies Act of 1856.

The next important Acts were the Companies Act of 1862 and 1908 which consolidated the law relating to the companies. Under the Act 1856 only those companies which had minimum number of seven members were allowed to limit the liability of their members but the Act of 1908 extended the principle of limited liability to the private companies and also which had at least two shareholders. Again the Companies Act was revised in 1929. The Act of 1929 for the first time provided that the annual profit and loss accounts must be laid before the shareholders. It made it necessary for all public companies to have at least two directors. Ultimately the Companies Act 1948 was passed. After the Companies Act of 1948, the two other Companies Acts have been passed, one in 1967 and other in 1976. However, the Companies Act of 1948 has been modified to a large extent by the Companies Act, 1967, 1976 and the Companies Act, 1980, 1981 and 1983. In 1985, the whole of the existing statute law relating exclusively to companies was consolidated in the companies Act, 1985 which is the present statute governing companies in England.

1.3.2 History of Company Law in India

Company legislation in India owes its origin to the English Company Law. The Companies Act passed from time to time in India has been following the English Companies Act with certain modifications to suit Indian conditions. The first legislative enactment for "Registration of Joint Stock Companies" was passed in the year 1850. This Act was based on the English Companies Act, 1844 (known as the Joint Stock Companies Act of 1844) which recognized the company as a distinct legal entity, but did not grant to it the privilege of limited liability.

The principle of limited liability was first introduced in England by the Limited Liability Act of 1855 under which a company was entitled to obtain certificate of registration with limited liability. The English Companies Act, 1856 (known as the Joint Stock Companies Act of 1856) replaced both the Acts of 1844 and 1855. Under this Act, the company legislation assumed for the first time a form which has been broadly handed down almost to the present day, subject to various amendments which were made from time to time to suit various exigencies. Under this Act, 7 or more persons could form themselves into an incorporated company, with or without limited liability, by signing a Memorandum of Association and complying with the requirements of the Act. Following the English Companies Act of 1856, the Joint Stock Companies Act of 1857 was passed in India. This Act recognized, for the first time in India, the principle of limited liability.

The concept of limited liability is not alien to the Indian society. The Hindu joint family system (which is the oldest and most common form of business activity) possesses many features which are conducive to the conduct of business by the members of the family as a group. Such a family is treated as distinct from its members and in that capacity can engage in any business activity through its Manager. The liability of the members of the Hindu Joint Family, other than the Manager of the family, in regard to the business of the family, does not extend to their 'separate' or 'self-acquired' property not employed in such business.

Both the English Act of 1856 and the Indian Act of 1857 did not extend the privilege of limited liability to banking companies. This disability was removed in England by the Joint Stock (Banking) Companies Act of 1857 and the Joint Stock (Banking) Companies Act of 1858 which brought banking companies, both with limited and unlimited liability, within the operation of the Act of 1856. In India, the Joint Stock Companies Act of 1860, passed on the lines of the English Act of 1856, enabled banking companies to register, subject to certain conditions, with limited liability.

Then came the companies Act of 1866 for consolidating and amending "the law relating to the incorporation, regulation and winding up of trading companies and other association". This Act was based on the English

Companies Act of 1862, which has been called "a masterpiece of legislation". Sir Francis Palmer described it as the "Magna Carta of co-operative enterprise."

The Companies Act of 1866 in India was recast in 1882 to bring the Indian Company law in conformity with the various amendments made to the English Company Act of 1862. This Act stood the test of time till 1913.

Following the English Companies (Consolidation) Act, 1908, the Indian Companies Act of 1913 was passed. This act also like its predecessors was almost a verbatim reproduction of the English Act of 1908; the decisions of the English Courts under the English Company Law were also closely followed by the Indian Courts.

The Companies Act, 1956:

After the end of World War II, the need for a further revision of the company law was felt. Many changes had taken place in the organization and management of joint stock companies. The government of India therefore appointed on 25th October, 1950, a committee of 12 members representing various interests under the chairmanship of Mr. H.C. Bhabha. The Bhabha Committee submitted a comprehensive report on all aspects of company law in April 1952. The recommendations of the Committee culminated in the most comprehensive and voluminous law on the subject in the Companies Act of 1956. This Act largely follows the English Companies Act of 1948 (subsequently replaced by Companies Act of 1967, 1976, 1980, 1981 and at present the Companies Act of 1985) which is based on the recommendations of the Company Law Amendment Committee, known as the Cohen Committee, which suggested that emphasis should be placed on the public accountability of incorporated companies.

Object of the Act: The Companies Act of 1956 is a comprehensive piece of legislation covering the entire field of company organization and management. All the statutory rules are intended:

(1) To protect the interest of creditors in view of the limited liability of the members of a company (e.g., the rules preventing reduction of capital without proper safeguards, appointment of liquidators where the company is insolvent):
(2) To protect the interest of investors (e.g., the rules concerning the prospectus and the accounts, holding of statutory and other general meetings, prevention of malpractices by directors and managers, prevention of oppression of minority and mismanagement, and investigation and to equip the Government with necessary powers to intervene in the affairs of a company in the interest of the shareholders and the public: and
(3) To help the growth of companies on healthy business lines.

The basic direction and objectives which throughout have inspired the course of Indian Company legislation was summarized in 1956 by Shrt C.D. Deshmukh, the then Finance Minister, while piloting the Companies Bill in Parliament, thus:

(1) Minimum standards of business integrity and conduct in the promotion and management of companies:
(2) Full and fair disclosure of all reasonable information relating to the affairs of a company:
(3) Effective participation and control by shareholders and thus the protection of their legitimate interests:
(4) Enforcement of proper performance of their duties by company management: and
(5) Power of intervention and investigation into affairs of a company, where it is being managed in a manner prejudicial to the shareholders or the public interest."

The Companies Act, 1956 has been amended several times since then. The major amendments were introduced in the years 1960, 1962, 1963, 1964, 1965, 1967, 1969, 1974, 1977, 1985, 1988, 1991.

In the wake of economic reforms process initiated from July, 1991 onwards, the Government recognized that many provisions of the Companies Act had become anachronistic and were not conducive to the growth of the Indian corporate sector in the changing environment. Consequently, an attempt was made to recast the Act, which was reflected in the Companies Bill, 1993. The Said Bill, however, was subsequently withdrawn. As part of continuing reforms process and in the wake of enactment of the Depositories Act, 1996, certain amendments were, however, incorporated by the Companies (Amendment) Act, 1996.

In the year 1996, a Working Group was constituted to rewrite the Companies Act, following an announcement made by then Union Minister for Finance in his Budget Speech to this effect. The main objective of the Group was to rewrite the Act to facilitate healthy growth of Indian corporate sector under a liberalized, fast changing and highly competitive business environment. Based on the report prepared by the working group and taking into account the development that had taken place in corporate structure, administration and the regulatory framework the world over, the Companies Bill, 1997 was introduced in Rajya Sabha on August 14, 1997 to replace by repealing Companies Act, 1956. In the meantime, as part of reforms process and in view of the urgency felt by the Government, the President of India promulgated the companies (amendment) Ordiance, 1998 on October 31, 1998, which was later replaced by the Companies (Amendment) Act, 1999 to surge the capital market by boosting morale of national business houses besides encouraging FIIs as well as FDI in the country. The amendments brought about number of important changes in

the Companies Act. These were in consonance with the then prevailing economic environment and to further Government policy of deregulation and globalization of economy. The corporate sector was given the facility to buy-back company's own shares, provision relating to investments and loans were rationalized and liberalized besides the requirement of prior approval of the Central Government on investment decisions was dispensed with, and companies were allowed to issue sweat equity" in lieu of intellectual property. In order to make accounts of Indian Companies compatible with international practices, the compliance of Indian accounting Standards was made mandatory and the provisions for setting up of National Committee on Accounting Standards was incorporated in the Act. For the benefit of investors provisions were made for setting up of "Investor Education and Protection Fund" besides introduction of facility of nomination to shareholders, debenture holders etc.

The year 2000, witnessed another bouquet of amendments in the form of companies (Amendment) Act, 2000 in order to provide certain measures of good corporate governance and for ensuring meaningful shareholders' democracy in the working of companies. Accordingly, it introduced certain far reaching changes and new concepts. These include:

(1) Minimum Paid-up Capital Requirement: All companies other than associations not for profit are required to have a minimum paid up capital. Private Companies since 13-12-2000, cannot be registered with less than Rs. 1,00,000 paid up capital and Public Companies must have a minimum paid up capital of Rs. 5,00,000.

(2) Small Depositor: In order to grant protection to small depositors, sections 58AA and 58AAA were introduced. Provisions are designed to protect depositors who have invested upto Rs. 20,000 in a financial year in a company.

(3) Shelf Prospectus Information Memorandum and Red-herring Prospectus: Financial institutions and banks have to make repeated offers of securities in a year may instead of issuing prospectus issue a 'Shelf Prospectus' which will have a shelf-life of one year. For any changes in between an 'information memorandum' containing those changes duly classified under appropriate heads need only be issued. Section 60A is designed to offer comfort to such institutions and also help reduce cost of issue. Information Memorandum, as contemplated in section 60B is an attempt to recognize the book-building process (allowed under SEBI Guidelines since 1997). Information Memorandum is essentially a document designed to elicit demand for the securities and to ascertain the price and terms of the issue. It's a necessary ingredient of 'book-building process.

(4) Non-Voting Equity Shares: Section 86 was amended to allow issue of non-voting equity shares by public companies.
(5) Passing of Resolutions through Postal Ballot: In order to encourage wider participation of shareholders, section 192A has been introduced to allow members/shareholders to vote on a particular resolution through postal ballot. Through Rules made by the Central Government, Postal ballot has been made mandatory for certain matters. Assent or Dissent to a resolution is required to be sent within 30 days.
(6) Directors' Responsibility Statement: Directors' Report is to include a responsibility statement with respect to the following matters:
   (i) Whether accounting standards had been followed in the preparation of annual account and reasons for material departures, if any;
   (ii) Whether appropriate accounting policies have been applied and on consistent basis.
   (iii) Whether directors had made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs and profit and loss of the company;
   (iv) Whether the directors had taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of this Act for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
   (v) Whether the directors had prepared the annual accounts on a going concern basis.
(7) Audit Committees: New section, *viz.,* 292A provides for constitution of audit committees by every public company having a paid-up capital of Rs. 5 crores or more. Audit Committee is to consist of at least 3 directors. Two-thirds of the members of the Audit Committee shall be directors other than managing or whole-time director. Recommendations of the Audit Committee on any matter relating to financial management including audit report shall be binding on the Board.
(8) Secretarial Audit: Section 383A was amended to provide for secretarial audit with respect to companies having a paid-up share capital of Rs. 10 lakhs or more but less than, presently, Rs. 2 crores. A whole time company secretary has to file with ROC a certificate as to whether the company has complied with all the provision of the Act. A copy of this certificate shall also be attached with the Report of Board of Directors.
(9) Issue of Indian Depository Receipts: Section 605A permits companies incorporated outside India, whether having a place of

business in India or not, to issue Depository Receipts in India and thus raise capital funds from Indian public.

Companies (Amendment) Act 2001 amended provisions of section 77A relating to buy-back of shares allowing Board of Directors (instead of through special resolution) to buy back shares upto 10% of the paid up capital and free reserves provided not more than one such buy back is made during a period of 365 days. Resolution for the afore said buy-back shall be required to be passed at a meeting of the Board and not through circulation

Companies (Amendment) Act, 2002: Two companies (Amendment) Acts were passed in December 2002. These are called Companies (Amendment) Act, 2002 and companies (Second Amendment) Act, 2002. The Companies (Amendment) Act, 2002 provides for setting up and regulation of cooperatives as body corporate under the companies act, 1956 to be called 'Producer Companies'. The objective of the companies (Second Amendment) Act, 2002 is to expedite the winding up process of the companies, facilitate rehabilitation of sick companies and protection of worker to winding up so that resources can be utilized for better purposes rather than blocking them in sick undertakings and thus, help in reducing the hardships to workers and other interested parties. The second Amendment Act provides for repeal of SICA and dissolution of BIFR. At the same time, it seeks to establish a National Company Law Tribunal providing it with power for expediting the winding up procedure.

Companies (Amendment) Act, 2006: *- The Companies (Amendment) Act, 2006* –

brought into force w.e.f. 1-11-2006 has introduced provisions with respect to: (A) Directors Identification Number (DIN); and (B) Electronic Filing of various returns and forms. For the purpose, section 253 has been amended and a few new sections, namely, sections 266A, 266B.266C, 266D, 266E, 266F, 266G, 610B, 610C, 610D and 610E have been added.

(A) Provisions Relating to Directors Identification Number (DIN) - By section 2 of the Companies (Amendment) Act, 2006, existing section 253 of the Companies Act, 1956 ('the Act') (dealing with only individuals to be appointed as directors) is amended. Newly inserted proviso to section 253 makes it obligatory for companies to ensure that directors have been allotted Directors Identification Number (DIN) as required under newly inserted section 266B of the Act. The said proviso requires that fresh appointment of any individual as director of the company cannot be made unless such an individual has been allotted DIN.Similarly, it requires that companies cannot re-appoint its director unless he has been allotted DIN. The company law requires that directors are liable to retire by rotation and to be reappointed at general meeting (Section 255). Thus, the companies

need to ensure at the time of appointing or reappointing any individual as its director that such an individual has obtained DIN.

By section 3 of the Companies (Amendment) Act, 2006, seven new sections, namely, sections 266A, 266B, 266C, 266D, 266E, 266F and 266G are inserted in the Act. These provisions relate to DIN. The said section 3 has been brought into force by the Central Government with effect from 1-11-2006 [Notification issued by the Ministry of Company Affairs, published in the Gazette of India, Extraordinary, Part II, section 3(f), *vide* G.S.R. 648E, dated 19-10-2006].

The Companies (Director Identification) Rules, 2006:- Pursuant to section 642(1) read with sections 266A, 266B and 266E of the Act, the Central Government has notified the Companies (Director Identification) Rules, 2006. It has appointed 1-11 -2006 as the date on which the provisions of these rules shall come in force [Issued by the Ministry of Company Affairs, published in the Gazette of India, Extraordinary, Part II, section 3(f), vide G.S.R. 649E, dated 19-10-2006].

Delegation of powers of Central Government in respect of Directors Identification Number (DIN) - The Central Government has delegated its powers and functions in respect of allotment of DIN under sections 266A and 266B to the Regional Director, Joint Director, Deputy Director or Assistant Director posted in the office of Regional Director Northern Region [Issued by the Ministry of Company Affairs, published in the Gazette of India, Extraordinary, Part II, section 3(*i), vide* G.S.R. 650E, dated 19-10-2006].

It may be noted that except the provisions contained in section 2 relating to certain definitions and provisions contained in sections 10FB to 10FG (relating to constitution of National Company Law Tribunal and Appellate Tribunal) the provisions of Companies (Second Amendment) Act, 2002 have not yet been brought into force. Further, in a recent judgment in *Union of India* v. *R. Gandhi*[3]*,* the Supreme Court has held that the wholesale transfer of powers exercised by High Courts in regard to company matters to proposed National Company Law Tribunal and National Company Law Appellate Tribunal as contemplated under Companies (Second Amendment) Act, 2002 would offend constitutional scheme of separation of powers and independence of judiciary needs to be given a fresh look and should, therefore, be heard by a Constitutional Bench.

The Central Government had earlier issued Forms DIN-1, DIN-2, DIN-3 and DIN-4. These Forms along with the rules thereto have now been notified.

[3] (2007) 76 SCL 350 (SC).

Accordingly:

(a) No Company shall appoint or re-appoint any individual as director of the company unless he has been allotted a Directors Identification Number (DIN) (proviso to section 253). *Vide its* Circular No. 5/2011 dated 04.03.2011, the Ministry of Corporate Affairs has notified the simplified procedure for obtaining Directors Identification Number (DIN) as follows:

1. Application for DIN will be made on eForm; No physical submission of documents shall be accepted and for this purpose scanned documents along with verification by the applicant will be attached with the eForm. Only online fee payment will be allowed *ie.* No challan payment.
2. The application can also be submitted online by the applicant himself using his DSC.
3. DIN 1 eForm can be digitally signed by the professional who shall also confirm that he has verified the particulars of the Applicant given in the application.
4. Where the DIN 1 is verified by the professional, the DIN will be approved by the system immediately online.
5. In other cases the DIN cell will examine the application and same shall be disposed of within one or two days.
6. Penal action against the applicant and professional certifying the DIN application in case of false information/certification as per provisions of section 628 of the Act will be taken in addition to action for professional misconduct and revocation of DIN, allotted on false information.

(b) Further, no individual, who had already been allotted a DIN, shall apply, obtain or possess another DIN (Section 266C).

(c) Every existing director shall, within one month of the receipt of DIN from the Central Government intimate his DIN to the company or all companies wherein he is a director. Intimation to company(ies) from Director shall be in Form DIN-2. In case, directors of a company have already obtained DIN on or before 30-11-2006, they shall intimate to all companies in which they are directors, on or before 30-11-2006 [Section 266D read with the Companies (Director Identification) Rules]. Intimation to companies by directors in Form DIN-2 may be given in physical/paper form.

(d) Companies, in turn, are required to file Form DIN-3 for sending intimation of DIN to the Registrar of Companies (online through MCA

21 portal) within one week of the receipt of intimation from directors; Form DIN-3 is required to be:

(i) verified by Managing Director or Director or Manager of the company, and

(ii) Certified by the Company Secretary in full-time employment of the company or Company Secretary in whole-time practice.

From 1-4-2007, the filing fee (as under Schedule X of the Act) shall be payable for Form DIN-3. No filing fee is payable if Form DIN-3 is filed on or before 31-3-2007 [Section 266E read with the Companies (Director Identification) Rules]. Form DIN-3 is to be filed electronically and one Form DIN-3 can have particulars of up to 12 directors, (e) For incorporating any changes in the personal particulars of a Director, including his address, after he has submitted the information initially in Form DIN-1 or in the event of change in his particulars after allotment of DIN, an intimation is required to be sent by the director to the Central Government in Form DIN-4. Form DIN-4 is required to be filed within 30 days of the change, in manual mode as in the case of Form DIN-1. No filing fee is payable for Form DIN-4.

Penalty - Every individual or director or the company, as the case may be, who or which, is in default, shall be punishable with fine up to Rs. 5,000 and where the contravention is a continuing one, with a further fine up to Rs. 500 for every day after the first day from which the contravention continues (Section 266G). E-Governance and E-Filing- the Central Government has notified the Companies (Electronic Filing and Authentication of Documents) Rules, 2006 [Notification No. G.S.R. 557(E) dated16-9-2006].The said rules provide for e-filing of forms, applications, documents and declarations in Portable Document Format (PDF) and authentication thereof using digital signature. The rules also provide for maintenance of website and electronic registry by the Central Government. The said rules also enable Registrar of Companies and the Central Government to issue certificate, license, receipt, approval or acknowledgement in electronic mode. By section 4 of the Companies (Amendment) Act, 2006 four new sections are inserted in the Act, namely, sections 610B, 610C, 610D and 610E. These provisions mainly relate to electronic filing of Forms under the Act with Registrar of Companies and the Central Government. It also provides for the payment of fees through electronic mode and elaborates provisions on usage and authentication with digital signature. The said section 4 of the Companies (Amendment) Act, 2006 has been made applicable with effect from 16-9-2006 [vide Notification No. S.0.1529 (E), dated 14-9-2006], It may be noted that filing

under the Act with the Company Courts and the Company Law Board continues to be in physical/paper mode.

1.3.3 Meaning of 'Company'

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 whereupon 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.[4]

Before the inception of company as a device for business enterprise, two modes of carrying out business activities were commonly prevalent, namely, (I) Monopoly, and (2) 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, on the other hand, was a suitable device for small scale enterprises which could be financed and managed by a limited number of persons called the partners who take mutual interest and there is also mutual trust and confidence among them.[5] But both these devices were unsuited to large scale business organisations which involved greater mobilisation 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.[6]

1.3.4 Definition of Company

A company has been defined in the Companies Act, 1956 as "a company formed and registered under this Act or an existing company. An 'existing company' means a company formed and registered under any of the previous company laws."[7]

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[4] Shah, S.M.: *Lectures on Company Law* (13th Ed.) P1.
[5] Avtar singh, Dr.: *Company Law* (10th Ed.) P1.
[6] Hahlo's Casebook on Company Law (42nd Ed.).
[7] Section 3(1)(i) of *the Companies Act*, 1956.

Lord Justice Lindley defined company as "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."[8]

This definition gives an idea of the incorporated company and has been popularly accepted.

In Halsbury's Laws 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."[9]

In common law, a company is a "legal person or 'legal entity', separate from, and capable of surviving beyond the lives of its members."[10]

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 an Act relating to companies."

Chief Justice Marshall of the Supreme Court of U.S.A. in *Dormouth Cottege* v. *Woodward,*[11] defined a Joint Stock Company as, "an artificial person—-invisible, intangible and existing only in the eyes of law. Being a mere creation of law, it possesses only those properties which the charter of its creation confers upon it either expressly or as incidental to its very existence, among the most important are immortality and if the expression may be allowed, individuality, properties by which a perpetual succession of many persons is considered as the same and may act as a single individual."

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[8] Lord Lindley on Companies, P.1.

[9] Halsbury Laws of England, P.301.

[10] Graf Evans : What is a Company? (1910) 26 LQR 259.

[11] 4 Wheat [US] 518.

Heney has defined a joint stock company as "a voluntary organisation formed with the object of earning profit, whose capital is divisible into transferable shares and membership is necessary for its ownership."

A company may further 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.

The definition of a Joint Stock Company is contained in Section 566 of the Companies Act, 1956. It reads as follows:

> "a joint stock company means a company having a permanent paid up or nominal share-capital of fixed amount divided into shares, also of fixed amount, or held and transferable as stock, or divided and held partly in one way and partly in the other, and formed on the principle of having for its members the holders of those shares or that stock and no other persons. Such company when registered with limited liability under this Act, shall be deemed to be a company limited by shares."

In modern times the functioning of companies has assumed a new role in society. Commenting on this aspect of Company's role Hon'ble Justice P.N. Bhagwati, former Chief Justice of the Supreme Court of India in *National Textile Worker's Union* v. *P.R. Ramkrishnan,*[12] *inter-alia* observed:

> "It is now accepted on all hands, even in predominantly capitalist countries that a company is not a property. The traditional view that the company is the property of its shareholders is now an exploded myth. A company, according to the new socio-economic thinking, is a social institution having duties and responsibilities towards the community in which it functions it is now acknowledged even in highly developed countries like the United States and England that maximisation of social welfare should be the legitimate goal of a company and shareholders should be regarded not as proprietors of the company, but merely as suppliers of capital entitled to no more than reasonable return and the company should be responsible not only to shareholders, but also to workers, consumers and. the other members of the community and should be

[12] AIR 1983 SC 75(81).

> guided by considerations of national economy and progress."

It must be stated that environmental degradation resulting from industrial pollution in recent years has become a positive danger to social security. Legal provisions are therefore incorporated in the Indian Penal Code,[13] to punish industrial and business organisations which create danger to public life by polluting water,[14] and District Magistrate can initiate proceedings against them under Section 133 of the Code of Criminal Procedure, 1973.

1.4. Summary

In India the first legislative enactment of registration of joint stock companies was passed in the year 1850. The concept of 'limited liability' was recognized, for the first time, in 1855 and in case of banking companies in 1858. Based on the English companies Act, 1862 was passed the companies Act, 1866 but had to be reast in 1882. This Act continued till 1913 when it was replaced by the Indian Companies Act, 1956 has been amended several times since then. The major amendments were introduced in the years 1960, 1962, 1963, 1964, 1966, 1967, 1969, 1974, 1985, 1988, 1991, 1996, 1997, 1999, 2000, 2001 and 2002. The amendments of 2002 are drastic and provide for corporatization of cooperatives; constitution of National Company Law Tribunal with powers earlier vesting in company Law Board, and the court; levy of a cess to form a Rehabilitation and Revival Fund; appointment of official Liquidator from a panel of specified professionals.

A 'Company' implies an association of persons for some common object or objects. A 'Company' under the Act is defined to mean a "company formed and registered under the Companies Act, 1956 or under any of the previous company law"

1.5 Suggested/Reference Material

1. Avtar Singh : Company Law.
2. N.D. Kapoor : Elements of Company Law.
3. N.V. Paranjape : Company Law.
4. Taxmann : Company Law.
5. Gower, L.C.B. : Principles of Moderen Company Law.
6. Ramiya : Guide to the Companies Act.

[13] Section 277, IPC.
[14] Water Pollution (Amendment) Act, 1978.

1.6 Self assessment questions

1. Discuss in detail the history of company legislation in India.
2. Discuss in detail the history of Company Legislation in England.
3. Explain in detail the meaning of Company.

LL.M. Part-1
PAPER CORPORATE LAW

Block 1 - Introduction

Unit 2- Corporate Personality, Advantage and disadvantage

STRUCTURE

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2.1Introduction:

A company means an association of certain persons registered under the Companies Act, 1956. According to Lindley, L.J. 'a company is an association of many persons who contribute money or money's worth to a common stock and employ it in some common trade or business and who share the profit or loss arising there form. On incorporation a company becomes a body corporate or corporation with a perpetual succession and a common seal. It also acquires a personality distinct from its members. Incorporation offers certain advantages to the business community which other types of business organization generally do not enjoy. The principle of separate legal entity may be referred as "the veil of incorporation". The courts in general consider themselves bound by this principle. The effect of this principle is that there is a fictional veil between the company and its members. That is, the company has a corporate personality which is distinct from its members.

The human ingenuity, however, started using this veil of corporate personality as a cloak for fraud or improper conduct. Thus, it becomes necessary for the courts to lift the corporate veil and look at the persons behind the company who are the real beneficiaries of the corporate fiction. There are certain exceptions where corporate veil has been lifted by the courts from time to time.
The choice of a proper form of business organization is essential for the success of a business by the enterprises. There may be following: (i) corporations, Partnerships and other Association of persons. (ii) State Corporations, Government Companies (iii) Small Scale, Co-operative, Corporate and Joint Sectors.

2.2Objective:

The objective of this lesson is to analyze the Corporate Personality, advantage and disadvantage of incorporation, lifting of corporate veil, corporations, partnership and other association of persons, state corporations, governments companies, small scale, cooperative, corporate and joint sectors with the help of statutory laws and the relevant case laws.

2.3.1. Corporate Personality:

From the date of its incorporation a company becomes in a law a different person altogether from the members who compose it.[15] Thus an incorporated company has a legal personality distinct from that of its members from the date of its incorporation.[16]

In England the legal personality of an incorporated company was recognized in 1867 in the case of Oakes v. Turquand and Harding.[17] However it was firmly established in 1897 in the case of Salomon v. Salomon & Co. Ltd.,[18] In Salomon v. Salomon & Co. Ltd.[19] person called Aron Salomon had for many years carried on business as a leather merchant and boot manufacturer. He decided to form a limited company to purchase his business, but he wanted to have control over the conduct of the business and therefore, his plan was that the members of the company should be limited to himself and the member of this family. The company was incorporated under the name “Salomon & Co. Ltd.” The subscribers to the memorandum were Salomon, his wife, his daughter and his four sons. Salomon sold his business to the company for £ 38782. Instead of paying him whole price in cash, the company gave him 20,000 fully paid up shares of £ 1 each and £ 10,000 in debentures and the balance was paid to him in cash. Salomon was appointed as the managing director and his two elder sons as directors. Because of a depression and strike in the boot trade, the company did not prosper and when it was wound up it was found that the company was liable to pay £ 10,000 to Salomon as debenture holder and £ 7000 to the unsecured creditors, while its assets were £ 6000 only. A debenture holder was and is given priority over an unsecured creditor. Thus it was found that if the assets of the company were applied in the payment of debentures held by Salomon, there would be no fund for the payment of the unsecured creditor. The unsecured creditors objected. It was contended on behalf of the unsecured creditors that the company had no independent existence; it was mere alias or agent for Salomon. Since Salomon was the principal and the company was his agent, Salomon was liable to indemnify the company against the claims of the unsecured creditors and no payment should be made on debentures held by Salomon until the unsecured creditors had been paid in full.

[15] S. 34, See Ashoka Marketing Ltd. v. P.N.B., (1940) 4 S.C.C., 406. In this case the court has explained the meaning of “body corporate”. See also *Electronics Corporation Of India v. Secretary Revenue Deptt. Govt. of A.P.,* AIR. 1999 S.C. 1734.

[16] For critical study, see B. Errabi, Problem to Juristic Personality of a Corporation, (1965) J.I.L.J. 158.

[17] (1867) L.R. 2 H.L. 325

[18] (1897) A.C. 22

[19] (1897) A.C. 22

The trial court gave judgment against Salomon and agreed with the claims made by the unsecured creditors and its judgment was confirmed by the Court of Appeal, but it was reversed by the House of Lords. The House of Lords reversed the decision of the Courts bellow and gave judgment in favour of Salomon on the grounds stated below:

(1) The Trial Court held that the company was an agent of Salomon and therefore, Salomon should indemnify the company against its debts and he must contribute to the assets of the company to enable it to meet its liabilities in full. The view of the Trial Court was rejected by the House of Lords. According to Lord Halsbury, the Trial judge becomes involved by this argument in a very singular contradiction. "Either the company was a legal entity or it was not. If it was, the business belonged to it and not to Mr. Salomon. If it was not, there was no person and nothing to be agent at all.[20]

(2) The reasoning of the Court of Appeal that the shareholder of the Salomon and Co. Ltd. Were not independent and the company was one man company completely controlled by Salomon and therefore, Salomon should meet the liabilities of the company was also rejected by the House of Lords. The House of Lords held that the Salomon and company Ltd. Was incorporated under the Companies Act, 1862 complying with all the necessary formalities and therefore it was a valid company having a personality distinct from that of its members. The companies Act of 1862 under which the company was incorporated did not require that the share holders should be independent or unconnected or that they should take a substantial interest in the undertaking or that they should have a mind or will of their own or there should be balance of power in the constitution of the company. The Salomon and Company Ltd. was incorporated complying with all the formalities necessary to incorporate a company under the companies Act of 1862 and consequently it was a valid company having a personality distinct from that of its members and since Salomon was one of its members of share holders he was under no obligation to meet to liabilities of the company. It has been made clear that even one Man Company like Salomon and Co. Ltd. has a corporate personality distinct from that of its members.[21]

(3) The argument of the Court of Appeal that the company was incorporated to defraud to creditors was also rejected by the House of Lords. Lords Watson mentioned several grounds in order to

[20] (1897) A.C. 22.

[21] Ibid. See also T.R. Pratt (Bombay) Ltd. v. E.D. Sassoon & Co. Ltd., A.I.R. 1936 Bom. 62.

refute this argument. The memorandum of the company gave notice that the main object for which the company was incorporated was to purchase the business of Salomon and the unsecured creditors of the company could have informed themselves of the terms of purchase by the company, of the issue of the debentures to Salomon and of the amount of shares held by each member. Even the Companies Act of 1862 under which Salomon & Co. was incorporated required the unsecured creditors to inquire these matters and a company was not required to warn the person giving loan to the company that they would run the risk of not being paid. Lord Watson appears to be right in his argument that a creditor who does not take the trouble to use the means which the statutes provide for enabling him to protect himself must bear the consequences of his own negligence. The Court below held that the incorporation of Salomon and Co. was a mere scheme to enable Salomon to carry on business in the name of the company and that the intention was to take profits, without running the risk of the debts and expenses of the company and that since the motive of those who took part in the promotion of the company was to form the company as an agent of Salomon, Salomon should indemnify the company against its debts and meet its liabilities. The House of Lord refused these arguments of the Court below on the ground that after incorporation the Salomon and Co. Ltd. became in law a different person altogether from its members with its rights and liabilities and the motives of its promoter, Salomon, could not affect its rights and liabilities. In other words, the House of Lords came to the conclusion that the Salomon and Co. Ltd. could not be treated as an agent of Salomon, even if the intention of its promoter (i.e. Salomon) was to incorporate it as his agent.

In India the corporate personality of an incorporated company[22] has been recognized since 1866 in In Re, Kondoli Tea Co. Ltd.[23] A company incorporated under the companies Act is conferred on legal personality distinct from that of its members even if it's all the shares are practically controlled by one person, i.e. even if it is one-man company.[24] In *Electronics Corporation India Ltd. v. Secretary, Revenue Department of Andhra Pradesh Govt.*,[25] The Supreme Court has observed that a clear distinction must be drawn between a company and its share-holders, even though that share holder may be only one, the Central or State

[22] For the critical study of Indian cases on the subject, see R.P. Singh Corporate Personality in India, (1968) 1 Company L.J. 9.
[23] (1866) I.L.R. 13 Cal. 43
[24] T.R. Patt (Bombay) Ltd. v. E.D. Sassoon & Co., supra.
[25] A.I.R. 1999 S.C. 1734.

Government. A company has a legal personality distinct from that of its members and the motives or intentions of the individual share-holders do not affect the existence of the company.[26] It is to be noted that after incorporation a company has an independent corporate personality separate and distinct not only from the entities of its members but also from the entities of its directors and other managerial personnel.[27] Thus even if two or more than two companies are composed of the same group of shareholders and directors they cannot be treated as one entity and each of them will have separate and independent legal personality. A managing director may appoint himself as a servant of the company and worked in both capacities. Thus company is a legal person distinct forms its members. It is capable of enjoying rights and being subject to duties which are not the same as those enjoyed or borne by its members.[28] In Lee's Air Farming Ltd.[29] a managing director in that capacity appointed himself as a pilot of the company. While piloting an aircraft of the company in the course of its business, he was killed. He was held to be a worker and his window recovered compensation under the Workmen's Compensation Act. The magic of corporate personality enables him to be master and servant both at the same time.[30]

2.3.2 Advantage of Corporate Personality:

1 Limited Liability: One of the principal advantages of an incorporated company is the privilege of limited liability. It is the main feature of registered companies which provides a special attraction to investors. The principle of limited liability implies that the liability of a member in the event of the company's winding up in respect of the shares held by him limited to the extent of the unpaid value on such shares. Thus the liability does not fluctuate but remains limited to the amount which, for the time being remains unpaid, whether from the original shareholder or the transferee of such shares as the case may be, thus if a shareholder has 100 shares of Rs. 10/- each at par, and has already paid Rs. 5/- on each share, he has paid Rs. 500/- and therefore his liability extends to remaining Rs. 500/- i.e. unpaid value of the shares held by him and nothing more than that. Even if he has transferred these partly paid shares, the transferee's liability shall be limited to the extent of unpaid value of share only.

[26] Dhulia-Amalner Motor Transport Ltd. v. Roychand Rupsi Dharamsi, A.I.R. 1952 Bom. 337. See also B. Errabi, Problem to Juristic Personality of a Corporation, (1956) J.I.L.I. 158.
[27] J.H. Pattisn v. Bindhya Debi, A.I.R. 1933 Pat. 196
[28] Deputy Commissioner v. Cherian Transport Corp. (1992) 74 Comp. Cas. 563 (Mad).
[29] Lee v. Lee's Air Farming Ltd. (1961) A.C. 12.
[30] Gower, Modern Company Law, P. 15.54

It must, however, be noted that limited liability of members extends only for company's debt in the event of its winding up. The company itself, being a legal persona, is always fully liable and therefore its liability is unlimited. In other words, it is liable to pay the debts so long as assets are available. The order of priority for payment of debt shall, however, depend on the class of creditors as laid down in the companies act.

The English Joint Stock Companies Act, 1844 which for the first time allowed associations of persons to obtain registration under the Act, did not initially provide for the privilege of limited liability. As such this privilege had to be obtained only by a specific Royal Charter or Act of Parliament. It was after a considerable deliberation in the British Parliament that the privilege of limited liability was extended to registered companies by the Limited Act, 1855.

In India, the Companies (Amendment) Act, 1857 allowed companies to be registered with limited but this privilege did not extend to companies which were formed for the purpose of banking and insurance business. The restriction on banking and insurance companies was later removed by the **Amendment Act of 1860.**

Section 34(2) of the Companies Act, 1956 provides that in the event of the company being wound up, the members shall have liability to contribute to the assets of the company in accordance with the Act. In the case of limited companies, no member is bound to contribute anything more than the nominal value of shares held by him. The privilege of limiting the liability is one of the main advantages of carrying ion business under a corporate organization.

Commenting on the advantages of limited labiality, Buckley, J., In Re London & Globe Finance Corporation[31], observed:-

"The statutes relating to limited liability have probably done more than any legislation of the last fifty years to further the Commercial prosperity of the country. They have, to the advantage as well of he investor as of the public, allowed and encouraged aggregation of small sums into large capitals which have been employed in undertakings of great public utility largely increasing the wealth of the country."

The contribution of the principle of limited liability to the commercial world is further emphasized by an eminent American scholar who expressed a view, "Limited Liability Corporation is the greatest single discovery of modern times. Even steam and electricity are less important than the limited liability company."[32]

Undoubtedly, the working of business organizations in the corporate sector over the years has established beyond doubt, the utility of the

[31] (1903) 1 Ch. 728 (731).
[32] Quoted by A.L. Diamond in Limited Liability and Corporation, (1982) p. 42.

limited liability clause, the main reason being the persons, who form or invest in such companies as shareholders, know beforehand, the exact quantum of risk involved in the investment and the maximum extent of their liability.

Despite the advantages of limited liability, some critics of this doctrine have refused to accept it as a sound principle. Thus to quote an example, Lawton, L.J. in Rolled Steel Products (Holdings) Ltd. V. British Steel Corporation,[33] inter alia observed :

"The fact that limited liability has all too often enabled many to enrich themselves at the expense of those who have given credit to the companies they control, is the price the business world has to pay for the potentiality for growth and convenience which goes with limited liability."

2. Perpetual Succession:

As stated in Section 34(2) of the Companies Act, 1956, an incorporated company has perpetual succession that is notwithstanding any change in its members, the company shall retain the same entity with the same privileges and immunities estate and professions.[34] In order words, the death or insolvency of individual member does not in any way, affect its corporate existence and the company shall continue its existence as usual until it is wound up in accordance with the provisions of the companies Act. The perpetual existence of an incorporated company is well illustrated by proverbial saying. "Members may come and members may go, but the company can go on forever."

Prof. Gower has cited an interesting illustration to explain the perpetual existence of a company. He says, "during the war all the members of a private company were killed by a bomb while they were in general meeting, but the company still survived and not even a hydrogen bomb could have destroyed it."[35]

The High Court of Calcutta in Gopalur Tea Co. Ltd. V. Penhok Tea Co. Ltd.,[36] applying the doctrine of company's perpetual succession observed that though the whole undertaking of a company was taken over under an Act which purported to extinguish all rights of action against the company, neither the company was thereby extinguished nor any body's claim against it.

3. Transferability of Shares:

Section 82 of the companies Act, 1956, specifically provides that the shares or other interest of any member in a company shall be movable property, transferable in the manner provided by the articles of association of the company. Thus the member of an incorporated company can

[33] (1985) 2 WLR 908.

[34] Canfield & Wormser : Cases on Private Corporation (2nd Ed.) p. 1.

[35] Gower : Modern Company Law (2nd Ed.) p. 75

[36] (1982) 52 Comp. Cas, 238.

dispose of his share by selling them in a open market and get back the amount so invested. The transferability of shares has two main advantages, namely it provides liquidity to investors and at the same time ensures stability of the company.[37] The transfer of shares of a company does not in any way affect its existence or management and the shareholder can conveniently get relieved of his liability by transferring his shares to some other person.

In R.T. Perumal v. John Deavin,[38] it has been observed that a company is a real person in which all its property is vested, and by which it is controlled, managed and disposed of. Their lordship further observed that “no member can claim himself to be the owner of the company’s property during its existence or in its winding up.”

4. Separate Property:

Incorporation helps the property of the company to be clearly distinguished from that of its members.[39] The property is vested in the company as a corporate and no changes of individual membership affect the title. The property remains vested in the company whereas the shareholders may come and go but the company may convey, assign, mortgage or otherwise deal with it.[40] In other words, the property of the company is not the property of shareholder; it is the property of the company.[41]

5. Permanence of capital and stability of the company:

The provision contained in Section 77(1) of the Companies Act, 1956 prohibits a company with limited liability from purchasing its own shares subject to certain exceptions. This ensures permanence of capital raised by the company which in turn provides its stability and at the same time protection to the creditors of the company to certain extent.

6. Protection to Investors against loss:

One of the advantages of incorporated company is that it affords an opportunity to even a common man with meager resources to invest a little part of his income in the company’s capital through purchase of sales or denatures without being exposed to substantial loss in the event of failure of company’s business. The company too, on its part can borrow money and raise its capital on debentures, which an ordinary trader cannot do. Any member of a company acting in good faith is as much entitled to take and hold company’s debentures as any outside creditor. Thus, incorporation of companies seeks to fulfill the desire of common men who

[37] Barle & Means : The Modern Coroporation and Private Property (1932) p. 282.
[38] AIR 1960 Mad. 43.
[39] Avtar Singh Company Law (1991 Ed.) p. 8.
[40] Palmer : Private Companies (1961 Ed.) p. 8
[41] Gramophone & Typewriter Co. V. Stanley, (1906) 2 KB 856 (869) : see also Hyderabad Sind Electric Supply Co. v. Union of India, AIR 1959 Punj . 199.

do not intend to directly participate in the business because of the risk involved therein, but wish to invest a part of their income in business ventures to earn profit.

7. Professional Management:

The corporate sector is capable of attracting the growing cadre of professional managers. Young management graduates willingly join companies because of the feeling that they would thereby belong to a managerial class. Their independent functioning as managers is assured because of the fact that there is no human employer and the shareholders exercise only a formative control and that also for the sake of name only. Such an atmosphere of independence gives them an opportunity to develop extraordinary managerial capabilities. With the financial backing that companies are able to provide, they are able to develop the business to a considerable extent. "Prudent developments may be made, and new branches established in different places, and other concerns may be acquired. Thus, before very long a great business may be built up this is worthy and capable of absorbing the attention of such a competent manager, assisted by other directors working in harmony with him. Men of this caliber are not to be found every day, but, when found and supported by capital, they are capable of achieving the very highest success in commercial undertakings.[42]

8. Finances:

The company is the only medium of organizing business which is given the privilege of raising capital by public subscriptions either by way of shares or debentures. Further, public financial institutions lend their resources more willingly to companies than to other forms of business organization. The facility of borrowing and giving security by way of a floating charge is also an exclusive privilege of companies. "Capital in many cases is the life-blood of a concern, and it is always a great misfortune where the development of a business is arrested or restricted by want of capital."[43]

2.3.3Disadvantage of Corporate Personality:

Lifting or piercing the corporate veil:

(1) From the juristic point of view, a company is a legal person distinct from its members.[44] This principle may be referred to as "the veil of incorporation". The Courts in general consider themselves bound by this

[42] Palmer's Private Companies, 25-26 (42nd Ed. 1961)
[43] Ibid, at p. 24
[44] Salomon v. Salomon & Co. Ltd., (1897) A.C. 32}

principle. The effect of this principle is that there is a fictional veil and (all not a wall) between the company and its members. That is, the company has a corporate personality which is distinct from its members.

The human ingenuity, however, started using this veil of corporate personality blatantly as a cloak for fraud or improper conduct. Thus it became necessary for the Courts to break through or lift the corporate veil or crack the shell of corporate personality and look at the persons behind the company who are the real beneficiaries of the corporate fiction. And while by fiction of law a corporation is a distinct entity, yet in reality it is an association of persons who are in fact the beneficial owners of all the corporate property.[45]

It United States v. Milwaukee Refrigerator Co.,[46] the position was summed up as under:

"A corporation will be looked upon as a legal entity as a general rule. but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons."

In *Littlewoods Mall Order Stores Ltd. V. Inland Revenue Commrs.,*[47] Denning, M.R. observed as follows:

"The doctrine laid down in Solomon v. Salomon & Co. Ltd., has to be watched very carefully. It has often been supposed to cast a veil over the personality of a limited company through which the Courts cannot see. But that is not true. The Courts can and often do draw aside the veil. They can and often do, pull off the mask. They look to see what really lies behind."

Exceptions:

The various cases in which corporate veil have been lifted are as follows:

1. **Protection of revenue**
2. The Courts may ignore the corporate entity of a company where it is used for tax evasion[48]. Tax planning may be legitimate provided it is within the framework of law. Colorable devices cannot be part of tax planning.[49] The following cases illustrate the point:

In Sir Dinshaw Maneckjee Petit, Re,[50] an assesses who was receiving huge dividend and interest Income, transferred his investments to 4 private companies formed for the purpose of reducing his tax liability. These companies transferred the income to D as a pretended loan. Held, the companies were formed by D purely and simply as a means of avoiding tax obligation and the companies were nothing more than the

[45] Gallaghar v. Germania Brewing Co., (1893) 53 Minn 214, 254, N.. 1115).
[46] (1905) 142 Fed. 247
[47] (1969) W.L.R. 1241,
[48] Jugglal v. Commr. Of Income tax, A.I.R. (1969) S.C. 982
[49] Union of Inida v. Playword Electronics (Pvt.) Ltd., (1990) 68 Comp. Cas. 582 (S.C.)
[50] A.I.R. (1927) Bom, 371. D.

assessee himself. They did no business but were created simply as legal entities to ostensibly receive the dividends and interest and to hand them over to D as pretended loans.

In *Bacha F. Guzdar v. Commr. Of Income-tax, Bombay*[51], G received certain amounts as dividend in respect of shares held by her in a tea company. Under the Income-tax Act, then in force only 40% of the company's income was treated as income from manufacture and the sale of tea and was, therefore, liable to tax (the other 60 percent of income was exempt as agricultural income). G claimed that this dividend income should be regarded as agricultural income up to 60 percent as in the case of the tea company. Held though the income in the hands of the company was partly agricultural yet the same income when received by G as dividend could not be regarded as agricultural income.

3.Prevention of fraud or improper conduct:

The legal personality of a company may also be disregarded in the interest of justice where the machinery of incorporation has been used for some fraudulent purpose like defrauding creditors or defeating or circumventing law. Prof. Gower observes in this regard that the veil of a corporate body will be lifted

Where the "corporate personality is being blatantly used as a cloak for fraud or improper conduct." Thus in the following case where a company was incorporated as a device to conceal the identity of the perpetrator of the fraud, the Court disregarded the corporate personality.

In Jones v. Lipman[52], L agreed to sell a certain land to J. He subsequently changed his mind and to avoid the specific performance of the contract, he sold it to a company which was formed specially for the purpose. The company had L and a clerk of his solicitors as the only members. J brought an action for the specific performance against L and the company. The Court looked to the reality of situation, ignored the transfer, and ordered that the company should convey the land to J.

4.Determination of character of a company whether it is enemy:

A company may assume an enemy character when persons in de facto control of its affairs are residents in an enemy country. In such a case, the Court may examine the character of persons in real control of the company, and declare the company to be an enemy company.

In Daimler Co. Ltd. V. Continental Tyre & Rubber Co. Ltd.[53] A company was incorporated in England for the purpose of selling in England tyres made in Germany by a German company which held the bulk of shares in the English company. The holders of the remaining shares, except one, and all the directors were Germans, resident in Germany. During the First

[51] A.I.R. (1955) S.C. 74,
[52] (1962) All E.R. 442
[53] (1916) 2 A.C. 307

World War, the English company commenced an action for recovery of a trade debt. Held, the company was an alien company and the payment of debt to it would amount to trading with the enemy, and therefore the company was not allowed to proceed with the action.

5.Where the company is a sham:

The Courts also lift the veil where a company is a mere cloak or sham (hoax). The following case illustrates the point:

In Gilford motor Co. Ltd. V. Horne[54]. Horne, a former employee of a company, was subject to a covenant not to solicit its customers. He formed a company to carry on a business which, if he had done so personally, would have been a breach of the covenant. An injunction was granted both against him and the company to restrain them from carrying on the business. The company was described in this judgment as "a device, a stratagem", and as "a mere cloak or sham for the purpose of enabling the defendant to commit a breach of his covenant against solicitation."

6.Company avoiding legal obligation:

Where the use of an incorporated company is being made to avoid legal obligations, the Court may disregard the legal personality of the company and proceed on the assumption as if no company existed.

Example: - A & B, partners in a firm, sell their business to C and undertake not to start a similar business and not to compete with C for a certain number of years. After some time, they form a private limited company, become the principal shareholders and directors and start a similar business. The court may restrain the company from carrying on the business competing with C.

7.Company acting as agent or trustee of the shareholders:

Where a company is acting as agent for its shareholders, the shareholders will be liable for the acts of the company. It is a question of fact in each case whether the company is acting as agent for its shareholders. There may be an express agreement to this effect or an agreement may be implied from the circumstances of each particular case.

In F.G. Films Ltd., in re[55]., An American Company financed the production of a film in India in the name of a British company the president of the American Company held 90 percent of the capital of the British company. The Board of Trade of Great Britain refused to register the film as a British Film. Held, the decision was valid in view of the fact that British company acted merely as the nominee of the American company.

8.Avoidance of welfare legislation:

[54] (1933) Ch. 935 C.A

[55] (1953) 1ALL E.R. 615

Avoidance of welfare legislation is as common as avoidance of taxation and the approach of the Courts in considering problems arising out of such avoidance has necessarily to be the same as avoidance of taxation. It is the duty of the Courts in every case where ingenuity is expended to avoid welfare legislation to get behind the smoke screen and discover the true state of affairs.[56]

9.Protecting public policy:

The courts invariable lift the corporate veil to protect the public policy and prevent transaction contrary to public policy. Thus where there is a conflict with public policy. The courts ignore the form and take into account the substance[57]

Statutory exceptions:

1. Number of members below statutory minimum (Sec. 45). If a company carries on business for more than 6 months after the number of its members has been reduced below 7 in case of a public company or 2 in case of a private company, every person who knows this fact and is a member during the time that the company so carries on business after the 6 months, is severally liable for the whole of the debts of the company contracted during that time, i.e., after 6 months. It may be noted that in such a case the continuing members (i.e., those who continue to be members after 6 months)

(a) Can be sued and not those who have withdrawn from the membership:

(b) Shall be liable only if they are aware of the fact of the number falling below the statutory minimum.

2. Failure to refund application money (sec. 69 (5). The directors of a company are jointly and severally liable to repay the application money with interest if the company fails to refund the application money of those applicants who have not been allotted shares, within 130 days of the date of issue of the prospectus.

3. Mis-description of company's name {Sec. 147(4)}. Where an officer or agent of a company does any act or enters into a contract without fully or properly mentioning its name and the address of its registered office. He shall be personally liable. Thus where a bill of exchange, hundi or promissory note is signed by an officer of a company or any other person on its behalf, without mentioning this fact that he is signing on behalf of the company; he is personally liable to the holder of the instrument unless the company has already paid the amount.

[56] Workmen of Associated Rubber Industry Ltd. V. Associated Rubber Industry Ltd., (1986) 59 Comp. Cas. 134 (S.C.).

[57] Connors v. Connors Ltd., (1940) 4 All E.R. 174

In *Hendon v. Alderman*[58], the directors of "L&R Agencies Ltd.", Signed a cheque in the name of the company stating the company's name as "L.R. Agencies Ltd." (Omitting the word "&" from the name) held they were personally liable.

4. Fraudulent trading (Sec. 542). Sometime in the course of the winding up of a company it may appear that some business of the company has been carried on with intent to defraud creditors of the company, or any other person or for any fraudulent purpose. In such a case, the court may declare that any persons who were knowingly parties to the carrying on the business in this way are personally responsible without any limitation of liability for all or any of the debts or other liabilities of the company as the court may direct. The court may do so on the application of the official liquidator, or the liquidator or any creditor or contributory of the company.

5. Holding and subsidiary companies. In the eyes of the law, the holding company and its subsidiaries are separate legal entitles. Even a 100 percent subsidiary is a separate legal entity and its creator and controller (i.e. the holding company) is not liable for its breaches of contracts and torts. Nor can the holding company sue to enforce rights which belong to its subsidiary.[59]

In *Free Wheel (India) Ltd, v. Ved Mitra*,[60] A holding company requested the Court for restraining its subsidiary form issuing further capital as it would deprive the holding company of its controlling interest and would depreciate the value of its shares. The injunction prayed for was refused on the ground that the subsidiary company had not lost its identity as a separate legal entity.

But in the following two cases, a subsidiary company may lose its separate identify to a certain extent:

1. Where at the end of its financial year, a company has subsidiaries, it must lay before its members in general meeting not only its own accounts, but also a set of group accounts showing the profit or loss earned or suffered by the holding company and its subsidiaries collectively, and their collective state of affairs at the end of the years (Sec. 212).
2. The court may, on the facts of a case, treat a subsidiary company as merely a branch or department of one large undertaking owned by the holding company.[61]

2.3.4 Corporation or Body Corporation:

[58] (1973), 117 S.J. 631
[59] Bell v. Lever Bros. Ltd., (1932) A.C. 161).
[60] AIR (1969) Delhi 258
[61] Free Wheel (India) Ltd. V. Ved Mitra, A.I.R. (1969) Delhi 258).

Sometimes, the term 'Corporation' (a word derived from the Latin word *'Corpus'* which means 'body') or a 'body Corporate' is used for a company in the Companies Act, 1956.

"Body corporate" or "Corporation" includes a company incorporated outside India but does not include –

(a) a corporation sole,
(b) a registered co-operative society, and
(c) Any other body corporate (not being a company as defined in the Act), which the central government may specify in this behalf [section 2(7)].

A body which has been or is incorporated under some statute and which has a perpetual succession, a common seal and is a legal entity apart from the members constituting it, will come within the definition of the term 'body corporate'.

The use of the word "includes" in the definition must be understood as comprising sometimes more than is defined. The term "body corporate" or "corporation" is thus wider in scope than the term "corporation" and is used in several sections of the Act to denote not only a company incorporated in India but also a foreign company. It includes –

(a) public financial institutions as defined in Sec. 4-A,
(b) nationalized banks,
(c) Corporations forms under the Acts of Parliament.

A society registered under the Society Registration Act, 1860 does not fall within the definition of the term "body corporate" though it is a legal person capable of holding property and becoming member of a company.[62]

A corporation may be –

(a) A corporation sole, or
(b) A corporation aggregate.

A corporation sole is a corporation constituted in a single person who, in right of some office or function, has corporate status. Examples of corporate sole are to be found in perpetual offices such as the President, Governors, Crowns, Ministers, a public trustee. A corporation sole is not a "body corporate" for the purposes of the Companies Act, 1956. It is still a legal person and as such can be a member of a company.[63]

[62] *Board of Trustees v. State of Delhi,* AIR (1962) SC 458.
[63] *Star Tile Works Ltd.v. Govindam,* AIR (1959) Ker. 254.

A corporation aggregate consists of a group of persons contemporaneously associated so that they form a single person e.g., a limited company, a municipality, or a municipal corporation.

Partnership form of Organization:

The partnership form of organization gained importance because an individual is not competent to possess enormous capital and knowledge or competence to manage everything, with the expansion of business and enlargement of the scale of its operation, it became necessary for a group of persons to join hands together and supply necessary capital and skills. Often it is found that a person may be having huge capital but may not possess the required skill. On the other hand, there may be another person who may be highly skilled but may not have the required capital. Individually, none of them can run a business enterprise but together they may be highly successful in its efficient conduct. Thus, partnership organization has grown out of necessity to arrange more capital, provide better skill, control and management to take advantage of high degree of specialization and division of labour and to share the risks.

Illegal association:

A company, association or partnership consisting of more than 10 persons for the purpose of carrying on banking business and of more than 20 persons for the purpose of carrying on any other business with the object of earning profits can be legally formed only when it is registered under the Companies Act, 1956, or is formed in pursuance of some other Indian law or is a Joint Hindu Family carrying on business as such. If the number of members in an association or partnership exceeds this statutory limit and it is not registered under the Companies Act, it is an illegal association and has no legal existence.

Example: An unregistered association consisting of 115 members was alleged to be formed at the instance of the Government to help it in distribution of gram among public. It was established from evidence that an element of acquisition of gain was present in its formation. Held, it was an illegal association under section 11.[64]

The word ‘Person’ as used in sec. 11 denotes an individual and does not include bodies of individuals whether corporate or not.[65]

[64] *Babu Lal v. Laxmi Bharat Trading Co.,* AIR (1966) Raj. 14.
[65] *Akola Gin Combination v. Northcote Ginning Factory,* (1914) 16 I.C. 613.

Condition of illegality: In *V. V. Ruia v. S. Dalmia,*[66] Mody, J. explained the conditions of illegality under sec. 11 in the following words:

1. The membership of the association must be more than 20 in any business or 10 in the case of banking business;
2. The association must have been formed for the purpose of carrying on a business;
3. The object of the association must be to acquire profits for itself or for its members; and
4. The association must not have been registered as a company under the Companies Act, nor must it have been formed in pursuance of some other Indian law.

2.3.5 Public Corporations & Undertakings:

In a welfare State, not all trade, business or commerce is left to private enterprise. In the modern democratic world, to some extent, government also participates in this activity. This is so because welfare state seeks to ensure social security and social welfare for the common mass. With the view to establish a socialistic pattern of society[67], it participates in trade, commerce and business. The political philosophy of the 20th century has thus, impelled the government to enter into trade and commerce with a view to making such enterprises pursue public interest and making them answerable to the society at large.

Once the government entered the field of trade and commerce, it became increasingly evident that the government machinery hitherto employed merely for the maintenance of law and order was wholly inadequate and unsuitable for business exigencies, which demanded a flexible approach. It was, therefore, felt necessary to evolve a device which combined the advantages of flexibility with public accountability. It was in response to this need that the institution of public corporation grew.[68]

Structurally, public undertaking can there, be classified into three broad categories: (i) Public Corporations, (ii) Departmental Undertaking, and (iii) Government Companies. Any one of these organizational forms can be preferred by the government according to the nature of the enterprise as is considered convenient in order to undertake and fulfill multifarious welfare and service commitments. The government may undertake to accomplish its socio-economic objectives through its own departments, or through

[66] AIR (1968) Bom. 347.
[67] See Industrial Policy Resolution of 1956.
[68] *R.D.Shetty v. International Airport Authority,* AIR 1979, SC 1628: (1979) 3 SCR 1014.

autonomous Public Corporations or through Government Companies. The choice between the various alternatives is a matter of policy.

2.3.6 Public Corporations: Statutory Public Undertaking

Where an undertaking is created by a statute, it is known as public corporation. Public enterprises play to-day a pivotal role in the economy of India. This development has been facilitated by certain constitutional provisions and economic policies. With a view to achieving the object of 'Socialist'[69] democratic republic, Constitutional protection is afforded to 'State monopoly'[70]. Under Article 19(6) the state can carry on any trade or industry by itself or through a corporation owned or controlled by it to the complete or partial exclusion of citizens. The Directive Principles of State policy contained in Article 39(b) and (c) enjoined the state to direct its policy towards securing:

(1) That the ownership and control of material resources of the community are so distributed as best to sub-serve the common good; and
(2) That the operation of the economic system does not result in the concentration of wealth and means of production to the common detriment.

The Industrial Policy Resolution of 1948 clearly indicated that the management of state enterprises will as a rule is through the medium of public corporation. All these factors led the growth of public undertakings as an instrument for the economic structurization of the country because in public body accountability, freedom of action, public purpose and conscience, corporate spirit and concern for consumer could be legitimately expected.

In the beginning the organizational choice for undertaking any activity was in favour of statutory corporations. But in course of time, a conspicuous shift favouring governmental companies as the organizational model for state enterprise was in evidence. However, the Administrative Reforms Commission in 1967 recommended statutory pubic corporations as a model for organizing governmental commercial activities. A trend favouring public corporations is again visible. Statutory Corporation have definite advantage over other forms of organization due to their autonomy, financial and managerial, freedom of action and commercial accountability.

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[69] Preamble to the Constitution of India.
[70] Article 19(6) (ii).

Departmental Undertaking:

There is no consistent pattern visible in the choice of government from the various forms of organizations. A large number of public enterprises are run by departments as well. Railway, Posts and Telegraph, Telephones and numerous defence industries are run departmentally. There is a separate Ministry for Railways. Defence industries fall under the Ministry of Defence.

2.3.7 Government Companies: Non – Statutory Public Undertakings:

Apart from government departments and statutory public corporations, another pattern utilized to run public undertaking is that of a government company. In some situations government companies as a mode of organization of any activity is preferred to statutory corporations, for companies obviate the necessity of rushing in a legislative measure every time a corporation is to be established. In case of companies a greater amount of flexibility in action is possible as the articles of Association of the company can be easily amended. Moreover, companies make collaboration and capital participation more easy.

Government Companies are non – statutory Public Undertaking registered under the Companies Act, 1956. They are limited liability companies where the government holds the majority share capital.

A government company is defined under section 617 of the Companies Act, 1956 in the following terms:

“for the purpose of this Act, ‘Government Company’ means any company in which not less than fifty-one percent of the paid-up share capital is held by the central government or by state government or governments, or partly by the central government and partly by one or more state governments and includes a company which is subsidiary of a government company thus defined”.

When registered, a government company, like any other company, becomes a legal person with perpetual succession and common seal. However, a government company differs from other companies inasmuch as its capital is subscribed by the government. It is controlled by the government. All or majority of the directors are appointed by the government. Its directors can be removed by the government.

A government company is not a 'State' within the meaning of Article 12 of the Constitution of India.[71] Employees of a government company are not government servants within the meaning of Article 311 of the Constitution.[72]

Since a government company is neither a creation of a statute nor a state within the meaning of Article 12 of the Constitution, it is not subject to the writ jurisdiction of the High Court under the Article 226 of the Constitution.[73] Nevertheless, a writ of *Mandamus* would be issued against a government company to enforce a statutory or public duty required by the statute.[74] Accordingly, the Kerala High Court issued a writ against a governmental company when it acted in violation of a statutory duty imposed upon it by the import and export Control Act, 1947 in matters of Regulation of import and export in cashewnuts.[75]

A number of huge projects are being run as government companies rather than statutory corporation, e.g., Hindustan Steel Ltd.; Heavy Engineering Corporation; Mining and Allied Machinery Corporation; Steel Authority of India; Fertilizer Corporation; Hindustan Antibiotics, Cement Corporation; State Trading Corporation of India etc.

2.3.8 Small Scale, Co-operative, Corporate and Joint Sectors:

1. Small Scale Sector:

Small industries of various types together occupy an important place in the country's economy. They face many serious problems, most of which are associated with the smallness of their operations. The measures to promote them are, in general, of a different variety from those needed for the development of large industries. For all these reasons, these industries are dealt with separately in this chapter. We take up the subject in two parts. In the first part we discuss the importance of these industries for the economy. While doing so we also examine the views of those who do not regard them of much significance. In the second part we explain the peculiar problems these industries face, and the remedies that are needed to put them on the growth-path, as also the government policy towards them.

[71] *Kartik Chandra Nandi v. W. B. Small Industries Corpn.,* AIR 1967 Cal. 231.
[72] *State of Assam v. Kanak Chandra Dutta,* AIR 1967 SC 884.
[73] *R. Lakshmi v. Neyveli Lignite Corpn.,* AIR 1966 Mad. 399.
[74] *Praga Tools Corpn. v. C.A. Immanuel,* AIR 1969 SC 1306.
[75] *K.L Mathew v. UOI,* AIR 1974 Kerala.

The small sector is identified in terms of fixed capital investment. All industrial units with a capital investment (on plant and machinery) of not more than Rs. One Crore are, at present (1990-00), treated as small – scale units. The investment limit for units in the hosiery and handloom sub-sectors has been raised to Rs. 5 Crore. For ancillary units (i.e., those supplying components etc., to large-scale industries and the export-oriented units), the limit of capital investment is also Rs. One Crore. There is also the "Tiny sector". Industrial units with an investment of up to Rs. 25 lakhs belong to this sector. Capital investment covers only investment in plant and machinery. Land and factory buildings are excluded, largely because of the wide variations in the pieces of land at different place. As per this classification all industries with capital investment higher than specified for small-scale units are large-scale industries.

2. Cooperative Sector:

Broadly speaking cooperation refers to an institutional framework to organize self-help among those who participate in it. In general, such an organization consists of persons of small means. Unable to face powerful market forces like competition, these people get together and organize themselves into cooperatives. They pool their resources and thereby enlarge them beyond what they would be if used separately. Thus, weak individuals, through this institution, acquire strength to perform tasks which they would not be able to do otherwise.

The organization of cooperatives is characterized by three main features. One is that its membership is entirely voluntary. Those intending to come together are under no pressure to join a cooperative organization. It is thus a voluntary institution. Two, the management of this organization is fully democratic. All members are treated as equals. Individuals are not distinguished on the basis of property, status or any such thing. Everyone has equal rights and opportunities. The principle of "one individual, one vote" is at the basis of the functioning of a cooperative organization. Thus this institution embodies the principles of equality and democracy. Three, its objectives include economic, political and social aims. It is not merely an organization to secure economic gains, but is also functions in the political and social interest of its members. As an institution, it caters to the humane needs of the society. It is not an organization of capitalists or profit-seekers. Its members are not motivated by the desire to enrich themselves by exploiting others. This is an institution whose basis is self-help through mutual help. It seeks the help of its members and works for their benefit and through them for larger good of the community. Thus, cooperatives functions for the welfare of society.

The cooperative organization which emerges as a result of voluntary association of individuals, in terms of resources, is able to stand up to big private institutions. But from the angle of membership and objectives, this organization is basically different from private bodies. It is voluntary association of individuals for the furtherance of predetermined economic and non-economic objectives. In the words of the Draft Fifth Plan, "Cooperation represents institutionalization of the principle and impulse of mutual aid. It has the merit of combining freedom and opportunity for the small man with the benefit of large-scale management and organization. Cooperation is, therefore, conveniently suited to bring about the desired socio-economic changes in the context of the existing conditions in the country."[76]

Corporate and Joint Sector:

In simple terms, the joint sector is a form of partnership between the private sector and the government. Unfortunately, considerable controversy has been created in the definition of the joint sector and the industries that should be brought under this sector. Part of this blame goes to the Dutt Committee Report which used the term "joint sector" for the first time and gave not one but three concepts of joint sector:

(a) Existing private enterprises belonging to the large industrial houses should be brought under the joint sector by public financial institutions converting their loans into equity. "in that case we would like to emphasize that they should be clearly treated as belonging to the joint sector and not to the private sector.

(b) The joint sector would include those industrial units in which both public and private investment had already taken place and where the state has already been taking an active part in direction and control.

(c) A larger sized industrial unit necessitated on account of technical and economic advantages of large scale, should necessarily be in the joint sector to prevent concentration of economic power. In this case, the joint sector should be treated as belonging to the public sector, for a large portion of the cost would be provided by the government and public financial institutions though, of course, private parties too would be permitted to have equity participation.

The Dutt Committee's concept of the joint sector was in favour of the public sector. But there was certain vagueness in the concept in the Dutt Committee Report. The Committee failed to specify the fields in which the joint sector ventures were to be encouraged, the nature of control and management, organizational details, etc.

[76] *Draft Fifth Plan*, Vol. II, p.78.

2.4 Summary:

Section 34(2) of the Companies Act, 1956 provides that from the date of incorporation, the subscribers to the memorandum and other members shall be a body corporate by the name contained in the memorandum, capable of exercising all the functions of the an incorporated company and having perpetual succession and common seal. This, in other words, means that an incorporated company exists as a complete being by virtue of its legal personality and is often described as an artificial person in contrast with a human being who is a natural person. The company, as a legal entity is separate and distinct from its promoters, shareholders, directors, officers or employees and such as such it is capable of enjoying rights and beings subject to duties which are not the same as those enjoyed or borne by its members. The property of the company belongs to it and not its members; it may sue or be sued in its own name; it may enter into contracts with third parties independently and even the members themselves can enter into contract with the company. Commenting on the advantages of an incorporated company, palmer observes:-
The principle of 'lifting the corporate veil' has found statutory recognition in certain provisions of the companies Act, 1956 Efficient administration of tax laws also several times necessitates piercing the corporate veil of an incorporated company. For the purposes of income tax law, the directors have been made personally liable for tax payments of such companies. Thus the courts have made inroads on the principle of separate legal personality of corporate bodies in order to prevent tax evasion. Again, the veil of corporate personality has to be lifted when a situation arises where the courts is called upon to decide as to who is responsible for certain acts or omissions of the company. The corporate veil is said to be lifted when the court ignores the company and concerns itself directly with the members or managers. The discretion of the court in the matter lifting the corporate veil will, however, depend on the socio economic policies and moral factors operating in or through the corporations.
In a welfare State, not all trade, business or commerce is left to private enterprise. In the modern democratic world, to some extent, government also participates in this activity. This is so because welfare state seeks to ensure social security and social welfare for the common mass. With the view to establish a socialistic pattern of society, it participates in trade, commerce and business. The political philosophy of the 20th century has thus, impelled the government to enter into trade and commerce with a view to making such enterprises pursue public interest and making them answerable to the society at large.
Structurally, public undertaking can there, be classified into three broad categories: (i) Public Corporations, (ii) Departmental Undertaking, and (iii)

Government Companies. Any one of these organizational forms can be preferred by the government according to the nature of the enterprise as is considered convenient in order to undertake and fulfill multifarious welfare and service commitments. The government may undertake to accomplish its socio-economic objectives through its own departments, or through autonomous Public Corporations or through Government Companies. The choice between the various alternatives is a matter of policy.

2.5 Suggested Readings/Reference Material:

7. Avtar Singh : Company Law.
8. N.D. Kapoor : Elements of Company Law.
9. N.V. Paranjape : Company Law.
10. Taxmann : Company Law.
11. Gower, L.C.B. : Principles of Moderen Company Law.
12. Ramiya : Guide to the Companies Act.

2.6. Self Assessment Questions:

1. Discuss the notion of corporate personality in the light of the decision given in Saloman v. Saloman Co. Ltd.?

2. “The Doctrine of legal personality as applied to a company has produced astonishing effects and has been applied with few exception” discuss.?

3. “A company is a legal entity distinct from its members” In what cases do the courts ignore this principle. ?

4. Write Short useless on the:
   (a) Lifting the corporate veil.
   (b) Separate legal entity.

5. Write Short Notes on the Following:
   (a) Corporation.
   (b) Partnership forms of Organization.
   (c) Government Companies.
   (d) Small Scale and Joint Sector.

LL.M. Part-1
PAPER CORPORATE LAW

Block 1 - Introduction

Unit 3- Formation and Incorporation of a Company, Memorandum of Association, Various Clauses, Alteration of Clauses, Doctrine of Ultra Vires.

STRUCTURE

3.1 Introduction

3.2 Objective

3.3 Presentation of Contents

3.3.1 Formation and Incorporation of a Company

3.3.2 Certificate of Incorporation

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3.3.4 Definition

3.3.5 Purpose of Memorandum

3.3.6 Contents of Memorandum

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3.5 Suggested Readings/Reference Material

3.6 Self Assessment Questions

3.1. Introduction:

Before a company is formed, certain preliminary steps are necessary, e.g., whether it should be a private company or a public company, what its capital should be, and whether it is worthwhile forming a new company or taking over the business of an already established concern. All these steps are taken by certain persons known as "promoters". They do all entire necessary preliminary work incidental to the information of a company.

The Memorandum of Association of a company contains the fundamental conditions upon which alone the company is allowed to be incorporated. 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 there from including matters incidental to the powers so conferred. Memorandum is therefore a document of great importance in relation to the proposed company.[77] It is in fact a charter of the company.

3.2. Objective:

The main objective of this lesson is to discuss formation and incorporation of company and definition, purpose, contents, and alteration of memorandum and Doctrine of ultra-vires with the help of statutory laws and relevant case laws.

3.3.1 Formation and Incorporation of company: Mode of forming incorporated company (sec. 12):

Any 7 or more persons (2 or more in case of a private company) associated for any lawful purpose may form an incorporated company, with or without limited liability. They shall subscribe their name to a memorandum of association and also comply with other formalities in respect of registration. A company so formed may be:

(1) a company limited by shares, or
(2) a company limited by guarantee, or
(3) an unlimited company.

[77] Palmer, Company Law (20th ed.),p.56

Lawful Purpose: the purpose for which a company is proposed to be established must be lawful. It must not be in contravention of the general law of the company. For example, where the main object a company is the conduct of a lottery, the mere fact that some of its objects are philanthropic, will not save the company from being unlawful. [78]

Subscribing their names: the expression "*subscribing their names to a memorandum of association"* means signing the memorandum. This implies an agreement between the persons concerned to associate themselves into a body corporate and "*subscribing'* in this context means signing by such persons or their nominees the memorandum in token of their agreement to so associate themselves.

Documents to be filed with the Registrar:

Before a company is registered, it is desirable to ascertain from the registrar of companies (for the state in which the registered office of the company is to be situated) if the proposed name of the company is approved.

Then the following documents duly stamped together with the necessary fees are to be filed with the registrar:

(1) The memorandum of association duly signed by the subscribers.
(2) The articles of association, if any, signed by the subscribers to the memorandum of association. A public company limited by shares need not have its own articles of association. It may instead adopt table A in schedule I to the Act.
(3) The Agreement, if any, which the company proposes to enter with any individual for appointment as its managing or whole-time director or manager [section 33(1)].
(4) A list of directors who have agreed to become the first directors of the company (this applies to a public company limited by shares) and their written consent to act as directors and take up qualification shares (section 266).
(5) A declaration stating that all the requirements of the companies Act and other formalities relating to registration have been complied with. Such declaration shall be signed by any of the following persons : viz.,
(a) an advocate of the supreme court or of a High Court ; or
(b) an attorney or a pleader entitled to appear before a High Court ; or
(c) a secretary or a chartered accountant in whole-time practice in India, who is engaged in the formation of the company ; or

[78] *Universal Mutual Aid etc. Assn V. Thoppa Naidu,* AIR (1933) Mad. 16.

(d) a person named in the articles as a directors, managers or secretary of the company [section 33(2)].

For the purpose of section 33(2), 'chartered accountant in whole-time practices in India' means a chartered accountant within the meaning of the chartered accountants Act, 1949 who is practicing in India and who is not in full-time employment.

Then within 30 days of the date of incorporation of the company, a notice of the situation of the registered office of the company shall be given to the registrar who shall record the same (section 146).

3.3.2 Certificate of incorporation:

When the requisite documents are filed with the registrar, the registrar shall satisfy himself that the statutory requirement regarding registration have been duly complied with. In exercising this duty, the registrar is not required to carry out any investigation. The only duty cast on him before he registers a company is to see that the requirements prescribed under section 33(1) & (2) are complied with.[79]

If the registrar is satisfied as to the compliance of statutory requirements, he retains and register the memorandum, the articles and other documents filed with him and issues a 'certificate of incorporation', i.e., of the formation of the company [section 33(3)].

If there is any minor defect in any document, the registrar may ask for its rectification. But if there is a material and substantial defect, he may refuse registration. If he improperly refuses to register, he may be compelled to register by the court.[80] The court generally does not interfere into the decision of the registrar unless it is perverse or clearly wrong.[81]

By issuing certificate of incorporation the registrar certifies under his hand that the company is incorporated and in the case of a limited company, that the company is limited (section 34).

3.3.3 Conclusiveness of Certificate of incorporation (Sec.35)

A certificate of incorporation given by the registrar in respect of a company is conclusive evidence that all the requirements of the company of the companies Act have been complied with in respect of registration. This is

[79] *Methodist Church V. UOI,* (1985) 57 Comp. Cas. 443.
[80] *R. V. Registrar of Companies,* (1914) 3 K.B. 1161.
[81] *Bowmkan V. Secular Society Ltd.,* (1917) A.C. 406.

known as Rule in Peel's case[82]. The reason for this rule was expressed by lord cairns in Peel's case thus:

"when once the memorandum is registered and the company holds out to the world as a company undertaking business, willing to receive shareholders and ready to contract engagements, then, it would be of the most disastrous consequences if after all that has been done, any person was allowed to go back and enter into an examination of the circumstances attending the original registration and the regularity of the execution of the documents."

Once the certificate of incorporation is issued by the registrar, nothing is to be inquired into as to the regularity of the prior proceedings. The certificate cannot be disputed on any grounds whatsoever. It cannot be challenged even in cases-

(a) where the memorandum is altered after the signatories put their signatures on the memorandum but before it is registered with the registrar, or
(b) where the memorandum is signed by only one person for all the 7 subscribers, or
(c) Where all the signatories are minors, or
(d) Where signatures to the memorandum are forged.

3.3.4 Definition:

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.

Lord Cairns in *Ashbury Co.* v. *Riche,*[83] observed :

> "The memorandum defines the limitations of the powers of the companyit contains in it, both that which is affirmative and that which is negative. It states affirmatively the ambit and extent of vitality and powers which by law are given to the corporation, and it states negatively, if it is necessary to state, that nothing shall

[82] *Barned's Banking Co; Re Peel's case,*(1867) L.R.2 Ch. 674.
[83] (1875) LR 7 HL 653

be done beyond that ambit.

3.3.5 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 investment. Secondly, the outsiders dealing with the company can know exactly the objects of the company and whether the contractual relation who intends to enter into with the company is within the objects of the company.

3.3.6 Contents of Memorandum:

The memorandum of a limited company must contain the following fundamental clauses which have often been described as the conditions of its incorporation[84],:—

1. Name clause;
2. Registered office clause;
3. Objects clause;
4. Limited liability clause;
5. Capital clause ; and
6. Association clause,

1. The name clause (Sec. 20)

The name of a company establishes its identity and is the symbol of its existence.

Rules regarding name. A company may, subject to the following rules, select any suitable name —

(1) *Undersirable name to be avoided. A* company cannot be registered by a name which, in the opinion of the Central Government, is undesirable. Broadly speaking, a name is undesirable and therefore rejected if it is either-

(a) too *similar* to the name of another company ; or

A company should not adopt a name 'which is identical with, or too closely resembles, the name of an existing

[84] Section 13

company.

(b) *misleading, i.e.,* suggesting that the company is connected with a particular business or/that it is an association of a particular type when this is not the case.

(2)*Injunction if identical name adopted.* If a company gets registered with a name which resembles the name of an existing company, the other company with whom the name resembles can apply to the Court for an injunction to restrain the new company from adopting the identical name[85]. This is because the name of a company is part of its business reputation and the company gains a monopoly of the use of that name and no other company can be registered under a name identical with it or so nearly resembling it as is calculated to deceive or to mislead the public.[86]

(3) *Prohibition of use of certain names.* The Emblems and Names (Prevention of Improper Use) Act, 1950 prohibits, the use of, or registration of a company or firm with, any name or emblem specified in the Schedule to that Act. The Schedule specifies, amongst others, the following items, ^s^*i.e„* the name, emblem or official seal of the United Nations Organisation, the World Health Organisation, the United Nations Educational, Scientific and Cultural Organisation, the Indian National Flag, the name, emblem or official seal of the Central Government and State Governments, the name, emblem or official seal of the President of India or Governor of any State. The Act also prohibites the use of any name which may suggest or be calculated to suggest (ij the patronage of the Government of India or the Government of any State, or *[ii)* connection with any local authority or any corporation or body constituted by the Government under any law for the time being in force, the name or pictorial representation of Rashtrapati, Rashtrapati Bhavan or any Raj Bhavan, Mahatma Gandhi and the Prime Minister of India. These names or emblems may be used with the previous permission of the Central Government.

***Publication of name* (Sec. 147): Every company shall**—

[85] *Ewing* v. *Buttercup Margarine Co. Ltd.,* (1917) 2 Ch. 1]

[86] *Hendriks* v. *Montague,* (1881) 17 Ch. D. 638k

(a) paint or affix its name and the address of its registered office, on the outside of every office or' place in which its business is carried on,

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

If a company does not paint or affix its name and the address of its registered office in the prescribed manner, the company and every officer of the company who is in default shall be punishable with fine of Rs. 5,000.

The registered office clause (Sec. 146)

Every company shall have a registered office from the day on which it begins to carry on business, or as from the 30th day after the date of its incorporation, whichever is earlier. All communications and notices are to be addressed to that registered office. Notice of the situation of the registered office and every change shall be given to the Registrar within 30 days after the date of incorporation of the company or after the date of change. If default is made in complying with these requirements, the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 500 for every day during which the default continues.

The situation of the registered office of a company determines its domicile [87]

3. The objects clause [Sec. 13 (1)]

The objects of a company shall be clearly set forth in the Memorandum, for a company can do what is within, or incidental to, the objects stated in the Memorandum. The objects clause both defines and confines scope of the company's powers, and once registered, it can only be altered as provided by the Act. Lord Cranworth L.C. observed in

[87] Daimler Co. Ltd. v. Continental Tyre & Rubber Co. Ltd., (1916) 2 A.C. 307]

Eastern Counties Rly. Co. v. *Hawkes,* [88] that "the legal personality of a company exists only for the particular purposes of incorporation as defined in the objects clause

The purpose of the objects clause is —

(1) to enable subscribers to the Memorandum to know the uses to which their money may be put, and
(2) to enable creditors and persons dealing with the company to know what its permitted range of enterprise or activities is [89] Stressing the need for statement of objects in the Memorandum, Lord Parker observed in *Cotman* v. *Rrougham,* [90]as follows :

"The *narrower the objects* expressed in the Memorandum *the less is the subscribers* risk* but *the wider such objects the greater is the security of those who transact business with the company."* The objects clause in the Memorandum of every company has to state—

(1)**Main objects** of the company to be pursued by the company on its incorporation and objects incidental or ancillary to the attainment of the main objects, and

(2)**Other objects** of the company not included in the above Clause. Further, in the case of a company (other than a trading corporation) whose objects are not confined to one State, the States to whose territories the objects extend has also to be stated.

A company, which has a main object together with a number of subsidiary objects, cannot continue to pursue the subsidiary objects after the main object has come to an end.

InCrown Bank, Re[91]. A company's objects clause enabled it to act as a bank and further to invest in securities and land and: to underwrite issue of securities. The company abandoned its banking business and confined itself to investment and financial speculation. *Held,* the company was not entitled to do so.

Incidental acts*.* The powers specified in the Memorandum

[88] (1855) H.L.C. 331
[89] *Egyptian Sjalt & Soda Co. Ltd.* v *Port Said Salt Assn. Ltd.,* (1931) A.C. 677].
[90] (1918) A.C. 514
[91] (1890) 44 Ch. D. 634

must not be construed strictly. The company may do anything which is fairly incidental to these powers. Anything reasonably incidental to the attainment or pursuit of any of the express objects of the company will, unless expressly prohibited, be within the implied powers of the company.

In Evans v, *Brunner, Mond & Co.,*[92]. A company, engaged in manufacture of chemicals, proposed to devote a substantial sum of money to the encouragement of scientific education. It was proved that this act would ultimately benefit the company, but a shareholder objected on the ground that it was beyond the powers of the company. *Held,* the proposal was fairly incidental to the company's objects.

In another important case *Foster* v. *London, Chatham & Dover Co.*[93]. A company acquired a piece of land for the purposes of its railway. The railway was erected on arches. The company let the arches as workshops, etc. The neighbours objected on account of noise and claimed that the act was *ultra vires* (beyond the powers) the company. *Held,* the letting of arches as workshops, etc., was valid as being fairly incidental to the powers of the company.

In Forrest v. *Manchester etc., Rly. Co.,*[94]. A railway company had the authority to keep boats to be supplied for a ferry. It employed the boats for excursion trips to the sea when these were not wanted for the ferry. *Held,* the use of the boats was incidental to the main purpose and was within the powers of the company.

4. The capital clause [Sec. 13 (4)]

The Memorandum of a company, having a share capital, shall state the amount of the share capital with which the company is to be registered and the division thereof into shares of a fixed amount. The capital with which a company is registered is called 'registered', 'authorised' or 'nominal' capital. A company cannot issue more shares than are authorised for the time being by the Memorandum. The shares issued by a company can only be equity shares or preference shares, but they cannot have disproportionate rights (Sees. 85 and 89). A

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[92] (1921) 1 Ch. 359
[93] (1895) 1 Q.B. 711
[94] (1861) 4 L.T. 666

private company which is not a subsidiary of a public company may issue shares of any kind and with disproportionate rights (Sec. 90).

5. The liability clause [Sec. 13 (2)]

The Memorandum of a company limited by shares or by guarantee shall also state that the liability of its members is limited. This means that the members can only be called upon to pay to the company at any time the uncalled or unpaid amount on the shares held by them, or up to the maximum of the amount which they have guaranteed. There is, however, one exception to this rule. The exception is contained in Sec. 45.

6. The association clause [Sec. 13 (4)]

The association clause states: "We, the several persons whose names and addresses are subscribed, are desirous of being formed into a company in pursuance of this Memorandum of Association, and we respectively agree to take the number of shares in the capital of the company set opposite our respective names." This is followed by the names, addresses and descriptions of the subscribers and the number of shares taken by each one of them. Each subscriber has to take at least 1 share.

The Memorandum shall be signed by at least 7 subscribers in the case of a public company, and by at least 2 subscribers in the case of a private company. The signature of each subscriber shall be attested by at least 1 witness who cannot be any of the other subscribers.

3.3.7 Alteration of the memorandum:

1. Change of name:

By special resolution (Sec 21). A company may change its name by a special resolution and with the approval of the Central Government signified in writing.

But a change of name which merely involves the deletion or addition of the word 'Private' on the conversion of a public company into a private company or *vice versa* does not require the approval of the Central Government.

By ordinary resolution (Sec. 22).[95] Sometimes, through inadvertence or otherwise, a company is registered by a name which, in the opinion of the Central Government, is identical with, or too nearly resembles, the name of an existing company. In such a case, the company—

[a) *may* change its name, by ordinary resolution and with the previous approval of the Central Government,

(b) *shall* change its name if the Central Government so directs within 12 months of its registration. When so directed by the Central Government the company *shall,* by ordinary resolution and with the previous approval of the Central Government, change its name within a period of 3 months from the date of the direction. The above rule also applies to an existing company which is registered by a new name which is identical with, or too nearly resembles, the name of an existing company. If the company makes default in complying with any direction given by the Central Government in this regard, the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 1,000 for every day during which the default continues.

Fresh certificate of incorporation (Sec. 23], Where a company changes its name, the Registrar shall enter the new name on the Register in the place of the former name. It shall also issue to the company a fresh certificate of incorporation. The change of name shall be complete and effective only on the issue of such a certificate. The Registrar shall also make the necessary alteration in the Memorandum of Association of the company.

Rights and obligations remain unaffected. The change of name shall not affect any rights or obligations of the company, or render defective any legal proceedings by or against the company. Legal proceedings which might have been continued or commenced by or against the company by its former name may now be continued by its new name. This is because the alteration is only in name and not in the identity of the

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[95] An ordinaey resolution is one which is passed by a simple majority of those voting at a meeting of which at least 21 day's notice in writing has been given.

company.[96]

2. Change of registered office

This may involve:

(I) *Change of registered office within a State [Sec. 17-A as inserted by the Companies (Amendment) Act, 2002].* No company shall change the place of its registered office from one place to another within a State unless such change is confirmed by the Regional Director. The company shall make an application in this regard in the prescribed form to the Regional Director for confirmation. The confirmation shall be communicated to the company within four weeks from the date of receipt of application for such change.

It is important to note that the above provisions shall apply only to the companies which change the registered office from the jurisdiction of one Registrar of Companies to the jurisdiction of another Registrar of Companies within the same State.

The company shall file with the Registrar a certified copy of the confirmation by the Regional Director for change of its registered office under Sec. 17-A, within two months from the date of confirmation, together with a printed copy of the Memorandum of Association as altered and the Registrar shall register the same and certify the registration under his hand within one month from the date of filing of such document.

The certificate shall be conclusive evidence that all the requirements of this Act with respect to the alteration and confirmation have been complied with and henceforth the Memorandum of Association as altered shall be the Memorandum of Association of the company.

(2) *Change of registered office from one State to another* (Sec. 17). A company may, by special resolution, change the place of its registered office from one State to another for certain purposes referred to in Sec. 17. These purposes are the same as in case of alteration of objects and are discussed under the

[96] *Kalipada* v. *Mahalaxmi Bank Ltd.,* A.I.R. (1966) Cal. 585

heading "Alteration of objects".

Procedure of alteration.

(1) *Special resolution.* A special resolution shall be passed at a general meeting so as to change the place of registered office from one State to another.

(2) *Confirmation by the Central Government.* The alteration shall not take effect until it is confirmed by the Central Government on petition.

(3) *Notice to affected parties.* Before confirming the alteration, the Central Government shall be satisfied that sufficient notice has been given to every person whose interest will be affected by the change, and that the consent of the creditors of the company has been obtained or their debts or claims have been discharged or secured.

(4) *Notice to Registrar.* The Central Government shall cause notice of the petition for confirmation of the change to be served on the Registrar. The Registrar shall also be given a reasonable opportunity to appear before the Central Government and state his objections and suggestions, if any, with respect to the confirmation of the change.

(5) *Power of the Central Government to confirm change discretionary.* The Central Government may confirm the change, on such terms and conditions as it thinks fit, and may make such order as to costs as it thinks proper.

(6) *Rights and interests of members and creditors to be taken care of* The Central Government shall have regard to the rights and interests of every class of the members and the creditors of the company.

(7) *Purchase of shares of dissentient members.* The Central Government may adjourn the proceedings for the purchase of interests of dissentient members and may give necessary directions in this regard.

(8) *Copy of special resolution and the order of the Central Government to be filed with the Registrar* (Sec. 18). A company shall file with the Registrar -

(a) the special resolution passed by the company within one month from the date of such resolution ;

(b) a certified copy of the order of the Central Government confirming the change within 3 months of

the order. The company shall also file a printed copy of the Memorandum as altered. The Registrar shall register the same and certify the registration within 1 month from the date of filing of such documents. The certificate shall be conclusive evidence that all the requirements of the Act with respect to change and the confirmation thereof have been complied with.

Time taken for drawing an order and for furnishing copy of the order by the Central Government will be excluded in computing the period of 3 months for filing it with the Registrar [97]

Extension of time. The Central Government may extend the time for the filing of documents or for the registration of the change under Sec. 18 by such period as it thinks proper.

***Effect of failure to register* (Sec. 19).** No alteration of Memorandum (as is referred to in Sec. 17) shall have effect unless it has been registered in accordance with the provisions of Sec. 18. If the documents to be filed with the Registrar under Sec. 18, are not filed within the prescribed period, such alteration and order of the Central Government and all proceedings connected therewith shall become void and inoperative.

A certified copy of the order confirming the change shall be filed by the company with the Registrar of the State in which the registered office is to be transferred and he shall register the same. All the records of the company shall then be transferred to the Registrar of the State in which the registered office of the company is transferred.

Loss of revenue of State, if relevant consideration.

At one time, the shifting of the registered offices of certain companies to places outside a State was opposed by the State on the grounds of loss of revenue and employment opportunities and the Courts (now the Central Government) were indulgent in declining confirmation. In *Orient Paper Mills*

[97] Beauty Art Dyers & Cleaners (Pvt.) Ltd. v. Registrar of Companies, (1974) 44 Comp. Cas. 460

Ltd. v. *The State,*[98] the Orissa High Court declined confirmation of change of registered office from Orissa to another State on the ground that in a Federal Constitution every State has got the right to protect its revenue and, therefore, the interests of the State must be taken into account.

But, in *Mackinnon Mackenzie & Co., Re*[99], where a company wanted to shift its registered office from the State of West Bengal to Bombay, the Calcutta High Court described the reasoning of the Orissa High Court as 'parochial' and allowed the transfer. It was observed in this case that "the question of loss of revenue to one State would have to be considered in the total conspectus of revenue for the Republic in regard to change of registered office from one State to another within India."

In *Rank Film Distributors of India Ltd.* v. *Registrar of Companies, West Bengal,*[100] a Division Bench of the Calcutta High Court also observed that State has no statutory right under *Sec.* 17 to oppose the shifting of the registered office from one State to another

Alteration of Objects Clause

In India, Section 12 of the Companies Act, 1882 permitted companies to alter their memorandum only for two purposes, namely, (1) to raise its capital, and (2) to change its name. Therefore a company could not alter its objects clause under the Act. This created practical problems for a company to expand its business operations and carry on its commercial activities more economically and efficiently. In order to remove these difficulties the Companies (Memorandum of Association) Act, 1895 was passed in India enabling the companies to alter their objects clause to a certain extent[101]. Similar provision is contained in Section 17 of the Companies Act, 1956 which allows alteration of objects within certain defined limits. These limits are of two kinds (1) Substantive and (2) Procedural.

Substantive Limits

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[98] A.I.R. (1957) Ori. 232
[99] (1967) 37 Comp. Cas. 516 (Cal.)
[100] A.I.R. (1969) Cal. 32
[101] Section 8 of the Companies (Memorandum of association) Act, 1895

A company may alter its objects for any of the following purposes :—

(/) To carry on its business more economically and efficiently. But it cannot make substantive alterations in its original activities. For example, *In Re Scientific Poultry Breeders Association Ltd.*[102] it was stated in the objects clause of the memorandum that the company shall not pay remuneration or profits to its managers. The company's area of operation expanded so much that it became necessary for the company to pay remuneration to its manager so that they would devote more time for the managerial work. The company, therefore, altered its objects clause allowing remuneration to its managers. A petition was filed against this alteration. The court justified the alteration on the ground that it was necessary for the efficient operation of the company's business and the change did not affect the main object substantively.

Similarly, alteration of objects was allowed to a company to make contributions to political parties as this could enable them to have a better rapport with the Government which would eventually be beneficial to its business.[103]

(ii) In order to enable the company to carry on its main purpose with new and improved means. Thus a company may avail of the advantage of new scientific discoveries or improved techniques to step up its business, its main object substantially remaining the same.

{iii) The company may alter its object clause to enlarge the local area of its operation.

(iv) The company may carry on some business which under the existing circumstances may be conveniently or advantageously be combined with the existing business of the company. The new business should not be detrimental to, or inconsistent with the existing business. Thus *In Re Cyclists Touring Club*[104] a club incorporated to protect cyclists on public roads was not allowed to undertake protection of motorists also, because cyclists

[102] (1933) Ch 227
[103] Straw Products Ltd. V. Register of Companies.(1967) 37 comp.case 20
[104] (1907) 1 ch.269

had to be protected against motorists themselves.

It is not necessary that the proposed new business must be ancillary or similar to the existing business of the company. The use of the term "some business" in Section 17(1) of the Companies Act, implies some new business not already provided for in the objects clause. The proposed new business may be entirely new and may even amount to a departure from the old business. Thus a company initially formed for carrying on the business of jute was allowed to include 'business of rubber' by altering its objects clause.[105] Similarly, a Spinning and Weaving Company was allowed to manufacture 'industrial and power alcohol.[106]

Again, the insurance business of a company having been taken over by the Central Government, the company was allowed to alter its objects to switch over to business of engineering works and import and export.[107]

In Re Rajendra Industries (P) Ltd.[108] the High Court of Madras ruled that where the company's financial position is sound and the alteration is not opposed by its shareholders or creditors, an alteration in the objects clause for expansion of business activities should normally be allowed.

It would be seen that in most of these cases alteration was opposed by the Registrar of Companies to prevent diversification of objects but the courts have generally taken a liberal view and avoided interfering with the unanimous decisions of the shareholders subject to the restrictions contained in Section 17 of the Act.

(v) Alteration of objects may also be allowed to restrict or abandon any of the objects specified in the memorandum.

(vi To sell or dispose of the whole, or any part of the undertaking of the company.

(vii) An alteration in the objects clause is permissible for the purpose of amalgamation of a company with other

[105] Juggilal Kamalpat Jute Mills v. Register of companies,(1967) 37 Comp cas.20.
[106] In Re Modi Spinning & Weaving Mills Co. Ltd.,(1963) 33 Comp.cas.33.
[107] In Re Asiatic Insurance Co. Ltd.(1965) 2 Comp.LJ 24 Punjab
[108] (1957) 2 Comp. LJ 144 Mod.

company or body corporate.[109]

Procedure for Alteration:

An alteration in the objects clause of a company shall not have any effect until a special resolution has been passed by the shareholders of the company for this purpose and is confirmed by the Central Government.[110] The Central Government is, however, free to confirm the alteration wholly or in part,[111] and it can even refuse, to confirm it on reasonable grounds. However, before confirming the alteration, the Central Government must be satisfied that:—

(1) sufficient notice has been given to every debenture-holder *(i.e.* creditor) of the company and to persons whose interests are likely to be affected by the alteration ; and
(2) the objections to the proposed alteration of objects, if any, have been properly disposed of to the satisfaction of the Central Government.[112]

The Central Government must also send a notice of alteration to the Registrar of Companies to enable him to appear before the Board and file objections, if any, in respect to confirmation of alteration.

The Central Government may choose to impose reasonable conditions while confirming the alteration of the memorandum of a company. The change in the objects clause may also require a consequential change in the company's name so as to indicate the change in the character of business of the company.[113]

The State Government may object to a change in the capacity of a creditor in respect of the arrears of revenue due to it from the company.

In Re Tinnevelly Tuticorin Electric Supply Ltd.,[114] the Company Law Board (now the Central Government) confirmed the alteration of objects-clause of the company and observed:

[109] Nagaisuree tea Co. v. Ram Chand Karnani (1966) 2 Comp.LJ.208.
[110] Section 17 (2) , the Companies Act ,1956
[111] Section 17 (5) , Ibid
[112] Section 17 (3) , Ibid
[113] In Re Standard General Assurance co. Ltd.,AIR 1965 Cal.16.
[114] Company petition no.224 (17) CLB (1975)

"As the company's electricity undertaking has been nationalised by the Tamil Nadu Government, the equity shareholders desire that the company should continue to function by incorporating other useful objects in the objects-clause of the memorandum of the company, legally under Section 17 of the Act, we do not find any reason to deny the same."

Registration of Alteration [Section 18]

After the confirmation of alteration of objects by the Central Government, a certified copy of the order of the Central Government together with the printed copy of the altered memorandum must be filed by the company with the Registrar of Companies, within three months of the date of order. The Registrar shall register the alteration and issue within one month certificate, which shall be conclusive evidence that all formalities regarding the alteration have been properly complied with.[115] Every copy of memorandum shall thereafter contain amended objects clause as confirmed by the Central Government.

Effect of non-registration of alteration

No alteration in the objects shall be effective until it is registered with the Registrar of Companies. In case the company fails to file the documents within three months of the date of confirmation order of the Central Government, or within the extended time allowed by it, such alteration and all the proceedings connected therewith, shall become void and inoperative. The Central Government may, however, revive the order on application made by the company within a further period of one month.[116]

Alteration of Share Capital

(a) *Alteration of capital clause*

Section 84 of the Companies Act, 1956 provides that a company can make the following types of alterations by an ordinary resolution, if authorised by its articles to do so :—

(i) increase its share capital by an issue of new shares;

[115] Section 18,the Companies Act, 1956
[116] Section 19, Ibid

(ii) consolidate existing shares into shares of larger denomination ;

(iii) sub-divide its shares or any of them into shares of smaller amount than is fixed by memorandum ;

(iv) convert fully-paid shares into stock or *vice versa* ; and

(v) cancel unissued shares and to that extent diminish the amount of its shares capital. Such cancellation shall not, however, be deemed as reduction of share capital.

All such alterations do not require the confirmation by the Company Law Board. These alterations are, however, required to be notified giving details of the shares consolidated, divided, converted, sub-divided, redeemed or cancelled or the stock reconverted, as the case may be, and a copy of the resolution should be filed with the Registrar within 30 days of the resolution.

The Registrar shall record the notice and make any alteration which may be necessary in the company's memorandum or articles or both. It must be noted that cancellation of shares does not amount to reduction of share capital.

(b) *Increase in share capital*

A limited company having a share capital can increase its share capital by such amount as it thinks expedient subject to the fulfilment of the following conditions :—

1. The articles of the company should contain powers authorising the company to increase its capital.
2. A resolution must be passed by the company in a general meeting.
3. A notice of increase in capital is required to be filed by the company which the Registrar within 30 days after the passing of the resolution and the Registrar shall thereupon record the increase and also make any alterations which may be necessary in the company's articles or memorandum or both.
4. The notice to be given to the Registrar should include particulars of the class of shares affected and the conditions, if any, subject to which the new shares have been or are to be issued.

The share capital of a company shall stand increased automatically without the procedure mentioned above being followed in the following circumstances:

1. Where the Central Government has, by an order made under sub-section (4) of Section 81 of the Act, directed that any debenture or loan or any part thereof shall be converted into share of the company and such an order has the effect of increasing the authorised capital of the company.
2. Where any public financial institution, in pursuance of option attached to debentures issued or loans raised by the company, proposes to convert such debentures or loans or part thereof into shares in the company, and such conversion results in the authorised share capital in the company, and the Central Government issues a direction in this behalf.

The company is required to file with the Registrar within 30 days from the date of receipt of the order a return in the prescribed form with regard to the increase of share capital. The Registrar will, on receipt of such order and the return, carry out the necessary alterations in the memorandum of the company.

(c)Reduction of capital

Share capital of a company can be reduced in any of the following ways:

(i) By extinguishing or reducing the liability on share capital not paid-up.

(ii) By refunding surplus of the paid-up capital.

(iii) By writing off the lost capital,

(iv) By any other method approved by the Court.

A company can reduce its share capital by any of the above mentioned methods, only when the following conditions are fulfilled:

(i) The Articles of the company permit such a reduction.

(ii) The company passes a special resolution for reducing share capital.

(iii) The company also obtains confirmation of the resolution by the Court.

Being a domestic affair, the Companies Act permits the companies to decide the extent, mode etc, of reduction of its share capital. With a view, however, to safeguarding the interests of the creditors and the minority shareholders as also to ensure that the scheme of reduction is fair and reasonable, it is provided that the scheme of reduction of the company shall be subject to the approval of the Court. Before putting its seal of confirmation on the scheme, it is the duty of the Court to see that the procedure adopted is formally correct, the creditors are not prejudiced and the scheme is fair and equitable between the different classes of shareholders.

However, the above mentioned procedure is not called for:

(a) Where redeemable preference shares are redeemed in accordance with the provisions of Section 80.

(b) Where any shares are forfeited for non-payment of calls.

Change in liability clause

A company limited by shares or guarantee cannot change its Memorandum so as to impose any additional liability on the members or to compel them to buy additional shares of the company unless all the members agree in writing to such change either before or after the change (Sec.38).

3.3.8 Doctrine Of Ultra Vires:

A company has the power to do all such things as are—

(1) authorised to be done by the Companies Act, 1956 ;
(2) essential to the attainment of its objects specified in the Memorandum ;
(3) reasonably and fairly incidental to its objects[117]

(4) Everything else is *ultra vires* the company. *'Ultra** means 'beyond' and *'vires'* means 'powers'. The term *ultra vires* a company means that the doing of the act is beyond *the legal*

[117]Fosterv.London Chatham & Dover Co., (1895) 1 Q.B. 711

power and authority of the company. The purpose of these restrictions is to protect—

(1) investors in the company so that they may know the objects in which their money is to be employed ; and
(2) creditors by ensuring that the company's funds are not wasted in unauthorised activities.

The rule of *ultra vires* can be understood from the facts of the following case :

Simmons v. *Heffer*[118], The main object of the company limited by guarantee was the prevention of cruelty to animals. It gave £ 80,000 to a political party, the election manifesto of which pledged the abolition of certain types of hunting; £ 50,000 were given unconditionally and the remaining £ 30,000 for publicizing the manifesto commitment of animal welfare. *Held,* the gift of £ 50,000 by the company to the political party was *ultra vires,* whereas the other £ 30,000 was within the powers of the company.

Ultra vires act is void. If an act is *ultra vires* the company, it does not create any legal relationship. Such an act is absolutely void and even *the whole body of shareholders cannot ratify it* and make it binding on the company. It is not necessary that an act to be considered *ultra vires* must be illegal; it may or may not be [119] the leading case on the point is :

In Ashbury Rly. Carriage & Iron Co. Ltd. v. *Riche*[120], A company was incorporated with the following objects:

(a) to make, sell, or lend on hire, railway carriages and wagons ;

(b) to carry on the business of mechanical engineers and general
contractors ;

(c) to purchase, lease, work, and sell mines, minerals, land and buildings.

The company entered into a contract with Riche for the

[118] The Times, May 23, 1985
[119] *Anand Parkash* v. *Asstt. Registrar,* A.I.R. (1968) All. 22
[120] (1875) L.R. 7 H.L.653

financing of the construction of a railway line in Belgium. The question raised was whether that contract was covered within the meaning of 'general contractors'. The House of Lords held that the contract was *ultra vires* the company and void so that not even the subsequent assent of the whole body of shareholders could ratify it.

The doctrine of *ultra vires* as laid down in the *Ashbury's Case* was affirmed by the House of Lords in *Attorney General* v. *Great Eastern Rly. Co.,* [121], but Lord Selborne gave a qualified approval to doctrine by adding that the doctrine of *ultra vires* "ought to be reasonably, and not unreasonably, understood and applied, and whatever may fairly be regarded as incidental to, or consequential upon, those things which the legislature has authorised, ought not to be held by judicial construction to be *ultra vires."* Note the following case:

In Deuchar v. *Gas Light & Coke Co.*[122]. A gas company was empowered to make and supply gas, manufacture and sell residuals arising from gas making and to provide such apparatus and materials as it deemed requisite for those purposes. To convert a particular residual, caustic soda was required. After purchasing caustic soda for a number of years, the company decided to manufacture its own caustic soda. *Held,* it was not *ultra vires* the company.

The main feature and facet of the doctrine of *ultra vires* is that a company being a corporate person should not be mulcted (fined or punished) for its own acts or acts of its agents, if they are beyond its powers and privileges.[123] Where the company exceeds its authority, the act is good to the extent of the authority and bad as to the excess. But if the excess cannot be separated from the authority conferred on the company by the Memorandum, the whole transaction would be affected by the doctrine of *ultra vires* and would be void. But there is nothing to prevent a company from protecting its property. The leading case on the point is :

In National Telephone Co. v. *St Peter Port Constables,*[124] A telephone company put up telephone wires in a certain area.

[121] (1880) 5 App. Cas. 473
[122] (1925) A.C. 691
[123] *Bhodani* v. *Bank of Baroda,* (1957) 27 Comp. Cas. 233
[124] (1900) A.C. 317

The company had no power in the Memorandum to put up wires there. The defendants cut them down. *Held,* the company could sue for damage to the wires. Whether a particular act on the part of a company is within its powers is a question of fact and is decided on the construction of the terms of the Memorandum.

***Ultra vires* the directors.** If an act or transaction is *ultra vires* the directors *{i.e.,* beyond their powers, but within the powers of the company), the shareholders can ratify it by a resolution in a general meeting or even by acquiescence provided they have knowledge of the facts relating to the transaction to be ratified. If an act is within the powers of the company, any irregularities may be cured by the consent of the shareholders [125]

***Ultra vires* the Articles.** If an act or transaction is *ultra vires* the Articles the company can ratify it by altering the Articles by a special resolution. Again if the act is done irregularly, it can be validated by the consent of the shareholders provided it is within the powers of the company.

Effects of *ultra vires* transactions

1. *Injunction.* Whenever a company does or proposes to do something beyond the scope of its activities or objects as laid down in the Memorandum, any of its members can get an injunction from the Court restraining the company from proceeding with the *ultra vires* act.
2. *Personal liability of directors.* Any member of a company can maintain an action against the directors of the company to compel them to restore to the company the funds of the company that have been employed by them in *ultra vires* transactions.[126] This is because it is one of the duties of the directors of the company to ensure that the funds of the company are used for the achievement of the objects for which the company is incorporated. If any funds of the company are misapplied *{i.e.,* spent on *ultra vires* transactions), the directors are personally liable to the company for breach of trust.

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[125] Express Enee Works Ltd., Re (1920) 1 Ch. 466

[126] *Russel* v. *Wakefield Water Works Co.,* (1875) L.R. 20 Eq. 474

In Sharpe, Re[127]. The directors of a company paid dividends on shares out of capital which is an *ultra vires* act. The company was afterwards wound up. *Held,* the directors were liable to refund the money to the company. But the person who receives the money with the knowledge that the payment to him is *ultra vires* is liable to indemnify the directors who refunded the money to the company, as he is in effect a constructive trustee of the money.

3.*Breach of warranty of authority*. When an agent exceeds his authority, he is personally liable for breach of warranty of authority in a suit by the third party. The directors of a company are its agents and as such they must act within the limits of the company's powers. If they induce, however innocently, an outsider to enter into a contract which is *ultra vires* the company, they will be personally liable to the third party for his loss for breach of warranty of authority.

In Weeks v. *Propert,*[128]. The directors of a railway company which had fully exhausted its borrowing powers advertised for money to be lent on the security of debentures. *W* lent £ 500 upon the footing of advertisement and received a debenture. *Held}* the debenture was void but *W* could sue the directors for breach of warranty of authority (as they had by advertisement warranted that they had the power to borrow which in fact they did not have).

4.***Ultra vires contracts.*** A contract of a company which is *ultra vires* the company is void *ab initio* and of no legal effect. Neither the company nor the other contracting party can enforce the *ultra vires* contract. The company may, however, alter the objects clause for the future, but such alteration will not validate the past *ultra vires* acts done.

In Jon Beaufort {London) Ltd.,[129]. The Memorandum of a company authorised it to carry on the business of costumiers, gown-makers and similar business within the clothing trade. The company decided to extend its activities to the manufacture of veneered panels which was beyond the scope

[127] (1892) 1 Ch. 154
[128] (1873) L.R. 8 CP. 427
[129] *Re* (1953) Ch. 131

of the powers of the company and hence *ultra vires.* For carrying out the manufacture, the company set up a factory and as a result became indebted to a firm of builders, to the supplier of veneers and to the supplier of coke. *Held,* all the 3 contracts were *ultra vires* the company and hence the claimants could not recover.

5 ***Ultra vires acquired property***. Although *ultra vires* transactions are void, yet if a company has acquired some property under an *ultra vires* transaction it has the right to hold that property and protect it against damage by other persons The property which is legally transferred to the company is in law duly vested in such company even though the company was not empowered to acquire such property.[130]

6. ***Ultra vires torts***. *A* company is not liable for torts (civil wrongs) committed by its agents or servants during the course of *ultra vires* transactions. This may result in injustice to the third party who has been the victim of an *ultra vires* tort. A company is, however, liable for a tort if it can be shown that the activity in the course of which tort was committed falls within the scope of the Memorandum and the agent or servant committed the tort within the course of his employment.

Exceptions to the doctrine of *ultra vires*

1. If an act is *ultra vires* the directors of a company but is *intra vires* the company, the company may ratify it.
2. If an act is *ultra vires* the Articles of a company, the Articles may be altered to include the act within the powers of the company.
3. If an act is *intra vires [i.e.,* within the powers of) a company, but is irregularly done, the shareholders may ratify it.
4. If a person borrows money from a company under a contract which is *ultra vires* the company, the company can sue him for the recovery of the money. The Courts are more favourably inclined to a claim by the company than against it. They consider it important to protect the company's

[130] *National Telephone Co.* v. *St. Peter Constables,* (1900) A.C. 317

creditors and shareholders against *ultra vires* transactions.

5. If an act is ultra *vires* the company, the rights arising independently of the act are not affected. Further the rights over the property acquired by *ultra vires* expenditure are protected.
6. If a company has purchased some property from a third party under an *ultra vires* contract or has taken an *ultra vires* loan, the third party has the right to follow his property or money if it exists *in specie.* He may also obtain an injunction from the Court restraining the company from parting with that property or money. But he must act before the identity of the property is lost or the money is spent.
7. If a company takes an *ultra vires* loan and uses it to pay off *intra vires* debts, the lender who has lent money under the *ultra vires* contract is substituted in place of the creditor who has been paid off and as such he can recover the money.
8. If a company has taken an *ultra vires* loan through some misrepresentation of fact by the directors, the lender has the right to make the directors personally liable on the ground of breach of implied warranty of authority.
9. If a director of a company makes payment *ultra vires* the company, the company can compel him to refund the amount. The director however has the right to be indemnified by the person receiving the money, provided he knew of the transaction to be *ultra vires* the company.

3.4. SUMMARY:

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

For the purpose of registration of a company, if the registrar is satisfied that all the requirements for the registration of the company here been complied with, he shall register the

documents and the company and issue a certificate of incorporation.

The memorandum of association being a basic document contains the fundamental conditions upon which alone the company is allowed to be incorporated. The memorandum of company contains the six clauses, namely, name clause, registered office clause, object clause, liability, capital clause and association clause. The name clause of the memorandum states the name of the proposed company. Where the liability of members of a company is limited, the last word of the name must be 'limited', in the case of a public limited company and 'Private Limited', in the case of a private limited company. Every company must have a registered office as soon as it begins to carryout business or within thirty days after its incorporation, whichever is earlier. The object clause must state the object for which business is to be carried on by the proposed company. Any act beyond the objects in the memorandum is ultra vires the company and thus void. However, besides the powers stated in the memorandum, every company has certain implied powers like the power to borrow, power to sell and purchase. But powers like acquiring a business similar to companies or helping them financially have been held to be outside the scope of limited powers of a company. The contents of a memorandum can be altered only in the manner and to the extent provided in the act.

3.5. SUGGESTED READINGS/ REFERENCE MATERIAL

13. Avtar Singh : Company Law.
14. N.D. Kapoor : Elements of Company Law.
15. N.V. Paranjape : Company Law.
16. Taxmann : Company Law.
17. Gower, L.C.B. : Principles of Moderen Company Law.
18. Ramiya : Guide to the Companies Act.

3.6. SELF ASSESSMENT QUESTIONS

1. Explain the steps requied to be taken for the formation of a company and the documents required to be filed with the registrar of companies?
2. Define 'Memorandum' as per section 2 (28) of the companies Act, 1956. What are its components?
3. Write short note on the following :
   (a) Name clause

   (b) Registered Office clause

   (c) Object clause

   (d) Liability clause

   (e) Capital Clause

   (f) Association Clause

4. Critically examine the doctrine of Ultra- vires with the help of reverent case law?.

LL.M. Part-1
PAPER CORPORATE LAW

Block 1 -Introduction

Unit 4 - Article of Association, biding force of Articles, Alteration, Relation with Memorandum, Doctrine of Constructive Notice and Indoor Management, Prospectus, Issue, Contents, liability for misstatements, Statement in lieu of Prospectus

STRUCTURE

4.1. Introduction
4.2. Objective
4.3. Presentation of Contents
4.3. Form and Signature of Articles
4.3.2Contents of Articles
4.3.3 Alteration of Article of Association
4.3.4 Relationship between Memorandum & Association
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4.3.8 Meaning & Definition of Prospectus
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4.3.14 Civil Liability
4.3.15 Criminal Liability
4.4. Summary
4.5. Suggested Readings/Reference Material
4.6. Self Assessment Questions

4.1. Introduction:

The articles of association of a company are the internal regulations which govern the management of the *internal affairs* of a company. As against the articles, the memorandum of a company contains the fundamental conditions for guidance and benefit of the creditors and outside public as also shareholders who are desirous of dealing with the company. The articles being meant for regulating the internal affairs of a company, the members have full control and may by resolution alter them as they think fit so long as they do not exceed the limits defined by the memorandum of the companies Act.

In order to finance its activities, a company needs capital which is raised by a public company by the issue of a prospectus inviting deposits or offers for shares and debentures from the public. A private company is prohibited from making any invitation to the public to subscribe for any shares in, or debentures of, the company. Hence it need not issue a prospectus.

The central theme of a prospectus, from the money raising point of view, is that it sets out the prospects of the company and the purpose for which the capital is required. The prospectus is the basis on which the prospective investors from their opinion and take decisions as to the worth and prospects of the company.

4.2. Objective:

The objective of this lesson is to examine Article of Association, biding force of Articles, Alteration, Relation with Memorandum, Doctrine of Constructive Notice and Indoor Management, Prospectus, Issue, Contents, liability for misstatements, Statement in lieu of Prospectus, Red-herring Prospectus, Shelf Prospectus, Information Memorandum etc., With the help of statutory laws and Relevant Case laws.

4.3.1 Form and Signature of articles:

It is a statutory requirement that the articles of association shall be printed, be divided into paragraphs numbered consecutively and be signed by

each subscriber of the memorandum of association (who shall add his address, description and occupation, if any) in the presence of atleast one witness who shall attest the signature and shall likewise add his address, description and occupation.[131]

4.3.2 Contents of articles:

The internal running of a company is carried out in accordance with its articles of association. The articles provides among other things for—

(i) the convening of meeting;
(ii) appointment and removal of directors and the proceeding for;
(iii) the manner for allotment and transfer of shares;
(iv) alteration of company's capital;
(v) borrowing procedure;
(vi) dividends and reserve fund; and
(vii) the right of shareholders of different classes, including preference and ordinary shares.

In the view of Section 9 of the Companies Act, though subscribers have the liberty to include anything in the articles of association, but such inclusion must not be contrary to any provision of the Companies Act, if any provision of the articles of association conflicts with the provisions of the Act, it will be void to the extent of repugnancy.

It is noteworthy that the articles of association being the second important document of the company would not have overriding effect over the, provisions of the memorandum of association, if there is conflict between these two documents. In other words, the articles of association of a company derive power from the memorandum of association.

4.3.3 Alteration of articles of association:

In View of Section 31 of the Companies Act it is a statutory power of every company to alter its articles of association by a special resolution. Therefore, it cannot be denied merely by an agreement. A provision in the articles depriving the company of its statutory power of alteration would be void.[132]

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[131] Section 30 of the Companies Act, 1956
[132] *All India* Railway Men's *Benefit Fund.v. Baheshwarnath,* A.I.R. 1945 Nag. 187.

But Kerala High Court in *Joseph Michael* v. *Travancore Rubbers Tea Co. Ltd.*[133]. has held that an alteration made in the articles of association without observing special resolution, is irregular, however it can be rectified by the Court order. However, the Court would be reluctant to interfere if the alteration had been acted upon for long or was the result of the shareholders agreement without a formal resolution. Thus, every part of the articles of association is alterable, however, a provision depriving the company of its power to alter its article is not effective and is void.[134]

Where the constitution of company is altered, it is effective and valid. For example—In *Andrews* v. *Gas Meter Company,*[135] the company's memorandum stated that the capital of company should be £60,000 divided into 600 shares of £100 each, but without mention of power in the memorandum or articles to issue preference shares. However, the company, by passing special resolution, altered its articles so as to give itself power to issue preference shares and issued them.

It was held by the Court of Appeal that the alteration was effective as it was not prohibited by the company's memorandum of association. The Court of Appeal observed that "it could not have been done but as it was not. it was immaterial that the change quite altered the company's Constitution.

It was alteration in the articles of association against the memorandum, which is permissible because it was not expressly forbidden in the memorandum.

4.3.4 Relationship between the memorandum and articles of association:

On this point there is no ambiguity that the articles of association are regarded as subordinate to the memorandum. When the articles and memorandum arc not consistent, the memorandum would over ride.

In *Bryon* v. *Metropolitan Omnibus Co.,*[136] it was observed that "this is so because the object of the memorandum is to state the purposes for which the company has been established, while the articles provide the manner in which the company is to be carried on and its proceedings disposed of.

[133] (1986) 59 Comp. Cas. 898 Ken; See also *Cane* v. *Jones,* (1981) 1 All E.R. 533.

[134] (1897) 1 Ch. 361 (C.A.).

[135] (1897) 1 Ch. 361 (C.A.).
[136] (1885) 27 LJ Ch. 685.

This makes main difference between the two documents. In view of Lord Cairns—as he puts it—

"The memorandum of association is, as it were, the area beyond which the action of the company cannot go, inside the area the share holders may make such regulations for their own government as they think fit."[137] However, in the words of Bowen LJ.[138]—

> "The memorandum of association states the fundamental conditions upon which alone the company is allowed to be incorporated. It may provide conditions for the benefit of shareholders, creditors and public at large. Whereas articles of association contains internal regulations of the company."

It is noteworthy that some conditions of the company's memorandum of association cannot be altered without the confirmation of the Central Government, on the other hand articles of association can be altered comparatively easily by a special resolution.[139] There is no. similar procedure for alteration of the memorandum and articles of association.

In principle the memorandum will always differ from the articles of association, unless the *ultra vires* rule is abrogated. It is well settled position that if anything is beyond the object clause in memorandum, it is void *ab initio* and not subject to ratification. On other hand, if anything is done by a company in violation of its articles of association, it is regarded as only irregular, which can always be confirmed by the shareholders of the company.

4.3.5 Binding effect of memorandum and articles of association:

In accordance with Section 36(1) of the Companies Act, which reads as under:—

"Subject to the provisions of this Act, the memorandum and articles shall, when registered, bind the company and the members thereof-to the same extent as if they respectively had been signed by the company and by each member, and contained covenants on its and his part to observe all the provisions of the memorandum and of the articles."

This section declares contractual enforceability of the memorandum and articles, if anything is done or signed or entered into agreement by the company, it would be treated as if it is signed by each member observing

[137] *See* also *Ashbury Rly. Co.* v. *Richie,* (1874-80) All E.R. Rep. Ext. 2219.
[138] *Genuineness* v. *Land Corporation of Ireland,* (1882) 22 Ch. D. 349.
[139] Section 31 of the Companies Act.

provisions of the memorandum and articles. On the basis of Section 36 of the Act the following propositions can be laid down:

1. The members are bound to the company
2. The company is bound to its members
3. Not binding to outsiders
4. Binding between members

1. The members are bound to the company—

In the first instant, by the provisions of the articles of association, the members are bound to the company. Every member of the company binds with the provisions of the articles the moment he becomes member of such company. There is contract between members and its company in terms of the articles of association.

For illustration—

In *Borland's Trustee* v. *Steel Brothers & Co. Ltd.*[140] the defendant company's articles stated that on the bankruptcy of a member his shares would be sold at the price fixed by the directors of company. *X,* a shareholder was adjudged as a bankrupt. It was claimed by his trustee that this provision of the articles was not binding upon him and he should be at liberty to sell out shares at their true value. It was held that since the shareholder had purchased shares in those terms and conditions as stated in the articles of association of defendant company, this being original incident of shares, it could not be said that those terms and conditions were not to be observed.

2. The Company is bound to its members:

As the members are bound to the company, the company is also bound to the members and to follow the articles of association. Each member is entitled to question whether the company is observing the articles of association and in case of breach of articles; the members are entitled to an injunction to prevent the breach.[141]

Thus, it is clear that the articles shall bind the company and adherence with the provisions of articles is necessary in terms of Section 36 of the Companies Act.

3. Not binding to outsiders: -

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[140] (1901) 1 Ch. 279; See also *New Leordon Brezilian Bank* v. *Brockle band,* (1882) 21 Ch. D. 302.

[141] Peveril Gold Mines Ltd., Re, (1898) 1 Ch. 122

Though the company is bound to its members and *vice versa,* but neither of them is bound to an outsider. A contract between the company and outsider cannot be made to give effect to the articles of association. For illustration in *Browne* v. *La Trinidad,*[142] it was held that no outsider or third party can enforce articles of association against the company even if they purport to give him certain rights.

The question is that who is an outsider? The expression "outsider" means who is not a member, but even a member may be an outsider. Section 36 of the Companies Act raises an obligation binding on the company in its dealings with the members, but the expression "members" in this section means members in their capacity as members, that is, excluding any relationship which does not flow from the membership itself.

On the point that "no article can constitute a contract between the company and a third person, a clear illustration is in *Browne v. La Trinidad* case wherein the articles of association contained a clause that *B* should be a director and should not be removable till after 1888. However, he was removed earlier. Resultantly, he filed a suit to restrain the company from excluding him. It was held that there was no contract between *B* and the company. The court further held that no outsider can enforce articles against the company even if they purport to give him certain rights.

4. <u>Binding between members</u>: -

By virtue of Section 36 of the Companies Act, the contractual enforceability is given to the articles of association of a company, however this binding effect is limited to matters arising out of the company's relationship with the members 'qua' members and it does not extend beyond the company's relationship.[143] In *Welton* v. *Suffery,*[144] Lord Herschell said: -

"The articles constitute a contract between each member of the company and there is no contract in terms between the individual members of the company, but the articles do not contain the clause, which in my opinion, regulate their rights *inter se.* Such rights can only be enforced by or against, a member through the company or through the liquidator representing the company, but I think that no member has, as between himself and another member, any rights beyond that which the contract with the company gives."

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[142] (1887) 7 Ch. D. 1.

[143] *Kusiram Baharsi Lai* v. *Hanutmal,* (1948) 53 CWN 505

[144] (1897) AC 299.

However, the Bombay High Court expressed different view in *Kanmaheswari* v. *Bansidhar Jagannath.*[145] in this case Gajendragadkar, J. (as he then was later on Chief Justice of Supreme Court of India) did not agree with the view expressed by Lord Herschell in *Welton's* case.[146] He said: -

"The articles of association do constitute a contract, not only between the company and its members, but even between members, *inter se,* though difficulties arise in determining the scope, nature and extent of the rights and obligations flowing from such articles of association in respect of the private transactions of members of the association."

"The articles of association (may be compared) with that of an agreement signed by several executors containing the term that each will carry out and observe the stipulations in the agreement, and he has added that, "where there are mutual promises between parties to an agreement which amount to consideration moving from each to others, the terms in the document can be enforced by and against each party."[147]

It is noteworthy that Mr. Justice Gajendragadkar's view finds favour later on in English case, *Layfield* v. *Hands*[148] In this case the Chancery's Court held that the members may compel enforcement of the provisions of the articles of association against another member without enjoining the company as a party.

4.3.6 Doctrine of constructive notice:

The registration of memorandum and articles are statutory requirements. In terms of Section 33(1) of the Companies Act, the memorandum and articles shall be presented for registration to the Registrar of the State in which the registered office of the company is stated by the memorandum to be situated.

Thus, only after due registration the company can attain a corporate status under the Companies Act. The company's memorandum and articles are treated as a public document which can be inspected by any one, whether member or outsider at the office of the Registrar of Companies on payment of prescribed fee.[149]

[145] A.I.R 1956 Bom. 459.
[146] *Welton V. Saffery.* (1897) AC 299.
[147] *Ibid.*
[148] (158) 2 Al E.R. 194 (Ch); See also *First National Ltd. V. Seth Shant Lal,* AIR 1959 Punjab 328.
[149] Section 610(1)(a) of the Companies Act.

According to Section 39 of the Companies Act, on request a company is required to send a copy of its memorandum and articles within seven days of such request, on payment of one rupee.

The result of this provision shows that under the Companies Act the memorandum and articles have been regarded as a public document and every person dealing with the company is deemed to have notice of their contents.[150] Thus, the plea as to non notice regarding the contents of these documents is not acceptable before the court of law. In *Mahony* v. *East Holy Ford Mining Co.*[151], the House of Lords said:—

"Every company has its memorandum and articles open to all who are minded to have any dealings whatsoever with the company, and those who so deal with them must be affected with notice of all that is contained in those two documents."

It is presumed that the persons who is dealing with the company, must not only have read these documents but also have understood them according to their proper meaning.[152] This is called constructive notice of memorandum and articles. This doctrine of constructive notice is illustrated in *Venkataswamy* v. *Ramamurthy*[153].—

The South Indian Agricultural and Industrial Improvement Co. Ltd.'s article of association required that all deeds and instruments etc. should be signed by the managing director, the secretary and the working director on behalf of the company. One Smt. Venkamma accepted a mortgage bond of Rs. 1,000/- executed by the Secretary and working director only. Smt. Venkamma assigned her interest to the appellant Venkataswamy. The company subsequently went into voluntary liquidation. The main question was whether the mortgage bond was validly executed so as to make the company liable.

It was held by the Madras High Court that the appellant could not claim under the mortgage bond which was invalidly executed. In the present case the court observed that:—

"If the plaintiff had consulted the articles she would have discovered that (the mortgage) deed required execution by three specified officers of the company and she would have refrained from accepting a deed inadequately signed. Notwithstanding therefore that the mortgagee may

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[150] *Pratt Ltd. V. Sasoon & Co. Ltd.* (1935) 37 Bom. LR 1109.
[151] (1857) 7 H.L. 869.
[152] *Oakabank Oil Co. V. Crum,* (1882) 8 A.C. at P. 71.
[153] A.I.R. 1934 Mad. 579.

have acted in good faith and that her money applied to the purpose of the company board nevertheless it is invalid and the plaintiff cannot recover on it."

Thus, persons having transactions with the company should read and understand the contents of memorandum and articles of the company and these documents should be checked with the Registrar of Companies who is its directors, managers and secretaries at any given time.[154]

Statutory reform and Constructive notice:

In the opinion of some legal experts the doctrine of constructive notice is considered as an unreal doctrine. This doctrine is not based on the realities of business of life. A company is known to the public at large through its officers and not through its memorandum and articles of association. The doctrine of constructive notice has been abolished by Section 9 of the European Communities Act, 1972. However, Section 9 of the said Act is now incorporated in Section 35 of the (English) Companies Act, 1985. The effect of new provision has been shown in *TCB Ltd.* v. Gray.[155]

Where a debenture issued by a company was not signed by the director personally as required by the terms of articles, in fact it was signed by a solicitor as attorney of a director. The articles of company contain the provision that "every instrument to which the seal shall be affixed shall be signed by a director". It was held that even so the company was held liable. The Court while considering the effect of new provision said that before this enactment was enforced a person dealing with the company was required to go through the memorandum and articles of the company to satisfy himself that the transaction was within the corporate capacity, but the scenario has been changed by virtue of Section 9(1). This Section 9(1) states that good faith is to be presumed and that the person dealing with the company is not bound to enquire.

The doctrine of constructive notice has not been taken so seriously by the courts in India. For illustration—In *Dehradun Mussouri Electric Tramway Co.* v. *Jagmandardas,*[156] as per articles, the directors could delegate all their powers except the power to borrow. Even so an overdraft taken by the managing agents without approval of the board was held to be

[154] *K.L.Engineering V. Arab Malaysia Finance,* (1995) 2 SCR 85 Malaysia.
[155] Financial Times, Nov. 27, 1985:1986 JBL 10.
[156] A.I.R. 1932 All. 141; See Also *Charnock Collieries Ltd. V. Bholanath, ILR* (1912) 39 Cal. 810 and *Probodh Chandra V. Road Oils (India) Ltd.* ILR (1992) 57 Cal. 1110.

binding. The Allahabad High Court said that such temporary loans must be kept beyond the scope **of** the relevant provision.

4.3.7 Doctrine of Indoor Management:

Area of operation—The doctrine of indoor management is contrary to the rule of constructive notice. It is to be noted that the doctrine rather rule of constructive notice protects the company against the outsiders, whereas doctrine of indoor management seeks to protect outsiders against the company. According to the doctrine of indoor management the persons dealing with the company are under obligation to read the memorandum and articles of the company and also to look that the proposed dealing is not inconsistent therewith, they are not bound to anything more, they need not inquire into the regularity of the internal operation and may assume that all is being done regularly.[157]

This doctrine was first described in a landmark case *Royal British Bank* v. *Titrqnaiid,*[158] it is popularly known as the rule of "Turquand case". The facts of this case are as under: -

The appellant company was not a banking company as its name indicates. It was a registered company formed for the purpose of carrying on mining business and forming a railway. The deed of settlement of company, corresponding to articles of association *inter alia* stated that the directors of company might borrow on bonds such sums as might from time to time be authorised by a general resolution of the company. Although, no such resolution was passed, but the directors of company borrowed £2000 from the respondent named Turquand and the bond was signed by two directors under the seal of the company. When company failed to pay the bond amount, the plaintiff (respondent) sued the company.

The defense was that the directors could borrow money on bond only when they were so authorised by a general resolution of the company and in the present case there had been none. On behalf of the plaintiff (Turquand) it was argued that the bond was taken in the firm belief that it was executed under the authority given by the company's resolution and that it must **be** binding and a valid security on the company. The. Court of Queen's Bench and in appeal the Court of Exchequer Chamber held that the bond was binding on the company, as the lenders were entitled to

[157] Palmer's Company Law., 21st Ed. P. 245.

[158] (1856) 7 E and B 327: 119 E.R. 886.

assume that a resolution authorising the borrowing had been passed. Jevis CJ. of the Court of Exchequer Chamber said :—

"The party, on reading the deed of settlement, would find not a prohibition from borrowing but a permission to do so on certain conditions finding that the authority might be made competent by a resolution, he would have a right to infer the fact of a resolution, authorising that which on the face of the document appeared to be legitimately done." Subsequently, in *Premier Industrial Bank Ltd. v. Carlton Manufacturing Co. Ltd.*[159] the doctrine of indoor management is thus stated—

"If the directors have power and authority to bind the company, but certain preliminaries are required to be gone through on the part of the company before that power can be duly exercised, then the person contracting with the directors is not bound to see that all these preliminaries have been observed. He is entitled to presume that the directors arc acting lawfully in what they do."

The above discussions show that the "doctrine of indoor management" is more practical and is founded on business convenience. It is just not possible for everyone, who is to deal with the company, to go through meticulously with the view to examine the internal operation of a company in order to make sure that the officials with whom he dealt had actual authority. It is to be noted that the memorandum and articles of association of company are registered documents and these are being public documents accessible to all who are interested to inspect them, but the details of internal machinery are not registrable and thus, not accessible to all.

The Allahabad High Court had an occasion to consider the "doctrine of indoor management in *Lakshmi Pattam Cotton Mills Ltd.* v. *J.K. Jute Mills Co. Ltd.*[160] the facts of this case were as under :—

M/s. J.K. Jute Mills Co. Ltd.'s articles of association authorised the directors to borrow money. This power to borrow could be delegated to one or more of the directors. One of the directors G. borrowed Rs. 1,50,000/-from the plaintiffs. But, the company declined to be bound by the loan on the ground that the power to borrow had not been formally delegated to the director by passing a resolution. It was held by the Allahabad High Court that the loan was binding on the company.

[159] (1909) 1 KB 106; See also *Rajendrs Nath Dutta V. Shibendra Nath Mukherjee, (*1982) 52 Comp. Cas. 293 Cal.

[160] (1957) 27 Comp. Cas. 660. All. : A.I.R. 1957 All. 311.

In the above cited case the Court observed that the actual delegation being a matter of internal management, the plaintiff were entitled to assume that the power which could have been delegated under the articles must have been conferred on the director. After considering *Turquand s* case and other Indian cases, the Court further held that the passing of such a resolution is a mere matter of indoor or internal management[161] and its non-compliance under such circumstances cannot be used to defeat the just claim of a *bona fide* creditor. Further, the Court commented: —

"The creditor was, therefore, dealing with a person who was armed with such formidable and all embracing powers. There was no reason whatsoever to suspect the propriety or validity of the transaction."

Exceptions to "doctrine of indoor management"

Though the scope of the "doctrine of indoor management" widened in due course as the corporate field occupied the central position in economic and social life. This doctrine rather rule is not regarded as absolute, however, it has certain exceptions. These are the following:-

1. Notice of irregularity
2. Notice of contents of articles
3. When, there is forgery
4. Acts outside the usual authority of official of company.

1.Notice of irregularity: -

It is well settled that when, the irregularity is known, the rule of indoor management would not be applied. In other words when a person has notice rather knowledge of an irregularity in its internal management pertaining to the subject matter of his dealings, he cannot seek protection of the rule of indoor management.' A clear illustration of this exception is *Howard* v. *Patent Ivory Co.,*[162] case—

The articles of association of the defendant company stated that the directors were authorised to borrow upto £1000 and such further sums as the company in general meeting might authorise. In fact the directors themselves lent £3500 to the company in absence of such authority and obtained debentures.

It was held that the company was liable to the extent of £1000, and directors were not entitled to the further amount as they have notice of the irregularity.

[161] John V. Rees, (1870) Ch. 345.
[162] (1888) 38 Ch. D. 156.

However, a person who is himself a component of the internal operation cannot take benefit of irregularities. Because this would encourage dereliction from duty and ignorance of knowledge.[163]

The rule of indoor management could not be invoked, wherein the transaction is surrounded by the suspicious circumstances. For example— In *Anand Bihari Lai* v. *Dinshaw & Co.,*[164]

Wherein the plaintiff accepted a transfer of the property of company from the company's accountant, the transfer was held void. It was held that in absence of duly authorised power of attorney, the plaintiff could have easily suspected that the company's accountant had no authority to transfer the company's property.

2.Notice of contents of articles.—

This exception to the rule of indoor management says that a person who has not actually gone through the contents of the memorandum and articles of association, at the time of entering into contract had no knowledge of the statements of memorandum and articles, he cannot seek to rely on statements therein. Even, no benefit to rule of constructive notice is available to such person because the rule of constructive notice does not operate against the company. A person cannot be allowed to rely and act upon something of which he was, really and completely ignorant. A clear illustration is *Rama Corporation Ltd.* v. *Proved Tin & General Investments Ltd.*[165] where the plaintiff company entered into contract with one titley who acted as a director of the defendant Proved Tin and General Investments Ltd. The contract was made for the sale of telephone directory holders produced by a third company. The defendant company repudiated the contract. Hence, the plaintiff company sued the defendant company on account of breach of contract. The defendant company had taken the plea of defence that the contract was not binding upon it because Titley had no power to make such contract for the company. The defendant company's articles of association, which were not read by the plaintiff company, although provided that the directors may delegate their contract making power etc. to any one director. The plaintiff claimed that they should be protected by this clause in the article of association which contained the power of delegation to a single director of the company. Whereas it was held that a person who at the time of entering into contract had not notice of the company's articles of association, later on cannot rely on these provisions of the articles.

[163] Morris V. Kanssen, (1946) AC 459.
[164] AIR 1942Oudh 417.
[165] (1952) 2 Q.B.D. 147: (1952) 1 All E.R. 554.

The law laid down in *Rama Corporation's* case that notice of the contents of the articles of association is necessary has not been followed by the English Courts.[166]

A person who is dealing with a company, should have knowledge of its articles, it is essential. In *Kishan Rathi* v. *Mondal Brothers and Co.*[167] the Calcutta High Court has observed that "if a person has not, in fact, the knowledge of the existence of the power of delegation contained in the company's articles he cannot rely upon its suggested exercise." However, in this case the company was held liable as the court found that the plaintiff had relied upon the provisions of articles in extending loan on a "hundi" to an officer of the company.

3. When, there is a forgery: -

If any transaction or deal has been done by practising forgery or based on forged document, the rule of Turquand's case will not be applied. This is an exception to the said rule. For example: in *Ruben* v. *Great Fingal Consolidated*[168] —

In this Ruben advanced money to the Secretary of the defendant company on the basis of security of a share certificate. In terms of articles of association of company the share certificate was required to be signed by two directors and counter signed by the Secretary. Evidently, the Secretary of the defendant company signed his own name on the certificate, affixed the seal of the company and forged the signature of two directors.

It was held by the House of Lords that the share certificate was simply a forged document and the company was not bound by it. In the instant case Lord Loreburn, L.C. said: -

"It is quite true that persons dealing with limited liability companies are not bound to inquire into their indoor management, and will not be affected-by Irregularities of which they had no notice. But this doctrine applies only to irregularities that otherwise might affect a genuine transaction. It cannot apply to a forgery."

The Madras High Court in *Official Liquidator v. Commissioner of Police*[169] — A company borrowed a sum of money on a document which was

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[166] *Hely-Hutchinson V. Brayhead Ltd.,* (1968) 1 Q.B. 549; *Freeman V. Buchkhurst park Properties Ltd.,* (1946) 2 Q.B. 480 (C.A).
[167] (1966) Comp. L. J. 10 Cal.
[168] (1906) A.C. 439.
[169] (1969) 1 Comp. L. J. 5 Mad.

executed by the managing director who was the chief component of the; company. In terms of articles of association of the company, the signatures of two directors were required, but these signatures were forged. The company was not allowed to eschew liability under the document in question.

5. Acts outside the usual authority of official of company: -

If the official of company does any act which would have usually not been done in ordinary exercise of power, the outsider will not be protected by "the rule of indoor management". In other words if the company's official exceeds his actual authority which that sort of official would not usually have," the outsider can seek protection of "the rule of indoor management". A clear illustration is a case of *Kredit Bank Cassel* v. *Schenker Ltd.,*[170]

The respondent Schenkers Ltd., an incorporated company was carrying on business of forwarding agents. The company's articles of association authorised the directors to decide who should have authority to draw, accept etc. bill on behalf of the company. The company had its branch at Manchester, C, the Manchester branch-manager, drew seven bills on behalf of the company in favour of Kredit bank Cassel, who took them believing *C* to be empowered to draw them. In fact C had no such power or authority.

In this case the Court of Appeal had held that the Company was not liable for the bills because the drawing of bills was not within the usual or apparent authority of the company's Manchester branch manager as the company had. not given him actual authority. Thus, it is obligation rather duty of the other party or company to enquire when there is unusual exercise of power by company's official.

4.3.8 Meaning and definition of a prospectus:

A prospectus, as per section 2(36), means any document described or issued as prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares or debentures of a body corporate.

Thus, a prospectus is not merely an advertisement; it may be

[170] 1927 1 KB 826 CA.

a circular or even a notice. A document shall be called a prospectus if it satisfies two things:

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

What constitutes an offer to the public? Section 67 lays down the following criteria as to what shall constitute an invitation to public:

1. An invitation to the public shall include an invitation to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner[171] However, a document, technically a prospectus, issued to invite existing members or debenture holders to subscribe to shares or debentures by way of right is not a prospectus. Similarly, in invitation to subscribe to any shares or debentures, which are, or are to be, in all respects uniform with shares or debentures already issued and being dealt in or quoted on a recognized stock exchange, will not be a prospectus[172]

To be a prospectus, it must be 'issued to the public'. Single private communication does not amount to issue to the public [173] In this case, several copies of a document marked "strictly confidential" and containing particulars of a proposed issue of shares, were sent by the managing director of a company to a co-director, who in turn sent a copy to a solicitor, who gave it to a client who, in turn, passed it on to a relation. Thus, a document was passed on privately through a small circle of friends of the directors. The House of Lords held that there had been no issue to the public. In Pramatha Nath Sanyal V. Kali Kumar Dutt[174] an advertisement was inserted in a newspaper stating: "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

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[171] The Companies Act ,1956.Section 67(2)
[172] Ibid [Section 56(5)]

[173] Nash V. Lynde [1929] A.C.158
[174] AIR 1925 Cal. 714

prospectus as it invited the public to purchase shares. The directors were, therefore, penalized, for not complying with the requirements of filling a copy thereof with the Registrar of Companies.

2. An invitation shall not be an invitation to the public if it cannot be calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the invitation. Thus, it will not be an invitation to public where B, a friend of A, who receives the invitation, also desires to subscribe, but his offer is refused because he was not invited to make the offer. On the other hand, it will become an invitation to public where his (B's) offer shall also be considered. However, the invitation by companies other than non-banking finance companies or public financial institutions, even though meant for subscription/purchase only by those who receive it, shall be construed as invitation to public if it is made to 50 persons or more [175]The effect of the aforesaid amendment shall be that private placements of companies other than non-banking companies and public financial institutions shall come under the purview of 'public issue' if such offer or invitation is made to 50 or more persons.

3. The offering of shares to kith and king of a director is not an invitation to the public to buy shares –*Rattan Singh V. Managing Director, Moga Transport Co. Ltd*.[176]Further, the learned judge in this case held that in all cases the determination of the question of an offer being made to the public depends upon the facts and language of the notice and the particular circumstances of each case.

In Nash V. Lynde [177], Justice Viscount Summer observed : "The 'public' is of course a general word. No particular numbers are prescribed. Anything from two to infinity may serve; perhaps even one, if he is intended to be the first of a series of subscribes, 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

[175] Proviso to sub-section (3), added by the Companies [Amendment] Act, 2000

[176] (1959) 29 Comp. Cas. 165

[177] [1929] Ac 158

applies in proper form, whether the prospectus was addressed to him on behalf of the company or not."

4. An offer to shareholders of an existing company 'A' of shares in a new company 'B' in exchange for existing of 'A' is not an offer to public – Govt. Stock Securities Investment Co. Ltd. V. Christopher [178]In this case, an offer was made to shareholders of company A to transfer their existing shares to company B against which they would be issued shares of company B. The question was whether the letter of offer was 'prospectus' inviting public subscription. Held that the test is not who receives the circular, but who can accept the offer put forward. In this case it could only be persons legally or equitably interested as shareholders in the shares of company 'A'. In these circumstances the impugned letter of offer was not a prospectus inviting public subscription.

4.3.9 Contents of a prospectus:

Section 56 of the Act lays down that the matters and reports stated in Schedule II to the Act must be included in a prospectus. The format of Schedule II was revised by the Government vide its Notification dated 3.10.1990. The revised format of prospectus requires the prospectus to be divided into three parts.

In Part I brief particulars are to be given about matters mentioned below:

1. **General information:** Under this head, information is given about-.

(i) Name and address of registered office of the company.

(ii) Name(s) of stock exchange(s) where application for listing is made.

(iii) Declaration about refund of the issue if minimum subscription of 90% is not received within 90 [179] days from closure of the issue.

(iv) Declaration about the issue of allotment

[178] [1956] 1 WLR 237

[179] However, SEBI guidelines now provide for a period of 60 days from the closure of the issue, if the issue is underwritten. In case of a non-underwritten issue, minimum subscription should be received on closure of the issue.

letters/refunds within a period of 10 weeks and interest in case of any delay in refund at the rate prescribed under section 73.

(v) Date of opening of the issue.

(vi) Date of closing of the issue including the date of earliest closing of the issue.

(vii) Name and address of auditors and lead managers.

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

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

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

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

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

2. Capital structure of the company :

(i) Authorized issued, subscribed and paid-up capital; also, paid up capital after the present issue or after conversion of debentures, if any.

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

3. Terms of the present issue:

(i) Terms of payment.

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

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

(iv) Rights of the instrument holders e.g., whether they will get dividend for the whole year or for the period of

holding only.

4. Particulars of the issue:

(i) Object(s) of the issue.

(ii) Project cost.

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

5. Company Management and Project:

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

(ii) Promoters and their background.

(iii) Location of the project.

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

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

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

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

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

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

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

(xi) Approach to marketing and proposed marketing set up.

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

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

A. General Information

It includes information on matters like:

(i) Consent of directors, auditors, solicitors, managers to the issue, registrars to the issue, bankers of the company, bankers to the issue and experts. If expert's opinion was obtained, the same should be given.
(ii) Change, if any, in directors and auditors during the last 3 years and reasons therefore.
(iii) Procedure and time schedule for allotment and issue of certificates.
(iv) Names and addresses of company secretary, legal advisor, lead managers, co-managers, auditors, bankers to the issue and brokers to the issue.
(v) Authority for the issue and details of resolution passed therefore.

B. Financial Information

It includes:

(i) Reports of the auditors of the company with respect to its profits and loses and assets and liabilities and the rates of dividends paid in respect of each class of shares for each of the five financial years immediately preceding the issue of prospectus; in case the statement of accounts has not been prepared for any period of part thereof out of the five years as aforesaid ending on a day three months before the issue of the prospectus, the auditor's report shall make a mention of the same along with a certificate on the statement of accounts in respect of aforesaid period or part thereof ending on a day not earlier to six months from the date of the prospectus indicating the profits or losses for the period or part thereof and assets and liabilities as on the last day of that period, that, such statement of accounts has been examined and found correct by him. The auditor's report shall also state the dividend not paid on any class of shares in respect of the five years or shorter period mentioned above.
(ii) Report by the accountants (who should be named) on the profits and losses for the preceding 5 financial years and on the assets and liabilities on a date which

must not be more than 120 days before the date of the issue of the prospectus.

C. Statutory and other information

It includes information about:-

(i) Minimum subscription.
(ii) Expenses of the issue (i.e. fee payable to Advisors, Registrars to the issue, and Managers to the issue and Trustees for the debenture holders.
(iii) Underwriting commission and brokerage.
(iv) Previous issue for cash.
(v) Previous public or right issue, if any, during the last five years, giving particulars, about date of allotment, refunds, premium/ discount, etc. and the reason for any difference in premium compared to premium paid or payable in any issue of shares during the last two years. Also, how any premium received has been disposed of should be stated.
(vi) Issue of shares otherwise than for cash
(vii) Commission or brokerage on previous issue
(viii) Revaluation of assets, if any (during the last five years).
(ix) Material contracts and time and place where such documents may be inspected.
(x) Debentures and redeemable preference shares or other instruments issued but remaining outstanding on the date of the prospectus and terms of their issue.
(xi) Purchase of any property with details as to :
   (a) names, addresses, occupations and description of vendors;
   (b) amount paid or payable in cash, shares and debentures to the vendor or vendors, specifying the amount, payable or paid, if any, for goodwill;
   (c) the nature of title or interest in such property acquired or to be acquired by the company;
   (d) Short particulars of each transaction relating to the property completed within two preceding years including interest therein of any person acting as promoter or director or as a proposed director of the company at the relevant time.[180]

[180] vide Clause 10(d) of Part II of Schedule II

(xii) If the proceeds of the issue are to be applied wholly or partly in payment for the property in (xi) above, or the property, acquisition of which is not complete at the date of the issue of the prospectus, the particulars thereof, unless the contract for purchase or acquisition was entered in the ordinary course of the business and not made in contemplation of the issue nor the issue in consequence of the contract and where the amount involved in the purchase was immaterial. If a business which has not been carried on for three years is proposed to be purchased, then the length of time during which the business was carried on.

(xiii) (i) Details of directors, proposed directors, whole time directors, their remuneration, appointment and remuneration of managing directors, interests of directors, their borrowing powers and qualification shares Any amount or benefit paid or given within the two preceding years or intended to be paid or given to any promoter or officer and consideration for payment of giving the benefit.

(ii) The dates, parties to, and general nature of-

(a) Every contract appointing or fixing the remuneration of a managing director or manager whenever entered into, that is to say, whether within or more than, two years before the date of the prospectus;

(b) Every other material contract, not being a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company or a contract entered into more than two years before the date of the prospectus. A reasonable time and place at which any such contract or a copy thereof may be inspected.

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

(a) In the promotion of the company; or

(b) In any property acquired by the company

within two years of the date of the prospectus or proposed to be acquired by it where the interest of such a director or promoter consists in being a member of a firm or company, the nature and extent of the interest of the firm or company with a statement of all sums paid or agreed to be paid to him or to the firm or company in cash or shares or otherwise by any person either to induce him to become, or to qualify him as, a director, or otherwise for services rendered by him or by the firm or company, in connection with the promotion or formation of the company.

(xiv) Rights of members regarding voting, dividend, lien on shares and the process for modification of such rights and forfeiture of shares.

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

(xvi) Certain prescribed particulars in regard to the company and other listed companies under the same management in terms of section 370(1B) which made any capital issue during the last 3 years.

(xvii) Outstanding litigations relating to financial matters or criminal proceedings against the company or directors under Schedule XIII. Similarly, particulars of default, if any, in meeting statutory dues, institutional dues and dues towards instrument holders like preference shares, debentures and deposits together with same particulars in respect of companies promoted by same private promoters and listed on stock exchanges.

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

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

Part III of the Schedule gives explanations of certain terms

and expressions used under Part I and Part II of the Schedule. It also requires a declaration that all the relevant provisions of the Companies Act, 1956, and the guidelines issued by the Government or the guidelines issued by the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992, as the case may be, have been compiled with and no statement made in prospectus is contrary to the provisions of the Companies Act, 1956 or the Securities and Exchange Board of India Act, 1992 or rules made there under or guidelines issued, as the case may be.

4.3.10 Shelf Prospectus and Information Memorandum [Sections 60A and 60B]

The Companies (Amendment) Act, 2000 has introduced two new sections, viz., section 60A and 60B relating to ‘Shelf Prospectus’ and ‘Information Memorandum’ respectively.

The Companies (Amendment) Act, 2000 has introduced the new concept of ‘shelf prospectus’.

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

Raising finance from the public by means of various securities is a time consuming process. Negotiations with various parties have to be finalized for typing up firm allotment / reservation. Matters to be specified in the prospectus have also become quite large and highly informative, particularly under the SEBI Guidelines. Recently, developmental financial institutions like IDBI and ICICI have successfully raised money from the public through issue of Bonds. Every time any such issue comes, a fresh prospectus is required to be filled. Although it is a repetitive matter, the procedural aspects take a lot of time. In order to minimize the burden on such institutions, it is now provided to introduce shelf prospectus, which will be valid for a period of one year from the date of opening of the first offering of the shelf prospectus. For subsequent offerings, information memorandum updating the information under the various heads will have to be filed and entire set comprising of shelf prospectus and the memorandum shall constitute the

prospectus and have to be circulated to the general public. This will help to reduce the expenses of preparation and issue of prospectus on the part of the issuer and will inform the investors up-to-date position of the issue. The provisions of section 60A, in this regard, are as follows:

(i) Any public financial institution, public sector bank or scheduled bank, whose main object is 'financing' shall file a shelf prospectus. 'Financing' means, making loans to or subscribing in the capital of, a private industrial enterprise engaged in infrastructural financing, or such other companies as the Central Government may notify in this behalf.

(ii) A company filing a shelf prospectus with the Registrar shall not be required to file prospectus afresh at every stage of offer of securities by it within a period of validity of such shelf prospectus.

(iii) A company filing a shelf prospectus shall be required to file on information memorandum[181] on all material facts relating to new charge created; changes in the financial position as have occurred between the first offer of securities, previous offer of securities and the succeeding offer of securities within such time as may be prescribed by the Central Government, prior to making of a second or subsequent offer of securities under the shelf prospectus.

(iv) An information memorandum shall be issued to the public alongwith shelf prospectus filed at the stage of the first offer of securities and such prospectus shall be valid for a period of one year from the date of opening of the first issue of securities under that prospectus.

(v) An update of information memorandum shall be filed every time an offer of securities is made. Such memorandum, together with the shelf prospectus, shall constitute the prospectus.

4.3.11 Information Memorandum [Section 60B]:

Information memorandum' means a process undertaken prior

[181] Use of the term "Information memorandum" in the section does not seem to conform to the definition of this term given in section 2 (19B) of the Act.

to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited, and the price and the terms of issue for such securities is assessed, by means of a notice, circular, advertisement or document {Section 2(19B)].

The provisions of section 60B, in this regard, may be noted as follows:

(1) A prospectus containing major information regarding the issuer company but without the price structure, called an information memorandum, can be circulated to the public along with notice, circular, advertisement or document to explore the demand for securities and the price offered for the same. *In other words*, a public company making an issue of securities may circulate information memorandum to the public prior to filing of prospectus.

(2) The company is required to file a prospectus prior to the opening of the subscription list and the offer as a red-herring prospectus at least 3 days before opening of offer. A red-herring prospectus is a prospectus, which does not have complete particulars on the price of securities offered and quantum of securities offered.

(3) The information memorandum and red-herring prospectus shall carry same obligation as are applicable in the case of a prospectus.

(4) Every variation between the information memorandum and the red-herring prospectus shall be highlighted by the issuing company and shall be individually intimated to the persons invited to subscribe to the issue of securities.

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

(6) If a company or underwriter or banker to the issue acts contrary to the aforesaid stipulation, such action shall be void and the applicant shall be entitled to receive a refund

of his post-dated cheques or stock-invests or subscription monies on cancellation of application. The applicants are entitled to receive back their original application money and interest at the rate of 15% p.a. from the date of encashment till payment of realisastion.

(7) The applicant or proposed subscriber shall exercise his right to withdraw from the application on any intimation of variation within 7 days from the date of such intimation and shall indicate such withdrawals in writing to the company and the underwriters.

(8) Once the offer for securities is closed, a final prospectus stating therein the total capital raised whether by way of debt or share capital, the closing price of the securities and any other details which are not complete in the red-herring prospectus shall be filed with the Registrar as well as SEBI, in the case of a listed public company and in any other case with the Registrar only.

4.3.12 Statement in lieu of prospectus (SLP) [Sec. 70]:

Section 70(1) required a public company having a share capital to file with the Registrar a statement called ‘statement in lieu of prospectus’ in the following cases :

(a) Where it does not issue a prospectus (because it feels that it can raise enough capital without inviting the subscription for the public); or

(b) Where it issued a prospectus but has not proceeded to allot any of the shares offered to the public for subscription (because the issue has been a failure and the minimum subscription has not been received).

The ‘Statement in lieu of prospectus’ must be filed with the Registrar at least three days before any allotment of shares or debentures is made.

Form of statement in lieu of prospectus : Schedule III contains a model form of a statement in lieu of a prospectus in pursuance of section 70; Schedule IV contains a model form of a statement in lieu of prospectus when a private comp-any is converted into a public company in pursuance of section 44.

Consequences / penalty for mis-statement in /not filing of statement in lieu of prospectus: If allotment of shares or

debentures is made without filing the statement in lieu of prospectus-

(i) the allottee may avoid the allotment within two months after the statutory meeting, or where no such meeting is held, within two months of the allotment [Sec.71(1)];

(ii) the person who authorized the delivery of SLP may be punished with imprisonment upto 2 years or with fine upto Rs. 50,000 or with both [Sec. 70(5)].

4.3.13: - Misstatements In Prospectus An Their Consequences:

The 'Golden Rule' as to framing of prospectus: The 'golden rule as to framing of 'prospectus' was laid down by V.C. Kindersley *in New Brunswick & Canada Rly. & Land Co. V. Muggeridge,* [182]in the following words:

"Those who issue 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 representations therein contained, are bound to state everything with strict and scrupulous accuracy and not only to abstain from stating as fact that which is not so, but to omit no one fact within their knowledge, the existence of which might in any degree affect the nature or extent and quality of the privileges and advantages which the prospectus holds as inducement to take shares."

If there is any misstatement of a material fact in a prospectus or if the prospectus is wanting in any material fact, there may arise-

I. Civil liability.

II. Criminal liability.

4.3.14 Civil Liability:

A person who has been induced to subscribe for shares (or debentures) on the faith of a misleading prospectus has remedies against the company, and the directors, promoters

[182] (1860) 1 Dr. and Sm. 363

and experts.

1. Remedies against the company:

If there is a misstatement or withholding of a material information in a prospectus, and if it has induced any shareholder to purchase shares, he can:-

(i) rescind the contract, and
(ii) Claim damages from the company whether the statement is fraudulent or an innocent one.

(I) Recession of the contract: -

Any person, who takes shares on the faith of statements of fact contained in a prospectus, can apply to the Court for the rescission of the contract if those statements are false or fraudulent or if some material information has been withheld. He must, however, apply for the rescission within a reasonable time and before the company goes into liquidation. But he will have to surrender to the company the shares allotted to him. His name is then removed from the register of members and he gets back the money paid by him to the company along with interest. The contract can be rescinded if the following conditions are satisfied:

(i) The statement must be a material misrepresentation of fact. The misrepresentation is material when it is likely to influence a reasonable man in his judgment whether or not to apply for the shares.

In the case of *Greenwood V. Leather Shod Wheel Co.*,[183]A company formed to manufacture leather tyred wheels for trolleys issued a prospectus stating in large type "Orders have already been received from the House of Commons, to be followed by large order later." In fact all orders received were trial orders, and no customer had yet expressed any intention to buy on a large scale. Held, the prospectus was misleading. In other important case, *Henderson V. Lacon*,[184]. A prospectus stated that the directors and their friends have subscribed a large portion of the capital and they now offer to the public remaining shares, whereas the fact was that the directors had

183 (1900) 1 Ch. 421
184 (1867) L.R. 5 Eq. 249

subscribed only 10 shares each. Held, the subscriber could rescind the contract. In this case the golden rule as to the framing of prospectuses was described as a 'golden legacy' which "had condensed in few words the whole doctrine as to the rule of conduct between the shareholders and the directors.

A statement of fact must be distinguished from a statement of opinion or expectation. Statements that the property of a company is worth a certain sum of money or that due to the hard work and efficiency of directors the profits are expected to reach a certain figure, are only opinions and will give no ground for an action for rescission. But statements that "the surplus assets, as appear by the last balance sheet, are more than Rs. 1 crore", "that certain persons have agreed to become directors", are material statements of fact and, if false, will give rise to a right of rescission.

The subscribers for shares on the faith of misleading prospectus were given the right to rescind the contract to take shares in the following cases:

In *Karberg's Case, Re Metropolitan Coal Consumers' Assn.*[185], The prospectus of a company stated that 2 businessmen of repute had agreed to become directors of the company. The fact was that they had only expressed their willingness to help the company. Held, the prospectus contained a misrepresentation of fact and the plaintiff could rescind the contract.

In *Edington V. Fitzmaurice,*[186]A company issued a prospectus inviting subscriptions for debentures. The object of the issue was stated to be that the money would be used for effecting certain alternations in the company's buildings and for developing the business of the company. The money, however, was needed to pay off pressing liabilities. The plaintiff applied for debentures in reliance on the statements in the prospectus. Held, the plaintiff could rescind the contract and the directors were liable.

In *Ross V. Estates Investment Co.,*[187]A prospectus stated that

[185] {1892} 3 Ch. 1
[186] 1885} 29 Ch. D. 459
[187] {1868} L.R. 3 Ch. 682

more than half the shares have already been sold, whereas the fact was that one promoter had only applied for more than half the shares but had not paid any money and ultimately he took only 200 shares. Held, the subscriber could rescind the contract.

(ii) The statements must have induced the shareholder to take the shares. Whether or not an applicant has been induced to take the shares by reason of the misrepresentation is a question of fact depending on the circumstances of each case. If the statement would influence a reasonable man, the Court will readily infer that it influenced the applicant [188]If the applicant's acts show that he did not rely on the statement, he is not entitled to rescind.

In *Jennings V. Broughton*,[189] A subscribed for shares in a mining company offered by a prospectus which inaccurately described the capacity of the company's mine. He inspected the mine himself. Held, he was not entitled to rescind the contract to take shares as he had inspected the mine himself and must have, therefore, relied on his own observations and not on the contents of the prospectus.

(iii) The statement must be untrue. A statement included in a prospectus is deemed to be untrue if it is misleading in the form and context in which it is included. Again, where the omission from a prospectus of any matter is calculated to mislead, the prospectus is deemed, in respect of such omission, to be a prospectus in which an untrue statement is included (Sec. 65). But a mere non-disclosure does not amount to misrepresentation unless the concealment has prevented an adequate appreciation of what was stated.

A statement can be false not only because of what is said but also because of what is concealed, omitted or implied.

In *Rex V. Lord Kylsant,* [190]A prospectus was issued by a company stating that the company had paid a dividend every year between 1921 and 1927 (years of depression) thus giving the impression of a financially stable company. However, the company had in each of those years incurred considerable

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[188] *Smith V. Chadwick*, (1884) 9 A[. Cas. 187].
[189] (1854) 23 L.J. Ch. 999
[190] (1932) 1 K.B. 442.

trading losses and was able to pay dividends only out of realized capital profits. This fact was suppressed. Held, the prospectus was 'false in a material particular' in that it conveyed a false impression.

(iv) *The deceived shareholder is an allottee and he must have relied on the statement in the prospectus*. If a person purchases shares in the open market, he has no rights against the company.

In Peek V. Gurney, [191]A company issued a prospectus containing false statements. A, relying on the prospectus applied for and was allotted shares. Later, he sold these shares to P. The company was wound up and P had to pay nearly **$** 100,000 as a contributory. P sought an indemnity for his loss from the directors at the time of the issue of the prospectus. Held, the directors were not liable to P. Lord Chelmsford observed in this case as follows:

"The office of a prospectus is to invite persons to become allottees, and the allotment having been completed, such office is exhausted and the liability to allottees does not follow the shares into the hands of subsequent transferees. Directors cannot be made liable ad infinitum for all the subsequent dealings which may take place with regard to those shares upon the stock exchange."

(v) The omission of material fact must be misleading before rescission is granted. If a person relies as a ground for the rescission of a contract on the omission of a statement, he must show that the omission of the statement makes what is stated misleading. It is not that the omission of material facts is an independent ground for rescission but the omission must be of such a nature as to make the statement actually misleading.

In *Coles V. White City Greyhound Assn. Ltd.,*[192]A prospectus described land as 'eminently suitable' for greyhound racing. However, before any buildings such as kennels or stands for the public could be erected, local authority's approval was necessary as a result of a town-planning resolution. The local authority refused approval. Held, the description of land was

[191] (1873) L.R. 6 H.L. 377
[192] (1929) 45 T.L.R. 230

misleading and rescission was granted.

(vi) The proceedings for rescission must be started as soon as the allottee comes to know of a misleading statement in the prospectus on the faith of which he had subscribed for shares and before the company goes into liquidation. Delay may defeat this right of the allottee.

Notice not enough. Where an allottee elects to rescind a contract on the ground of any fraudulent misrepresentation, a mere notice to the company to this effect is not enough. He must take effective steps for the rectification of register of members and removal of his name there from.

(1)Loss of right of rescission:

The right to rescind a contract induced by a fraudulent statement or withholding of some material fact is lost in the following cases:

(i) Affirmation. Where a shareholder, after discovering that he has a right to rescind, treats the contract as subsisting or does any act adopting the contract, he cannot afterwards rescind it. For example, he loses the right to rescind where, after discovering that he has the right to rescind, he-

(a) attempts to sell the shares ;

(b) executes a transfer

(c) pays calls or received dividends ;

(d)attends and votes at a general meeting of the company in person or by proxy.

(ii) Unreasonable delay. Where a shareholder who purchases shares from the company on the faith of a misleading prospectus, does not rescind it promptly, that is, within a reasonable time of his becoming aware of the fraud or misrepresentation giving him the right to rescind, he loses the right to rescind. A delay of 15 days in such circumstances was held to be too long and amounted to waiver of the right to rescind [193]

[193] *Scottish Petroleum Co., Re Wallace's Case*, (1883) 23 CH. D. 413

(iii) Winding up. Where the winding up of the company has commenced and the rights of the creditors of the company have intervened, the right of rescission is lost. But where the shareholder has started active proceedings to be relieved of his shares, the passing of the winding up order during their pendency would not prejudice his right of getting relief [194]

(2)Damages for deceit.

Any person induced by a fraudulent statement in a prospectus to take shares is entitled to sue the company for damages. He must prove the same matters in claiming damages for deceit as in claiming rescission of the contract. He cannot both retain the shares and get damages against the company. He must show that he has repudiated the shares and has not acted as a shareholder after discovering the fraud or misrepresentation.

2 Remedies against the directors, promoters and experts:

The persons who are liable to pay compensation for any loss or damage to subscribers for any shares or debentures on the faith of a prospectus containing untrue statements are the

(a) directors at the time of the issue of the prospectus ;
(b) persons who have authorized themselves to be named as directors in the prospectus;
(c) promoters ; and
(d) persons who have authorized the issue of the prospectus.

Their liability may be studied under the following heads :

(1)**Liability for damages for misstatement in prospectus** {Sec. 62).

Every director, promoter and every person who authorizes the issue of the prospectus (no matter whether he had seen it or not) is liable to pay compensation to the aggrieved party (who subscribes for any shares or debentures on the faith of the prospectus) for loss or damage he may have incurred by reason of any untrue statement in the prospectus.

Defences of directors, promoters, etc: A director etc. shall not be liable if he puts up the following defences :

[194] *Shiromani Sugar Mills Ltd. V. Debi Prasad, Supra*

(a) Withdrawal of consent. A director, etc., is not liable if he withdrew his consent before the issue of the prospectus and it was issued without his authority or consent.

(b) Absence of consent. Where a prospectus was issued without a director's, etc., knowledge or consent, and on becoming aware of its issue, he forthwith gave reasonable public notice of that fact, he is not liable.

(c) Ignorance of untrue statement. A director, etc., may sometimes by ignorant of the untrue statement contained in the prospectus. If after the issue of the prospectus and before allotment there under, he on becoming aware of any untrue statement therein withdrew his consent to the prospectus and gave reasonable public notice of the withdrawal and of the reasons therefor, he is not liable.

(d) Reasonable ground for belief. If a director, etc., has reasonable ground to believe that the statement was true and he, in fact, believed it to be true up to the time of allotment, he is not liable. But it is not enough for a director to say that he was honest; he has to show that his honest belief was based on reasonable grounds.

In Adams V. Thrift, [195]The directors of a company were sued for damages in respect of false statements in a prospectus. They, however, contended that they had relied on statements made to them by the promoters. Held, although the directors honestly believed the statements to be true they were liable as they had no reasonable grounds for believing the truth of the matter stated.

(e) *Statement of expert.* If the statement is a correct and fair representation or extract or copy of the statement made by an expert who is competent to make it and had given his consent and had not withdrawn it, the director, etc., is not liable. Likewise, if the statement is a correct and fair representation or extract or copy of an official document or is based on the authority of an official person, no liability attaches to the director, etc.

Right of contribution: Every person who becomes liable to make any payment under Sec. 62 may recover contribution from other guilty persons who are liable for fraudulent misrepresentation in the prospectus.

[195] (1951) 2 Ch. 21

Measure of damages: The principle for measuring damages is one of the general laws as contained in Sec. 73 of the Indian Contract Act, 1872. The measure of damages is the difference between what the shareholder paid for the shares and what they were worth when they were allotted to him.[196]

(2) Liability for damages for non-compliance with Sec. 56. The omission from the prospectus of a matter required to be included by Sec. 56 may give rise to an action for damages at the instance of a subscriber for shares who has suffered loss thereby, even if the omission does not make the prospectus false or misleading. The Act does not say that the directors, etc. will be liable, but this seems to be implied from Sec. 56 [4]. According to it, a director or other person responsible for the issue of a prospectus is not liable if-

(a) he is ignorant of the matter not disclosed ; or

(b) the non-compliance arises from an honest mistake of fact on his part ; or

(c) the non-compliance is not material, and the Court thinks he ought to be excused.

(3). Liability under the general law. Under the general law, a shareholder can hold all or any of the persons responsible for the issue of a prospectus liable for any misstatement or fraud on their or his part if he was actually deceived by reason of his having acted on the faith of the misstatement or fraud in the prospectus. According to Sec. 17 of the Indian Contract Act, 1872, 'fraud' means and includes, inter alia, the suggestion, as a fact, of that which is not true by one who does not believe it to be true and active concealment of a fact by one having knowledge or belief of the fact.

A person can only be liable in fraud in a prospectus where he makes a statement to be acted upon by others, which is false and is made-

(a) knowingly ;

[196] McConnell V. Wright, (1903) 1 Ch. 546

(b) without belief in its truth ; or

(c) recklessly, not caring whether it was true or false.

In *Derry V. Peek*, [197]The directors of a tramway company issued a prospectus containing a statement that by the Special Act incorporating it, the company had the right to work its trams by steam power instead of horses. In fact, the company had authority to use steam power with the consent of the authority. P took shares on the faith of the statement in the prospectus. The authority refused its consent and the company was wound up. P sued the directors in fraud for damages. Held, the directors were not liable in fraud because they honestly believed what they said in the prospectus to be true.

The remedy under general law is also available-

(a)where the right of rescission as against the company is lost either through laches or negligence, and

(b) where the company goes into liquidation.

4.3.15 Criminal Liability:

Where a prospectus contains any untrue statement, every person who authorized the issue of the prospectus is punishable with imprisonment which may extend to 2 years, or with fine which may extend to Rs. 50,000 or with both. He will not be liable if he proves either-

(1) that the statement was immaterial, or

(2) that he had reasonable ground to believe that the statement was true (Sec. 63).

The punishment for issuing an application for shares or debentures that is not accompanied with a memorandum containing salient features of a prospectus is a fine which may extend to Rs. 50,000 [Sec. 56 (3)].

Penalty for fraudulently inducing persons to invest money (Sec. 68): A person shall not (i) either knowingly or recklessly by making any statement, promise or forecast which is false,

[197] (1889) 14 App. Cas. 337

deceptive or misleading, or (ii) by any dishonest concealment of material facts, induce or attempt to induce another person to enter into or to offer to enter into any of the following agreements, namely, :

(a) An agreement for acquiring, disposing of, subscribing for, or underwriting shares or debentures;

(b) An agreement to secure a profit to any of the parties from the yield of shares or debentures, or by reference to fluctuations in the value of shares or debentures.

If he does any of the above things, he shall be punishable with imprisonment for a term which may extend to 5 years, or with fine which may extend to Rs. 1, 00,000, or with both.

Sec. 68 is expected to serve as a sufficient deterrent to unscrupulous company promoters against making untrue and deceptive statements in a prospectus with a view to obtaining capital from the public.

Issue and allotment of shares in fictitious names (Sec. 68-A)

A person shall be punishable with imprisonment for a term which may extend to 5 years if he-

(1) Makes in a fictitious name an application to a company for acquiring, or subscribing for, any shares therein, or

(2) Otherwise induce a company to allot, or register any transfer of shares therein to him, or any other person in a fictitious name.

These provisions shall be prominently reported in every prospectus issued by the company and in every form of application for sharers which is issued by the company to any person.

4.4. sUMMARY

The articles of association of a company are its bye – laws or rules and regulations that govern the management of its internal affairs and the conduct of its business. The articles define the powers of its officers. They also establish a contract

between the company and the members and between members *inter se.*

In order to finance its activities, a company needs capital which is raised by a public company by the issue of a prospectus inviting deposits or offers for shares and debentures from the public. A private company is prohibited from making any invitation to the public to subscribe for any shares in, or debentures of, the company. Hence it need not issue a prospectus.

The central theme of a prospectus, from the money raising point of view, is that it sets out the prospects of the company and the purpose for which the capital is required. The prospectus is the basis on which the prospective investors form their opinion and take decisions as to the worth and prospects of the company.

When a company does not invite public for the subscription of the shares and its promoters are confident to raise the capital through their contacts, it need not issue the prospectus. In such case the company is required to file a statement in lieu of prospectus to the registrar of companies.

4.5. SUGGESTED READINGS/ REFERENCE MATERIAI

1. Avtar singh : Company Law
2. Taxman : Company Law
3. N.D.Kapoor : Elements of Company Law
4. Kailash Rai : Company Law
5. Gower,L.C.B. : Principles of Modern company Law

4.6. self assessment questions

1. What are the 'article of association'? How can they be altered? Discussed the limits upon the powers of the company to alter or add to the article of association?
2. Discuss the binding effect articles of association when registered on the shareholders & outsiders?

3. “Doctrine of indoor management is a silver line to strangers dealing with the company.” Comments.
4. What do you mean by ‘Prospectus’? Also discuss the contents of the Prospectus.
5. Who are liable for misstatements in a prospectus? Explain the extent of civil and criminal liability for such misstatements.
6. Write short notes on the following:
   (a) Statement in lieu of Prospectus.

   (b) Shelf Prospectus.

LL.M. Part-1
PAPER CORPORATE LAW

Block II – Director And Managerial Personal
Unit 5- Position, Appointment, Qualifications and Disqualifications, Removal, Power and Duties, Liabilities, Remuneration, Nominee Director, Managing Director, Manager etc.

STRUCTURE

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5.6. Self Assessment Questions

5.1. Introduction:

A company is an artificial person having existence only in contemplation of law and as such it cannot act in its own person. Therefore there must be some human agency to carry on the company's business. Commenting on this, Viscount Haldane L.C. in *Lennard's Carrying Co. Ltd* v. *Asiatic Petrolium Company Ltd,*[198] *inter-alia* observed :

"A corporation is an abstraction. It has no mind of its own any more than it has a body of its own; its active and directive will must consequently be sought in the person of somebody who for some purposes may be called an agent, but who is really the directing mind and will of the corporation, the very ego and centre of the personality of the corporation."

The invisible and intangible nature of a company makes it obligatory for this corporate body to appoint some living person or persons through whom it may act and carry on its business. Such persons are usually called 'directors' of the company. Section 2 (13) of the Companies Act, 1956 defines the term 'director' as any person occupying the position of director by whatever name called. This obviously means that a director is to be recognised by his function.

The directors of a public company need not necessarily be experts in the type of business which company is promoting. A company's Board of Directors may, however, consist of persons specialised in different branches of business administration such as accounts, finance, law, banking, management etc., including a few experts in the field of company's business. Thus it was pointed out In Re *City Equitable Fire Insurance Co.,*[199] "a Director of a Life Insurance Company does not guarantee that he has the skill of an actuary or a physician".

5.2. Objects:

Section 252 of the Companies Act, 1956 requires that every public company shall have at least three directors and every private company shall have at least two directors. Efficient and skillful management of the company is of utmost need. In this lesson an attempt has been made to discuss management of companies, Directors and other managerial personnel with the help of statutory laws and the relevant case laws.

5.3.1 Definition [Sec. 2 (13)]

[198] (1915) AC 705 (713)
[199] (1925) Ch 407 (428)

'Director' includes any person occupying the position of director, by whatever name called. The important factor to determine whether a person is or is not a director is to refer to the nature of the office and its duties. It does not matter by what name he is called. If he performs the functions of a director, he would be termed a director in the eyes of the law even though he may be named differently. A director may, therefore, be defined as a person having control over the direction, conduct, management or superintendence of the affairs of a company. Again, any person in accordance with whose directions or instructions, the Board of directors of a company is accustomed to act is deemed to be a director of the company. But such a person shall not be deemed to be a director if the Board acts on advice given by him in a professional capacity.

Only individuals can be directors (Sec. 253)

No body corporate, association or firm can be appointed director of a company. *Only* an individual can be so appointed. The idea behind this *is* that as the office of a director is to some extent an office of trust, there should be somebody readily available who can be held responsible for the failure to carry out the trust.[200]

5.3.2 Director Identification Number

Companies (Amendment) Act, 2006 has introduced provisions with respect to Director Identification Number (DIN) w.e.f. 1.11.2006. For the purpose, Section 253 has been amended and seven new sections, namely, Sections 266A, 266B, 266C, 266D, 266E, 266F and 266G, have been added.

Newly inserted proviso to Section 253 makes it obligatory for companies to ensure that directors have been allotted Director Identification Number (DIN) as required under newly inserted Section 266B of the Act. The said proviso requires that fresh appointment of any individual as director of the company cannot be made unless such an individual has been allotted DIN. Similarly, it requires that companies cannot re-appoint its director unless he has been allotted DIN.

The Central Government has notified the Companies (Director Identification) Rules, 2006. It has appointed 1-11-2006 as the date on which the provisions of these rules shall come in force. The Central

[200] *Oriental Metal Pressing Works (Pvt.) Ltd.* v. *B.K Thakoor,* (1961) 31 Comp. Cas. 143 (S.C)

Government has also issued and notified Forms DIN-1, DIN-2, DIN-3, and DIN-4.
DIN Form 1: Application for allotment of DIN.
DIN Form 2: Director is to intimate his DIN to the company or all
DIN Form 3: Company is to intimate DIN to Registrar within one week of receipt from the Director.
DIN Form 4: Changes in the particulars of a Director are to be filed within 30 days of change. The central Government has delegated its powers and functions in respect of allotment of DIN under Sections 266A and 266B to the Regional Director, Joint Director, Deputy Director or Assistant Director posted in the office of Regional Director, Northern Region.
Only a single DIN is required for an individual irrespective of number of directorships held by him. All the directorships of an individual would be mapped in the database through that DIN. No individual, who has already been allotted a DIN, shall apply, obtain or possess another DIN (Section 266C) DIN is also mandatory for directors of Indian companies who are not citizens of India. But, DIN is not mandatory for directors of foreign companies having branch offices in India.

The provisions and rules regarding DIN are set out as under:

(a) No company shall appoint or reappoint any individual as director of the company unless he has been allotted a Director Identification Number (DIN) (proviso to Section 253).
(b) Every existing director shall, within one month of the receipt of DIN from the Central Government intimate his DIN to the company or all companies wherein he is a director. Intimation to company(ies) from Director shall be in Form DIN-2. (Section 266D).
(c) Companies, in turn, are required to file Form DIN-3 for sending intimation of DIN to the Registrar of Companies (online through 21 portal MCA) within one week of the receipt of intimation from directors (Section 266E).
(d) For incorporating any changes in the personal particulars of a Director, including his address, after he has submitted the information initially in Form DIN-1 or in the event of change in his particulars after allotment of DIN, an intimation is required to be sent by the director to the Central Government in Form DIN-4. Form DIN-4 is required to be filed within 30 days of the change, in manual mode as in the case of Form DIN-1.
(e) Every individual or director or the company, as the case may be, who or which, is in default, shall be punishable with fine upto Rs. 5,000 and where the contravention is a continuing one, with a

further fine up to Rs. 500 for every day after the first day from which the contravention continues (Section 266G).[201]

5.3.3 Number of Directors:

Minimum number (Sec. 252). Every public- company (other than a deemed public company) shall have at least 3 directors and every other company [e.g. a, private company, a deemed public company) at least 2 directors.

A public company having—

(a) a paid-up capital of Rs. 5 crore or more ;

(b) one thousand or more small shareholders, may have a director elected by such small shareholders in the manner as may be prescribed.

"Small shareholders" means a shareholder holding shares of nominal value of Rs. 25,000 or less in a public company to which Sec. 252 applies.

Increase or reduction in number of directors (Sec. 258): Subject to the statutory minimum limit, the Articles of a company may prescribe the maximum and minimum number of directors for its Board of directors. The number so fixed may be increased or reduced within the limits prescribed by the | Articles by an ordinary resolution of the company in general meeting. If the number falls below the minimum, *prima facie* the Board cannot act [202] unless the Articles allow it to act notwithstanding vacancies.

Article 75 of Table A provides that if the number of directors is reduced below the quorum fixed by the Act for a meeting of the Board, the continuing directors, or director may act for the purpose of increasing the number of directors to that fixed for the quorum or of summoning a general meeting of the company but for no other purpose. A third party who has no notice of such an irregularity is not affected by it, unless he has a notice of the irregularity[203]

Sanction by the Central Government (Sec. 259): Any increase in number of directors beyond the maximum permitted by the Articles shall be approved by the Central Government. But where the increase in number

[201] Companies (Amendment) Act, 2006 has introduced provisions with respect to Director Identification Number (DIN) w.e.f. 1.11.2006.

[202] *Alma Spinning Co., Re* (1880) 16 Ch. D. 681

[203] *Rule in Royal British Bank v. Turquand,* (1856) 6 E. and B. 327; *British Asbestos Co. v. Boyd ,* (1903) 2 Ch. 439.

does not make the total number of directors more than 12, no approval of the Central Government is needed.

5.3.4 Appointment of Directors:

It may be reiterated that only individuals *i.e.* natural living person can be appointed as the directors of a company and as such no body corporate, association or firm can be appointed as director of a company. Explaining the reason as to why only an individual can be appointed as a director, the Supreme Court in *Oriental Metal Pressing Works (P.) Ltd.* v. *Bhaskar Kashinath Thakre,*[204] observed that the office of a director is to some extent an office of trust, therefore there should be somebody who can be held responsible for the failure to carry out the trust and it might be difficult to fix that responsibility if the directors were a company or an association or a firm. It is for this very reason that Section 312 prohibits assignment of the office by a director[205].

1. **Appointment of First Directors [Section 254]**

Directors play a crucial role in the management of a company. Therefore it is highly desirable that only the persons of proven ability and integrity should be appointed as directors of a company[206]. The Companies Act contains elaborate provisions relating to appointment of directors so as to ensure that management of the company does not go into the hands of unscrupulous persons.[207]

The first directors of a company are usually appointed by the subscribers of the memorandum. In case they do not appoint any directors, all the subscribers who are individuals and signatories to memorandum, become directors of the company. They, however, hold office only upto the date of the first annual general meeting of the company in which subsequent directors are appointed as provided by Section 255 of the Companies Act. The first directors so retiring at the first general meeting of the company may, however, be re-appointed as directors.

No person shall, however, be capable of being appointed as the first director of a public company having a share-capital unless he has—

(i) signed and filed with Registrar of Companies, a consent in writing to act as such director; and

[204] AIR 1961 SC 573.
[205] Sec.204 prohibits appointment of firms etc. to any office of profit in a company.
[206] Indians States Bank Ltd. V. Sardar Singh, AIR 1934 All 855.
[207] Secs. 202 & 203 of the Companies Act, 1956

(ii) signed the memorandum for his qualification shares, if any, or taken qualification shares from the company and paid or agreed to for them; or

(iii) signed and filed with the Registrar a written undertaking to take qualification shares from the company, if any, and pay for them; or

(iv) filed with the Registrar an affidavit to the effect that his qualification shares are registered in his name.

2. Appointment of Directors by the Members in General Meeting [Section 255]

Section 255 of the Act provides for appointment of directors of a public company and a private company by the members in its annual general meeting. In the case of a public company and a private company which is a subsidiary of a public company, out of the total number of directors only one-third can be permanently appointed.[208] The office of rest of them *i.e.* two-thirds, must be subject to retirement by rotation. At each annual general meeting one-third of these two-third directors who are subject to retirement by rotation must retire.[209] The retiring directors are, however eligible for re-appointment.[210] This provision is intended to obviate the possibility of self-perpetuating mismanagement.

The rotational retirement of directors is decided on the basis of length of period they have been in office. The directors who have been in office longest since their last appointment shall be liable to retire first. If two or more persons become director on one and the same date, the question of their retirement shall be settled by lots unless there is any mutual agreement between them.

The vacancies of directors created by retirement should be filled up in the same meeting either by re-appointing the retiring director or some one else. The general meeting may, however, decide that the vacancies shall not be filled up. If this has not been done, the meeting shall stand adjourned for a week. If no fresh appointments are _made in the adjourned meeting also, nor is there any resolution against appointment, the retiring directors shall be deemed to have been re-appointed except in the following cases :—

(i) Where the appointment of a particular director was put to vote but the
resolution was lost;

[208] The articles of a company may, however, provide for all the directors to be rational and none of them being permanent.

[209] Sec. 256 (10) if the number is not 3 or a multiple of 3, then no nearest to one third shall retire.

[210] *Sarker J. in oriental pressing Metal Works v. Bhaskar*, AIR 1961 SC 573.

(ii) Where the retiring director has expressed in writing his unwillingness to be re-appointed;

(iii) Where he is not qualified or is disqualified for appointment; and

(iv) Where a special or ordinary resolution is necessary for his appointment.

In case the annual general meeting of the company is held in accordance with Section 166 (1) of the Companies Act, the terms of office of those directors who are to retire by rotation at the meeting shall last only upto the date on which the meeting should have been held. The Delhi High Court in *B. R. Kundra* v. *Motion Pictures Association,*[211] has held that director cannot prolong their tenure by not holding the annual general meeting in time. They shall automatically retire from office on expiry of the maximum prescribed period within which the meeting ought to have been held.[212] If no directors are left in office, then the Company Law Board has the power of calling the meeting to appoint directors and this will be extraordinary general meeting of the company.

The general meeting for this purpose means the meeting which is validly called and is capable of taking a decision but which does not expressly take a decision on filling up a vacany caused by the retirement of a director. It was held in *Cardamom Marketing Co Ltd.* v. *Krishna Iyer*[213]. that where a meeting is adjourned for want of quorum as it cannot transact any business and no decision is taken at the adjourned meeting regarding the reappointment of director, the director is not deemed to have been re-appointed in terms of Section 256 (4) (b) of the Companies Act.

Where a director retiring by rotation is also holding the office of managing director, the latter office shall go with the former, but expiry of the term or removal from managing directorship, does not automatically result into cessation of his office as a director.[214]

When it is proposed to appoint a new director in place of a retiring director, the procedure prescribed by Section 257 must be followed. A notice in writing for this appointment should be left at the registered office of the company at least fourteen days before the date of meeting along with a deposit of rupees five hundred which is refundable after the candidate gets elected as a director.[215] The company is required to give information to the members at least seven days before the meeting about the candidature. This information can be given by the company either through a personal notice to all the

[211] (1976) 46 Comp Cas 339 (Del.)

[212] *Colaba Land & Mills Co. Ltd. V. Vasant Investment Co. Ltd*. AIR 1953 Mad. 467

[213] (1982) 52 Comp. Cas 299 (Ker).

[214] *Swapan Das Gupta v. Navin Chand Suchant*, (1988) 64 Comp. Cas 562 (cal).

[215] Sec. 45 of the Companies (Amendment) Act, 1988

members or by an advertisement in any two local newspapers one of which should be in English while the other in the regional language.[216]

Voting on Director's Appointment [Section 263]

The appointment of every director in a public company or in its subsidiary must be made by ordinary resolution at the general meeting. It therefore follows that candidates cannot be put to vote *en bloc,* but each candidate must be voted on individually.[217] If two or more directors are appointed by a single resolution, such an appointment would be void.[218] But if meeting has unanimously so resolved, more than one person may be elected by a single resolution. In such a case it shall be necessary first to pass a resolution authorizing their appointment without even a single dissenting vote. These provisions are not applicable to private companies which are not subsidiaries of public companies. Such private companies may, therefore, appoint their directors *en bloc* or in any other manner.

Section 264 of the Act provides that a person who has been appointed as a director for the first time is required to file with the Registrar within thirty days of his appointment, a written consent to act as a director.

Appointment by Proportional Representation [Section 265]

It must be reiterated that the basic method for appointment of directors is election by simple majority of the shareholders. There is, however, one serious defect in this method that a substantial minority cannot succeed in placing even a single director on the Board. Section 265, therefore, enables the minority to place their representatives on the Board by means of proportional representation. The system is also known as cumulative voting system.

The proportional representation may be achieved either through a system of single transferable vote or by cumulative voting or in any other manner. The principle of cumulative voting may be applied in respect of all or at least 2/3rd of the total number of directors.

Under this system, a member has as many votes as there are candidates to be elected as directors. He may give all his votes to one single candidate or opt to distribute them among the candidates in the manner he likes. In the case of single transferable voting system, the member indicates his preferences amongst the various candidates by indicating his choices *i.e.* first, second and third so on.

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[216] Sec. 257 (1a) Proviso.

[217] Sec 263-A – A exempts from these provisions a company which does not carry on business for profit or which prohibits the payment of dividend to its members.

[218] *Raghunath Swarup Mathur v. Dr. Raghuraj Bahadur*, (1966) 2 Comp. LJ 100

The system of proportional representation can be followed only if the articles provide for it. The appointments under this system are made once in every three years and the directors so appointed cannot be removed under Section 284 which contains provisions relating to the removal of directors.[219]

3. Appointment of Directors by the Board

Subject to the provisions of articles, the Board of Directors has the powers regarding the appointment of directors in the following cases :

(a) The appointment of Additional directors.
(b) Appointment of Alternate directors.
(c) To fill in casual vacancies.

Additional Directors [Section 260]

The Board of Directors may if the articles so authorise, appoint additional directors provided that the total number of directors shall not exceed the maximum limit fixed by the articles. Such additional directors shall hold office only upto the date of the next annual general meeting.

Alternate Directors [Section 313]

An alternate director is one who is appointed to act in place of a director who is absent from the State in which the meetings of the Board are held ordinarily, for a period of not less than three months. The Board may appoint an alternate director in his place if so authorised by the articles or by a resolution passed by the company in its general meeting.

An alternate director shall *ipso facto* vacate office as and when the original director returns to the State in which the meetings of the Board are generally held. He is not entitled to hold office as such for a period longer than that permissible to the original director in whose place he was appointed. If the tenure of office of the original director terminates before his return to the State, the alternate director shall cease to be a director and the provisions of the Act relating to automatic re-appointment of retiring directors, in absence of another appointment will apply to the original director and not to the alternate director. Thus the original director and not the alternate director shall be deemed to be reappointed.

Casual Vacancy [Section 262]

Sometimes the director appointed by the general meeting may resign or a vacancy may arise on account of his death or due to some other reason. In such a situation, the Board may appoint a director to fill a casual vacancy subject to the provisions made by the company in this regard in its articles. Such a director shall hold office until such time the original

[219] For details See: Ved Parkash Juneja on "*Proportionate Representation on Board of Companies*", (1962) 2 Comp LJ 29

director, in whose place he is appointed, would have held the office had he not vacated the office before the expiry of his term.[220] This provision does not apply to a private company unless it is a subsidiary of a public company.

A casual vacancy once filled up if falls vacant again, the resulting vacancy for the second time cannot be regarded as a casual vacancy and, therefore, cannot be filled under this section. Such a subsequent appointment, if made, shall be considered only as that of an additional director.

A vacancy caused by death, resignation or failure to accept the directorship on being elected, would be considered as a casual vacancy, but not the one caused due to retirement by rotation.

The Board's power to fill casual vacancy has occasionally resulted into a conflict between the general meeting and the Board as evident from the case of *Vishwanathan* v. *Tiffins B. A. & Co. (P) Ltd.*[221] In this case the articles of the company authorised the Board to fill casual vacancy and also increase the number of directors within the maximum permissible limit. There occurred some casual vacancies which were promptly filled at the general meeting of the shareholders. The Board challenged this action of the company on the ground that once the power to fill casual vacancies had been delegated to the Board, it could not have been exercised at a general meeting.

Justice Venkatarama Iyer upheld the appointment made at the general meeting and observed that it is true that once power is delegated to the Board, such delegation shall be binding on the shareholders *i.e.* the company but if there is no legally constituted Board or the Board is unable or unwilling to function, then the authority delegated to the Board lapses and the members can exercise the right inherent in them through its general meeting. Since there was no director validly in the office at the time of general meeting, therefore the members had every right to fill the casual vacancy at its general meeting.

The Privy Council had expressed a similar view earlier in the case of *Ram Kissendas* v. *Satya Charan,*[222] wherein their Lordships held that the articles may delegate the power of appointing new directors to the Board to the exclusion of the general meeting.

[220] Sec. 262
[221] AIR 1953 Mad 520.
[222] AIR 1950 PC 81

In *Needle Industries (India) Ltd.* v. *Needle Industries Newey (India) Holding Ltd?*[223] the Supreme Court held that if the power of appointing additional directors is delegated to the Board by the articles, the Board can appoint additional directors without taking this item on the agenda of its meeting.

4. Appointment of Directors by the Central Government [Section 408]

Section 408 of the Companies Act provides that on application (petition) of not less than one hundred members of the company or of members holding not less than one-tenth of the total voting power therein, the Central Government may if satisfied after making an enquiry that it deems it necessary to prevent the affairs of the company being conducted in a manner which is prejudicial to the interests of the public or the company, appoint such number of persons as the Company Law Board[224] may, by order specify in writing, to hold office as directors thereof for such period, not exceeding three years on any one occasion.

The directors appointed by the Central Government under Section 408 need not be the members of the company. The Government Directors may be required to keep the Government informed about the affairs of the company. [225]They shall not be required to hold qualification shares nor be liable to retire by rotation. But they can be removed by the Central Government at any time or substituted by other persons appointed in their place.

The powers conferred by Section 408 of the Act on the Central Government are extra-ordinary powers which should be invoked only in genuine cases where the Central Government is satisfied that the affairs of the company are being grossly mis-managed or its minority-shareholders are being unduly oppressed and a remedial action is needed. The company should be given an opportunity of being heard before directors are appointed by the Central Government.

After the Central Government has appointed directors or additional directors under Section 408, no change in the company's Board of Directors shall have any effect unless it is confirmed by the Central Government.[226] Alternatively, the Central Government may direct the company to alter its articles so as to arrange for the election of its directors on the basis of proportional representation.[227]

[223] AIR 1981 SC 1298
[224] Sec.53 of the Companies (Amendment) Act, 1988
[225] Sec. 408 (7)
[226] Sec. 408 (5)
[227] Sub – sections (1) & (2) substituted by Companies (amendment) Act, 1988 we from 31-5-91

It must, however, be pointed out that the power of the Central Government to appoint directors as the Company Law Board may direct, under Section 408 is subject to limitations mentioned in the section itself. Since the exercise of this power seriously affects the reputation and credibility of the company's management, it must be exercised sparingly only when the requisite conditions are fully complied with. The power cannot be exercised in an arbitrary manner.[228]

The Relief Undertaking Special Provisions Acts of some States also provide that the State Government shall have power to appoint directors when the relief undertaking protection is granted to them.

Section 409 of the Act empowers the Company Law Board to prevent change in Board of Directors of a company which is likely to affect the company prejudicially. When a complaint[229] is made to the *Company Law Board* by the managing director or any other director or manager of a company that as a result of change which has taken place or is likely to take place in the ownership of any shares held by the company, a change in Board of Directors is likely to take place which, if allowed, would affect the company adversely, the Company Law Board, may if satisfied, order an inquiry as it thinks fit and direct not to effect any change in the Board of Directors unless confirmed by the Company Law Board. The Company Law Board may make an interim order to this effect before completing the inquiry[230] if it deems it necessary to do so. But the provisions of Section 409 shall not apply to a private company, unless it is a subsidiary of a public company.[231]

5. Appointment of Directors by Third Parties / Nominee Directors

Section 255 of the Companies Act permits one-third of the total number of directors of a public company or a private company which is a subsidiary of a public company, to be appointed on a non-rotational basis, in the manner provided in the articles.

The articles may confer right on the debenture-holders, financial institutions or banking companies who have advanced substantial loans to the company to nominate directors on the Board of the company. The number of directors so nominated shall not, however, exceed one-third of

[228] *South India Viscos Ltd. V. Union of India,* (1982) 52 Comp. Cas 242 (Del.)
[229] The complaint is to be made in prescribed Form No. 35-B of the Companies (Central Govt.'s), General Rules and forms, 1956
[230] Sec. 409 (2)
[231] Sec. 409 (3)

the total strength of the Board of Directors. They shall not be liable to retire by rotation.

Such nominee-directors are generally appointed to protect the interests of the controlling agencies. Though the Companies Act has not specifically defined the term "nominee directors" but it is common practice that the companies usually provide for the appointment of nominee directors in their articles of association.

The nominee directors appointed by the Industrial Finance Corporation of India, Industrial Development Bank of India etc. are outside the purview of the provisions of the Companies Act as these institutions are created under special statutes.

Appointment of whole-time Director or Managing Director requires approval of the Central Government [Section 269]

After the commencement[232] of the Companies (Amendment) Act, 1988 no appointment of a person as a managing director or whole-time director or a manager in a public company or a private company which is subsidiary of a public company shall be made except with the approval of the Central Government unless such appointment is made in accordance with the conditions specified in Parts I and II of Schedule XIII and a return in the prescribed form[233] is filed within ninety days from the date of such appointment.[234]

Before giving approval to an appointment as specified above, the Central Government shall satisfy itself that (1) the person proposed to be appointed as managing director/whole-time director/manager is a fit and proper person, (2) such an appointment is in the interest of the company and (3) the terms and conditions of the appointment are fair and reasonable.[235]

5.3.5 Qualifications And Disqualifications Of Directors:

A director must—

(a) be an individual,

(b) be competent to contract, and

(c)hold a share qualification, if so required by the Articles.

Share qualification of directors (Sec. 270)

The Companies Act nowhere requires the holding of share qualification by a director. The Articles of a company may require every director to hold a

[232] W.e.f. 15-6-1988

[233] Prescribed Form No. 25 c vide GSR 694 (E) dt. 10-6-88

[234] Sec. 269 (3) inserted by Companies (Amendment) Act, 1988 vide Sec.46.

[235] Sec. 269 (4) (a) & (b).

specified number of shares known as *qualification shares.* Article 66 of Table A specifically lays down that "the qualification of a director shall be the holding of at least one share in the company." The object of provisions relating to share qualification of persons to act as directors is to ensure that they have a personal interest in the company. But the fact is that qualification holding is so small as to make little difference to the acts of a director.

When a person accepts an appointment as director of a company knowing that the holding of a certain number of shares in it (as required by the Articles) is a necessary qualification and acts as a director, he is deemed to have contracted with the company that he will within 2 months of his appointment obtain the qualification shares. This he may do either by transfer of shares from the existing shareholders or by purchase from the company itself directly. But he should not obtain shares by way of gift from a promoter[236] as this would amount to breach of The holding of shares jointly with another constitutes sufficient qualification [237] unless the Articles require sole holding. Holding of shares by a firm in which the director is a partner has also been held to be sufficient.[238]

Any provision in the Articles of a company requiring a person to hold the qualification shares before his appointment as a director or to obtain them within a period shorter than 2 months shall be void. The nominal value of the qualification shares shall not exceed Rs. 5,000, or the nominal value of one share where it exceeds Rs. 5,000.

The bearer of a share warrant shall not be deemed to be the holder of the shares for the purpose of share qualification of a director.

Penalty (Sec. 272). If a director fails to acquire his qualification shares within 2 months of his appointment, he shall be punishable with fine which may extend to Rs. 500 for every day between such expiry and the last day on which he acted as a director.[239]

Disqualifications of Directors (Sec. 274)

The following persons are disqualified for appointment as directors of a company :

(a) A *person of unsound mind*

(b) An *undischarged insolvent.*

[236] *Eden* v. *Ridsdales Rly. Lamp Co. Ltd.,* (1899) 23 Q.B.D. 368
[237] *Grundy* v. *Briggs,* (1910) 1 Ch. 444
[238] *Spencer* v. *Kennedy,* (1926) Ch. 125
[239] *Zamir Ahmed Raz* v. *D.R. Banaji,* (1957) 27 Comp. 634

(c) A person who has applied to be adjudicated as an *insolvent* and his application is pending.

(d) A person who has been *convicted* by a Court of any offence involving moral turpitude [say conviction under the Foreign Exchange (Regulation) Act, 1973 and sentenced in respect thereof to imprisonment for not less than 6 month], and a period of 5 years has not elapsed from the date of expiry of the sentence.

(e) A person whose *calls* in respect of shares of the company held for more than 6 months have been in arrear.

(f)A person who is *disqualified* for appointment as director by an order of the *Court* under Sec. 203 (which deals with power of the Court to restrain fraudeulent persons from managing companies) on the ground of fraud or misfeasance in relation to the company.

(g) such person is already a director of a public company which—

(A) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April. 1999 ; or

(B) has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more.

Moreover, such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public company, in which he is a director, failed to file annual accounts and annual returns under sub-clause (A) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in clause (B). [This clause has been introduced by the Companies (Amendment *Act,* 2000].

The disqualifications mentioned in Clauses (d) and (e) may be removed by the Central Government by notification in the Official *Gazette.*

A private company which is not a subsidiary of a public company may, its Articles, provide that a person shall be disqualified for appointment as **a** director on any additional grounds.

A director who has been removed from office by the Central Government shall not be a director of any company for a period of 5 years from the date of removal.

5.3.6 Director's position in a company:

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. *Leis Air Framing Ltd.*[240] 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*[241]*,* the position that the directors occupy in a corporate enterprise is not easy to explain. In realities, 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 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 are the brain and the only brain of the company, which is the body and the company can and does act only through them[242]. Thus, the board of directors represent the mind or will of the company.

[240] (1961) AC 12 (PC)
[241] A.I.R. 1966 S.C. 1899
[242] *Bath* ***v.*** *Standard Land Co*. (1910) 2 Ch. 408.

"When the brain functions the corporation is said to function."[243] The Calcutta High Court in *Gopal Khaitan* v. *State,*[244] 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 who have authorities to sign contracts on behalf of the company and also liable for the entire machinery of the corporate body.

Lord Justice Denning rightly said in *Bolton (Engineering) Co. Ltd.* v. *Graham & Sons*[245] *:—*

"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 will 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." Thus, it was held that it is sufficient to show that the board of directors is the mind of a corporate body indeed.

Directors as agents of corporate body:

It is 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*[246]*,* 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 LJ**.** said—

"Directors arc 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

[243] *State Trading Corporation v. CTO* , A.I.R. 1963 S.C. 1811
[244] A.I.R. 1969 Cal. 132.
[245] (1957) 1 Q.B. 159 C.A.
[246] (1866) 2 Ch. 77.

no personal liability, if they acted within the scope of their authority while entering into a contract on behalf of the company. 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*[247]*.,* 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 director 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 arc 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*[248]*.* 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*[249] 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*[250]*.,* 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.[251]

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 entrusts 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

[247] A.I.R. 1938 P.C. 159.
[248] (1869) 8 E.Q.376.
[249] (1953) 16 Beav. 485
[250] (1966) 1 Comp. L.J.107 Mad.
[251] Percival v. Wright, (1902) 30 Mad. L.R. 34

of directors are not the same as the duties of trustees. According to Romer J. in *Re, City Equitable Fire Insurance Co. Ltd.*[252]

"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 duly 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[253]

5.3.7 Removal of Directors:

Directors may be removed by—

1. the shareholders,
2. the Central Government,
3. the Company Law Board,

1. Removal by shareholders (Sec. 284). The shareholders may remove a director before the expiry of his period of office by passing an ordinary resolution. This does not, however,

(A)apply to the case of a director appointed by the Central Government under Sec. 408 (which deals with powers of the Central Government to prevent oppression or mismanagement).

(a) authorise, in the case of a private company, removal of a director holding office for life on April 1, 1952.

(b) apply to the case of a company which has adopted the system of electing 2/3rds of its directors by the principle of proportional representation.

The shareholders cannot be restrained from calling a general meeting to remove existing directors and appoint new directors.[254]

[252] (1925) Ch. 407

[253] G.E.Railway v. Turner, (1972) 8 CH.149.

[254] *Life Insurance Corpn. ofIndia* v. *Escorts Ltd.,* (1986) 59 Comp. Cas. 548 (S.C.)

Special notice. A special notice shall be required of any proposed resolution to remove a director or to appoint somebody instead of a director so removed at the meeting at which he is removed. On receipt of notice, the company shall forthwith inform the members of the proposed resolution. It shall forthwith send a copy thereof to the director concerned. The director (whether or not he is a member of the company) shall be entitled to be heard on the resolution at the general meeting.

Right of the director to make representations. When notice is given of a resolution to remove a director, the director concerned has a right to make representations in writing (not exceeding a reasonable length) to the company He may also request that these representations be notified to the members of the company. On being so notified, the company shall—

(a) state the fact of the representations having been made in any notice of the resolution given to the members of the company ; and

(b) send a copy of the representations to every member of the company whom notice of the meeting is sent (whether before or after receipt of the representations by the company).

If a copy of the representations is not sent as aforesaid because they are received too late or because of the company's default, the director may (without prejudice to his right to be heard orally) require that the representations shall read out at the meeting.

Representations not to be sent where Central Government is satisfied. The company or any other person who feels aggrieved may apply to the NCLT that the copies of representations need not be sent out and they need not be read out at the meeting. If the Central Government is satisfied that the right of representation is being abused to secure needless publicity for defamatory matter, it may order that copies of representations need not be sent out and representations need not be read out at the meeting.

Vacancy. *A* vacancy created by the removal of a director may be filled up in the same meeting provided special notice of the proposed appointment was also given. The successor can hold office until the date up to which his predecessor would have held office if he had not been removed. If the vacancy is not filled at the meeting, the Board may fill it as a casual vacancy provided the director who has been removed is not appointed.

Compensation. Sec. 284 does not deprive a director who is removed of any compensation or damages payable to him in respect of the termination of his appointment as director or any appointment (for example that of managing director) terminating with that as director.

2. **Removal by Central Government** (Sees. 388-B to 388-E). The Central Government may, in certain circumstances, remove managerial personnel from office on the recommendation of the Tribunal.

Case to be made out against the managerial personnel (Sec. 388-B). The Central Government may state a case against the managerial personnel of a company and refer the same to the Tribunal with a request that the Tribunal may inquire into the case and record a finding whether he is a fit or proper person to hold the office of director or any other office connected with the conduct and management of the company. The Central Government may exercise this power where in its opinion there are circumstances suggesting—

(a) that any person concerned in the conduct and management of the affairs of the company is or has been guilty of fraud, misfeasance, persistent negligence or default in carrying out his obligations and functions under the law, or breach of trust ; or

(b) that the business of the company is not or has not been conducted and managed by such person in accordance with sound business principles or prudent commercial practices ; or

(c) that the company is or has been conducted and managed by the person concerned in a manner which is likely to cause, or has caused, serious injury or damage to the interest of the trade, industry or business to which such company pertains ; or

(d) that the business of the company is or has been conducted and managed by the person concerned with intent to defraud its creditors, members or any other person or otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest.

The person against whom a case is presented shall be joined as a respondent to the application. The application made by the Central Government to the shall contain concise statement of the circumstances and materials as the Central Government may consider necessary for the purpose of the inquiry.

Interim *order by the NCLT* (Sec. 388-C). The Tribunal may on the application of the NCLT or on its own motion, by an interim order, direct that the respondent shall not discharge any of the duties of his office until further orders of the NCLT. It may also appoint a suitable person in place of the respondent to discharge the duties of the office held by the respondent subject to such terms and conditions as it may specify in the order. Every such person shall be deemed to be a public servant.

Removed person not to hold office for 5 years (Sec. 388-D and 388-E). At the conclusion of the hearing of the case, the NCLT shall record its

findings .Sec. 388-D). If the finding of the NCLT is against the director, the NCLT by order shall remove him from office. The person so removed shall not hold the office of a director or any other office connected with the conduct and management of the affairs of the company for a period of 5 years. The Central Government may, with the previous concurrence of the NCLT, remit or relax this period of 5 years. On the removal of a person from office in the above manner, no compensation shall be payable to him for the loss or termination of office. The company may, with the previous approval of the Central Government, appoint another person to the office in place of the person removed (Sec. 388-E).

4. **Removal by Tribunal (NCLT)** (Sec. 402). Where, on an application to the NCLT for prevention of oppression (under Sec. 397) or mismanagement (under Sec. 398), the NCLT finds that the relief ought to be granted, it may terminate, set aside or modify any agreement between the company and the managing director or any other director or the manager. When the appointment of a managerial personnel is so terminated or set aside, he cannot sue the company for damages or compensation for the loss of office, nor can he be appointed, except with the leave of the NCLT, in any managerial capacity in the company for a period of 5 years from the date of the order.

5.3.8 Powers Of Directors:

General Powers of the Board (Sec. 291)

The Board of directors of a company is entitled to exercise all such powers and to do all such acts and things as the company is authorised to exercise and do. This means the powers of the Board of directors are co-extensive with those of the company. This proposition is, however, subject to two conditions:

First, the Board shall not do any act which is to be done by the company in general meeting.

Second, the Board shall exercise its powers subject to the provisions contained in the Companies Act, or in the Memorandum or the Articles of the company or in any regulations made by the company in general meeting. But no regulation made by the company in general meeting shall invalidate any prior act of the Board which would have been valid if that regulation had not been made.

Directors' and shareholders' control. It is the first and elementary principle of company law that when powers are vested in the Board of directors by

the Articles of a company, they cannot be interfered with by the shareholders as such.[255]

In exercising their powers the directors do not act as agent for the majority members or even all the members. The members therefore cannot by resolution passed by a majority or even unanimously supersede the powers of directors or instruct them how they shall exercise their powers. If the shareholders are dissatisfied with what the directors do, their remedy is to alter the Articles, and also to remove the directors in the manner provided by the Articles. In *John Shaw & Sons Ltd.* v. *Shaw,*[256], Greer, L.J. observed as follows :

"A company is an entity distinct alike from its shareholders and directors. Some of its powers may, according to the Articles, be exercised by directors, certain other powers may be reserved for the shareholders in **a** general meeting. If powers of management are vested in the directors, they and they alone can exercise these powers. The only way in which the general body of the shareholders can control the exercise of the powers vested by the Articles in directors is by altering their Articles, or, if opportunity arises under the Articles, by refusing to re-elect the directors of whose action they disapprove."

Powers to be exercised at Board meetings (Sec. 292)

The Board of Directors of a company shall exercise the following powers on behalf of the company by means of resolutions passed at the meetings of the Board, *viz.,* the power to—

(a) make calls on shareholders in respect of money unpaid on their shares ;

(aa) the power to authorise the buy-back of shares by a resolution of the Board of Directors at its meeting [This clause has been inserted by the Companies (Amendment) Act, 2001];

(b) issue debentures ;

(c) borrow moneys otherwise than on debentures (say through public deposits) ;

(d) invest the funds of the company ; and

(e) make loans.

The Board may, by a resolution passed at a meeting, delegate the last three powers to a committee of directors or the manager or any other principal office: of the company, but the Board shall specify the limits of such delegation.

[255] *Murarka, etc., Works Ltd.* v. *Mohanlal,* A.I.R. (1961) Cal. 251

[256] (1935) 2 K.B. 113

Other powers. There are certain other powers which must be exercised by the Board of directors *only at the meeting of the Board.* These powers are :

(a) to fill vacancies in the Board (Sec. 262) ;

(b) to sanction or give consent for certain contracts in which particular directors, their relatives and firms are interested (Sec. 297) ;

(c) to receive notice of disclosure of directors' interest in any contract or arrangement with the company (Sec. 299) ;

(d) to receive notice of disclosure of shareholdings of directors (Sec. 308) ;

(e) to appoint as managing director or manager a person who is already managing director or manager of another company (Sees. 316 and 386) ;

(f) to make investments in companies in the same group (Sec. 372).

Every resolution delegating the power to borrow money otherwise than on debentures shall specify the total amount outstanding at any one time up to which moneys may be borrowed by the delegate.

Every resolution delegating the power to invest the funds of the company shall specify—

(a) the total amount up to which the funds may be invested, and

(b) the nature of the investments which may be made by the delegate.

Every resolution delegating the power to make loans shall specify—*(a)* the total amount up to which loans may be made by the delegate, *(b)* the purposes for which the loans may be made, and

(c) the maximum amount of loans which may be made for each such purpose in individual cases.

Sec. 292 does not in any manner affect the right of the company in general meeting to impose restrictions and conditions on the exercise by the Board of any of the powers specified in Sec. 292.

Exceptions: In the following cases, the general meeting of shareholders is competent to intervene and act in respect of a matter delegated to the Board of directors:

1. *Directors acting mala fide.* Where the directors act against the interest of the company[257], or where the personal interest of the directors clashes with their duty towards the company, they will try to avoid taking

[257] *Marshall's Valve Gear Co.* v. *Manning Wardle & Co. Ltd.,* (1909) 1 267

steps for the redressal of the wrong done to the company. In such a case, the majority shareholders may to redress the wrong.

2. *Directors themselves wrong-doers.* Where the directors who are the only persons who can conduct litigation in the name of the company, are themselves the wrong-doers and have acted *mala fide,* the shareholders can take steps to redress the wrong.[258]

3. *Incompetency of Board.* When the directors become incompetent to act,
e.g., when all the directors are interested in a transaction with the company, the majority of shareholders may exercise power in a general meeting of the company.

4. *Deadlock in management.* When there is a deadlock in the management
so that directors cannot exercise some of their powers, the majority shareholders may exercise the power in a general meeting of the company.

In Barron v. *Potter*[259]*,*. The Articles of a company gave the Board of directors power to appoint an additional director. But owing to differences between the directors, no meeting could be held for the purpose. The Articles did not confer any power on the shareholders to increase the number of directors. *Held,* the company retained the power to appoint additional directors in a general meeting.

5. *Residuary powers.* The shareholders can always exercise the residuary
powers, *i.e.,* powers not expressly conferred on the directors or shareholders, in a general meeting.

Powers to be exercised with the approval of company in general meeting (Sec. 293)

The Board of directors of a public company, or of a private company which is a subsidiary of a public company, shall exercise the following powers only with the consent of the company in general meeting: (say under amalgamation scheme) —

(a) To sell, lease or otherwise dispose of (say under amalgamation scheme) the whole, or substantially the whole, of the undertaking of the company.

(b) To remit or give time for repayment of any debt due to the company by a director except

[258] *Satya Charan Lai* v. *R.P. Bajoria,* (1950) S.C.R. 394
[259] (1914) 1 Ch. 895

in the case of renewal or continuance of an advance made by a banking company to its director in the ordinary course of business.

(c) To invest (excluding trust securities) the amount of compensation received by the company in respect of the compulsory acquisition of any undertaking or property of the company.

(d**)** To borrow moneys where the moneys to be borrowed (together moneys the already borrowed by the company) are more than the paid-up capital of the company and its free reserves (that is to say reserves not set apart for any specific purpose, e.g., balance in the share premium account, general reserve, profit and loss account, capital redemption account). The amount of temporary loans raised from banks in the ordinary course of business is excluded.

The expression 'temporary loan' in Sec. 293 means—

(a) loans repayable on demand, or

(b) within 6 months from the date of the loan. Such loans include—

(i) short term loans,

(ii) (ii) cash credit arrangements,

(iii) the discounting of bills and the issue of other short term loans seasonal character.

The expression 'temporary loans', however, does not include loans raised for the purpose of financing expenditure of a capital nature.

(e) To contribute to charitable and other funds not directly relating to the business of the company or the welfare of its employees, amounts exceeding in any financial year Rs. 50,000 or 5 per cent of the average net profits of the three preceding financial years, whichever is greater. The Board may contribute up to Rs. 50,000 even if the company is incurring a loss.

Every resolution passed by the company in general meeting to borrow moneys shall specify the total amount up to which moneys may be borrowed by the Board of directors. Likewise every resolution passed by the company in general meeting to contribute to charitable and other funds shall specify total amount which may be contributed to charitable and other funds in financial year.

5.3.9 Duties of Directors:

There are certain duties of a general nature of the following type :

1. Fiduciary duties, and
2. Duties of care, skill and diligence.

1. Fiduciary duties

As fiduciaries, the directors must—

(a) exercise their powers honestly and *bona fide* for the benefit of the company as a whole ; and

If, for example, the power to issue further shares is exercised by, the directors not for the benefit of the company but simply and solely for their personal aggrandisement and to the detriment of the company, the Court will interfere and prevent the directors from doing so.[260]

(b) Not place themselves in a position in which there is a conflict between their duties to the company and their personal interests. They must not make any secret profit out of their position. If they do, they have to account for it to the company. The leading cases on the point are Regal (hastings) Ltd. V. Gulliver,[261] in that case R Co. Ltd. Owned 1 cinema and wanted to buy 2 others with a view to selling the three together. It formed a subsidiary company to buy the two cinemas. It was, however, unable to provide the necessary finances. As such, its directors themselves subscribed for some of the shares in the subsidiary company. The cinemas were acquired and the shares in R Co. Ltd. And the subsidiary sold at a profit. Held, the directors must account to R Co. Ltd. For the profit they made because it was only through the knowledge and opportunity they gained as directors of R Co. Ltd. that they were able to obtain the shares.

3. **Duties of care, skill and diligence:** Directors should carry out their duties with reasonable care and exercise such degree of skill and diligence as is reasonably expected of persons of their knowledge and status.[262] He is not bound to bring any special qualification to his office. And this was illustrated by Romer J. in the case of *City Equitable Fire Insurance Co.Ltd.*[263] that the director of a life insurance company is not expected to guarantee that he has the skill of an actuary or physician. But if a director fails to exercise due care expected of him in the exercise of his duties, he is guilty of negligence.

Standard of care: the standard of care, skill and diligence depends upon the nature of the company's business and circumstances of the case. There are various standards of the care depending upon:

(a) The type and nature of work.

[260] Nandlal Zaver V. Bombay Life Ass. Co. Ltd., AIR (1950) S.C. 172.
[261] (1942) 1 All E.R. 378.
[262] *Re,* Brazilian Rubber Plantations & Estates Ltd., (1911) 1 Ch. 425.
[263] (1925) Ch. 407.

(b) Division of powers between directors and other officers:

(c) General usages and customs in that type of business; and

(d) Whether directors work gratuitously or remuneratively.

There is a brilliant exposition of director's duties in relation to a company's affairs in the following case:

City Equitable Fire Insurance Co. Ltd., Re supra. The directors of an insurance company left the management of the company's affairs almost entirely in the hands of B, the managing director. Owing to B's fraud a large amount of the company's assets disappeared. B and the firm in which he was a partner had taken a huge loan from the company, and the cash at the bank or in hand included `7,300 pond in the hands of the company's stock brockers, in which B was a partner. The directors were negligent. The articles, however, protected the directors in this case from liability as there was no willful neglect or default and consequently they were not held liable.

Romer, L.J. observed in this case as follows:

"in ascertaining the duties of a directors it is necessary to consider the nature of the company's business and manner in which the work of the company is reasonably, in the circumstances and consistently with the articles, distributed between the directors and other officials of the company. In discharging duties a director-

(a) Must act honestly;

(b) Must exercise such degree of skill and diligence as would amount to the reasonable care which an ordinary man might be expected to take in the circumstances on his behalf; but

(c) He need not exhibit in the performance of his duties a greater degree of skill than what can reasonably be expected of a person of his knowledge and experience; in other words, he is not liable for mere errors of judgment;

(d) He is not bound to give continuous attention to the affairs of his company, his duties are of an intermitted nature to be performed at periodical board meeting and the meeting of any committee to which he is appointed, and through not bound to attend all such meetings, he ought to attend them when reasonably able to do so; and

(e) In respect of all duties which, having regard to the exigencies of business and the articles of association, may properly be left to some other official to perform such duties honestly."

In *Lagunas Nitrate Co. v. Lagunas Nitrate Syndicate*[264], Lindley M.R observed:

“if directors act within their powers, if they act with such care as is reasonably to be expected of them having regard to their knowledge and experience, and 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.

Other Duties of Directors:

The other duties of directors are –

(1) to attend board meetings,

(2) not to delegate his functions except to the extent authorized by the Act or the constitution of the company, and

(3) to disclose his interest.

5.3.10 Liability of Directors:

The directors may incur liability for acts without the authority of the company *(i.e. ultra vires* acts) and they may also be held personally liable for acts which arc *intra vires* the company but beyond the scope of their authority if they are not ratified by the company. The liability of directors can broadly be classified into two heads, namely, (i) criminal liability and (ii) civil liability.

1. Criminal Liability.—the directors may be criminally held liable for default in compliance with certain provisions of the Companies Act, apart for being liable for acts which are otherwise included as an offence in the Indian Penal Code. In the context of working of the Companies, offences under the Penal Code generally relate to fraud, misrepresentation, embezzlement of funds, perjury etc. Most of these offences are now covered under the Act itself.

It must be stated that apart from those sections which impose a direct and specific liability upon a director, many sections make the company and every officer who is in default, punishable with fine or imprisonment or with both of a specified amount or term, as the case may be. The term 'officer who is in default' has been substituted in

[264] (1899) 2 Ch. 392.

various penal provisions of the Act by the Companies (Amendment) Act, 1988. Therefore, it would be pertinent to understand the exact meaning of this term. The expression 'officer who is in default' includes the following officers of the company:

(a) the managing director or managing directors ;
(b) the whole-time director or whole-time directors ;
(c) the manager;
(d) the secretary;
(e) any person in accordance with whose directions or instructions the Board of Directors is accustomed to act;
(f) any person charged by the Board with responsibility of complying with any provision of the Act;
(g) where a company does not have any of the officers specified in clauses (a) to (c) above, any director or directors specified by the Board in this behalf or where no particular director is specified, all the directors.

Provided that where the Board exercises any power under CI. (f) or CI. (g) above, it shall, within thirty days of the exercise of such powers, file with the Registrar, a return in the prescribed form.

It must further be stated that *mens rea* is an essential ingredient of an offence created by a statute unless the statute expressly or by necessary implication excluded it. The High Court of Delhi in *Sukhbir Saran Bhatnagar* v. *Registrar of Companies*[265], held that where there is failure to comply with the statutory provision and failure to comply with it is made punishable, it is clear that *mens rea* is by necessary implication excluded.

Section 629-A of the Companies Act provides that when a director or any officer of the company who is in default for any provision of the Act for which no specific penalty-is prescribed by the Act, he may be punishable with fine which may extend to five hundred rupees, and where the default is a continuing one, with a further fine which may-extend to fifty rupees for every day till the default continues. But where the penalty is specifically provided under the Act, there is no question of application of Section 629A for prosecution of the director or officer who is in default.

If a director of a company which is being wound up destroys, mutilates, alters, falsifies or secretes any books, papers or securities or is

[265] (1972) 42 Comp Cas 408 Del.

instrumental to such acts, he shall be punishable with imprisonment which may extend to seven years, and is also liable to fine.

2. Civil Liability.—Directors may be liable to the company for *ultra-vires* acts *i.e.* acts which are outside the powers of the company as defined in the memorandum. For example, any misapplication of the company's funds may render a director liable to replace such funds. Thus the directors of a company are held personally liable to replace the funds of the company in the following cases:

1. Buying up shares of the company;
2. Paying dividends out of the capital;
3. Paying promoters a bonus;
4. Purchasing property which company had no power to purchase;
5. Returning capital without reduction in capital.

If the directors act *mala fide* misusing the powers bestowed on them, they would incur civil liability for breach of warranty like any other agent. Likewise, he shall also be liable for negligence in performance of his duties resulting in loss to the company. He shall, however, not be said to be negligent if he fails to enquire about matters which are dealt with by the managing director or co-directors or other trusted officers of the company. Thus in *D. Ovey* v. Cory,[266] the Board of Directors declared dividend on the basis of a profit and loss account laid before them by the managing director but it was later found that it was in fact paid out of the company's capital. The House of Lords held that the Directors were not liable for negligence in placing reliance on the profits and loss account submitted to them by the managing director.

A director also incurs civil liability to pay damages to the company for any personal gain which he may have obtained by the use of information or opportunity available to him in his capacity as a director. The liability in such cases arises out of the principle of unjust enrichment *i.e.* director enriching himself unjustly by abusing his fiduciary position.

Though directors are not, as a rule, personally liable to third parties for transactions they enter into on behalf of the company. They may, however, be liable to third parties in the following circumstances:

(1) Where the directors have expressly contracted in their own name without disclosing that they were acting on behalf of the company.
(2) Where they have acted fraudulently or guilty of fraudulent trading with third parties.
(3) Where directors have issued prospectus which does not comply with the statutory requirements.

[266] (1901) AC 477 HL.

(4) In cases where personal liability is expressly imposed on directors by the Act *e.g.* for irregular allotment of shares or failure to return application moneys under the provisions of Section 69(5) or Sec. 73(2) of the Act.

(5) For acts which are outside their (director's) authority, but which they have impliedly warranted that they have authority to do. However, if the third party has actual or constructive notice of the lack of authority, the directors shall not be liable in that case.

(6) The directors may incur tortious liability against third parties for the wrongs caused to them. The liability may be in addition to company's liability to third parties. The directors are only liable for torts committed by the company if they have expressly directed, ordered or perpetuated their commission. But they are not liable for tortuous acts committed by the inferior servants of the company, although those servants are appointed and controlled by them.

(7) The directors, who use the seal or sign a business document or a negotiable instrument without company's name being mentioned on it, will be personally liable to the holder of the document for obligation if the company does not satisfy the obligation. Thus in *Penrose* v. *Martyr,*[267] the signatories were held personally liable for the omission of words 'Limited' or Ltd' on an instrument. But if the error in the name is caused by the holder of the instrument himself, he will not be able to enforce that instrument personally against the director who signed it.

5.3.11 Appointment of Managing Director [Section 269]

The power of appointment of a managing director is generally conferred on the Board of Directors by inserting a provision to this effect in the articles of the company. The Board may appoint one of its directors as the managing director and the general meeting of the shareholders can not interfere in this appointment[268].

Section 269 as amended by the Companies (Amendment) Act, 1988 makes it compulsory for all public companies and private companies which are subsidiaries of a public company with paid-up capital of five crores rupees or more[269], to appoint a managing director, whole-time director or a manager. The appointment must have approval of the Central

[267] (1958) EB & E 499.

[268] *Thomas Logan v. Davis,* (1911) 105 LT 419

[269] Earlier this amount of one crore rupees or more but it has been raised to five crores rupees or more by Deptt. Of Company Affairs Notification No. GSR 794 (e) dt. 18-9-90

Government unless it is made in accordance with the provisions specified in Part I and II of Schedule XIII as these parts are subject to the provisions of Part III. A return of the appointment must be filed with the Registrar of Companies within ninety days. If the appointment is not approved by the Central Government, the office of the managing director shall stand vacated from the date of refusal by the Central Government. Contravention of this provision shall render the appointee liable to a penalty of five thousand rupees for every day till the contravention continues[270].

Where the Central Government, on receipt of the information or *suo motu* forms an opinion that the company has made appointment of a managing director in contravention of the provisions of Part I and II of Schedule XIII, it may refer the matter to the Tribunal. The Tribunal shall on receipt of a reference issue a show cause notice to the company concerned, the appointee and any other officer of the company who is responsible for making such irregular appointment. The Tribunal shall take any final decision in the matter only after giving appropriate opportunity of being heard to the company and the concerned persons. In case the Tribunal comes to the conclusion that the appointment has been made in contravention of the provisions of the Act, it shall make an order to the following effect[271]-—

(a) The company shall be liable to a fine which may extend to fifty thousand rupees;

(b) Every officer of the company who is in default shall be liable to a fine of one lakh rupees; and

(c) The appointment shall stand terminated and the appointee is liable to refund the entire amount of salaries, commissions and perquisites received or enjoyed by him during the period he worked as a managing director of the company In addition, he shall also be liable to a fine of one lakh rupees.

The violation of the Tribunal's order in this regard shall make every officer of company who is in default and the concerned managing director liable to punishment which may extend to imprisonment up to three years and with fine up to five hundred rupees for everyday of default.

Section 269 (12), however, provides that all acts done by the managing director whose appointment was found to be in contravention in such capacity shall be valid if they are otherwise valid notwithstanding any order made by the Tribunal.

[270] Sec 269 (6) as amended by Sec 130 of the Companies (Amendment) Act, 2000

[271] 269 (10) the word 'Tribunal ' substituted for the words 'Company Law Board' by the Companies (Second Amendment) Act, 2002.

5.3.12 Restrictions on Appointment of Managing Director [Section 316]

The Companies Act provides that a public company and a private company which is a subsidiary of a public company, may employ a person as managing director, if he is already a managing director or manager of more than one, and not more than one, other Company. But such appointment shall only be made by a resolution passed in the Board's meeting with the consent of all the director present at the meeting.[272]

The Central Government may, however, by order permit any person to be appointed as managing director of more than two companies at a time, if it is of the opinion that such permission is necessary for proper working and functioning of those companies.[273]

The appointment of a managing director cannot be made for a period more than five years at a time.[274] He shall, however, be eligible for re-appointment provided that any such re-appointment or extension shall not be sanctioned earlier than two years from the date on which it is to come into force.[275]

It must be pointed out that 'Explanation' contained in Section 269 of the Act expressly provide that the word 'appointment' in this section includes 're-appintment' and 'whole-time director' includes a director who is in the whole-time employment of the company.[276]

While granting or withholding approval to an appointment of a person as a managing director, the Central Government has to determine whether the proposed appointee is a fit and proper person and it may refuse to grant approval where a prosecution is pending against the proposed appointee.[277] The Government has also the power to make the appointment subject to certain conditions as it deems fit.[278] The case of *Raymond Engineering Works* v. *Union of India,*[279] is an illustration on this point.

In this case, the prospectus of the company showed that it had purchased its managing agents property for six lakhs rupees but did not disclose that

[272] Sec. 316 (2).
[273] Sec.316 (4).
[274] Sec. 317 (1).
[275] Sec.317 (3) Proviso.
[276] Sec269 'Explation'
[277] Rampur Distillery & Chemical Co. v. Company Law Board, AIR 1970 SC 1789
[278] Sec. 637-A
[279] AIR 1970 Del.5.

the managing agent had himself paid only three and half lakhs rupees for it, thus concealing a profit of about 2.5 lakhs. The company sought the approval of the same person as managing director from the Central Government. The Government granted approval subject to the condition that the proposed appointee would remit the amount of concealed profit *i.e.,* about 2 lakh rupees to the company. The High Court of Delhi held that the condition imposed by the Central Government was just and reasonable and hence valid.

Manager:

Section 2 (24) of the Act states that a 'manager' means an individual who has the management of the whole or substantially the whole of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, and whether under a contract of service or not. Thus, to be deemed as the manager of a company, the individual must be in charge of the whole business of the company *e.g.,* General Manager. A mere head of a department or a branch manager would not be a manager for the purpose of this section. Thus Blackburn J. in *Gibson* v. *Barton*[280] held that manager, "is a person who has management of the whole of the affairs of the company, not an agent who is to do a particular thing, or a servant who is to obey orders, but a person who is entrusted with power to transact the whole of the affairs of the company."

Like a managing director, the manager manages the affairs of the company subject to the control, direction and superintendence of the Board of Directors.

As stated earlier, unlike a managing director, a manager being a paid executive of the company is subordinate to and under the control and superintendence of the Board. The managing director, on the other hand, being a part of the Company's Board, is not subordinate to the Board.

5.3.13 Appointment of Manager [Section 384]

Section 384 of the Companies Act provides that only an *individual* can be appointed as a manager of a company, whether it is a public or a private company. The provisions with regard to the appointment of the manager are same as for the managing director. No firm or a body corporate can be appointed as manager of the company.

[280] (1875) 10 QB 329

The tenure of office of a manager shall be for a period of five years at a time and the conditions of remuneration are same as those for a managing director.

Like a managing director, a manager cannot assign his office[281]. Similarly, he cannot manage more than two companies at a time and that too subject to the consent of all the directors of the appointing company present in the meeting.

5.3.14 Disqualification of Manager [Section 385]

Section 385 of the Act states that no company shall appoint or continue the appointment or employment of any person as its manager who—

(a) is an undischarged insolvent; or
(b) has any time within the preceding five years been adjudged an insolvent; or
(c) suspends or has suspended payment to his creditors; or
(d) makes or has at any time within preceding five years made a composition with his creditors; or
(e) is or has at any time within the preceding five years been convicted of an offence involving moral turpitude.

The Central Government, however, reserves the right of removing any of the above qualifications either generally or in relation to any particular company or companies.[282]

The provisions relating to the procedure of appointment and requirement of approval for increase in remuneration are the same as in case of managing director.

5.3.15Remuneration of Directors:

Section 198 lays down the overall maximum of managerial remuneration which can be paid by a public company or a subsidiary of a public company. According to this section the total managerial remuneration payable to directors or manager in respect of a financial year shall not exceed eleven per cent of the net profits of the company. The net profits are to be computed in the manner laid down in Sections 349 and 350, except that the remuneration of the directors is not to be deducted from

[281] Sec.312
[282] Sec. 385 (2)

the gross profits.[283] This percentage is exclusive of any sitting fees i.e. fees paid for attending Board of Director's meeting.[284]

In case a company has no profit in a financial year, the company may with the previous approval of the Central Government, pay by way of minimum remuneration any sum as may be authorized.[285] The Central Government has, however clarified[286] that in the event of loss or inadequate of profits, approval of the Central Government is not required for payment of remuneration if the appointment of a managing director or manager has been made in accordance with the terms and conditions specified in Schedule XIII and a resolution passed in the general meeting provided a cut of ten per cent of the salary proposed to be paid in terms of para 2 of Part III of Schedule XIII. [287] Where it proposed to pay remuneration by way of commission, no remuneration shall be payable to the director in the event of loss.

The remuneration to a Managing Director or a whole-time director may either be paid on a monthly basis or on the basis of a specified percentage of the net profits of the company or partly by one way and partly by the other. But the amount shall not exceed five per cent of the net profits in case of one director or if there are more than one, ten per cent for all of them taken together,[288]except with the approval of the Central Government

As regards directors other than a managing director or whole-time directors remuneration may be paid to them by way of monthly or quarterly payment. But it should be done with the approval of the Central Government or by a special resolution of the company.

The amount of remuneration payable to all the directors should not exceed one per cent of the profits of the company if the company has a managing or whole time director or manager, and three per cent in other cases.[289] However, the company may by a special resolution in its general meeting and with the approval of the Central Government sanction more than this

[283] Sec. 198 (1)
[284] Sec. 198 (4)
[285] Ec. 198 (4) proviso
[286] Circular No. 3 dt 13-4-1989 issued by the Dept. of Company Affairs, Ministry of Finance, Govt. of India.
[287] Circular No. 3 dt 13-4-1989 issued by the Dept. of Company Affairs, Ministry of Finance, Govt. of India.
[288] Sec.309 (3)
[289] Sec. 309 (4)

limit.[290] But such special resolution shall remain in force only for a period of five years, which may be renewed further.

The Companinies (Amendment) Act, 1988 has now provided statutory guideline in Schedule XIII, which can be enforced without any legal constraint. It has already been stated earlier that under this Amendment Act a public company, or a private company which is a subsidiary of a public company, can now appoint a managing or whole-time director without seeking the approval of the Central Government, if such appointment fulfills the conditions set out in Schedule XIII.

5.4. Summary:

A company is an artificial person created by law. It is intangible and invisible but function through the human agency. The Companies Act, 1956 envisages the following forms of management.

(a) the board of directors

(b) the board of directors with managing directors

(c) the board of directors with manager

The definition of directors as per section 2 (13) of the act includes any person occupying the position of director, by whatever name called. Therefore a person, who performs the functions of a director, would be termed as director even though he may be named differently. Every public company must have atleast three directors and every other company at least two directors. The directors are the agents of the company for which they act. They are not only agents but they are to some extent trustees or in the position of trustees. The directors are usually named in the articles of the company. When a new director is to be appointed, a notice in writing should be given to the company at least fourteen days before the date of the meeting. The powers of the directors are generally set out in the articles of the company. Every company is required to hold at least one meeting in every months and at least four meeting in a year.

5.5. SUGGESTED READINGS:

19. Avtar Singh : Company Law.
20. N.D. Kapoor : Elements of Company Law.
21. N.V. Paranjape : Company Law.
22. Taxmann : Company Law.

[290] Sec. 309 (7)

23. Gower, L.C.B. : Principles of Moderen Company Law.
24. Ramiya : Guide to the Companies Act.

5.6. SELF-ASSESSMENT QUESTION:

1. Discuss the definition of 'Director' as given in section 2 (13) of the Companies Act, 1956. How directors are appointed?
2. Discuss in detail the qualification and disqualification of directors.
3. Write short notes on the following :
   (a) Removal of Directors
   (b) Powers of Directors
   (c) Duties of Directors
   (d) Managerial Remuneration

LL.M. Part-1
PAPER CORPORATE LAW

Block II –Director and Managerial Personal

Unit 6- Company Meetings, Kinds, Procedure, Voting

STRUCTURE

6.1. **Introduction**

6.2. Objective

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6.3.1 Statutory Meeting

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6.3.4 Class Meetings

6.3.5 Requisites of a Valid Meeting

6.4. Summary

6.5. Suggested Readings/Reference Material

6.6. Self Assessment Questions

61. Introduction:

A company being a legal abstraction cannot act at its own. It can express its will only through resolution passed at its properly convened meetings of the members. A meeting may broadly be defined as the gathering, assembly or the coming together of two or more persons for transaction of any *lawful* business.

The expression 'lawful business' in relation to companies denotes normal business of administering the affairs of the company by its Board of Directors and the business transacted by the members in general meeting convened as per the statutes or the articles of association of the company. Since the term 'meeting' connotes coming together of two or more persons, therefore, a single person cannot usually constitute a meeting even though he holds proxies for several other persons[291]. The Company Law, however, provides certain exceptions when presence of one member alone would constitute a valid meeting of the company.

A company is an artificial person and, therefore, cannot act itself. It must act through some human intermediary. The various provisions of law empower members to do certain things. These are specifically reserved for them to be done in company's general meetings. Section 291 empowers the Board of directors to manage the affairs of the company. In this context holding of meetings of members and of directors become indispensable. In this Chapter meetings of members are dealt with the companies Act has made provisions for different types of meetings of members, namely*: (i)* Statutory Meeting, *(ii)* Annual General Meeting, *(iii)* Extraordinary General Meeting, and *(iv)* Class Meetings.

6.2. Objective:

The main objective of this lesson is to analyze all the aspects relating to meeting i.e, kinds of meeting along with procedure and conduct of meetings.

6.3.1 Statutory meeting

Object of statutory meeting - Statutory meeting is a meeting of the members held only once during the lifetime of the company. Generally, it is the first general meeting. The main purpose of this meeting is to enable the members to know at an early date the financial position and prospects

[291] *Per Lord Coleridge in Sharp v. Dawes*, (1876) 2 QBD 26.

of the company and also to provide them an opportunity of discussion on various matters arising out of the promotion and formation of the company.

When to be held - Section 165 of the Companies Act requires that every company limited by shares, and every company limited by guarantee and having a share capital, neither being a private limited company, must within a period of not less than one month but not more than six months from the date the company becomes entitled to commence business hold a general meeting of the members of the company which shall be called the statutory meeting.

It may be noted that a meeting held before the said period of one month cannot be called a statutory meeting. Moreover, the notice must set out that the meeting is intented to be the statutory meeting.[292]

Exemptions - Section 165(10) provides that the provisions of section 165 are not applicable to a private company. However, if a private company becomes a public company by virtue of section 43 or converts itself into a public company within a period of 6 months from the date of its incorporation (in case of a private company the date of incorporation and date of entitlement to commence business are the same), it will have to hold the statutory meeting as per section 165. But if a private company becomes a public company after six months of its incorporation, it will not be required to hold the statutory meeting.

Section 165 of the Act does not apply to a Government company even registered as a public company.[293]

Thus, we may say that statutory meeting need not be held by :

- *(a)* a private company, whether independent or subsidiary of a public company
- *(b)* a public company not having share capital;
- ***(c)*** a public company having liability of its members unlimited;
- *(d)* a public company having liability of its members limited by guarantee and having share capital; and
- *(e)* a Government company, whether registered as a private or a public company

Notice of the meeting (Sections 171-172) - Under section 171, a notice of the statutory meeting must be given at least 21 clear days before the meeting: statutory meeting may, however, be called after giving shorter notice *(i.e.* less than 21 clear days), if consent is accorded thereto by

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[292] *Gardner v. Tredale* (1912) 1 Ch. 700.

[293] *Govt, of India Notification No. GSR 578 (E. 16-7-1985).*

members of the company holding not less than 95% of such part of the paid-up share capital of the company as gives a light to vote at the meeting.

The notice of the meeting must describe the meeting to be statutory meeting. Also time, date and place of the meeting must be mentioned in the notice.

Notice of the meeting must be given to:

1. every member of the company;
2. legal representative of a deceased member;
3. official receiver/assignee;
4. the auditor(s) of the company.

Since, each item of statutory meeting constitutes special business, an explanatory statement should be added for each item on the agenda.

Statutory report has to be sent along with the notice of the meeting. However if the report is forwarded later, it shall be deemed to have been duly forwarded if it so agreed to by all the members entitled to attend and vote at the meeting.

A copy of the statutory report should also be sent to the Registrar of Companies

It may be noted that in the absence of a specific requirement, similar to section 166 (2) of the Act, in section 165 of the Act, a statutory meeting may be called even on a holiday at any reasonable hour and at any place considered convenient. These issues should be judged by reference to reasonability and surrounding circumstances.

Scope of the statutory meeting - Sub-section (7) of section 165 allows to members to discuss any matter relating to the formation of the company or arising out of the statutory report, whether previous notice as regards the same has been given or not.

However, no resolution may be passed of which notice has not been given in accordance with the provisions of the Act.

Adjournment of statutory meeting [Section 165(8)] - The statutory meeting may adjourn *from time to time,* and *at any adjourned meeting, any resolution of which notice has been given in accordance with the provisions of the Companies Act, whether before or after former meeting, may be passed.* The adjourned meeting shall have the same authority as an original meeting. *However,* the *Chairman of the meeting has not been vested with the power to adjourn.* It is *to be decided on the basis of majority vote.*

List of members [Section 165(6)]-Sub-section (6) of section 165 requires the *Board of directors to cause a list showing the names, addresses and occupations of the members of the company, and the*

number of shares held by them, respectively, to be produced at the commencement of the statutory meeting, and to remain open and accessible to any member of the company during the continuance of the meeting.

Penalties [Section 165(9)]- if default is made in complying with any requirement of section 165, every director or other officer of the company who is in default shall be punishable with fine which may extend to five thousand rupees. You may also note that if a statutory meeting is not held, as aforesaid, it becomes a ground for winding up of the company through Court under section 433(b).

Statutory report:

The Board of directors should get a report, called the statutory report, sent to each member along with the notice of the meeting. If the statutory report is forwarded later, it shall be deemed to have been duly forwarded if it is so agreed to by all the members entitled to attend and vote at the meeting. A copy of the statutory report should also be sent to the Registrar for registration forthwith after the copies thereof have been sent to the members [section 165(5)].

Contents of the statutory report [Section 165(3)] - The statutory report shall set out -

(a) the total number of shares allotted, distinguishing shares allotted as fully or partly paid-up otherwise than in cash, and, stating in the case of shares partly paid-up, the extent to which they are so paid-up, and in either case the consideration for which they have been allotted;

(b) the total amount of cash received by the company in respect of all the shares allotted distinguished as aforesaid;

(c) an abstract of the receipts of the company and of the payments made thereout, up to a date within seven days of the date of the report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payments made thereout, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company, showing separately any commission or discount paid or to be paid on the issue or sale of shares or debentures;

(d) the names, addresses and occupations of the directors of the company and of its auditors; and also, if there be any, of its manager, and secretary; and the changes, if any, which have occurred in such names, addresses and occupations since the date of the incorporation of the company. (It may be noted that a company is ordinarily obliged to appoint its first auditor within one month of its incorporation.

(e) the particulars of any contract which, or the modification or the proposed modification of which, is to be submitted to the meeting for its approval together in the latter case with the particulars of the modification or proposed modification;

(f) the extent, if any, to which each underwriting contract, if any, has not been carried out, and the reasons therefore ;

(g) the arrears, if any, due on calls from every director; and from the manager and

(h) the particulars of any commission or brokerage paid or to be paid in connection with the issue or sale of shares or debentures to any director or the manager.

Certification of the statutory report-Since it is a basic document of a public company containing all relevant facts about its formation and cash and other dealings at the stage of the formation, it is a requirement of the law that the report should be certified by not less than two directors, one of whom should be the managing director where there is one. On the statutory report certified as above, the auditors of the company will certify the matters in the report as relate to the shares allotted by the company, the cash received in respect of such shares and the receipts and payments of the company as appears under (c) of the contents of the Statutory Report given above.

6.3.2 Annual General Meeting [Section 166]

Every company, whether public or private, has to hold a periodical general meeting of its members annually for the purpose of transacting its routine ordinary business. Such a meeting is called the 'Annual General Meeting' of the company. Section 166 (1) of the Act requires that every company must, in each year, hold a Annual General Meeting in addition to any other meetings in that year and must specify that the meeting is a Annual General Meeting in the notices calling it. The first annual general meeting of a company must be held within eighteen months from the date of its incorporation, and then no meeting will be necessary for the year of incorporation and the following year. For example, suppose a company is incorporated in January 1993, then its first annual meeting should be held within eighteen months, that is, up to June 1994, and then no further meeting will be necessary either in 1993 or 1994. Thereafter, one annual general meeting must be held every year. The interval between two such meetings should not exceed fifteen months. Failure to comply with either requirement constitutes an independent and separate default.[294]

[294] Smedley v. Registrar of Companies (1919) 1 KB 97.

The Registrar of Companies may, for valid reasons, extend, the time of holding the annual general meeting (not being the first annual general meeting) by a period not exceeding three months.[295] Such as extension may allow a company to hold its annual general meeting beyond the calendar year.[296]

The meeting should be held during the business hours, on a day which is not a public holiday and at the registered office of the company or at any place within the town where the registered office is situate.[297] The Central Government may, however, exempt a company from this provision of Sec. 166 (2).
Where a company fails to hold the Annual General Meeting, two consequences may follow. *Firstly,* any member may apply to the Central Government for directing the company to call the meeting. The (now Central Government) can give any ancillary directions to the company which it deems expedient for calling the meeting. This power has been exclusively conferred on the Central Government by Section 167 (2) of the Act and the Tribunal cannot exercise it even under its inherent powers.[298] *Secondly,* failure to call the annual general meeting by the company or in pursuance of the order of the (now Central Government) is an offence punishable with fines which may extend to fifty thousand rupees and in case of continuing default, with a further fine which may extend to two thousand five hundred rupees for every day until the default continues.[299] This provision is applicable to public as well as private companies.[300]

The new Section 167, as substituted by the Companies (Second Amendment) Act, 2002 provides that the directions that may be given under sub-section (1) of this Section may include a direction that one member of the company present in person or by proxy, shall be deemed to constitute a meeting.

Sub-section (2) further makes it clear that a general meeting held in pursuance of sub-section (1), subject to any directions of the Central Government, be deemed to be an annual general meeting of the company:

Provided that in the case of revival and rehabilitation of sick industrial companies under Chapter VIA, the provisions of this section shall have

[295] Sec.166 (1) Proviso
[296] Deptt. Of Company Affairs Notification 34/11/69- Cl-iii, dt. 13-1-1971
[297] Sec.166 (2)
[298] *A.K.Zacharca v. Magestic Kuries & Loans (P) Ltd.*, (1987) 62 Comp. Cas. 865 (ker)
[299] Sec. 168 as amended by Sec. 73 of the Companies (Amendment) act, 2000.
[300] *Registrar of companies v. F.S.Carbal,* (1988) 63 Comp. Cas 126 (Bom.)

effect as if for the words "Central Government", the word "Tribunal" has been substituted.[301]

In *Bejoy Kumar Karnani* v. *Asstt. Registrar of Companies,*[302] the Calcutta High Court held that as provided in Section 166 (1) of the Companies Act, in no case the interval between the two consecutive annual general meetings of a company should exceed the statutory limit of fifteen months. The Registrar can extend the period upto three months for such a meeting provided it is not the first annual general meeting. The meeting must be brought to completion within the period of fifteen months notwithstanding adjournments.

In *PSNSA Chettiar & Co.* v. *Registrar of Companies,*[303] the defaulting company pleaded in its defence that the annual general meeting could not be held within the statutory limit provided by Section 168 because some important books were exhibited in the court on account of a criminal case against the secretary of the company and the same had not been released by the court in time, hence accounts could not be prepared for holding the meeting. The court however, rejected the defence and held to be company liable.

But in *Kastoormal Banthiya* v. *State,*[304] where the accused and his brother were the only two members and directors of a private company and during the period when a meeting should have been held, his brother was lying seriously ill. The failure to hold the meeting was not considered to be a wilful default as there was valid reason for the delay.

In Re *Asia Industries Ltd.*[305] the court held that where the account-books of the company have been seized by the Police for investigation and the directors were not able to hold the annual general meeting of the company in absence of the account-books, the company shall not be liable for default under Section 168 of the Act.

In *Shree Meenakshi Mills Co. Ltd.* v. *Asstt. Registrar of Companies,*[306] the company was prosecuted for failure to call annual general meeting in time. One general meeting of the company was called in December 1934. This was adjourned and held in March 1935. The company held its subsequent meeting in February 1936. The prosecution against the Company was for not holding the annual general meeting for the year 1935. The company contended that a meeting was held in that calendar year. Rejecting the

[301] Substituted by the Companies (Second Amendment) Act, 2002
[302] (1985) 58 Comp LJ 17 (Mad).
[303] (1966) 1 Comp LJ 17 (Mad).
[304] AIR 1951 Ajmer 39.
[305] (1951) 3 Comp. Cas. 269
[306] AIR 1938 Mad. 640

contention of the company the court held that the meeting of March 1935, was the adjourned meeting of 1934 and "there should be one meeting per year and as many meetings as there are years." The company was therefore convicted for the default in holding the general meeting for the year 1935.

In S. *S. Jlmnjhunwala* v. *State*[307] it was held that the managing director who was insisting upon his collegues to call the annual general meeting but failed in his efforts, could not be held to be an "officer in default" for the purposes of Section 166 for not calling the annual general meeting.

In the context of Section 165, it must be noted that the section requires the annual general meeting to be held *in addition to* any other meeting that may have been held in the year. The question, therefore, quite often arises whether an extra-ordinary general meeting held in a year would be a sufficient ground for the company not to hold its annual general meeting in that year. Answering in the affirmative, the High Court of Allahabad in *Lachmi Narayan* v. *Emperor,*[308] held that an extraordinary general meeting would amount to a annual general meeting and would therefore exonerate the company from holding annual general meeting for that year. But the Bombay High Court[309] expressed a contrary view and held that extra-ordinary general meeting would not be counted as annual general meeting for the purposes of Sec. 166 (1) of the Act. The view expressed by the Bombay High Court was reiterated in *India Nutriments Ltd.* v. *Registrar of Companies,* [310] and indeed, it seems to be the correct view.

Business transacted in Annual General Meeting

The annual general meeting of a company provides a forum for the shareholders to come together and review the working of the company for the preceding year. Under Section 173 of the Act, the business to be transacted at an Annual General Meeting of a company has been classified into two heads, namely, (1) Ordinary Business; and (2) Special Business.

The ordinary business to be transacted at the Annual General Meeting relates to -

(a) consideration of accounts, balance sheet and the reports of the Board of Directors and auditors;
(b) declaration of dividend;[311]

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[307] (1970) ALL WR 814
[308] AIR 1920 ALL.357.
[309] *Emperor v. Nasurbhai*, AIR 1923 Bom. 194.
[310] (1914) 1 Comp LJ 56.
[311] Sec.210. Failure to present accounts is punishable under Secs. 219 and 220.

(c) appointment or re-appointment of directors in place of retiring directors;[312]

(d) appointment or re-appointment of auditors[313] and deciding their remuneration.

All other business transacted at the annual general meeting is treated as special business. Likewise, every business transacted at any other annual meeting of company is also treated as special business.[314] The distinction between ordinary business and special business lies in the fact that in case of the latter, a special notice of the nature of the matter in question has to be given to all the persons entitled to attend the meeting;[315] whereas in case of former *(i.e.,* ordinary business) no particular itemisation in the form of explanatory statement is needed in the notice.

Explanatory Statement [Section 173 (2)]

Where a special business is to be transacted at any annual general meeting of the company, there must be annexed to the notice of the meeting an explanatory statement stating all the material facts concerning each item of such business, including in particular, the interest, if any, of every director and the manager. The shareholding interest of every director or manager of any other company which is likely to be affected by such special business must also be set out in the explanatory statement except where the shareholding is less than 20% of the paid up share capital of that other company.

Section 173 (2) requires that explanatory statement must be annexed to the notice of a meeting at which a special business is to be transacted. It, however, docs not require the shareholders requisitioning an extraordinary general meeting to disclose the reasons for the resolutions which they propose to move at the meeting.[316] Therefore no explanatory notice need be annexed to a special notice given under Section 190 of the Companies Act.

Where any item of special business involves approved of any document by the meeting, the time and place where the document can be inspected shall be specified in the Explanatory Statement.

It has been held in *Joseph Michael* v. *Travancore Rubber & Tea Co. Ltd.,*[317] that the provisions of Section 173 (2) are mandatory and their non-compliance shall render the special business transacted at such a meeting

[312] Sec.255
[313] Sec.244
[314] Sec.173.
[315] *Kaye v. Croydon Tramsways co.,* (1898) 1 Ch 358.
[316] *LIC v.Escorts Ltd.,* (1986) 59 Comp Cas 548.
[317] (1986) 59 Comp Cas 898

null and void without any legal effect. The special business that can be transacted at the annual general meeting of a company may include appointment or reappointment of managing director and increase in his remuneration, increasing the share-capital of the company, alterations in the articles of association of the company or in the memorandum, to consider amalgamation or winding up of the company etc.

6.3.3 Extra ordinary Meeting [Section 169]

All general meetings of a company other than the statutory and the annual general meeting are called extraordinary general meetings.[318] Extraordinary meetings may either be called by the Board of Directors *voluntarily* whenever they wish to transact some special or urgent business which cannot be awaited till the next annual general meeting or it may also be called on the *requisition* of a specified number of members.[319] The requisition must be signed by holders of at least one-tenth paid-up capital of the company having the right to vote on the matter of requisition.[320] In case the company does not have share capital, the requisition must be signed by as many members as have one-tenth of the total voting power.

The meeting can be called by giving not less than twenty one days notice in writing by the requisitionists and the meeting should be actually held within forty five days from the date of requisition.[321] The meeting can be called by giving even a shorter notice consent is accorded thereto by members of the company holding not less than 95 of such part of the paid-up share capital as gives a right to vote at the meeting. In case of a company not having share capital, the members holding not less than 95% of the voting power exercisable, at that meeting must consent to a shorter notice.

The requisition must set out the matters for consideration of which the meeting is to be called and it shall be signed by the requisitionists and deposited at the registered office of the Company. No other business than the one for which the extraordinary general meeting is called, can be transacted in such a meeting. Thus in *Ball* v. *Metal Industries Ltd.,*[322] the shareholders requisitioned the meeting for appointing three new directors and subsequently the chairman wanted to add to the agenda the removal

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[318] Clause 47 of Table A.
[319] Sec. 169.
[320] Sec.169 (4) (a)
[321] Sec. 169 (6)
[322] 1957 SLT 124 Scotland

of one director also, the company was restrained from considering the matter.

If the directors fail to hold the extraordinary general meeting within forty five days from the date of requisition, the requisitionists themselves may proceed to call the meeting[323] and claim necessary expenses from the company. The company may indemnify itself out of the remuneration due to the directors in default.[324] The requisitionists must hold this meeting not later than three months after the date of deposit of the requisition at the registered office of the company.

In *Escorts Ltd.* v. LIC.,[325] the Bombay High Court held that where an extraordinary general meeting of the company was requisitioned for the purpose of removing a bunch of directors, it was necessary for the requisitionists to state the reasons for removal so that the directors may get an opportunity of making a representation against their removal. But the Supreme Court reversed this decision of the Bombay High Court in appeal and held that it is not necessary for the requisitionists to state the reasons for removal of directors.

In *Balkrishna Gupta* v. *Swedeshi Polytex Ltd.*[326], the Supreme Court held that the right of requisitioning a meeting or exercising normal voting rights is not affected by the fact that a receiver in respect of a member's shares has been appointed under Sec. 182- A of the U. P. Land Revenue Act, 1901 or the management of the company is with the Government under the Industries D. & R. Act, 1951. It was further held that even if the shares of the shareholders have been attached under Sec. 149 of the U.P. Land Revenue Act, 1901, their title to share is not affected thereby and therefore they have a right to requisition extraordinary general meeting of the company.

If the requisitionists have complied with the requirement of Section 169, the requisition deposited in the company must be regarded as valid requisition and the directors cannot refuse to call the extraordinary general meeting on the ground that the requisition or the resolution proposed to be passed was contrary to the Act and hence invalid. Thus in *Cricket Club of India* v. *Madhav L. Apte,*[327] the requisitionists wanted to insert a clause to the articles that person who had occupied the position of a director for six years, he should not be eligible for re-election for three years. The Court pointed out that although such a clause would be contrary to Section 274

[323] *Rathnavelusami v. MRS Manickavelu*, AIR 1951 Mad. 542
[324] Sec. 169 (9)
[325] (1984) 3 Comp LJ 387
[326] AIR 1985, SC 520.
[327] (1975) 45 Comp Cas 574 (Bom).

(3) of the Companies Act since it would prescribe additional disqualifications, but even so the directors were not justified in refusing to respond to the requisition.

Power of the Tribunal[328] to Order Meeting to be called: [Section 186]

Section 186 of the Companies Act provides that where the holding of a meeting, other than the Annual General Meeting has for any reason, become impracticable, the Company should apply to the Tribunal. In such cases the Tribunal may, at its own motion or on the application of the director or a member, order a meeting to be called and held in accordance with its directions and also give ancillary or consequential directions which it deems expedient including a direction that one member present in person or by proxy shall be deemed to constitute the quorum for the meeting.

The Tribunal should, however, not appoint an outsider to conduct the meeting or to be present as an observer, as there are other remedies provided in the Act to prevent improprieties or irregularities in the meeting.[329]

Reviewing the entire case law on this subject, Justice Mitra of the Calcutta High Court. In Re *Ruttanjee & Co. Ltd.[330],* laid down the law in this regard in eight broad propositions and observed that this power should be sparingly used with caution so that the Company Law Board (now Tribunal) does not itself become the shareholder or a director of the company to solve its squabbles. The Tribunal should intervene only when it is fully satisfied that the application under Section 186, has been made *bona fide* in the larger interests of the company in order to remove the deadlock and there are reasons to believe that a valid meeting cannot be validly held without its intervention. In this case the directors were divided in two groups, each group challenging the validity of the other, but none of them made an effort to requisition a meeting. Instead an application was made to the court,[331] to order a meeting. The court advised them first to requisition the meeting themselves to see what is the reaction of it on the other group and then only the Court (now Tribunal) would see what has to be done in the matter.

A private company which is not a subsidiary of a public company may, by its articles, provide that Section 186 will not apply to it and thus prevent the Tribunal from exercising its powers under this section.

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[328] This power is now vested in Tribunal due to dissolution of the company Law Board by the companies (second Amendment) Act, 2002

[329] *T.M Menon v. Universal Film (India) Pvt. Ltd.* (1981) 2 MLJ 384

[330] (1968) 2 Comp LJ 155 (172).

[331] Now Company Law Board after the Companies (Amendment) Act, 1974

In *R. Rangachari* v. S. *Suppiah,*[332] the Supreme Court held that the Company Law Board (now Tribunal) does not have the power to give directions for the conduct of a meeting which was already called earlier by the directors nor has it the power to decide the validity of such earlier meeting.

In Re *Lothian Jute Mills,*[333] there was a dispute between the shareholders of the company as to who were the lawful directors of the company to call a meeting. It was held to be proper that the Court (now Tribunal) should intervene and call a meeting the validity of which shall be beyond question.

6.3.4 Class Meetings:

Besides the general meetings of the company, namely, (i) Statutory meeting, (ii) Annual General meeting and (iii) Extraordinary general meetings, the articles of a company may provide that certain matters affecting the interests of the holders of a particular class of shares shall be subject to the consideration and decision of a meeting of those holders only. Such meetings are called 'Class Meetings'. In other words, class meetings are those meetings which are held by shareholders of a particular class of shares *e.g.,* preference shares. The class meetings are usually required to be held when it is proposed to alter, vary or affect the rights of a particular class of shares. For effecting such changes, it becomes necessary to call separate class meetings of the holders of those shares and seek their approval. Thus for example, where a company desires to cancel the arrears of dividends on cumulative preference shares, it is necessary to call a meeting of such shareholders and pass a special resolution as required by Section 106 of the Companies Act.[334]
Article 3(2) of Table A provides that regulations contained of this Table relating to general meeting will apply to every such class meeting of shareholders or of debenture holders with such adaptations and modifications if any, as may be prescribed by the Act.[335]

When in pursuance of alterations in the rights of holders of a particular class of shares, the holders of not less than ten per cent of the issued shares of that class who did not consent to or vote in favour of the

[332] AIR 1976 SC 73
[333] (1950) 55 CWN 646.
[334] Secs. 106 and 107 deal with alteration of rights of holders of special classes of shares.
[335] Sec. 107

resolution for such alteration, may apply to the Tribunal[336] to have the alteration cancelled within twenty-one days after the date on which the consent was given or resolution was passed. The Tribunal may, after hearing the applicants and any other interested person, if satisfied, disallow the variation and if not satisfied allow it. The decision of the Tribunal in this regard shall be final.[337]

Meeting of the Creditors [Section 391]

The meeting of the creditors is usually called when the company wants to make any compromise or arrangement with the creditors or any class of them. In fact these meetings are not the meetings of the company as they are called by the creditors. Creditor's meeting may be called for any of the following purposes[338]—

(i) to enter into a compromise or arrangement proposed between a company and, its creditors or any class of them; or for a compromise or arrangement between a company and its members or any class of them;

(ii) to seek approval of creditors for amalgamation or reconstruction of a company; or

(iii) to seek consent of the creditors for winding up of a company.

In case of a company which is being wound up, any creditor or class of creditors or liquidator may apply to the court for ordering a meeting of the creditors or class of creditors. If the majority in number representing 3/4th in value of the creditors be present and voting either in person or by proxy (where allowed under rules made under Sec. 643) agree to the compromise or arrangement, shall if sanctioned by the court, be binding on all the creditors, liquidators or contributories, as the case may be.[339]

In case of voluntary winding up, the company, shall cause a meeting of its creditors to be called on the day or the next day on which the general meeting of the company is held at which the resolution for voluntary winding up was proposed and cause notices of the meeting of creditors to be sent by post to the creditors simultaneously with the notice of the meeting of the company.[340]

The notice of each such meeting shall be published not less than one month before the meeting in the Official Gazette and also in some

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[336] Sec. 107 (1). In this Section the word 'Tribunal' substituted for the word 'court' by the Companies (Second Amendmend) Act, 2002.

[337] Sec. 107 (4)

[338] Sec. 391

[339] Sec. 390 (2)

[340] Sec. 500

newspaper circulating in the district where the registered office of the company is situate.[341]

Meeting of Debenture-holders

The company may call the meeting of debenture holders to consider, (i | a variation in the conditions of their security or (ii) any alteration in their rights. The company may also hold debenture holder's meeting for issuing new debentures or effecting a change in the rate of interest on the existing debentures. The rules and procedure of these meetings are usually stated on the reverse of the debenture trust deed.

Meetings of Board of Directors

The directors of a company collectively constitute the Board of Directors which exercises its powers at periodical meetings of the Board. Section 285 of the Companies Act provides that a meeting of the Board of Directors of the Company should be held at least once in every three months and at least four meetings should be held in every year. The Central Government may, however, modify this rule in relation to any class of Companies.[342]

The notice of every Board meeting has to be given in writing to every director who is in India.[343] The Act, however, does not prescribe any form of notice or mode of service of the notice. The notice need not specify the agenda for the meeting. Even a few minutes may be sufficient to hold the Board's meeting.[344]

The quorum for the Board's meeting is one third of its total strength (any fraction to be rounded off as one) or two directors, whichever is higher.[345]

The procedure of conducting the meeting of the Board of Directors is contained in Regulations 64 to 81 of Schedule I of the Companies Act. The matters are put in the form of resolutions proposed and approved.

The proceedings of every meeting of the Board of Directors or any of its committees have to be recorded in a Minute Book which enables the shareholders to know exactly "what their directors have been doing, why it was done and when it was done.

6.3.5 Requisites of a Valid Meeting:

[341] Sec. 509 (2) (b).
[342] Sec. 285 proviso.
[343] Sec. 286 (1)
[344] Smith v. Paringa Mines Ltd. (1906) 2 Ch 193.
[345] Sec. 287

A meeting can validly transact any business if the following requirements are satisfied:

1. The meeting must be duly convened by a proper authority.
2. A proper notice must be served in the prescribed manner.
3. A *quorum* must be present.
4. A *chairman* must preside.
5. *Minutes* of the proceedings must be kept.

1. Proper authority:

The proper authority to convene a general meeting (whether statutory, annual general or extraordinary) of a company is the Board of directors. The Board should pass a resolution to call the general meeting, at a duly convened meeting of the Board. If the directors do not call the meeting, the members or the Company Law Board may call the meeting.

If some defect in the appointment or qualification of the directors present at the Board meeting comes to light after the Board has acted *bona fide,* such a defect is not necessarily fatal to the validity of their resolution to call the meeting. Even if the meeting of the Board at which it is resolved to call a general meeting is not properly convened or constituted, the general meeting called by the Board can act.[346]

Notice of meeting:

A proper notice of the meeting should be given to the members and all others who are entitled to attend the meeting.

Length of notice (Sec. 171)

Not less than 21 days' notice. A general meeting of a company *may be* called by giving not less that 21 days' notice in writing to the members. The use of the word 'may' in Sec. 171 does not mean that the notice can be dispensed with.

The expression "not less than 21 days' notice" implies notice of 21 whole or clear days. Part of the day, after the hour at which the notice is deemed to have been served, cannot be combined with the part of the day before the time of a meeting, or the day of the meeting, to form one day. Each of the 21 days must be a full or a calendar day, so that notice can be said to be not less than 21 days' notice.[347]

The period of 21 days is computed from the date of receipt of the notice by the members. It excludes the day of service of the notice and the day on which the meeting is to be held. Notice is deemed to have been received

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[346] *Browne* v. *La Trinidad,* (1887) 37 CH. D. 1

[347] *Bharat Kumar v. Bharat Carbon Ribbon Mfg. Co. Ltd., [19m* Comp. Cas. 1973 43.

by the *members at the expiration of 48 hours* after the letter containing it is posted.

Example. The Board of directors of *B.* Ltd. sent a notice of statutory meeting on 1st June, 1998. The earliest date by which this meeting can be held is 25th June, 1998. In this case the day of sending the notice, i.e., Ist June, 1998 and the day on which the meeting is to be held, *i.e.,* 25th June, 1998 are to be excluded. Similarly, 2nd and 3rd June are to be excluded for service of the notice of the meeting.

Less than 21 days' notice. A general meeting may be called by giving a notice of less than 21 days if it is so agreed—

(1) In the case of an annual general meeting, by all the members entitled to vote thereat. The members can voluntarily consent to a shorter notice either before or after the meeting.

(2) (a): In the case of any other meeting (e.g., a statutory meeting or an extraordinary general meeting) of a company having a share capital, by members holding not less than 95 per cent of the paid-up share capital as gives a right to vote, and

(b) in a company hot having share capital, by members having not less than 95 per cent of the voting power exercisable at the meeting.

If the members agree to accept a shorter notice, a resolution to that effect must be recorded in the minutes of the meeting with sufficient details of voting.[348]

In *Bailey, Hay & Co., Re*[349]., the notice of a meeting for, the voluntary winding up of a company was short by 1 day. All the 5 members of the company attended the meeting. The necessary resolution was passed by the votes of 2 members; the other 3 members abstained from voting. *Held,* the resolution was validly passed with the unanimous assent of all the members and those who abstained were treated as having acquiesced in the winding up.

Persons on whom notice is to be served and contents of notice (Sec. 172)

Notice to whom. Notice of every meeting of a company shall be given to—

(1) every member of the company entitled to vote ;

(2) the persons on whom the shares of any deceased or insolvent members **may** have devolved ; and

(3) the auditor or auditors of the company.

[348] Pearce *Duff &Co. Ltd., Re* (1960) 3 All E.R. 222.
[349] (1971) 1 W.L.R. 1357.

If notice of a meeting is not given to every person entitled to receive notice, any resolution

passed at the meeting will be of no effect.

In *Young* v. *Ladies' Imperial Club,*[350] A committee of a club and passed a resolution expelling *Y* from the club. The notice convening meeting stated that it was summoned "to report and discuss the matter concerning *Y." X,* a member of the committee, was not summoned to the meeting, as she had previously informed the chairman that she would be unable to attend meetings. *Held,* the omission to give notice to all those entitled to notice invalidated the proceedings of the committee and in any event the notice did not give sufficient indication of the purpose (i.e., expulsion of *Y)* of the meeting.

Omission to give notice. Deliberate omission to give notice even to a single member may invalidate the meeting.[351] An accidental omission to give notice to, or the non-receipt of notice by, any member or other person to whom it should be given, does not invalidate the proceedings at the meeting. 'Accidental omission' means that the omission must not be deliberate. The following is a case in point :

In *West Canadian Collieries, Ltd., Re.,*[352] Nine members of a company were not served with notice of a meeting. The addressograph plates containing the names and addresses of these members had been removed from the file because the dividend warrants sent to those addresses been returned or remained uncashed with the result that the company wished to verify their addresses. When the notices were sent out, these plates had not been replaced. *Held,* this was an accidental omission and the meeting was valid.

However, in the following case the failure to give notice of the meeting was not accidental and as such the meeting was held void.

In *Musselwhite* v. *CH. Musselwhite & Son Ltd.*[353]*, M sold* shares in *M* Ltd. to *D.* The payment was to be made by *D* to M by instalments. M was to remain on the register of members until the last instalment was paid. Before the last instalment was paid an annual general meeting was held but M did not receive the notice of the meeting as the directors erroneously believed that M was no longer a member. *Held, the* failure to give notice was not 'accidental' and the meeting held without notice to M was void.

[350] (1920) 2 K.B. 523.
[351] *Smyth* v. *Darley,* (1849) 2 H.L. Cas. 789.
[352] (1962) 1 All E.R. 26.
[353] (1962) Ch. 964.

Contents of notice. Every notice of a company calling a meeting shall specify the place and the day and hour of the meeting. It shall also contain a statement of the business to be transacted at the meeting.

The notice of a general meeting must fairly and intelligently convey the purpose for which the meeting is called to enable a person having the right to attend reasonably to make up his mind whether to attend or not. It should not be misleading or equivocal.[354]

In *Baillie* v. *Oriental Telephone & Electric Co.*[355] Between 1907 and 1914 the directors of a holding company had been receiving remuneration as directors of a subsidiary company without the shareholders of the holding company knowing this. A special resolution was passed at an extraordinary meeting authorising the directors to keep the money. The notice did not specify that the sum involved was nearly £45,000. *Held the* notice was bad because it did not give sufficient details.

In *Kaye* v. *Croydon Tramways Co.,*[356] A notice convening a meeting stated that the object of the meeting was to adopt an agreement for the sale of the company's undertaking to another company. The notice did not disclose that the directors were interested in the' agreement as a substantial part of the sale proceeds was to be paid to the directors as compensation for loss of office. *Held,* the notice was bad as it did not fairly disclose the purpose for which the meeting was called.

<u>Ordinary business and special business</u> <u>(Sec. 173)</u>

The notice shall contain a statement of the business to be transacted at the meeting. The business may be *ordinary* business or *special* business.

Ordinary business. In the case of an annual general meeting, the following business is deemed as ordinary business, *viz.,* business relating to—

(1) the consideration of the accounts, balance sheet and the reports of the Board of directors and auditors,
(2) the declaration of a dividend,
(3) the appointment of directors in place of those retiring, and
(4) the appointment of auditors and the fixing of their remuneration.

Special business. In the case of an annual general meeting, any business other than the ordinary business, and in the case of any other meeting, all business, is deemed special.

Some of the examples of special business are—

(1) Removal of a director,
(2) Issue of rights/bonus shares,
(3) Election of a person (other than a retiring director) as director.

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[354] *Laljibhai C. Kapadia* v. *Lalji B. Desai,* (1973) 43 Comp. Case. 17 (Bom).
[355] (1915) 1 Ch. 503.
[356] (1898) 1 Ch. 358.

If the notice does not specify the nature of the business to be special, it is bad in law. A meeting held in pursuance of such a notice is not said to be duly convened and the resolutions passed thereat are void and *ultra vires.*

In *Tiessen* v. *Henderson,*[357] A notice convening an extraordinary general meeting to consider two alternative schemes of reconstruction of a company did not disclose that the directors were strongly interested as underwriters in one of the schemes. *Held,* the notice was bad.

While ordinary business can be transacted at the annual general meeting only, special business can be transacted at the annual general meeting as also at the extraordinary general meeting.

Expl*anatory statement.* Where any special business is to be transacted at a meeting of a company, the notice shall specify its nature. It shall also have annexed to it an explanatory statement containing the following information :

(a) All material facts concerning each item of special business, including in particular the nature of the concern or interest (if any) therein of every director manager, if any.

Where the directors of a company are interested in a proposed contract which is to be considered at the meeting of the company, the notice convening the meeting should give particulars as regards such interest.

(b) Where any item of special business relates to, or affects, any other company, the extent of shareholding interest in that other company of every director and the manager (if any) of the company, if such interest is not less than **20** per cent of the paid-up share capital of that other company.

(c) Where any item of business consists of the accordance of approval to any document by the meeting, the time and place at which the document can be inspected.

Explanatory statement must give all facts which have a bearing on the question on which the shareholders have to form their judgment. A minor defect arising out of absence of strict conformity with the provisions of Sec. 173 relating to explanatory statement might not render an amendment of the Articles of Association null and void.[358]

Adjourned meetings—notice. An adjournment, if *bona fide,* is only a continuation of the meeting and the notice that was given for the first meeting hold good for and includes all the other meetings following it up.

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[357] (1899) 1 Ch. 861.

[358] Joseph Michael v. Travancore Rubber &tea Co. Ltd., (1986) 59 Comp. Cas. 898 (Ker.)

If, however, the meeting is adjourned sine *die,* a fresh notice must be given.[359]

Sec. 173 is mandatory and not directory. Any disobedience of the provisions of Sec. 173 must lead to nullification of the action taken.[360]

Quorum for meeting (Sec. 174)

Quorum' means the minimum number of members who must be present in order to constitute a valid meeting and transact business thereat. The quorum is generally rally fixed by the Articles. If the Articles of a company do not provide for a larger quorum, the following rules apply:

(1) *5 members personally present* in the case of a public company (other than a deemed public company), and *2* in the case of any other company, shall be the quorum for a meeting of the company. For the purpose of quorum a person may be counted as 2 or more members if he holds shares in different capacities, *e.g.,* as a trustee and also in his own right.

The representative of a body corporate appointed under Sec. 187 or the representative of the President of India or a Governor of a State under Sec. 187-A is *a member personally present* for the purpose of a quorum.

(2) If within half an hour a quorum is not present, the meeting, if called upon the requisition of members, shall stand dissolved. In any other case, it shall stand adjourned to the same day, place and time in the next week. The Board of directors may adjourn the meeting to be convened on any particular day, time and place to be fixed on the date of the meeting itself or at least before the commencement of the same in the next week. Where the Board of directors fails to do so, the meeting stands statutorily adjourned to the same day in the next week.[361]

(3) If at the adjourned meeting also, a quorum is not present within half an hour, the *members present* shall be the quorum.

The Articles may provide for a larger quorum. The Articles cannot provide for a quorum smaller than the statutory minimum. For the purposes of quorum only members present in person and not by proxies are to be counted. A company cannot, by its Articles or otherwise, provide for proxies being counted for purposes of a quorum.

Where the total number of members of a company becomes reduced below the quorum fixed for a meeting, the rules as to quorum will be satisfied if all the members of the company are present.

When should quorum be present? Article 49 (1) of Table A requires the quorum to be present at the time when the meeting *proceeds to transact*

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[359] *Chandrakant* v. Khaire v. *Shanta Kala,* (1989) 65 Comp. Cas. 130 (SC).

[360] *Vardhman Publisher Ltd.* **v.** *Mathrubhumi Ltd.,* (1991) 71 Comp. Cas. 1, 24 (Ker.

[361] *Ashok Mathew* v. *Majestic Kuries & Loans* (Pvt. Ltd. (1987)] 62 Comp. Cas. 865 (Ker.)

business. It need not be present throughout or at the time of taking vote on any resolution. Note the *following* case :

In *Hartley Baird Ltd., Re.,*[362] A meeting was summoned for the purpose of altering the class rights of certain shareholders. A quorum was present when the meeting began but it fell below the required number when a member, who opposed the resolution, left the meeting before the vote was taken. *Held,* the alteration was valid.

If during the meeting some shareholders leave so that quorum is not present, the meeting must be discontinued by adjournment. However, if a meeting is once organised and all parties have participated, no person or faction can, by withdrawing capriciously and for the sole purpose of breaking the quorum render subsequent proceedings invalid.

Rule in Sharp v. Dawes - *One person cannot constitute a meeting:*

The word 'meeting' *prima facie* means a coming together of more than one person. Strictly speaking, therefore, one shareholder cannot constitute a meeting. This is known as Rule in *Sharp* v. *Dawes.*

In *Sharp* v. *Dawes,*[363] A general meeting of a company was called for the purpose of making a call. Only one shareholder attended the meeting. The business of the company was carried through including a call on the shareholders. *D* was sued for the call he had failed to pay. In his defence, *D* argued that the call had not been validly made at a general meeting. *Held,* one person could not constitute a meeting.

Exceptions. In the following cases, one person may constitute a meeting :

(1) Where there is a class meeting of shareholders and all the shares of that class *[e.g.,* preference shares) are held by one person, he alone can constitute a meeting of the class and can pass a class resolution by signing it.

(2) Where the Company Law Board calls or directs the calling of an annual general meeting under Sec. 167, it has the power to direct that one member present in person or by proxy shall be deemed to constitute a meeting.

(3) Where the Company Law Board orders a meeting of a company (other than the annual general meeting) under Sec. 186 to be held, it may direct that even one member of the company present in person or by proxy shall be deemed to constitute a meeting.

(4) Where the Board of directors delegates, subject to the provisions of the Act. any of its powers to a committee, the committee may consist of

[362] (1955) Ch. 143.
[363] (1876) 2 Q.B.D. 26.

any one person (Article 77, Table A). In such a case, the only member of the committee shall constitute the quorum.

(5) Where a quorum is not present at a general meeting within half an hour of the meeting, the meeting shall stand adjourned to the same day in the next week at the same time and place. If at the adjourned meeting also a quorum is not present within half an hour of the time of the meeting, the members present are the quorum. In such a case even one member may constitute the meeting (Sec. 174).

4. Chairman of the meeting (Sec. 175)

Presiding officer of the meeting. A chairman is necessary to conduct a meeting. He is the presiding officer of the meeting. Unless the Articles of a company otherwise provide, the members personally present at the meeting shall elect one of themselves to be the chairman of the meeting on a show of hands. If a poll is demanded on the election of the chairman, it shall be taken forthwith. In such a case, the chairman elected on a show of hands shall exercise all the powers of the chairman. If some other person is elected chairman as a result of the poll, he shall be the chairman for the rest of the meeting. The Articles may provide some other method of election of chairman.

Importance of chairman. From the legal point of view, the importance of the chairman lies in the fact that he is responsible for keeping order and conducting the meeting.[364] He is the proper person to put motions to the meeting, count the votes, declare the result, and authenticate the minutes by his signature.

Duties of the chairman.

1. He must act at all times *bona fide* and in the interests of the company as a whole.
2. He must ensure that the meeting is properly convened and constituted, i.e., *(a)* a proper notice has been given, (b) the rules as to quorum are observed, and (c) his own appointment is in order.
3. He must ensure that the proceedings at the meeting are properly and regularly conducted.
4. He must ensure that the provisions of the Act and the Articles are observed, and the business is taken in the order set out in the agenda.
5. He must see that all the business transacted at the meeting is within the scope of the meeting.

[364] *Indian Zoedone Co., Re* (1884) 26 Ch. D. 70.

6. He must preserve and maintain order in the meeting and decide any points of order submitted to him.
7. He must ascertain the sense of the meeting properly with regard to any question before it. He must do so by putting the motions in their proper form, and declare the result of the voting.
8. He must decide incidental questions arising for decision during the meeting.
9. He must exercise his casting vote *bona fide* in the interests of the company.
10. He must exercise correctly his powers of adjournment and of taking a poll. He must see that any disorderly persons are removed, and where it is impossible to maintain order, he should adjourn the meeting. Even if the relevant rules do not give him the power to adjourn the meeting, he may do so in the event of disorder. The adjournment must not be longer than he considers necessary and he must, so far as possible, communicate his decision to those present.[365]
11. He must give the members who are present a reasonable and sufficient opportunity to express their views on a motion before the meeting. He must not allow discussion except upon the motion. But at the expiration of a reasonable time he is entitled, if he thinks fit, to put a motion to the meeting that the discussion be terminated and issue decided by voting.[366]
12. He must take care that the rights of the minority are not ignored.

Conduct of the meeting. The way in which a meeting is to be conducted is a matter for the chairman, with the assent of the persons properly present, to be determined in the light of the general law and the company's Articles of Association.[367]

5. Minutes of meeting (Sees. 193 to 196):

Minutes are a record of what the company and directors do in meetings.

Minutes **of** proceedings **of** meetings: (Sec. 193)

Every company shall keep a record of all proceedings of every general meeting and of all proceedings of every meeting of its Board of directors and of every committee of the Board. This is done by making within 30 days of the conclusion of every such meeting concerned, entries of the

[365] *Chandrakant Khaire* v. *Shantaram Kale,* (1989) 65 Comp. Cas. 121 (S.C.)

[366] Wall v. London 8-Northern Assets Corpn., (1898) 2 Ch. 469.

[367] *Carruth* v. *Imperial Chemical Industries Ltd.,* (1937) A.C. 707.

proceedings in the books kept for that purpose. These records are known as *minutes.*

Minutes book. The book in which the record of the proceedings of a meeting is kept is known as the minutes book. Separate minute books are required to be kept for shareholders' general meetings of the company and directors' meeting and usually there are also separate minute books for committee meetings of Board of directors.

The chief use of the minutes is that—

1. they contain a record of the business transacted with the decisions of the
shareholders and directors at their respective meetings;
2. they are available for inspection by interested parties, *e.g.,* shareholders, directors, secretary, auditors (shareholders are usually allowed to inspect only the general meetings' minutes book); and
3. they can be produced as evidence of the proceedings in a Court of Law.

Numbering of pages. The pages of every minutes book shall be consecutively numbered. In no case is the attaching or pasting of papers of proceedings of a meeting allowed in minutes books.

Signing of minutes. Each page of the minute's book which records proceedings of a Board meeting shall be initialled or signed by the chairman of the same meeting or the next succeeding meeting. The last page of the record of proceedings of each meeting in the minute's book shall be dated and signed. This has to be done—

(a) in the case of a Board or a committee meeting, by the chairman of the
or the next succeeding meeting, and

(b) in the case of a general meeting, by the chairman of the same meeting within
30 days of the meeting, or in the event of the death or inability of that chairman
within 30 days of the meeting, by the director duly authorised by the Board
for the purpose.

Fair and correct summary. The minutes of each meeting shall contain a fair and correct summary of the proceedings at the meeting, so that the absentee shareholders may be in a position to form some reliable idea of what transpired at these meetings. All appointments of officers made at any of the meetings aforesaid shall also be included in the minutes of the meeting.

***Contents of minutes of Board meeting**.* In the case of a meeting of the Board of directors or of a committee of the Board, the minutes shall also contain—

(a) the names of the directors present at the meeting ; and

(b) in the case of each resolution passed at the meeting, the names of the directors, dissenting from the resolution.

***Defamatory and irrelevant matters to be excluded**.* The chairman has a right to exclude from the minutes any matters which are defamatory, irrelevant, immaterial or detrimental to the interests of the company. He has an absolute discretion in this regard.

Penalty. If default is made in complying with the provisions of Sec. 193 in respect of any meeting, the company, and every officer of the company who is in default, shall be punishable *with fine which may extend to Rs. 500.*

Evidentiary value of **minutes** (Sec. 194)

Minutes of meetings kept in accordance with the provisions of Sec. 193 shall be evidence of the proceedings recorded therein and shall be conclusive of the facts stated therein. For example:

In *Kerr* v. *John Mottram, Ltd.*[368] An extraordinary general meeting of a company was summoned in order to offer for sale to the members' shares over which the company had a lien. The plaintiff claimed that he was the highest bidder for a block of shares and, therefore, there was a contract for the sale of such shares. The minutes of the meeting did not show that any such contract was entered into. *Held,* the minutes were conclusive evidence of the facts stated.

Presumptions to be drawn where minutes duly drawn and signed (Sec. 195). where minutes of the proceedings of any general meeting of a company or of any meeting of its Board of directors or of a committee of the Board have been kept in accordance with the provisions of Sec. 193, the meeting shall be deemed to have been duly called and held, until the contrary is proved. The proceedings at the meeting shall also be deemed to have duly taken place, and in particular, all appointments of directors or liquidators made at the meeting shall be deemed to be valid.

Location and inspection of minute books of general meetings (Sec. 196)

Location and inspection. The minute books containing the minutes of the proceedings of any general meeting of a company shall be—

(a) kept at the registered office of the company, and

[368] (1940) Ch. 657.

(b) open, during business hours, to the inspection of any member without
charge subject to reasonable restrictions. However, at least 2 hours in each day
are to be allowed for inspection.

Furnishing of copy. A member shall be entitled to be furnished, within 7 days of his request to the company, with copies of minutes on payment of such sum as may be prescribed for every 100 words or fractional part thereof required to be copied.

Penalty. If any inspection of the minute books is refused or if any copy required of the same is not furnished within 7 days, the company, and every officer of the company who is in default, shall be punishable with fine which may extend to Rs. 5,000 in respect of each offence.

Intervention by Central Government. In the case of any refusal in allowing inspection of minute books or default in furnishing the minutes, the Central Government may order immediate inspection of the minute books or direct that the copy required shall forthwith be sent to the person requiring it.

Publication of reports (Sec. 197)

Reports of the proceedings of any general meeting of a company shall not be circulated or advertised at the expense of the company unless all matters required by Sec. 193 to be included in the minutes of the proceedings of the meeting are included in the reports. If any report is circulated or advertised in contravention of Sec. 197, the company, and every officer of the company who is in default, shall be punishable in respect of each offence, with fine which may extend to Rs. 5,000.

Proxies (Sec. 176)

The term 'proxy' has a double meaning. A member entitled to attend and vote at a meeting may vote either in person or by proxy. A proxy is an authority to represent and vote for another person at a meeting. It is also an instrument appointing a person as proxy. The person so appointed is also called a proxy. A proxy is not entitled to act contrary to the instructions of the appointer. The proxy may or may not be a member of the company but he shall not have any right to speak at the meeting.

If the Articles do not otherwise provide—

(1) A proxy can vote only on a poll.

(2) A member of a private company cannot appoint more than one proxy to attend on the same occasion.

(3) A member of a company not having a share capital cannot appoint a proxy.

Proxy to be in writing. The instrument appointing a proxy shall be in writing and signed by the appointer or his attorney duly authorised in writing.

Proxy to be deposited 48 hours before the meeting. A proxy, in order to be effective, shall be deposited with the company 48 hours before the meeting. Any provision in the Articles of a public company or of a private company which is a subsidiary of a public company which requires a longer period than 48 hours before a meeting of the company for depositing a proxy, shall have effect as if a period of 48 hours had been specified for such deposit.

There is nothing in law to exclude Sunday in the computation of the 48 hours before a meeting before which proxies have to be delivered. Therefore, a proxy delivered on Sunday for a meeting to be held on Tuesday, that is, 48 hours later, would be valid, provided the receipt of the proxy at the time stated could be identified in some way.[369]

Proxy is revocable. A proxy is an agent of the person appointing the proxy, i.e., the principal. The principal may revoke the authority given to his agent at any time before the authority has been exercised [Sec. 203 of the Indian Contract Act, 1872]. The right of revocation can, however, be exercised before the proxy has voted. Where a shareholder who having appointed a proxy personally attends and votes at the meeting, the proxy is revoked thereby, and he can vote in person.

In *Cousins* v. *International Brick Co. Ltd.,*[370] Lord Hanworth observed in this regard: "It would be strange if a person in the position of an agent could say to his principal 'you have entrusted to me a power which I will not allow to pass back to you, although you demand the right to exercise it'."

The death or insanity of a shareholder after he has appointed a proxy shall not revoke the authority of the proxy, until the company has notice of the death or insanity (Article 63 of Table A).

Notice calling meeting to mention that members entitled to vote can appoint proxy. Every notice calling a meeting of a company shall mention with reasonable prominence that a member can appoint a proxy and that a proxy need not be a member. If default is made in complying with this provision, every officer of the company who is in default shall be punishable with fine which may extend to Rs. 5,000.

Invitation to appoint a person as proxy, sent at the expense of the company. For the purpose of any meeting of a company, invitations to appoint particular persons as proxy are sent to the members of the company at its expense, every officer of the company who knowingly or wilfully contravenes this provision shall be punishable with fine which may extend to Rs. 10,000.

[369] *K.P. Chackochan* v. *Federal Bank,* (1989) 66 Comp. Cas. 953 (Ker.)
[370] (1931) 2 Ch. 90.

Members can inspect proxies. A member is entitled to inspect the proxies lodged at any time during the business hours of the company. This can be done any time during the period beginning 24 hours before the meeting and till the conclusion of the meeting, provided at least 3 days' notice in writing of the intention so to inspect the proxies is given to the company.

A body corporate can appoint a proxy. A body corporate, which is a member of a company, can appoint a proxy, by resolution of the Board of directors. The proxy form shall be under seal or be signed by an officer or an attorney duly authorised by the body corporate.

Representation of the President of India and Governors of States (Sec. 187-A) The President of India or the Governor of a State may, if he is a member of a company, appoint any person to act as his representative in a meeting.

Validity of proxies—mistakes. It is the duty of the chairman to decide on the validity of proxies. If the Articles provide that votes cast at a meeting and not disallowed shall be deemed to be valid, the decision of the chairman in allowing or disallowing a vote will not be reviewed in the Courts if there is no bad faith or fraud on his part.[371]

A mere misprint or quite a palpable mistake (i.e., a mistake which is perceptible or which can be easily found out) on the face of a proxy form does not entitle the company to refuse to accept the proxy.

In *Oliver* v. *Dalgleish,*[372] The proxies referred to the 'annual general meeting' instead of to the 'extraordinary general meeting' and there was no other meeting which could be confused with that, the date of which was stated in the proxies. *Held,* the company could not refuse to accept the proxy.

Blank proxies. In *Swadeshi Polytex Ltd., re,*[373] the Delhi High Court has held that there is nothing wrong with the practice of blank proxy forms. A proxy form signed in blank as to the name of the proxy or as to the date of the meeting, and delivered with the authority to fill up the blanks, is not open to objection if, when deposited with the company, the blanks have been duly filled up.

Multiple proxies. Sometimes a shareholder may, deliberately or inadvertently, sign 2 proxy forms and hand them over to 2 persons, although both the forms represent the same shares. The persons to whom the forms are given may present the forms, after duly filling them up, to the company. If both the forms bear the same date, the company will reject both. If the 2 forms bear different dates, the proxy bearing the later

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[371] Wall v. Exchange Investment Corpn. Ltd. (1926) 1 Ch: 143 (C.A.)
[372] (1963) 3 ALL E.R. 330.
[373] (1988) 63 Comp. Cas. 709.

date would be entitled to attend the meeting. The proxy bearing a later date amounts to revocation of the one bearing an earlier date. If a proxy form does not bear any date, the company might reject it. When out of 2 forms in respect of the same shares, one does not bear any date that will be rejected and if both are undated both will be rejected by the company.[374]

Voting and Poll:

The motions proposed in a general meeting of a company are decided on the votes of the members of the company. The members holding any equity share capital therein have the right to vote on every motion placed before the company. Members holding preference shares can vote only on those motions which affect rights attached to their capital (Sec. 87).

A shareholder's vote is a right of property, and *prima facie* may be exercised by him as he thinks fit in his own interest. He is not bound to exercise it in the best interests of the company.

The voting may be:

1. by a show of hands, or
2. by taking a poll.

1. **Voting by a show of hands** (Sees. 177 and 178)

At any general meeting, motions put to vote are in the first instance decided by a show of hands, unless a poll is demanded (Sec. 177). In taking a vote by show of hands, the duty of the chairman is to count the hands raised and to declare the result accordingly, without regard to the number of votes that a member raising the hand possesses. Proxies cannot be used on a show of hands.[375]

Chairman's declaration of result of voting by a show of hands conclusive: (178). A declaration by the chairman as evidenced by an entry in the minutes book shall be conclusive evidence of the fact that a resolution has, on a show of hands, been carried. This will be so even without proof of the member of votes cast in favour of or against such resolution. And it is not open to a party to show from any alleged record of actual voting that the resolution was not carried.[376] The declaration of the chairman shall also not be affected even if it is later found that the resolution was passed by votes of unqualified shareholders. But the declaration would be of no avail if it contains the chairman's statement of the number of votes in

[374] *Swadeshi Polytex Ltd., Re* (1988) 63 Comp. Cas. 709.

[375] Earnest *Loma Gold Mines,* (1906) 2 Ch. 572.

[376] *Sassoon Ltd., Re,* 30 Bom. L.R. 598.

favour of and against the resolution and it apparently conflicts with the statement.

In *Caratal (New) Mines Ltd., Re,*[377] A special resolution was put to vote to the general meeting of a company and the chairman, on a show of hands, declared: "Those in favour 6; those against 23; but there are 200 voting by proxy, and I declare the resolution carried." *Held,* the chairman had no right to count the proxies and that; therefore, on the face of the declaration of the chairman the resolution had not been passed by the majority required by the Statute.

Rough and ready method. Voting by a show of hands may not effectively reflect the interests of the members of a company. Although results of voting by a show of hands can be known quickly, it is not an accurate method of ascertaining the wishes of the members as proxies are not counted. Again, every member, even though he may be the holder of a large number of shares, has only one vote on a show of hands. As such this method does not pay due regard to the wishes of a member holding a large number of shares. A more proper mode of ascertaining the wishes of the members is by taking a poll.

2. **Voting by poll** (Sec. 179)

If the members are dissatisfied with the result of voting by a show of hands, they may demand a poll. And unless a poll is demanded, voting is to be by a show of hands of persons present.[378] 'Poll' means counting of votes cast, and obviously it is taken to find out the votes cast for or against a motion.

The voting right of every member of a company on a poll is in *proportion* to his share of the paid-up equity capital of the company. Before or on the declaration of the result of voting on any motion on a show of hands, a poll may be taken by the chairman of the meeting of his own accord. It shall, however, be taken on a demand made in that behalf by the persons specified low:

(a) In the case of a public company having a share capital, a poll shall be
taken on a demand by any member or members present in person or by proxy
and holding shares in the company—

(i) which confer a power to vote on the resolution not being less than l/10th of the total voting power in respect of the resolution, or

(ii) on which an aggregate sum of not less than Rs. 50,000 has been paid up.

[377] (1902) 2 Ch. 498.
[378] *Nand Prasad* v. *Arjun Prasad,* (1959) 29 Comp. Cas. 552.

(b) In the case of a private company having a share capital, a poll shall be taken on demand by one member having the right to vote on the resolution and present in person or by proxy if not more than seven such members are personally present, and by two such members present in person or by proxy if more than seven such members are personally present.

(c) In the case of any other company, a poll shall be taken on demand by any member or members present in person or by proxy and having not less than l/10th of the total voting power in respect of the resolution.

The demand for a poll may be withdrawn at any time by the person or persons who made the demand. When, at a general meeting, a poll is demanded in respect of more than one motion, each such motion shall be put to poll separately.[379]

The provisions of Sec. 179 apply to a private company which is not a subsidiary of a public company unless the Articles of the company otherwise provide [Sec. 170 (l)(i)].

Time of taking poll (Sec. 180). A poll demanded on a question of adjournment or the appointment of a chairman shall be taken forthwith. In any other case, a poll shall be taken within 48 hours of the demand for poll.

Meeting in continuance until result of poll ascertained. A poll is complete when its result is ascertained, and not on an earlier day when the votes were cast. Where a poll is taken, the meeting is regarded as continuing until the ascertainment of the result of the poll.[380]

A meeting reconstituted after a poll is in continuance of the same meeting and a poll itself is part of the meeting.

In *Jackson* v. *Hamlyn,*[381] A poll was demanded on a question of adjournment and taken, but the scrutineers informed the chairman that the result could not be announced within the time during which the meeting hall was available. *Held,* the meeting subsequently convened to hear the result was a continuation of the original meeting and not an adjournment of it.

Manner of poll and result thereof (Sec. 185). The chairman of the meeting has the power to regulate the manner in which a poll is to be taken. However, the method usually followed is that of a ballot paper on which members record their decision, *i.e.,* 'for' or 'against' the motion. The result

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[379] Blair Open Hearth Furnace Co. Ltd., Re (1914) 1 Ch. 390.

[380] *Holmes* v. *Lord Keyes,* (1959) Ch. 199.

[381] (1953) 1 All E.R. 887.

of the poll shall be deemed to be the decision of the meeting on the motion on which the poll is taken.

Scrutineers at poll (Sec. 184). When a poll is to be taken, the chairman shall appoint 2 scrutineers to scrutinise ballot papers and report thereon. One of the scrutineers shall be a member of the company present at the meeting provided he is willing to be so appointed. The chairman shall have power, at any time before the result of the poll is declared, to remove a scrutineer from office and to fill vacancies in the office of scrutineer arising from such removal or from any other cause.

A private company which is not a subsidiary of a public company is not bound to follow the provisions of Sees. 180, 184 and 185 provided it makes its own provisions in the Articles as regards matters contained in these Sections [Sec. 170 (1) *(ii)].*

Restrictions on voting power (Sees. 181 and 182)

The Articles of a company may provide that no member shall exercise any voting right in respect of any shares registered in his name on which a call or
any other sum due to the company has not been paid (Sec. 181). This restriction also applies in respect of shares in regard to which the company has any right of lien and has-exercised this right (Sec. 182).

Where the Articles of a company do not contain any provision restricting the exercise of voting right of members, a member cannot be prevented from voting even though calls or other sums payable by him have not been paid or the -company has, or has not, exercised any right of lien over the shares.

Right of member to use his votes differently (Sec. 183)

On a poll taken at a meeting of a company, a member entitled to more than one vote, or his proxy, need not, if he votes, use all his votes or cast in the same way all the votes he uses.

A private company which is not a subsidiary of a public company may make its own provisions in the Articles as regards matters contained in Sees. 181 to 183 [Sec. 170 (1)].

Representation at meetings:

Representation of companies at meetings (Sees. 187). Where a body corporate is a member of another company, it may, by a resolution of its Board of directors or other governing body, authorise some person to act as its representative at any meeting of the company. A person appointed to act as aforesaid shall be entitled to exercise the same rights and powers as the body corporate could exercise.

Representation of the President and Governors at meetings (Sec. 187-A). The President of India or the Governor of a State, if he is a member of a company, may appoint such person as he thinks fit to act as his representative at any meeting of the company. A person appointed to act as aforesaid shall be entitled to exercise the same rights and powers as the President or the Governor could exercise.

Benami holding of shares (Sees. 187-C and 187-D)

All benami holdings of shares must be declared within a specified time both by the benamidar and the beneficial owner and failure to do so is punishable (Sec.187-C).

Sec. 187-D makes provision for investigation for the purpose of ensuring compliance with Sec. 187-C.

Voting on shares held in trust (Sec. 187-B)

The rights and powers (including the right to vote by proxy) of trustees of shares have now been vested in the public trustee appointed under Sec. 153-A. The public trustee may, instead of himself attending the meeting and exercising the rights and powers, appoint a Government officer or the trustee himself as his proxy. He may also abstain from exercising the rights and powers if in his opinion the objects of the trust or the interests of the beneficiaries of the trust are not likely to be adversely affected by such abstention. If, however, the trustee considers that the public trustee should not abstain from exercising the rights and powers, he may communicate his views to the public trustee. This he can do when he considers it necessary to safeguard the objects of the trust or the interest of the beneficiaries of the trust. The public trustee may in his discretion either accept the views of the trustee or reject the same. If he abstains from exercising the rights and powers conferred on him, no suit, prosecution or other legal proceeding shall lie against him.

6.4. SUMMARY:

The general meeting of the members of a company is intended to be the means whereby the members exercise control over the management. There are three kinds of general meeting of members of a company, i.e.,

(1) the statutory meeting

(2) the annual general meeting

(3) the extraordinary general meeting

The object of the statutory meeting is to provide the shareholders with all the important facts and information relating to the new company, as early

as possible. In addition to it, every company must hold in each year a general meeting of its shareholders as its annual general meeting in addition to any other meeting in that year. The main object of the annual general meeting is to place before the shareholders, the result of the year's working. All general meetings other than annual general meeting and statutory meeting. The extraordinary general meeting is called for transacting some special or urgent business which cannot be postponed till the next annual general meeting. In order to constitute a valid meeting a quorum of members must be present.

6.5. SUGGESTED READINGS/REFERENCE MATERIAL:

25. Avtar Singh : Company Law.
26. N.D. Kapoor : Elements of Company Law.
27. N.V. Paranjape : Company Law.
28. Taxmann : Company Law.
29. Gower, L.C.B. Principles of Moderen Company Law.
30. Ramiya : Guide to the Companies Act.

6.6. SELF-ASSESSMENT QUESTIONS:

(1) What is Statutory Meeting? When and how is it held?

(2) What are the statutory provisions with respect to notice of annual general meeting as to length, time, place, form and person entitled thereto?

(3) Write short note on the following:

  (a) The annual general meeting

  (b) The extraordinary general meeting

  (c) Conduct of annual general meeting

  (d) Quorum for meetings

  (e) Minutes.

LL.M. Part-1
PAPER CORPORATE LAW

Block II –Director And Managerial Personal
Unit 7- Protection of Minority Rights, Prevention of Oppression and Mismanagement

STRUCTURE

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7.1. Introduction:

Like any other institution, a company is run by democratic process and administration of its affairs is carried on by resolution of a majority of shareholders passed at the duly convened general meeting and at the meeting of the Board of Directors. The matters on which the members are divided are decided by the majority votes of the shareholders. Thus majority power has great importance in the working of a company and the "Tribunal will not generally intervene at the instance of shareholders in matters of internal administration, and will not interfere with the management of a company by its Board of directors so long as they are acting within the powers conferred on them under the articles of the company".[382]

In a public limited company, the members holding paid-up equity shares have a right to vote in respect of every resolution placed before the company in its general meetings. The right of a member to vote has been recognized as right of property and he may exercise this right in a manner he likes according to his choice and wishes. The resolutions carrying majority support are normally binding upon the minority shareholders and consequently upon the company.[383]

It has already been stated earlier that supremacy of the majority is the fundamental rule governing Company Law administration. But sometimes the majority shareholders may tend to abuse their powers to the detriment of the minority shareholders. Therefore it becomes necessary to maintain a proper balance between the rights of majority and minority shareholders for the smooth functioning of the company.

It has also been said that the ultimate authority of the company's management vest with the general meeting which can decide certain issues by an ordinary resolution and some other issues by a special resolution. The directors of the company are elected by the shareholders and their powers are regulated by the articles of association. The acts done with the consent of the majority of the company in its general meetings are deemed to have been done properly and are therefore legally valid. There are, however, certain exceptions to this general principle which are explained under the Foss v. Harbottle Rule (see 3.1). In order to extend protection to minority interests, a positive check has been provided in Section 265 of the Companies Act which contains provision relating to

[382] *Rajmundry Electric Supply Corporation v. Nageshwara Rao* , AIR 1956 SC 213 (217).
[383] *North-West Transportation Co. v. Beatty,* (1887) LR 12 AC 589.

proportional representation for the appointment of directors so that minority interests may also get proper representation in the Board of Directors. However, this check may not itself be sufficient enough to ensure adequate protection to minority shareholders in all the cases. Therefore some additional safeguards are deviced under the Companies Act, to provide relief in case of oppression and mismanagement in the affairs of the company. The ultimate object of these provisions is to protect the interest of investors and public in general.

7.2. Objective:

The objective of this lesson is to apprise the students about the concepts like Majority Rule and Minority Rights and prevention of oppression and mismanagement under Companies Act, 1956 along with the discussion on the principle of Majority Rule, Advantages and Exceptions to the rule, Protection of minority investors and creditors as well as who may apply for prevention of oppression and mismanagement and what are the powers of NCLT and Central Government with the help of statutory laws & the relevant case laws.

7.3.1 The Rule in Foss vs. Harbottle:

The principle that the will of the majority should prevail over the will of the minority in matters of internal administration of the company is known as the rule in *Foss* v. *Harbottle.*[384] According to this principle the Courts will not, in general, interfere at the instance of the shareholders, in the management of a company by its directors so long as they are acting within the powers conferred on them by the articles of the company. As James, LJ put it, "nothing connected with the internal disputes between the shareholders is to be made the subject of an action by a shareholder.[385] The principle of non-interference in the exercise of powers by majority is based on the assumption that the shareholders who provide the capital to the company and bear the risk should be given wide powers of control. Therefore, a resolution of majority of members passed at a duly convened and constituted meeting is binding upon the minority as also the company as a whole. This rule was for the first time laid

[384] (1843) 67 ER 189.
[385] Mac Dougall v. Gardiner, (1875) 1 Ch D 13.

down in the historic case of *Foss* v. *Harbottle* the facts of which are as follows:

In this case an action was brought by two shareholders (Foss and Turton) in an incorporated company called the 'Victoria Park Company' against company's five directors and others, alleging fraudulent and illegal transactions whereby the property of the company had been misapplied and wasted and certain mortgages were improperly given over the company's property. The plaintiffs sought appointment of a receiver and action against the defendants for losses caused to the company. The Court rejected the petition and ruled that it was incompetent for the plaintiffs to bring such proceedings, the sole right to do so being vested in the company in its corporate character. The Court observed:

"The conduct with which the defendants are charged is an injury not to the plaintiffs exclusively; it is an injury to Whole Corporation. In such cases the rule is that the corporation should sue in its own name and in its corporate character. It is not a matter of course for any individual members of a corporation thus to assume to themselves the right of suing in the name of the corporation. In law the corporation and the aggregate of members of the corporation are not the same thing for purposes like this."

The rule established in this case was that Courts will not ordinarily intervene in a matter which the company is competent to settle itself or in case of an irregularity, can ratify or condone it by its own internal procedure. The rationale behind majority-rule is that on becoming a member of a company the shareholder agrees to submit to the will of the majority of the members expressed in general meeting and in accordance with the law, memorandum and articles. Therefore, an action which is supported by majority shall be binding on the minority and no suit against such action would lie at the instance of the minority.

The essence of the rule is that the majority have a right to determine everything connected with the management of the company where a general meeting has confirmed the action taken by the directors, the minority cannot be permitted to bring an action which might nullify the wishes of the majority shareholders. The supremacy of this rule was affirmed by Mellish, LJ in *Macdougall* v. *Gardiner.*[386] Wherein he observed:

"In my opinion if the thing complained of is a thing which, in substance, the majority of the company are entitled to do, or something has been done irregularly which the majority of the

[386] (1875) 1 Ch D 13 (25

company arc entitled to do regularly, or if something has been done illegally which the majority of the company arc entitled to do legally, there can be no use having litigation about it, the ultimate end of which is only that a meeting has to be called, and then ultimately the majority gets its wishes.

The rule in *Foss* v. *Harbottle* was also referred to by Lord Davey in *Burland* v. *Earle*[387] in the following words:

"It is an elementary principle of law relating to joint stock companies that the Court will not interfere with the internal management of companies acting within their powers and in fact has no power to do so."

It has now been well settled that in order to redress a wrong done to the company or to recover damages alleged to be due to the company, the action should be brought by the company itself and not by its members. The principle holds good even in the case of an act of a company which has been done in an irregular manner provided that irregularity is of such a nature that it is within the power of the majority to regularise it.

The rule was again re-stated in *Edward* v. *Halliwell,*[388] wherein Jenkins, LJ observed:

"The rule in *Foss* v. *Harbottle* comes to no more than this. First, the proper plaintiff in respect of a wrong alleged to be done to a company is *prima facie* the company itself. Secondly, where the alleged wrong is a transaction which might be made binding on the company by a simple majority of members, no individual member of the company is allowed to maintain an action in respect of that matter for the simple reason that, if a mere majority of the members of the company is in favour of what has been done, then *cadet questio.* If on the other hand, a simple majority of members of the company is against what has been done; then there is no valid reason why the company itself should not sue."

Again, in *Pavlides* v. *Jensen,*[389] minority shareholders brought an action for damages against three directors and against the company itself alleging that they had been negligent in selling a mine owned by the company for £ 1,82,000 whereas its real value was £ 10,00,000. The Court held that the action was maintainable. Giving reasons for the decision the learned Judge observed, "It was open

[387] (1902) AC 83.
[388] (1950) 2 AII ER 1064 (1066)
[389] (1956) Ch 565.

to the company, on the resolution of a majority of the shareholders to sell the mine at a price decided by the company by a vote of majority to decide that if the directors by their negligence or error of judgment had sold the company's mine at an under-value, proceedings should not be taken against the directors."

In *Gray* v. *Lewis,*[390] it was held that a company is a persona at law; therefore the action is vested in it and cannot be brought by individual shareholder. Where there is a corporate body capable of filing a suit for itself to recover property either from its directors or officers or from any other person that corporate body is the only proper plaintiff to sue and none else.

Again, in *Bamford* v. *Bamford,*[391] the Court held that if the directors exercise any of their *intra vires* powers improperly, their act may be ratified by an ordinary resolution after full and frank disclosure by the directors to the shareholders.

Lindley, LJ in *Browne* v. *La Trinidad,*[392] said in more emphatic terms:

"It is most important that the Court should hold fast to the rule *i.e. ,Foss* v. *Harbottle* upon which it has always acted, not to interfere for the purpose of forcing companies to conduct their business according to the strictest rules, where the irregularity complained of can be set right at any moment."

The principle of majority rule was applied by Plowman, J. in *Bentley Stovens* v. *Jones,*[393] where a notice of motion was taken out by the plaintiff for an interlocutory injunction restraining the defendant company from acting upon a resolution removing him from directorship on the ground that the extra-ordinary meeting at which the resolution was alleged to have been passed was not properly convened, since no Board meeting was held for the purpose of convening such meeting. It was held, that the plaintiff was not entitled to injunction to restrain company from exercising its statutory right to remove him.

The Supreme Court of America affirmed the principle laid down in *Foss* v. *Harbottle* in *Mc Candless* v. *Furland.*[394] Justice Cardozo in this case held that the erring directors can get themselves absolved from their liability provided they can muster the support of majority shareholders.

[390] (1873) 8 Ch 1035 (CA)
[391] (1969) 1 All Er 969 (CA).
[392] (1887) 37 Ch D 1 (17)
[393] (1974) 2 AII ER 653
[394] 296 US 140 (157)

In India the importance of the majority power has been recognised in *Bhajekar* v. *Shinkar*[395], In this case the directors of a company resolved to appoint a company as its managing agents.[396] The appointment was confirmed at two general meetings of the company despite objections from certain shareholders. Thereupon, the dissenting shareholders who were in minority brought action to restrain the managing agents from acting. Their argument was that the appointee managing agents were a dummy company and it was not in the company's interest to appoint them. The Court ordered a general meeting to be held under the supervision of a chairman appointed by it. The chairman put a resolution to the effect "whether the company is willing to maintain the suit and proceed with it". The resolution was lost. Under these circumstances Court held, "it is difficult to see how a few shareholders who represent a minority are entitled to maintain the suit and ask the Court to interfere on the question as to who should be the managing agents of the company". The action therefore failed.

In *Parashuram* v. *Tata Industrial Bank,*[397] it was held that unnecessary interference of the Court is likely to paralyse the working of the joint stock companies and therefore the Court should not intervene in the internal affairs of the company. In this case the minority shareholders prayed for injunction restraining the newly appointed directors and auditors from assuming their office since their appointment at the general meeting held on 1st May, 1923 was alleged to be invalid due to irregular procedure at the meeting. The Court, however, refused to intervene in the majority decision of the company taken at its duly convened general meeting.

Again, in *Jhajharia Bros. Ltd.* v. *Sholapur Spinning & Weaving Co. Ltd.*[398]*,* the Court refused to intervene in the majority decision of the company. The facts of the case were:

The plaintiffs Jhajharias, were the managing and the sole selling agents of the defendant company. They held minority interests in the company. The company dismissed them from both the offices. They owed certain sums to the company for which a good number of their shares were forfeited and allotted to the new managing agents. The new agents, with the help of these votes combined with those of directors and some shareholders managed to pass a

[395] AIR 1934 Bom. 243

[396] Managing agencies (i.e Sections 324 to 348) have been abolished w.e.f. 3-4-1970 by reason of Amendment act of 1969.

[397] AIR 1924 Bom. 102. See also Ram Kumar Poddur v. Sliolapur Spinning and Weaving Co. Ltd. AIR 1934 Bom. 427.

[398] AIR 1941 Cal. 174

resolution for further increase of capital which was underwritten by them. They thus placed themselves in a position of safe majority. The plaintiffs challenged this action of the majority. The Court refused to intervene and observed that there was no inherent wrong in majority further increasing its own majority, unless there is an element of expropriations or coercion. Proof of animosity by itself would not be enough for the action to succeed.

The rule had also been applied in *Normandy* v. *Ind Coope & Co. Ltd.,*[399] where a shareholder was not allowed to maintain an action against directors increasing their remuneration without the sanction of the general meeting. The Court held that plaintiff must appeal to the general meeting for redressed and relief.

7.3.2 Advantages of rule in *Foss* v. *Harbottle:*

1. *Recognition of the separate legal personality of company:* If a company has suffered some injury, and not the individual members, it is the company itself which can seek redress.

2. *Need to preserve right of majority to decide.* The principle in *Foss v. Harbottle* preserves the right of majority to decide how the affairs of the company shall be conducted. It is but fair that the wish of the majority should prevail.

3. *Multiplicity of futile suits avoided.* Clearly, if every individual member were permitted to sue anyone who had injured the company through a breach of duty, there could be as many actions as there are the members. Legal proceedings would never cease, and there would be enormous wastage of time and money.

4. *Litigation at the suit of a minority is futile if majority do not wish it.* If the irregularity complained of is one which can be subsequently ratified by the majority, it is futile to have litigation about it except with the consent of the majority in a general meeting.

In the case of *MacDougall* v. *Gardiner,*[400] the Articles of a company empowered the chairman, with the consent of the meeting, to adjourn a meeting, and also provided for taking a poll if demanded by the shareholders. The adjournment was moved and declared by the chairman to be carried. A poll was then demanded and refused by the chairman. A shareholder brought an action for a declaration that the chairman's conduct was illegal. *Held,* the action could not be

[399] (1908) 1 Ch 84
[400] (1875) 13 Ch. D.1

brought by the shareholder; if the chairman was wrong, the company alone could sue.

7.3.3 Exception to the rule in *Foss* v. *Harbottle:*

Even though the will of majority in a company prevails, there are a number of occasions when the principle of majority rule has been misused. The whip of majority has often produced sullen effects, prejudicial to the best interests of the company. On these occasions the minority shareholders may bring an action. These are the exceptions to the rule in *Foss* v. *Harbottle.* In these cases, the will or supremacy of the majority cannot prevail. The exceptions are based on the principles of natural justice and fair play. Palmer has rightly observed in this regard that "a proper balance of the rights of majority and minority shareholders is essential for the smooth functioning of a company."

The exceptions to the rule in *Foss* v. *Harbottle* are as follows:

(1) *Where the act done is illegal or ultra vires the company.* Every shareholder has a right, by injunction, to restrain the company from doing any act which are *ultra vires* the company or are illegal. These acts cannot be adopted even by a unanimous vote of the shareholders. As such even a majority resolution of the company not to sue may be of no avail against an action by a minority to restrain the commission of an *ultra vires* act, or an action to compel the directors to compensate the company for loss sustained by such acts.

Suppose, for instance, that the directors of a company decide with the support of the majority, to use its funds for purposes not authorised by the memorandum and Articles of Association. The decision, if carried out, will not only be injurious to the company but also beyond its powers. It is a well-settled law that in such an event even a minority of shareholders can sue to restrain the company from giving effect to the decision.[401]

In *Bharat Insurance Co. Ltd.* v. *Kanhaya Lai*[402]*,* one of the objects of a company was to "advance money at interest on the security of land, house, machinery, and other property situated in India” A shareholder of the company complained that "several investments have been made by the company without adequate security and contrary to the provisions of the Memorandum" and therefore

[401] *Marikar (Motors)* v. M.I. *Ravikumar,* (1982) 52 Comp. Cas. 392

[402] A.I.R. (1935) Lah. 792.

prayed for a perpetual injunction to restrain the company from making such investments. *Held,* the shareholder could maintain the suit.

2. *Where the majority are perpetrating a fraud on the minority.* Where the majority of a company's members use their power to defraud or oppress the minority, the Court will interfere at the instance of the minority.' Take a case, for instance, where the directors decide upon a course of action which is advantageous to themselves but injurious to the company. A suit by a minority in such a case as champions of the company's interests would lie.

Examples of fraud or oppression by majority are found in the following cases:

In *Menierv. Hooper's Telegraph Works Ltd.*[403]*,* majority of the members of Company *A* were also members of Company B and at a meeting of Company *A* they passed a resolution to compromise an action against Company *B* in a manner alleged to be favorable to Company B but unfavourable to Company *A. Held,* the minority shareholders of Company *A* could bring an action to have the compromise set aside. It was observed that it would be a shocking thing if the majority of shareholders are allowed to put something into their pockets at the expenses of the minority.

In Cook v. *Deeks,*[404] three directors of a railway construction company entered into a contract in their own names. They have however used their position as directors to obtain the contract. As such they were trustees for the benefit of the company. But by virtue of their shareholding (three-quarters of the issued share capital), they induced the company to pass a resolution declaring it had no interest in the contract. *Held,* the directors must account to the company for the profit they made, which was obviously at the expense of minority.

3. *Where the company is doing an act which is inconsistent with the Articles.* The minority shareholders can restrain the company from doing an Act which is inconsistent with the Articles. They can also bring an action to restrain the alteration of the Articles which is not made *bona fide* for the benefit of the company as a whole.

In *Brown v. British Abrasive Wheel Co.,*[405] A large majority of the shareholders wished to buy up the minority with a view to extending the capital. The minority refused to sell, and the majority then passed a special resolution altering the Articles so as to enable 9/l0

[403] (1874) L.R. 9 Ch

[404] (1916) 1 A.C. 554

[405] (1919) 1 Ch.290

of the shareholders to buy any other shareholders. The alteration of the articles was restrained.

4. *Where the act can only be done by a special resolution, but in fact has been done by a simple majority by passing only an ordinary resolution:* In such a case any member or members can bring action and get injunction restraining the majority. Again, if an insufficiently informative notice is given (e.g., a notice not stating the purpose of the meeting with sufficient detail or deliberately holding back some material information) of a resolution to be passed at a meeting of members, any member who did not attend the meeting may bring action to restrain the company and its directors from carrying out the resolution.

5. *Where the personal rights of an individual member have been infringed*: Every shareholder has certain rights against the company. Some of these rights have been conferred by the Companies Act itself; some arise out of the articles or general law. If any such right is in question, a single shareholder can defy a majority consisting of all other shareholders. Thus, for example, where the dividend of a shareholder has been withheld or where he has been disallowed to cast a vote, the company's duty to him has been broken and he is injured thereby. He can, in such a case, take action against the company for enforcement of his right.

Jessel, M.R. observed in *Pender* v. *Lushington*[406], in this regard as follows:

"He is a member of the company, and whether he votes with the majority or the minority, he is entitled to have his votes recorded—an individual right in respect to which he has a right to sue. That has nothing to do with the question like that raised in *Foss* v. *Harbottle* and that line of cases. He has a right to say, 'whether I vote in the majority or minority, you shall record my vote, as that is a right of property belonging to my interest in the company, and if you refuse to record my vote, I will institute legal proceedings against you to compel you."

6. *Where there is breach of duty.* The minority shareholders may bring an action on against the company where there is a breach of duty by the directors and majority shareholders to the detriment of the company. The action will be allowed even where there is no fraud.

In Daniels v. *Daniels*[407], A company, on the instruction of two directors (who were husband and wife) having majority

[406] (1877) 6 Ch. D. 7Q

[407] (1978) Ch. 406

shareholding, sold the company's land to one of them (the wife) at a gross undervalue. The minority shareholders brought an action against the directors and the company. *Held,* the minority shareholders had a valid cause of action as the directors knew or ought to have known that the sale was at a gross undervalue.

7. *Where there is oppression of minority or mismanagement of the affairs of the company:* Sections 397 and 398 (discussed in the same Chapter) which provide for prevention of oppression and mismanagement are also an exception to the rule in *Foss* v. *Harbottle.*

7.3.4 Minority Protection:

Majority rule and its counter-balance in minority protection - The Companies Act, 1956 attempts to maintain a proper balance between the rights of the majority and the minority shareholders. It admits in principle the *rule of majority* but limits it at the same time by a number of well-defined minority rights, thus protecting the minority shareholders.

Minority shareholders are protected by various rights given to shareholders by the Companies Act, 1956. These relate to:-

(a) the variation of class rights (Sees. 106-107);

(b) the right to apply to the Central Government/Company Law Board to have the affairs of the company investigated (Sections 235 to 250);

(c) schemes of reconstruction and amalgamation (Sees, 391 to 395); and

(d) prevention of oppression of minority and of mismanagement (Sees. 397 and 398).

These rights of minority shareholders are discussed below:

(a) *Variation of class rights:* If the capital is divided into different classes of shares, the Memorandum or the Articles may provide that the special rights of each class of shareholders may be altered with the consent of the 3/4ths majority of the shareholders of that class. Where this is done and the rights are varied by the requisite majority vote, shareholders holding not less than 10 per cent of the issued shares of that class who had not assented to the variation may apply to the Court for the cancellation of the variation under Sec. 107 of the Act.

(b) *Investigation by Central Government* (Sec. 235)

(c) *Schemes of reconstruction and amalgamation.* Protection is given to minority shareholders under Sec. 391 which deals with scheme of reconstruction.

(d) *Prevention of oppression and mismanagement* A member, who complains that the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to some of the members, including himself, may apply to the NCLT by petition under Sec. 397 of the Act. He may also apply for appropriate relief on the ground of mismanagement of the company under Sec. 398.

There are also a number of other Sections in the Companies Act, 1956, which protect the minority interest, *e.g.,*

1. Consent of the Central Government is necessary before certain acts can be validly done by a company, *e.g.,* change of registered office of a company from one State to another State (Sec. 17), and consent of the Tribunal is necessary in case of reduction of share capital (Sec. 101).
2. An aggrieved shareholder can appeal to the NCLT against the arbitrary action of the Board of directors in refusing to register a transfer of shares (111).
3. A specified number of members can hold up the reconstruction or amalgamation of a company (Sec. 394).
4. A specified number of members can apply to Central Government for appointment of directors of the company to look after the interests of oppressed minority (Sec. 408).
5. Even a single contributory of a company is entitled to present a petition to the Tribunal for its winding up (Sec. 439).
6. An arrangement between a company and its creditors may be confirmed or set aside by the NCLT on the application of any creditor or contributors 517).
7. In the course of winding up of a company, the liquidator or any or contributory of a company may apply to the NCLT to examine into the conduct of a delinquent officer and take action (Sec. 543).

7.3.5 Protection of investors and creditors:

The Act contains a number of provisions for the protection of the interest of the investors and creditors of a company. These provisions relate to the following:

1. Full disclosure of material particulars in prospectus.
2. Reduction of capital.

3. Special resolutions in respect of certain matters.
4. Variation of class rights.
5. Disclosure of interest of the managerial personnel.
6. Limits on managerial remuneration.
7. Special audit.
8. Inspection and investigation.
9. Prevention of oppression and mismanagement.
10. Removal of managerial personnel in certain cases.
11. Re-organisation and amalgamation.
12. Winding up.

7.3.6 Prevention of Oppression and Mismanagement:

The general rule is that the decisions of the majority shareholders in a company bind the minority. The right of the majority to have their way has, however, been occasionally abused and the 'whip of majority has often produced sullen effects prejudicial to the best interests of the shareholders. Sometimes a group of unscrupulous persons or a particular person may obtain control of the affairs of a company by purchasing majority shares and run the company in a manner prejudicial to the interests of the company or minority shareholders. In such a case, a proper balance of the rights of majority and minority shareholders is essential for the smooth functioning of the company. The oppression of minority or mismanagement of a company by majority therefore calls for some remedial action. In such a case, the minority shareholders may apply to—

(1) the NCLT for the winding up of the company on the ground of ‘just and equitable’ to do so.

(2) the NCLT for appropriate relief (short of winding up);

(3) the Central Government for appropriate relief.

Sections 397 to 409 empower the NCLT and the Central Government to prevent oppression and mismanagement.

7.3.7 Prevention of Oppression (Sec.397):

Application to the NCLT: Sec. 397 provides that a requisite number (as laid down in Sec. 399) of members of a company who complain that the affairs of the company are being conducted in a manner

prejudicial to the public interest or in a manner *oppressive to any member or members,* may apply to the NCLT for appropriate relief.

There is oppression—if it justifies winding up: Oppression must be of such a nature as will make it just and equitable for the Court to wind up the company, but to order winding up would unfairly prejudice the interest of the oppressed member or members, and the remedy of winding up to eliminate oppression may be worse than the disease itself.

Meaning of the term public interest: The term 'public interest' is a vague and elusive expression. It cannot be precisely defined. Common good or general welfare of the community is conducive to the public interest.

Broadly speaking, a thing is said to be in the public interest where it is or it can be made to appear to be conducive to the general welfare rather than to the Special privileges of a class, group or individual.

The expression 'public interest' cannot be considered in vacuum. It must be decided on the facts and circumstances of each case. In the case of a company operating in a modern welfare State, the concept of public interest takes the company outside the conventional sphere of being a concern in which the shareholders alone are interested. It emphasizes the idea of the company functioning for the public good or general welfare of the community, and not in a manner detrimental to the public good.[408]

Relief by the NCLT: The NCLT may give relief if it is of opinion—

(1) that the company's affairs are being conducted

(a) in a manner prejudicial to public interest, or

(b) in a manner oppressive to any member or members ;

(2) that the facts justify the compulsory winding up order on the ground that it is just and equitable that the company should be wound up ;

(3) that to wind up the company would unfairly prejudice the applicants.

On being satisfied about the above requirements, the NCLT may pass such order as it thinks fit with a view to bringing an end to the matters complained of. This provision would help salvage an otherwise sound concern which would have been, but for this principle, forced to go into winding up.

Meaning of 'oppression'

[408] *State of Bihar v. Kameshwar Singh*, (1952) S.C. 25

As regards meaning of the term 'oppression' [in the context of Sec. 397), Lord Cooper observed in *Elder v. Elder & Watson Ltd.,*[409];

"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."

The sum and substance of the matter is that 'oppression' or 'oppressive conduct' means not keeping to the accepted standards of honesty and fairness and a lack of regard of other shareholders' interest. More succinctly, it has been stated that the complaining shareholders must be under a burden which is unjust or harsh or tyrannical. A persistent and persisting course of unjust conduct must be shown. Where allegations of this nature are made in the petition and substantiated, the company can even be ordered to purchase the minority's shares at a fair value.[410] One single and solitary instance of any act does not seem to answer the oppressive continuity of conducting the affairs of the company implicit in the construction of the language of Sec. 397, *viz.,* 'the affairs are being conducted'. Where there is an isolated act of oppression, an injunction may be obtained under the general law.[411]

In *Needle Industries (India) Ltd.* v. *Needle Industries Newey (India) Holding*,[412] the Supreme Court observed in this regard: "The true position is that an isolated act, which is contrary to law, may not necessarily and by itself support the inference that the law was violated with a *mala fide* intention or that such violation was burdensome, harsh and wrongful. But a series of illegal acts following upon one another can the context, lead justifiably to the conclusion that they are a part of same transaction, of which the object is to cause or commit the oppress of persons against whom those acts are directed."

Who is a member? Once a person's name is entered as a member of the company in its register of members it is not open to question his membership. However the names and particulars of shareholders as members of the company entered in the register of members are not conclusive. The shareholders of the company in whose favour share certificates are issued can exercise right as members of the company notwithstanding the omission of their names as members

[409] (1952) S.L.T 112
[410] *Ramashankar v. S.I. Foundry,* A.I.R. (1966) 512
[411] Broadcasting Station 2 G.B. Pty. Re (1964-65) S.W.R. 1648
[412] (1981) 51 Comp. Cas. 743 (SC)

in the register of members. They can file a petition under Secs.397 and 398 giving the distinctive numbers of the shares held by them and the relevant share certificate numbers. The respondents cannot take advantage of their failure to maintain the prescribed register to non-suit the petitioner.[413]

The personal representative of a deceased member on whom title of his shares devolved by operation of law 'is a 'member' for purposes of Sec. 397.[414]

Remedy available to a member in his capacity as a member: The 'oppression' dealt with under Sec. 397 is only oppression of a member in his capacity *as a member* and not in any other capacity. The following is a case in point:

In the case of *Elder v. Elder & Watson Ltd.,*[415] The applicants claimed that they had been wrongfully removed from office as directors and from employment as secretary and manager. *Held,* the remedy under Sec.397 (Sec. 210 of the English Companies Act, 1948, under which this arose) was not available to them, for no wrong had been done to them as members.

The harsh treatment, for instance, of a member who is a director or other officer or employee by the Board of directors or the oppression of a person as a director (for instance, his exclusion from the Board of directors) and not a member, is outside the purview of Sec. 397. If the majority of the Board of directors overrides the minority directors, the latter cannot resort to Sec. 397.[416]

Cases when remedy is not available under Sec. 397:

There is no oppression in the following cases and relief under Sec. 397 will not be granted:

(1) When there are minor acts of mismanagement, *e.g.,* where passengers traveling without tickets on a company's buses were not checked or where the petrol consumption by a transport company was excessive. Negligence and inefficiency, even

[413] N.*Satyaprasad Rao* v. *V.L.N. Sastry,* (1988) 64 Comp. Cas 492 (A.P.)
[414] Margaret T. Desor v. Worldwide Agencies (Pvt.) Ltd., (1989) 66 Comp. i (Del.)
[415] (1952) S.L.T. 112
[416] *Lundie Bros. Ltd., Re* (1965) 2 All E.R. 692

assuming that these are proved, do not amount to oppression or mismanagement as contemplated by the Act.[417]

(2)Where a shareholder holding even 30 per cent shares of a company is denied access to or inspection of books of account of the company. This is because no such right is recognised by the Companies Act, 1956.[418]

(3)Where a petition is brought with the object of exerting pressure in order to achieve a collateral purpose, *e.g.,* the repayment of a loan owed by the company to the petitioner's group of companies.[419]

(4)Where there is a mistaken omission by the directors of a company to give notice of meetings to the administrators of a deceased member.

(5)Where a director withdraws excessive remuneration to which he is not entitled.[420]

(6)Where there is non-declaration of dividend. The shareholders cannot insist on dividend being paid even if they are unanimous.

(7)Where a resolution is passed by the members in a general meeting suspending operation of Sec. 81 (governing issue of new shares) simply because it does not suit the interests of the minority.

In the case of *Shanti Prasad Jain* v. *Kalinga Tubes Ltd.,*[421] There were three shareholders in a private company holding shares in equal proportion and with equal representation on the Board of directors, subsequently the company was converted into a public company and 3,900 more shares were proposed to be issued. Two shareholders who constituted majority resolved both in the Board meeting to offer and a general meeting, to offer and allot the new shares to outsiders. These shares were subsequently allotted to such outsiders. The third shareholder alleged oppression. Held, there was no oppression.

(8)Where an alteration, of voting rights by a majority is brought about in consequence of which the minority suffer, provided such alteration is in the interest of the company as a whole.[422]

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[417] *Mohta Bros v. Calcui: Landing & Shipping Co. Ltd.,* (1970) 40 Comp. Cas. 119 (Cal.)

[418] *Lalita Rajyn Lakshmi v. India Motor Co.,* A.I.R. (1962) Cal. 127

[419] *Bellador Silk Ltd., Re* (1965) 1 All E.R. 667

[420] *Jermyn Street Turkish Baths Ltd.* Re (1970) 1 W.L.R. 1042

[421] (1965) 35 Comp. Cas. 35

[422] *Right & Issues Investment Trust Ltd. V. Stylo Shoes Ltd.,* (1965) Ch. 250.

(9)Where the complaining member suffers oppression not in his capacity as a member but as a person holding office in the company.

7.3.8 Prevention Of Mismanagement (Sec. 398):

Sec. **398** provides for relief against mismanagement.
Application to the NCLT: A requisite number of members (as laid down in 399) of a company may apply to the NCLT for appropriate relief on the ground of mismanagement of the company.
Relief by the NCLT: The NCLT may give relief if it is of opinion— (a) that the affairs of the company are being conducted in a manner prejudicial to the public interest or in a manner prejudicial to the interests of company, or
(b) that by reason of a material change in the management or control of the company, the affairs of the company are likely to be conducted in a manner preudicial to the public interest or in a manner prejudicial to the interests of company.
The change in management or control of the company may be due to an alteration in its Board of directors or manager or in the ownership of the company's shares, or if it has no share capital, in its membership or in any other manner. The material change in the management or control does not include a change brought about by, or in the interests of any creditors including -holders, or any class of shareholders of the company.

The expression "the affairs of the company are being conducted in a manner prejudicial to the interests of the company" in Sec. 398 will also take within its ambit the non conduct of the affairs of the company which non-conduct results in prejudice being caused to the company. The non-conduct may arise from a variety of reasons including serious disputes amongst the Board of directors of the company which results in a complete deadlock or stalemate[423]! Likewise not taking action against the manager of the company, who had misappropriate huge amounts, amounts to non-conduct.[424]

Order by NCLT: On an application being made under Sec. 398, the NCLT order as it thinks fit to prevent or bring an end to the matters complained of or apprehended.

Proceeding under Sections 397 and 398: section 397 & 398 are intended to avoid winding up of a company under section 433(f)] if

[423] Chander V. Pannalal Girdharilal Pvt. Ltd.(1984) 55 Comp. Cas. 702 (Delhi)
[424] Kuldip Singh Dhillon Utility Financiers Pvt. Ltd.; (1988) 64 Comp. Cas. 19 (P & H)

winding up of a company is possible and keep it going while at the same time relieving the minority shareholders from acts of oppression and mismanagement or preventing its affairs from being conducted in a manner prejudicial to public interest. Relief undoubtedly, under Sections 397 and/or 398, is in fact alternative to winding up.

By the introduction of Sections 397 and 398, a shareholder aggrieved by oppression and mismanagement has two alternative remedies. Before that, he had only one remedy, *viz.,* to apply for the winding up under the 'just equitable" clause of Sec. 433 (f). Now the second choice open is an application “under Sections 397 and 398 for an appropriate order to bring to an end the mismanagement of a company or oppression of minority.

Between a winding up petition under Section 433 (f) (i.e., when it is 'just equitable') and a petition under Sections 397 and 398, there are following distinguishable features:

Petition under Sections 397 and 398 Petition for winding up under Sec. 433 (f)

Petition under Sections 397 and 398	Petition for winding up under Sec. 433 (f)
1. Petition under Sees. 397 and 398 is to be made to the NCLT.	1. Petition for winding up is to made to the Tribunal.
2. Remedy is of preventive nature and provides for continuity of the company.	2. Winding up results in civil death of the company.
3. Notice to Central Government is necessary under Sec. 400.	3. No such notice is required.
4. Share qualification is required for an application under Sees. 397 and 398, vide Sec. 399.	4. No minimum share qualification required.
5. Under Sec. 401, the Central Government may apply under Sec. 397 or 398.	5. The Central Government cannot apply but the Registrar can apply under Sec. 439 (5).
6. Nature of reliefs under Sees. 397 and 398 is much wider, *vide* Sec. 402.	6. Nature of relief is narrow, *vide* 443.

1. Effect of arbitration clause in the Articles:

Merely because there is an article in the Articles of Association of a Company to the effect that any dispute between the companies on the one hand and its members on the other will be referred to arbitration, the NCLT will stay a petition under Sec. 397 or 398 for relief against oppression or mismanagement in the affairs of the company. Such an article cannot be called into play for the purpose

of staying proceedings under Sec. 397 or 398. Provisions of Sections 397 and 398 give exclusive jurisdiction to the NCLT and matters dealt with thereby cannot be referred to arbitration.[425]

7.3.9 who may apply for relief under sections 397/398? (Sec. 399)

Requisite number of members who may apply: The number of member who may apply to the NCLT for relief under Sec. 397 or 398 is as follows:

(1) *In the case of a company having a share capital-*

(a) Not less than 100 members or not less than l/10th of the total number of members, whichever is less, or

(b) A member or members holding not less than 1/10th of the issued share capital of the company, on which all calls and other sums due have been paid, apply to the NCLT for relief.

(2) *In the case of a company not having a share capital,* not less than l/5th of the total number of members, may apply to the NCLT for relief. Sec. 399 does not limit the right to apply under Sec. 397 or 398 to members holding equity shares only; the preference shareholders may also apply for the appropriate relief.

Joint owners to be treated as one member: Where any share or shares is/are held by two or more persons jointly, they shall be counted only as one member.

Consent in writing of other members. Where any members of a company are entitled to make an application, any one or more of them may obtain the consent in writing of the rest and may then make an application on behalf of and for the benefit of them.

The expression 'consent in writing' implies that the writing itself should indicate that the persons who had affixed their signatures had applied their mind to the question before them and had given their consent to a certain action being taken. If a person obtains another shareholder's signature on a blank piece of paper and wishes to supplement it by an affidavit or an oral sworn statement himself or his agent, the signature on the blank paper does not become consent in writing.[426] To say that a person had given his

[425] O.P.Gupta V. General Finance Pvt. Ltd. (1977) 47 Comp. Cas. 297 (Delhi)

[426] Makhan Lai Jain V. Amrif Banaspati Co. Ltd.; (1953) 23 MP Cas. 100 (All)

'consent in writing, it should also be proved that he gave his consent after having understood the contents of the petition.[427]

Number less than the requisite number may apply in certain circumstances. The Central Government may authorise any members (even though their number is less than the requisite number) to apply to the NCLT (formerly Company Law Board) under Sec. 397 or 398. At the stage of grant of this authorization, it would be undesirable that the Central Government should be required to give reasons. For, such reasons would needlessly prejudge the merits of the case. It would rather be in the interest of the company or the company management that no observations on merits should be made by the Central Government at this stage.[428]

The Central Government may, before authorising any member or members as aforesaid to apply, require such member or members to give security for the payment of any costs which the NCLT dealing with the application may order such member or members to pay to any other persons who are parties to the application. This envisages that frivolous applications are not moved.

Withdrawal of consent: Once the petition is presented, it cannot be withdrawn without the sanction of the Company Law Board.[429]The validity of the application under Sec. 399 must be judged on the facts as they were at the time of presentation of the application. If the application is valid when presented, it does not cease to be maintainable merely because some of the applicants have transferred their shares and ceased to be the shareholders of the company.[430]

Legal representatives of deceased director: In proceedings instituted under Sections 397 and 398 for prevention of oppression and mismanagement, it is not permissible to implead the heirs and legal representatives of a deceased director and continue the proceedings against them.[431]

<u>Notice to be given to Central Government</u> <u>(Sec. **400)**</u>

Under Sec. **400,** the NCLT is required to give notice of every application made to it under Sec. 397 or 398 to the Central Government. It has also to take into consideration the representations, if any, made to it by the Government before passing a final order.

[427] K.P. Chackochan V. Federal Bank, (1989) 66 Comp. 953 (Kerala)
[428] Sri Krishna Tiles & Potteries, Madras (pvt.) Ltd. V. The Company Law Board (Now NCLT), (1979) 49 Comp. Cas. 409 (Delhi)
[429] Jacob Cherian V. K.N. Cherian, (1973) 43 Comp. Cas. 235
[430] Jagdish Chand Mehra V. The New Indian Embroidery Mills Ltd.; (1964) 1 Comp. L. J. 291.
[431] Rajinder Nath Bhaskar V. Bh. Stoneware Pipes (Pvt.) Ltd.; (1990) 68 Comp. Cas. 256 (Delhi)

Right of Central Government to apply (Sec. **401)**

Sec. 401 confers a discretionary power on the Central Government to apply to the NCLT for an order under Sec. **397** or **398.** The Central Government also authorizes any person in this behalf to apply.

7.3.10 Power of the Tribunal: (Section 402)

Section 402 of the Act confers wide powers on the Tribunal in respect of applications made to it under Section 397 or Section 398. The Tribunal may make an order for the regulation of the conduct of the affairs of the company upon such terms and conditions as it deems just and equitable keeping in view the circumstances of the case. The ultimate object of the power conferred upon the Tribunal under Section 402 is to bring an end to the matter complained of. For example, in *Lord Krishna Sugar Mills Ltd. v. Abnash Kaur,*[432] where the CLB (now Tribunal) by its order had constituted an interim Board of management for the company, held that it also had the power under Section 402 to give directions and instructions from time to time to resolve the problems of the interim Board. However, without prejudice to the generality of powers under Section 397 or 398, the Tribunal may in exercise of its powers under Section 402 provide for:—

1. *The regulation of the conduct of the company's affairs in future: -* Thus, in *Richardson & Cruddas Ltd.* v. *Haridas Mundra,*[433] while clarifying the scope of Section 402, the CLB (now Tribunal) held that the constitution of an Advisory Board to assist the special officer appointed by the CLB (now Tribunal) in managing the affairs of the company is within the competence and powers conferred under this section.

In *Chennabasappa* v. *Multiplast Industries,*[434] where a section of a company had no records, registers etc., whatever, it was held to be a fit case for the appointment of an administrator.

In *Bennet Coleman & Co.* v. *Union of India,*[435] the Bombay High Court ordered to insert a new article into the articles of association providing that all the shareholders directors will retire every year and opined that such a clause was valid despite it being against the provisions of Section 255 of the Companies Act.

[432] (1977) 44 Comp Cas 210 Del.
[433] AIR 1959 Cal. 695
[434] (1985) 57 comp Cas 541 Karnatka.
[435] (1977) 47 Comp Cas 92 Bom.

In *Debi Jhora Tea Co. Ltd.* v. *Barendra Krishna Bhowmick,*[436] the Calcutta High Court ordered appointment of a chairman to preside over the company's shareholders meetings as well as director's meetings. Similarly, *In Re Combust Technic (P) Ltd.,*[437] a special officer was appointed pending the constitution of a new Board. In *Pradeep Kumar Sarkar* v. *Laxmi Tea Co. Ltd.,*[438] it was held that the Tribunal, may take-over the management in its own hands or appoint a receiver or special officer to do so even if the directors who are in office enjoy majority support.

2.*The acquisition of shares or interests of any members by other members or b\ the company: -* Thus, in *Suresh Kumar Sanghi* v. *Supreme Motors Ltd.,*[439] where the group in actual control was given an opportunity to buy out the other at a value to be fixed by a judge. Likewise, in *Surendra Singh Bindra* v. *Hindustan Fastners (P) Ltd.*[61,] where one group of shareholders was installed in power and directors were issued for taking over the shares of the other group.

3.In case of a purchase by the company of its shares, the consequent reduction of its share capital.

4.The termination, setting aside or modification of any agreement between the company and managing director, or any other director, and the manager.

5.The termination, setting aside or modification of any agreement with any person, provided due notice has been given to him and his consent obtained.

6.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 of the application which would amount to a fraudulent preference in case of an individual's insolvency. Thus, in *Roshan Lai Agarwal* v. *Sheoram Bubna,*[440] the Patna High Court set aside a fraudulent preference made within three months before the date of application and held that there should be a net period of three months between the date of transfer and that of application. The Court excluded the date of transfer in computing the period of three months.

[436] (1980) 50 Comp Cas 771.
[437] (1986) 60 Comp Cas 872.
[438] (1990) 67 Comp Cas 491 Cal.
[439] (1983) 54 comp Cas 235 Del.
[440] (1980) 50 Comp Cas 243 Pat.

7.Any other matter which in the opinion of theTribunal is just and equitable. Thus, in *Gajanbai* v. *Patni Transport Ltd.*[441], the Court issued directions to the directors of the company to transfer the shares to the petitioners in accordance with the terms of the will. Again, in *Jhambu Kumar Raniwala* v. *Edward Mill Co.*,[442] the Court issued directions regulating the conduct of directors.

The Gujarat High Court,[443] has widened the protective cover of the remedy under Section 402 has gone to the extent of giving retrospective effect to the provisions relating to misfeasance proceedings against guilty officers *(i.e.* Section 406) and allowed proceedings in respect of offences committed before these remedies were introduced by the Companies Act, 1956.

In suitable cases, the Tribunal may order contribution of an advisory body for the management of the company as it did in the case of *Life Insurance Corporation of India* v. *Haridas Mundra.*[62] The application under Section 397 or 398 must, however, state the nature of relief sought. The Tribunal is competent to modify its order if the circumstances so require. It may also make an interim order for regulating the conduct of the company's affairs upon such terms and conditions as may appear to be just and equitable.[444]

Where the Tribunal orders any modification or alteration in the memorandum or articles of the company, the company shall not introduce any provision inconsistent with the order.[445] If the order seeks to set aside or modify any agreement with any managerial personnel, it will not give rise to any claim for compensation or damages for the consequent loss of office.[446]

Section 404 of the Act requires that a certified copy of the order of the Tribunal altering the memorandum or articles must be filed by the company with the Registrar within thirty days of the order. Misfeasance proceedings can be commenced against the guilty officers even though the company is not being wound up.[447]

The powers of the Tribunal under the provisions of Section 402 are not affected by the existence of an arbitration clause. The Tribunal

[441] (1965) 2 Comp LJ 234 AP.
[442] (1970) 2 Comp LJ 43.
[443] Colaba Land & Mills Co. v. J. Pillani, (1971) 41 Comp cas 1078 Guj.
[444] Secs. 403.
[445] Secs. 404 (1) to (4).
[446] Secs. 407 (1) (a)
[447] Secs. 406

may, however, at its discretion refer the matter to arbitration in terms of agreement between the parties.[448]

In would thus be seen that the powers of the Tribunal in respect of prevention of mis-management are not only wide-ranging but have proved equally effective. It is however, subject to the satisfaction of the Tribunal that the conditions of relief exist presently and not with reference to some future possibility.[449] The remedy available under Section 402 being essentially preventive in character, there is an advantage of certain amount of flexibility and therefore it is less drastic than winding up. The power conferred by Section 402 is very wide and the Tribunal can pass different orders in different cases keeping in view the nature of the allegations and the facts and circumstances of each case.[450]

***Locus standi* for filing petition under Section 398**

The use of the legislative expression that *'any person interested in the affairs of the company'* may draw the attention of the Tribunal to a situation which warrants Tribunal's intervention, clearly suggests that the question of *locus standi* hardly arises in case of application under Section 398 for prevention of mismanagement in a company. It would, therefore, appear that the connotation *'any person interested in the affairs of the company'* has a much wider application than merely a member, creditor or liquidator of a company. Tribunal can even act *suo motu.* As pointed out in *S.K. Gupta* v. *K.P. Jain*[451] it is immaterial as to who drew the attention of the Tribunal to a situation which necessitated Board's intervention. There is no reason to circumscribe the expression 'on the application of any person interested in the affairs of the company' so as to limit it to mere creditor or a member.

However, while moving an application under Section 398 for prevention of mismanagement in a company, the petitioner must indicate the relief sought for but he need not show what interest he has in claiming the relief against mis-management. Thus, in a nutshell unlike Section 392 there is no requirement of *locus standi* in an application under Section 398.

7.3.11 Power of the Central Government to Prevent Oppression or Mismanagement (Section 408)

[448] Gurvir Singh gil v. saz International (P) Ltd., (1987) 62 Comp Cas 197 Del.
[449] Peerless General Finance & Investment Co. Ltd. V. Union Of India, (1989) 1 Comp LJ 56 Cal.
[450] Bajrang Prasad Jalan v. Mahavir Prasad Jalan, AIR 1999 Cal. 156 (158).
[451] AIR 1979 SC 734

Besides the powers of the Tribunal to provide relief in cases of oppression and management as contained in Sections 397 to 407 of the Act, the Central Government also has the power to prevent oppression or mismanagement under Sections 408 and 409 of the Act. Prior to the Companies (Amendment) Act, 1988, the power to *grant relief* against oppression or mismanagement was vested in the Court,[452] and the power to *prevent* oppression or mismanagement was vested in the Central Government.

Section 408 (1) provides that the Central Government may appoint such numbers of directors on the Board of a company as the Tribunal may, by order in writing, specify as being necessary to effectively safeguard the interests of the company or its shareholders or the public interest. The directors so appointed shall hold office for a period not exceeding three years on any one occasion as the Tribunal may think tit.

The Tribunal may make such order on receipt of (1) a reference from the Central Government; or (2) on an application from not less than one hundred members of the company; or (3) on an application from members holding not less than one-tenth of the total voting power therein. The Tribunal, however, may make such inquiry as it deems fit in order to decide whether such appointment is necessary to prevent the affairs of the company being conducted in a manner which is oppressive to any members of the Company or which is prejudicial to the public interest or company's interest. The Tribunal has to mention the period for which such an appointment may be made, but the same is not to exceed three years in any case. In *Peerless General Finance & Investment Co. Ltd.* v. *Union of India,*[453] it has been held that the provisions of this section *i.e.* Section 408 must be construed strictly and it does not extend to regulating the financial schemes of the company.

Instead of passing an order for the appointment of directors, the Tribunal may order the company to amend its articles to provide for the appointment of directors by proportional representation in accordance with the provisions of Section 265 of the Act and make fresh appointments of directors within the specified time limit.[454] Pending the appointment of new directors, the Tribunal may ask the Central Government to nominate certain additional directors on the company's Board of Directors. Such additional directors need not

[452] Consequent to the enactment of the Companies (Amendment) Act, 1988 this power is now vested in the Company Law board.
[453] (1989) 1 Comp LJ 56 cal.
[454] Sec.408 (1).

hold the qualification shares if any, nor shall he be liable to retire by rotation. The Central Government may, however, remove or replace him. After such appointment any change in the Board of Directors can only be made with the consent of the Tribunal.[455] The object of this provision is to prevent the company from altering the composition of its Board of Directors to frustrate the action of the Central Government.

Where the Central Government appoints any director or additional director on a Company's Board of Directors, it may issue such directions to the company as it may consider necessary or appropriate in regard to its affairs.[456] Such directions may include directions to appoint or replace an auditor, to alter the articles etc.

The Central Government may require the persons appointed by it as directors or additional directors to report to that Government from time to time with regard to the affairs of the company.[457]

It must, however, be pointed out that the powers of the Central Government under Section 408 are essentially preventive in nature and therefore an order made under this section may not be able to cure the illegal or prejudicial acts which may have already been performed by the company and its directors, but it can surely prevent repetition of such acts in future by appointing directors or additional directors on the Company’s Board of Directors.[458]

It is further to be noted that it is not necessary that there must be oppression to the minority shareholders to invoke the provisions of Section 408 of the Act. The section may be used even where the majority shareholders are carrying on business in a manner which is earning profits for the company and is not oppressive to the minority shareholder, but it is being carried on in a manner which is prejudicial to the public interest[459] or the company's interest. The Central Government should, however, exercise the power under Section 408 very sparingly and only when requisite conditions of the section are fully complied with since it seriously affects the reputation and credibility of the management of the company. In *South India Viscose Ltd.* v. *Union of India,*[460] it has been held that mere non-compliance with some of the provisions of the Companies Act

[455] Sec. 408 (5).
[456] Sec.408 (6).
[457] Sec.408 (7)
[458] Sakthi Trading Co. Pvt. Ltd. V.union of India, (1985) Comp Cas 789 Del.
[459] Ibid
[460] (1982) 52 Comp Cas 247 Del.

or certain unwise decisions on the part of company's management are not enough to invoke the provisions of Section 408 and make an order thereunder.

Further, while making an order under Section 408 the Tribunal, has to comply with the principles of natural justice and therefore must give an adequate opportunity to the affected parties to show cause as to why the Government directors should not be appointed or re-appointed. The Tribunal has the discretion as to the number of directors to be appointed or re-appointed and who should be so appointed or re-appointed.[461]

7.3.12 Power of the Tribunal to Prevent change in Board of Directors (Section 409)

Section 409 of the Act confers special powers on the Tribunal to prevent changes in the Board of Directors in consequence of a change in the ownership of shares, if it is likely to affect the company prejudicially. This power can be exercised when a complaint is made to the Tribunal by the managing director or any other director or manager of a company. The Tribunal, if satisfied after an inquiry that it is just and proper to intervene, may pass an order that no change in the Board of Directors of the company shall have effect unless confirmed by the Tribunal The Tribunal can also make an interim order pending inquiry. The ultimate object of this provision is to prevent the control of company going into the hands of undesirable persons which may be prejudicial to the public interest or the interests of the company itself. The powers under Section 409 cannot be exercised by the Tribunal in relation to a private company unless it is a subsidiary of a public company.

7.3.13 Procedure for applying to the Central Government to prevent oppression or mismanagement.

Pursuant to Section 640 (B) (2) of the Companies Act, 1956, the members fulfilling the requirements of Section 408(1) of the Act should publish a general notice indicating the nature of the application proposed to be made at least once in a newspaper in the principal language of the district in which the registered office of the company is situate and circulating in that district in that language and at-least once in English language in an English

[461] Sakthi Trading Co's case, Supra

newspaper circulating in that district. Three copies of the notice published in the newspaper should be forwarded to the Stock Exchange, in case the company is listed on recognised Stock Exchange.

The application to the Central Government should be made in Form No. 23-D of the Companies (Central Government's) General Rules and Forms, 1956 giving full details and indicating clearly the eligibility of the applicant to make such an application. Usually, the application is made by one or two members on behalf of other members authorised by them in writing to do so. This is an application in representative capacity and can be filed directly by the members complaining of oppression and mismanagement. But the Central Government can authorise a member or members of the company if satisfied that circumstances existed who make it just and equitable to do so.

The application should be accompanied by:—

(a) a copy of the memorandum and articles of the company;

(b) a list of names and addresses of all the members applying;

(c) a treasury challan evidencing payment of requisite fee as prescribed under the Companies (Fees and Application) Rules, 1968:

(d) an affidavit in support of the statements made in the application; and

(e) copies of the notices published in the newspapers together with certificate as to the due publication thereof.

A copy of the application alongwith each of the documents annexed to it should simultaneously be delivered to the Registrar of Companies.

7.4. Summary:

Companies are essentially governed through resolutions passed at the meeting of the shareholders. For distinct purposes resolutions required are either simple majority resolutions (ordinary resolutions) or three-fourth majority resolutions (special resolutions). Since companies are governed by majority resolutions, the courts do not ordinarily intervene to protect the interests of the minority that may be alleged to have been affected thereby. This is also called as ‘principle of majority rule’ and was laid down in the famous case of Foss v. Harbottle. The rule in Foss v. Harbottle laid down two basic propositions. The first proposition is that the court will not ordinarily intervene in the case of an internal irregularity if the matter is one

which the company can ratify or condone by its own internal procedure. The second is that where it is alleged that a wrong has been done to the company, prima facie, the only proper plaintiff is the company itself.

The aforesaid rule of Foss v. Harbottle does not apply in relation to acts which are illegal or ultravires the company, where directors or promoters have been guilty of breach of their fiduciary duties to the company, where the majority uses its power to defraud or oppress the minority, where resolutions were passed under an inadequate notice, where personal rights of an individual member are infringed.

7.5. SUGGESTED READINGS:

31. Avtar Singh : Company Law.
32. N.D. Kapoor : Elements of Company Law.
33. N.V. Paranjape : Company Law.
34. Taxmann : Company Law.
35. Gower, L.C.B. Principles of Moderen Company Law.
36. Ramiya : Guide to the Companies Act.

7.6. SELF-ASSESSMENT QUESTION:

(1) Explain the true scope of the rule in Foss v. Harbottle on the majority rule and minority's rights. State the exception to the rule.

(2) What are the powers of the Company Law Board (Now Tribunal) to prevent oppression and Mismanagement? Under what circumstances can these are exercised?

(3) Examine the Legal Provisions Relating to Prevention of Oppression and Mismanagement.

LL.M. Part-1
PAPER CORPORATE LAW

Block II –Director And Managerial Personal
Unit 8- compromises, arrangements, reconstruction and amalgamation, meaning, difference, powers of tribunal, legal provision regarding reconstruction and amalgamation

STRUCTURE

8.1. **Introduction**

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8.6. Self Assessment Questions

8.1. Introduction:

Looking to the magnitude of the company's business and commercial activities and diversities of interests of persons who deal with them, occasions of clash and conflict often arise which need to be resolved amicably. The companies, therefore, have to resort to arbitration or compromises to settle their disputes or differences by mutual consent of the parties. That apart, at certain stage of its development it may become necessary for a company to reorganize itself by entering into compromises with its members and creditors or it may also have to join another company either by amalgamation or takeover.

'Reconstruction' occurs when a company transfers the whole of its undertaking and property to a new company under an arrangement by which the shareholders of the old company are entitled to receive some shares or other similar interests in the new company. A reconstruction is effected, for example, to bring about material alteration of the rights of a class of shareholders or creditors.

'Amalgamation' takes place when two or more companies combine into one company, the shareholders in the amalgamating companies becoming substantially the shareholders in the amalgamated company. There may be amalgamation either by the transfer of one or more undertakings to a new company or by the transfer of one or more undertakings to an existing company.

The Companies Act, 1956 therefore contains provisions relating to various methods of reorganization of companies under Sections 390 to 396 of the Act.

8.2. Objective:

The main objective of this lesson is this to analysis the concept of compromises, arrangements, reconstruction and amalgamation along with difference, powers of tribunal with the help of statutory laws and the relevant case laws.

8.3.1 Meaning of Compromise and Arrangements:

Section 391 of the Companies Act empowers the company to settle its disputes with its creditors and members by compromise without going to any arbitration for this purpose. On the other hand, Section 390(b) provides for 'arrangement' which for the purposes of this section means "reorganization of the share capital of company by consolidation of shares

of different classes or by division of shares into shares of different value or by both these methods".[462] Thus the term 'arrangement' has a much wider connotation than compromise as it includes re-arrangement of rights and liabilities of shareholders and the company without the existence of any dispute.

In Re N.F.U. Development Trust,[463] the English Court held that surrender of shares without any compensatory advantage cannot be regarded as a compromise or arrangement. Elaborating the point further, Bowen J. *In Re Alabama New Orleans, Taxas & Pacific Junction Railway Co.,*[464] had earlier observed:

"A compromise or arrangement…….must be reasonable, and that no arrangement or compromise can be said to be reasonable in which you can get nothing and give up everything. A reasonable compromise…. .... must be beneficial to those on both sides who are making it. It would be improper for the Court to allow an arrangement to be forced on any class of creditors if it is not supposed to be for the benefit of that class as such ; otherwise the sanction of the Court would be a sanction to a scheme of confiscation. The object of this section,[465] is not confiscation. Its object is to enable compromises to be made which are for the common benefit of the creditors, or class of creditors as such."

A scheme of arrangement modifying the rights of shareholders can be brought out under Section 390(b) as held *In Re Investment Corporation of India Ltd.*[466]

As to the question whether a group of creditors or members constitutes a 'class' as referred to in Section 391, the decision in *Sovereign Life Assurance Co.* v. *Dodd,*[467] may be cited by way of illustration. In this case the Court of Appeal held that for the purpose of an arrangement affecting the policy-holders of an assurance company, the holders of policy which had matured were creditors and therefore a different class from policy-holders whose policy had not so matured. Lord Esher MR referring to term 'class' with reference to arrangement under Section 206 of the English Companies Act, 1948 observed :

"Creditors comprising different classes have different interests and, therefore, if we find a different state of facts existing among different

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[462] *Hindustan Commercial Bank v. Hindustan General Electrical Corp.* AIR 1960 CAL. 637
[463] (1972) 1 WLR 1548
[464] (1891) 1 Ch 213
[465] The provision relating to 'compromise' is contained in Sec. 206 of the English Companies Act, 1948 which is analogous to Sec. 391 of the Indian Companies Act, 1956.
[466] (1987) 61 Comp Cas 92
[467] (1992) 2 QB 573

creditors which may differently affect their minds and judgments, they must be divided into different classes."

The distinction between a compromise and an arrangement lies in the fact that there cannot be a compromise unless there is some dispute whereas the existence of a dispute is not necessary in case of an arrangement. Thus where the scheme provided that each shareholder of the company should transfer some of his shares to another company and its shareholders, the Court of Appeal sanctioned the scheme as 'arrangement' and not compromise.[468]

Section 390 (b) provides that 'arrangement' includes a reorganization of the share capital of a company by consolidation of shares of different classes, or by division of the shares into shares of different classes, or by both those methods. Thus it is clear that all modes of reorganizing share-capital even when it involves interference with the preferential or special rights attached to shares by the memorandum, can be affected as part of an arrangement with members under Section 391 of the Act.[469]

Section 390 of the Act provides that provisions of Sections 391 and 393 regulating the matters relating to compromises, arrangements, reconstruction, amalgamations etc. apply to companies 'which are liable to be wound up'. This should, however, not mislead one to believe that only companies in financially perilous position can avail of these provisions and the companies which are otherwise in a sound financial condition are not covered by them. Even a going concern with good financial position can resort these methods if the circumstances are created making them liable to be wound up, for example, by passing a special resolution to this effect.[470] The expression 'any company liable to be wound up under the Act' as used in Section 390 (a) really means all companies to which the provisions relating to winding up apply. Thus the provisions relating to compromises and arrangements as contained in Sections 391 and 393 shall apply to unregistered companies and also the foreign companies.[471]

The company can make compromises and arrangements to take itself out from a winding up proceeding. Thus *In Re Rajdlumi Grains & Joggery Exchange Ltd.*[472]*,* the High Court of Delhi held that even after a winding up order against a company has been made, every member of the company has a right to file a petition under Section 391 for compromise or arrangement for the revival of the company which is going to be wound up. The application under Section 391 for compromise or arrangement

[468] In Re Guardian Assurance Company, (1971) 1 Ch 431
[469] In Re Katni Cement Co. Ltd. ,39 Bombay LR 675
[470] *Bank Of India v. Ahmedabad Mgf & Calico Priting Co. Ltd.,* (1972) Tax LR 2352 (Bom.)
[471] In Re *Khandelwal Udoyog Ltd. & Acme Mfg Ltd.,* (1977) 47 Com Cas 503
[472] (1983) 54 Comp Cas 166 (Del.)

can be made not only by the liquidator of the company which is in liquidation, but also by any of its creditor or member.[473]

A company may draw a scheme of compromise or arrangement in order to resolve its dispute with the creditors, other companies or persons in the following cases :

(i) when its winding up is ordered ;
(ii) when it is a going concern and wants to resolve any matter by compromise or arrangement;
(iii) by its reconstruction or amalgamation.

A compromise or arrangement, short of reconstruction or amalgamation is a mode of reorganising the working of a company so as to make it viable. Some of the factors which may call for a compromise with creditors or members of the company may be :

(1) in the course of normal working of the company, it is no longer possible to pay all the creditors in full ;
(2) some of the units of the company cannot function without incurring losses ;
(3) there may be need to compromise debts outstanding to the creditors. Government or the workers ;
(4) liquidation of the company may prove harsh on creditors or members of the company.

The scheme of 'arrangement' may be necessary in the following cases :

(1) reorganizing the share capital of the company ;
(2) fresh issue of shares :
(3) issue of shares to creditors in lieu of debt;
(4) sale, lease or other variations in property rights ;
(5) conversion of one class of shares into another etc.

8.3.2 Procedure for the scheme of compromise and arrangement:

Section 391 of the Companies Act read with Rules 67 to 87 of the Companies (Court) Rules, 1959 lays down the procedure for making compromise or arrangement and for invoking the assistance of the Tribunal for this purpose.

Where it is proposed to make a compromise or arrangement, a company, a member or a creditor of the company or the company which is being wound up, its liquidator, shall make an application to the Tribunal

[473] *Rajendra Prasad Agarwal v. Official Liquidator,* (1978) 48 Comp Cas 476 (DB.) Cal.

proposing a compromise or an arrangement, between them and the company, seeking directions of the Tribunal to convene a meeting of each class of creditors/members.

After the Tribunal gives any directions, the meeting of the creditors and/or members affected shall be convened. When the scheme proposed is between the company and its members, it is not mandatory to hold the meeting of the creditors. However, if the Tribunal feels that the scheme is likely to adversely affect the creditors, it may direct a meeting of the creditors also to be held.

The meeting of creditors was deemed unnecessary where in a scheme of amalgamation between two companies, the creditors of the transferor company stood in a better position by reason of amalgamation as the financial position of the transferee company was substantially better than before the amalgamation.[474]

It has been held *In Re Ipco Paper Mills Ltd.,*[475] that the depositors governed by the provisions of Section 58A of the Act and rules made there under stand outside the purview of Section 391 regarding scheme of compromise and arrangement because the companies might use this as a shield to protect themselves against prosecution under sub-sections (5) and (6) of Section 58A.

When the proposed scheme of compromise/arrangement has been approved at the meeting called under Section 391 by a majority of creditors or members representing 3/4th in value present and voting, either in person or by proxy, such approved scheme shall be placed before the Court for its sanction as required by Section 391(2).

8.3.3 Sanction of the Tribunal [Section 391]

Before sanctioning the scheme of compromise or arrangement under Section 391, the Tribunal should satisfy itself that:

(1) the company or any other person by whom the application is made, has disclosed to the Tribunal, by affidavit all the material facts such as the financial position of the company, the latest auditor's report etc. ;

(2) the relevant statutory provisions of the Act have been duly complied with ;

(3) class or classes of creditors, members etc. affected by the scheme have been fairly represented; and

[474] In Re Vijay Durga Cotton Trading Co. , (1980) 50 Comp Cas 785 (A.P.)

[475] (1984) 55 Comp Cas 281

(4) the arrangement is such that a man of business would reasonably approve it.

The Tribunal would not sanction the scheme of compromise or arrangement if it finds that there was no approval by the appropriate 'class' as it had not been properly represented. Thus where in a scheme of arrangement persons with dissimilar interests were put in a single class the Tribunal refused the sanction of the scheme and observed that the members whose shares arc paid up in advance constitute a different class from those whose shares are not so paid up.[476]

In Re Hellenic & General Trust Ltd.,[477] the scheme of arrangement involved the purchase of shares of a wholly owned subsidiary company which was one of the shareholders of an investment company, by the holding company. The Court held that wholly owned subsidiary company was also a separate 'class' by itself for the purpose of the scheme which was different from the other shareholders for the purpose of class meeting.

In Re Suri And Nayar Ltd.,[478] the Court refused to consider the question of sanction under Section 391 because the scheme could not get the approval of the members for want of quorum at the meeting.

The Supreme Court in *Punjab National Bank Ltd.* v. *Sliri Vikrani Cotton Mills,*[479] observed that the obligation arising out of a compromise between the company and its creditors under Section 391 of the Companies Act, shall not in any way affect the liability of sureties unless there is a provision to this effect in the contract of surety itself.

In *N.P.V. Ramaswamy Udayar vs All India Subscribers, Assam,*[480] held that a subsidiary company under winding up, delivering rupees ten crores received by it by way of chit fund subscription to its holding company about fifteen years age, the High Court rightly provided for protection of interests of chit fund subscribers under Section 391 read with Sections 499(2) and 434 of the Act.

The Delhi High Court has held in the case of *National Steel & General Mills* v. *Official Liquidator,*[481] that in case of a company against which a winding up order has been made, the liquidator can make a scheme for compromise or arrangement and file an application under Section 391 to

[476] In Re United Provident Assurance Co. , (1910) 2 Ch 477.
[477] (1975) 3 All ER 382
[478] (1983) 54 Comp Cas 868 (Kant.)
[479] AIR 1970 SC 1973
[480] (1993) 3 SCC 233
[481] (1990) 69 Comp Cas 271 (Del.).

the Court. But in such cases the company, its creditors or members shall also have right to apply to the Tribunal under Section 391 of the Act.

After the Tribunal has given the direction for convening a meeting of the creditors and/or members of the company, a twenty one day prior notice,[482] to creditors/members concerned and a statement of the terms of the compromise or arrangement and its effect should be sent with the notice calling the meeting. The power of the Tribunal to accord sanction to the scheme of compromise or arrangement being judicial in nature, its proper exercise demands that notice must be given to all the interested parties including the shareholders and the Central Government.[483] The statement should contain all the material disclosure about the interests of the directors, managing directors or manager of the company and the effect of the proposed compromise or arrangement on those interests where proper information has not been given to the persons concerned, the Tribunal will refuse to sanction the scheme although it has been approved by the requisite majority.

Thus In *Re Dorman Long & Co.,*[484] the Tribunal refused to sanction the scheme on the ground of inadequate disclosure because the circular sent to debenture-holders stated that the scheme has been approved by the trustees, but failed to disclose that the trustees were the bankers of the company and therefore were interested in the scheme and that the assets had been revalued but the amount of revaluation had not been stated in the scheme.

Where in case of a composite scheme, the secured creditors rejected it whereas the unsecured creditors approved it, it was held that the scheme cannot be said to have been approved by the creditors and hence the Tribunal refused to give sanction to it.[485]

In a case,[486] where a potential creditor, a powerful financial institution, refused to approve the scheme and without it statutory majority was wanting, the Tribunal could neither approve the scheme nor conduct an inquiry into the motives of the creditor.

According to Rule 74 of the Companies (Court) Rules, 1959, where the notice calling the meeting has been given by advertisement in newspapers, either such an advertisement should include all the material disclosure or a statement to the effect that the material particulars would be available to the interested party at a specified place.[487] Such a place is

[482] Rule 73 of the Companies (court) Rules , 1959 prescribes the form of Notice i.e. Form No. 36
[483] *Hind Auto Industries Ltd. V. Premier Motors (P) Ltd.* AIR 1970 All . 165.
[484] (1934) Ch 635.
[485] In Re *Auto Steering (P) Ltd.,* (1977) 47 Comp Cas 257 (Del.).
[486] M.M.Sehgal v. Sehgal Papers Ltd., (1966) 1 Comp Lj 192 (P&H).
[487] Sec. 393(1) (b).

usually the registered office of the company or the office of the Advocate engaged by the company. In the latter case, it is the duty of the company to furnish free of charge, within 24 hours of requisition made to this effect, a copy of the statement of the material particulars to every member or creditors who asks for it.[488]

The power of the Central Government to make representations before the Tribunal on a proposal for compromise or arrangement, has been delegated to the Regional Director,[489] Tribunal. The Regional Directors are, however, required to consult the Tribunal or the Central Government in cases of companies having assets of a certain size and above.

Section 393(5) of the Act requires every officer of the company to give notice to the company of such matters relating to himself as may be necessary for the purposes of the scheme.[490] In case of default every officer who is in default is punishable with fine.[491] The liquidator of the company and trustees for debenture holders are deemed to be officers for this purpose. Notwithstanding proceedings initiated for sanction of the Tribunal, the criminal proceedings can be commenced or continued against the erring officers.[492]

Where the scheme of compromise or arrangement has been duly approved by a majority representing three-fourth in value of the creditors or members, as the case may be, the Tribunal shall give sanction to such scheme under Section 391 of the Act.[493]

Rule 81 of the Companies Court Rules provides that an order shall be in Form No. 41, which contemplate the sanction and directions necessary to give effect to it. Form No. 41 contemplates the sanction of the compromise scheme, giving liberty to any person to move the Tribunal for any directions necessary for giving effect to the compromise.

An Order of sanction made by the Tribunal under Section 391(2) shall have no effect until a certified copy of the order has been filed with the Registrar within 14 days from the date of sanction order.[494]

A copy of every such order shall also be annexed to every copy of the memorandum of the company issued after the sanction is received from the Tribunal.[495]

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[488] Sec. 393 (3).
[489] Vide Notification dated 22nd February, 1969.
[490] Sec. 393 (5)
[491] Sec. 393 (4)
[492] In Re *Uma Investment (P) Ltd*., (1977) 47 Comp Cas 242 (Bom.).
[493] In Re *Mehta Investment (P) Ltd*., (1990) 1 Comp LJ 285 (Del.).
[494] Sec. 391 (3).
[495] Sec. 391 (4).

The Tribunal will sanction the scheme if it is fair and reasonable. Thus in *Premier Motors (P) Ltd.* v. *Ashok Tondon*[496] the company had taken deposits from the public at 12 per cent interest and most of the depositors were women and aged persons. A scheme was drawn which provided full payment to the depositors but at a lesser rate of interest and no date for repayment was fixed. The Court held that the scheme was illusory and intended to bluff the poor depositors hence sanction to it was refused.

An "Arrangement' in Section 391 includes an amalgamation of the companies which are concerned with the compromise either as creditor or as debtor of the company in liquidation or liable for liquidation *i.e.* the company which is not yet wound up but is shortly liable to be wound up.[497]

8.3.4 Duties of the Tribunal:

The Tribunal, before passing an order of sanctioning the scheme of compromise or arrangement, shall satisfy itself that the following three conditions,[498] are duly complied with, namely :

1. The provisions of the Companies Act have been complied with ;
2. The 'class' being affected by the scheme has been fairly represented by those who attended the meeting and they were acting *bona fide* ; and
3. The scheme of compromise or arrangement is such as a man of business would reasonably approve. The Court should satisfy itself that having regards to the general condition and object of the scheme, it is reasonable one and if the Court so finds, it should not interfere into the wisdom of the shareholders of the companies amalgamating.[499]

The Tribunal may thus refuse sanction to a scheme which is *ultra vires* the Act, the Calcutta High Court *In Re Mary-bong & Kyel Tea Estates Ltd.*[500], held a view that for the validity of the scheme it is not necessary that a company should have an express power of amalgamation in its memorandum because Sections 391-395 confer statutory power to every company for this purpose.

As regards the second condition, namely, the majority approving the scheme must be acting *bona fide,* if the Tribunal finds that 'majority was composed of persons who had not really the interests of that class at

[496] (1971) 41 Comp Cas 656 (All)
[497] In Re *Vasant Investment Corporation Ltd*. (1982) 52 Comp. Cas. 139 (Bom.).
[498] Observation of Ashbury J. In Re *Anglo Continental Supply Co*., (1922) 2 Ch 723 (736).
[499] In Re *Coimbatore Cotton Mills Ltd*., (1980) 50 Comp. Cas. 623 (Mad.).
[500] (1977) 47 Comp. Cas. 802 (Cal.).

stake', it would decline sanction of the scheme.[501] It must be noted that majority referred to in the section is the majority not only in number but also in value of those present in person or by proxy, and voting at the meeting.

Thirdly, the scheme should be reasonable, fair and equitable, the Tribunal will, however, not concern itself with the commercial merits of the scheme. Thus in *Commissioner of Income Tax* v. *Calcutta Discount Co. Ltd.,*[502] where the company had transferred some of its shares to its subsidiary for lesser price than their market price and the Income Tax Department sought to hold the company liable to tax for profit on the basis of market value of those shares, the Supreme Court dismissing the appeal, observed:

"An assesses can so arrange his affairs as to minimize his tax burden. Hence if the assesses in this case has arranged its affairs in such a manner as to reduce its tax liability by transferring its shares to that subsidiary company and thus foregoing part of its own profits and at the same time enabling the subsidiary to earn some profits, such a course is not impermissible under law."

If in the opinion of the Tribunal the scheme ought not to be sanctioned without necessary amendment or alteration, it has no power to impose the conditions *suo moto* except with the consent of those who have agreed to it.[503]

The Tribunal should desist from undertaking any investigation or probe into the matters which are not involved in the scheme. The Tribunal should, however, make sure that the scheme is not prejudicial to the interest of the shareholders of the transferor or transferee company and the creditors thereof; nor is it prejudicial to the public interest. Any scheme which is fair and reasonable and made in good faith will be sanctioned if it could be reasonably supported by sensible people to be for the benefit of the members of the companies who are direct parties to the compromise scheme and its approval will be sanctioned.[504]

The Tribunal's sanction cannot be provisional or a conditional sanction. Nor can it be a partial sanction. It should be complete without any condition whatsoever.[505]

8.3.5 Powers of the Tribunal:

[501] *British America Nickel corporation v. O'Brien Ltd.*, (1927) AC 369 PC.

[502] (1974) 3 SCC 260

[503] *Mihirendra v. Brahmanberia Loans Co. Ltd.,* 61 Cal 913.

[504] See *Alabama New Orleans Roy Company,* 1891 Ch. 213.

[505] *Smt. Bhagwanti v. New Bank of India Ltd.*,AIR 1950 EP 111.

Section 392 of the Act confers wide power on the Tribunal relating to sanctioning or rejecting the scheme of compromise or arrangement. After sanctioning the scheme the Tribunal has power to :

(i) supervise the carrying out of the compromise or arrangement;
(ii) to modify the scheme for its proper working ; or
(iii) to order winding up of the company, if it is satisfied that the scheme of compromise or arrangement is not workable.

The purpose of conferring power on the Tribunal to exercise continued supervision over the effective working of the scheme after granting sanction to it, is to remove obstacles or impediments by suitable orders or directions for the smooth working of the scheme. Thus in *S.K. Gupta* v. *K.P. Jain,*[506] the Supreme Court held that even a person to whom shares of the company have been transferred but his name has not been entered in the register of members, can apply for modification of the scheme or arrangement initiated by a subsidiary company which was in liquidation, with its holding company.

Section 392 confers power on the Tribunal,[507] which sanctioned the scheme of compromise or arrangement to supervise the carrying out of the scheme. It may either itself *i.e., suo moto,*[508]or on an application from a creditor or member having interest,[509] in the scheme modify the scheme to make it workable. The Tribunal, however, cannot modify a scheme which was never approved by it.,[510] If the Tribunal finds that the scheme cannot be carried out satisfactorily in any case, it may make an order for compulsory winding up of the company.[511] The case *In Re New Kaiser-i-Hind Spinning & Weaving Co.,*[512] is an illustration on the point.

In this case two groups of shareholders were contending for the control of a company. They agreed that one of the groups should transfer the controlling shares to another at a nominal value and in return, the other should provide finance for the running of the company's mills and when company stabilises, to execute a second mortgage in favour of the former for debt. The scheme was confirmed at shareholder's and creditor's meetings and duly sanctioned by the Court. But subsequently that other group of shareholders failed to provide necessary finance for running the company as agreed earlier. The Court (now Tribunal) held that in absence

[506] AIR 1979 SC 734.
[507] Sec. 392 as amended by the Companies (Second Amendment) Act, 2002 has now conferred these powers to the Tribunal Instead of the Court.
[508] *Ramlal Anand* v. *Bank ofBaroda.* (1976) 46 Com Cas 307 (Del.).
[509] Sec. 392(2).
[510] *Nathumal Lalchand v. Bharat Jute Mills Ltd.,* (1983) 53 Comp. Cas. 382 (Cal.).
[511] *J.K.Bombay (P) Ltd. V. New Kaiser-i-Hind S & W Co.,* AIR 1970 SC 1041.
[512] (1968) 2 Comp. LJ 225 (Bom.).

of adequate finance, the scheme became unworkable and therefore there was no other way but to order its winding up.

If the Court (now Tribunal) finds that the scheme of compromise placed before it is *prima facie* not reasonable and fair, it may refuse consideration of the scheme for sanction. Thus *In Re Krishna Kumar Mills Ltd.*[513] the scheme required the workers to waive of their compensation claim under the Industrial Disputes Act, 1948 along with the notice-money and gratuity etc. The Court (now Tribunal) refused to order the meeting of creditors for consideration of the scheme as it was grossly unjust and unfair to the workers. But where the employees and workers voluntarily agreed to a scheme of arrangement involving heavy sacrifices on their part, and agreed to restart a closed textile mill, the Court sanctioned the scheme.[514] The disclosure of the source of financing the scheme by the concerned parties was considered unnecessary in this case.

In Re John Wyeth (India) Ltd.,[515] the Bombay High Court held that in an arrangement for amalgamation of two drug companies, the employees cannot be compelled to join the transferee company. In this case the employees of Jaffery Manners & Co. Ltd. opposed the amalgamation of the company with John Wyeth (India) Ltd. on the ground that the latter was running in huge loss and they refused to go to the transferee company. The Company Law Board (now NCLT) also opposed the amalgamation on the ground that the transfer of shares in the scheme was disproportionate. The Court ordered modification of the scheme. It, however, refused to disallow the scheme on the ground of disproportionate transfer of shares because shareholders of both the companies had agreed to it.

It must be noted that sub-clause (2) was inserted in Section 391 by the Companies (Amendment) Act, 1965 which provides that before making a sanction order, it is the initial duty of the Tribunal to satisfy itself that all the relevant material including the latest financial position of the company and the latest auditor's report and accounts of the company, pendency of investigation proceedings etc. have been placed before the Tribunal. The Tribunal cannot sanction any compromise or arrangement unless it is satisfied that the company or any other person by whom an application has been made has disclosed to the Tribunal by an affidavit or otherwise all material facts relating to the company.

In *Smt. Pramila Devi* v. *People's Bank of Northern India,*[516] it was held that once a scheme of arrangement has been sanctioned by the Court, any variation or change in it cannot be effected by mere acquiescence of the

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[513] (1975) 45 Comp. Cas. 248 (Guj.).
[514] In Re *Hathi singh Manufacturing Co. Ltd.*, (1976) 46 Comp. Cas. 59 (Guj.).
[515] (1988) 63 Comp. Cas. 233 (Bom.).
[516] (1939) 9 Comp.Cas.1 (PC).

shareholders and creditors, but that will require the approval of the meeting of the shareholders and creditors and subsequent sanction of the Court (now Tribunal).

8.3.6 Meaning of Reconstruction:

The term 'reconstruction', *inter alia,* indicates the process which involves *(i)* the transfer of undertaking of an existing company to another company, usually incorporated for the purpose. The old company ceases to exist. However, all the assets might not pass to the new company; *(ii)* the carrying on of substantially the same business by the same persons; *(iiii)* the rights of the shareholders in the old company are satisfied by their being allotted shares in the new company.

A *reconstruction is made for any of the following purposes:*

(i) *To extend the operations of the company.* If the shares are fully paid-up and it is desired to raise further capital, the shareholders in the old company may be issued only partly paid shares in the new company so that by calling up the uncalled amount, the company would have the necessary funds for carrying on its business.

Also, if the company wants to do business which is totally unrelated to its objects, it may resort to reconstruction. The objects clause of the new company may include the business which it wants to pursue.

(ii) For purposes of reorganization - It implies alteration or modification of the rights of shareholders or creditors or both.

There is also the concept of internal reconstruction, wherein the company continues to exist and operate with adjustments of rights of shareholders and/or creditors, lenders, etc. In such a reconstruction, always some sacrifice is present for members and creditors to enable the company to operate as a going concern. If, pursuant to any scheme, shareholders who hold few shares get eliminated, such scheme cannot be rejected, if otherwise it meets all the requisites of an acceptable scheme .[517]

8.3.7 Meaning of Amalgamation and Merger

Amalgamation is the blending of two or more undertakings (companies) in to one undertaking, the shareholders of each blending undertaking

[517] ITWSignodge (I) Ltd., In re (2004) 52 SCL 147 (AP).

becoming substantially the shareholders of the other company which holds blended undertakings.

Merger - Merger is a form of amalgamation where all the properties and liabilities of transferor company get merged with the properties and liabilities of the transferee company leaving behind nothing with the transferor company except its name, which also gets removed through the process of law. In reality, companies do not merge only the assets and liability merge.[518] This concept of merger is in conformity with the concept given in Accounting Standard 14 issued by the ICAI and adopted as one of the National Standards. The other form of amalgamation is by way of purchase of assets and liabilities of the transferor where all the assets and liabilities may not be taken over.

8.3.8 Difference between Amalgamation and Reconstruction:

The difference between amalgamation and reconstruction is that amalgamation involves the blending of two or more different entities, and not merely the continuance of one entity; reconstruction implies the carrying on of an existing business in some altered form, so that persons interested in the business may remain substantially the same.

However, on the question of whether the term 'amalgamation', 'compromise' or 'arrangement', the High Court in *Patrakar Prakashan (P.) Ltd.,* In Re [519] has held that section 391 of the Companies Act has the effect of section 394 of the same Act which includes in its fold the powers to make arrangement or compromise and amalgamation of two or more companies. Definition of 'amalgamation' as contained in section 2 of the Income-tax Act cannot be lifted and read for the purpose of the Companies Act.

8.3.9 Procedure to be followed:

1. *Approval of scheme by holders of three-fourths in value of the shares.* Where a compromise or arrangement has been proposed for the purposes of reconstruction of a company or its amalgamation with another company, the scheme shall be approved by the holders of three-fourths in value of the shares concerned.

[518] *Areva T. and D. India Ltd., In* re[2008] 81SCL 140(Cal.).
[519] (1997) SCL XIH (M.P.)

2. NCLT's sanction. The scheme shall then be sanctioned by the NCLT. The NCLT may sanction the compromise or arrangement and pass orders for any the following matters :

(a) the transfer of the undertaking, property, and liabilities of the transferor company to the transferee company ;

(b) the allotment or appropriation by the transferee company of any shares debentures, policies, or other like interests in that company which are to be allotted or appropriated under the contract ;

(c) the continuation by or against any transferee company of any legal proceedings by or against any transferor company ;

(d) the dissolution, without winding up, of any transferor company ;

(e) the provision to be made for any persons who dissent from the compromise or arrangement ; and

(f) such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation shall be fully and effectively carried out.

Report from the Registrar in case of amalgamation of a company which is being wound up. A compromise or arrangement proposed in connection with a scheme for the amalgamation of a company, which is being wound up, with any other company, shall be sanctioned by the NCLT. However, if the NCLT has received a report from NCLT or the Registrar that the affairs of the company have not been conducted in a manner prejudicial to the interests of its members or to public interest, it shall not sanction the compromise or arrangement. A similar report from the Official Liquidator is necessary before the NCLT orders dissolution without winding up of any transferor company.

In *Re Piramal Spg. & Wvg. Mills Ltd.,*[520] the Company Law Board (now abolished) objected to the valuation of shares of a transferor company for the allotment of corresponding shares in a transferee company, on the ground that the shares in the transferor company were undervalued. The valuation of shares had been accepted by all the shareholder of both the companies. The Bombay High Court held that since the scheme cf amalgamation did not affect public interest, there was no reason for not sanctioning the scheme.

A certified copy of the NCLT's order to be filed with the Registrar. Within 30 days after the making of an order by the NCLT, every company in relation to which the order is made shall file a certified copy thereof with the Registrar for registration. If default is made, the company, and every

[520] (1980) 50 Comp. Cas. 514

officer of the company who is in default shall be punishable with fine which may extend to Rs. 500.

Notice to Central Government (Sec. 394-A). The NCLT shall give to the Central Government notice of every application made to it under Sec. 391 or 394. It shall also take into consideration the representations of the Central Government, if any.

8.3.10 Acquisition of shares of dissenting shareholders (Sec. 395)

Sec. 395 deals with the acquisition of shares of the shareholders who dissent with the scheme of reconstruction and amalgamation. The provisions of Sec. 395 are as follows :

(1) *Scheme may involve transfer of shares.* A scheme of reconstruction and amalgamation or contract may involve the transfer of shares by one company called the transferor company) to another company (called the transferee company).

(2) *Approval of holders of not less than 9/lOths in value of the shares required within 4 months.* After the transferee company makes an offer to the shareholders of the transferor company to acquire their shares, the offer shall be approved within 4 months by holders of not less than 9/10ths in value of the shares of the transferor company. In calculating the 9/lOths in value of the shares, shares already held by the transferee company or its nominee or subsidiary shall not be counted.

(3) *Right to acquire the shares of dissenting shareholders.* When the acceptance of 9/lOths in value of the shareholders is duly received, the transferee company shall get the right to acquire the shares of the dissenting shareholders, if any.

(4) *Notice to dissenting shareholders.* Within 2 months after the expiry of the 4 months (the period for the approval of offer to take shares), the transferee company shall give notice to the dissenting shareholders that it desires to acquire their shares.

Within 1 month of the notice any dissenting shareholder may apply to the NCLT. The NCLT will interfere if the scheme appears to be manifestly oppressive, unjust, unfair, or unconscionable or the consent of majority has been obtained by fraud, deception or other improper means. If no application is made to the NCLT or if the NCLT refuses it, the transferee company shall become entitled to acquire the shares of all persons on whom notice is served. In fact the transferee company shall be entitled and bound to acquire those shares on the terms on which the shares of other shareholders are to be transferred.

Further, the transferee company shall, within 1 month of its acquiring 9/lOths in value of shares, give notice to the dissenting shareholders of the transfer under the scheme or contract. Such shareholders may require the transferee company to acquire their shares within 3 months of the notice. The company shall in such a case be entitled and bound to acquire those shares.

(5) *Registration of transferee company as holder of shares in transferor company.* When the transferee company acquires the shares and pays their price, the transferor company shall register the transferee company as the holder of those shares. Within one month of the date of such registration, the transferor company shall inform the dissenting shareholders of the fact of such registration and of the receipt of the amount or other consideration representing the price payable to them by the transferee company.

(6) *Deposit of money received into a separate bank account.* The transferor company shall pay into a separate bank account the money received from the transferee company and shall hold the money in trust for its shareholders.

Who is a dissenting shareholder? The expression "dissenting shareholder" includes—

(i) a shareholder who has not assented to the scheme or contract, and also

(ii) a shareholder who has failed or refused to transfer his shares to the transferee company in accordance with the scheme or contract.

A dissenting shareholder, in an application to the NCLT to prevent the compulsory acquisition of his shares, must prove that, in spite of the approval of a large majority of the shareholders, the scheme is affirmatively, patently, obviously and convincingly unfair, or the price offered for the share is inadequate.[521]

Provisions which apply to scheme involving transfer of shares. The provisions which apply in relation to every offer of a scheme or contract involving the transfer of shares in the transferor company to the transferee company are as follows :

(1) Every such offer or recommendation to the members of the transferor company by its directors to accept such offer shall be accompanied by the prescribed information.

[521] *Evertite Locknuts Ltd., Re* (1945) Ch. 1220

(2) Every such offer shall contain a statement by or on behalf of the transferee company disclosing the steps it has taken to ensure that necessary cash will be available.

(3) Every circular containing such offer shall be presented to the Registrar for registration and no such circular shall be issued until it is registered.

(4) The Registrar may refuse to register any such circular which does not contain the prescribed information or which sets out such information in a manner likely to give a false impression.

(5) An appeal shall lie to the NCLT against an order of the Registrar refusing to register any such circular.

Whether workers should have a say in amalgamation: In *Gujarat Nylons Ltd.* v. *Gujarat State Fertilisers Co. Ltd.,*[522] one of the conditions in the scheme of amalgamation of the transferor and transferee companies was that on the scheme being effective all employees of the transferor company shall be deemed to have become the employees of the transferee company with effect from the appointed date without a break in their service and that they shall continue to be governed by the terms and condition of their employment in the transferor company. The workers' union of the transferor company objected to the granting of sanction of the proposed amalgamation. The Gujarat High Court rejected the workers' petition.

8.3.11 Conditions prohibiting reconstruction or amalgamation of company:[523]

Where any provision in the Memorandum or Articles of a company, or in any resolution passed in general meeting by, or by the Board of Directors of the company or in an agreement between the company and any other person whether made before or after the commencement of this Amendment, prohibits the reconstruction of the company or its amalgamation with any body corporate or bodies corporate, either absolutely or except on the condition that the managing director or manager of the company is appointed or reappointed managing director or manager of the reconstructed company or of the body resulting from amalgamation, as the case may be, shall become void with effect from the commencement of the Companies (Amendment) Act, 2000 or be void as the case may be.

[522] (1992) 8 C.L.A. 166
[523] Sec. 396 as inserted by the Companies (Amendment) Act, 2000

8.3.12 Amalgamation of Companies in National Interest: (Sec. 396)

Sec. 396 is intended to provide, at the instance of the Central Government, for the amalgamation of two or more companies in the national interest.

Satisfaction of Central Government. Where the Central Government satisfied that it is essential in the public interest that two or more companies should amalgamate, it may, by order notified in the Official *Gazette,* provide for the amalgamation of these companies into a single company. The amalgamated company shall have such constitution, property, powers, rights, interests, authorities and privileges and shall be subject to such liabilities, duties, and obligations as may be specified in the order.

Continuation of legal proceedings. The order of the Central Government may provide for the continuation by or against the transferee company of any legal proceedings pending by or against any transferor company. It may also contain such consequential, incidental and supplemental provisions as may be necessary to give effect to the amalgamation.

Interest of every member or creditor in the amalgamated company. Every member or creditor (including a debenture-holder) of each of the companies before amalgamation shall have, as nearly as may be, the same interest in or right against the amalgamated company as he had in the company of which he was originally a member or creditor. If his rights in the new company are in any manner less, he shall be entitled to compensation which shall be assessed by the prescribed authority. Every such assessment shall be published in the Official *Gazette.*

Appeal to the NCLT. Any person aggrieved by the assessment of compensation may, within 30 days from the date of publication of the assessment in the Official *Gazette,* prefer an appeal to the NCLT. Thereupon the assessment of the compensation shall be made by the NCLT.

Conditions subject to which Central Government may pass order. No order shall be made under Sec. 396 unless—

(a) a copy of the proposed order has been sent in draft to each of the companies concerned ;

(b) the time for preferring an appeal has expired or where any such appeal
as been preferred, the appeal has been finally disposed of ; and

(c) the Central Government has considered and made such modifications, if any, in the draft order as may seem to it desirable.

This shall be done in the light of any suggestions and objections which may be received by the Central Government from the companies concerned, or from shareholders therein, or from any creditors.

Copies of order to be laid before Parliament. Copies of every order made under Sec. 396 shall, as soon as may be after it has been made, be laid before both Houses of Parliament.

8.4 SUMMARY:

Compromise and arrangement: Compromise means an amicable settlement of differences by mutual concessions by the parties to dispute or difference. 'Arrangement', on the other hand, embraces a far wider class of agreements than a compromise. It includes agreements which modify rights about which there is no dispute.

Sections 391 to 393 contain provisions with respects to compromise or arrangement between the company and its creditors/members. Under section 391, where a compromise or arrangement is proposed between a company and its creditors, members, the court (now Tribunal) may, on the application of the company or any creditor or member or liquidator, order that a meeting of the creditors or members (or any class of them) be called and held in the manner directed by the court (now tribunal). If 3/4ths (in value) of the creditors or members (or any class of them) present in person or by proxy agree to the compromise or arrangement, then the same shall be binging on all the creditors/members and the company/liquidator/contributories of the company.

Reconstruction and amalgamation: arrangements and compromise may take place for the purposes of reconstruction and amalgamation of companies. The term reconstruction, *Inter alia,* indicates the process which involves: (i) the transfer of undertaking of an existing company to another company, usually incorporated for the purpose, (ii) the carrying on of substantially the same business by the same persons, (iii) the rights of the shareholders in the old company are satisfied by their being allotted shares in the new company.

A reconstruction is made either for extending the operations of the company or for purposes of reorganization.

Amalgamation, on the other hand, is the blending of two or more undertakings into one undertaking. The shareholders of each blending company become substantially the shareholders of the other company which holds blended undertaking.

Sometimes amalgamation or reconstruction may take the form of take-over or merger. The distinction between a take-over and a merger is essentially that of a degree than of a kind. In a take-over the direct or indirect control over the assets of the acquired company passes to the acquirer. But, in a merger the shareholding in the combined enterprise is spread between the shareholders of the two companies.

8.5 SUGGESTING READINGS/REFERENCE MATERIAL:

37. Avtar Singh : Company Law.
38. N.D. Kapoor : Elements of Company Law.
39. N.V. Paranjape : Company Law.
40. Taxmann : Company Law.
41. Gower, L.C.B. : Principles of Moderen Company Law.
42. Ramiya : Guide to the Companies Act.

8.6 SELF-ASSESSMENT QUESTION:

(1) Explain the terms ‘compromise’, ‘arrangement’ ‘reconstruction’ and ‘amalgamation’. Who can apply to court (now Tribunal) for compromise or arrangement? What are the powers of the High Court (now Tribunal) with regard to enforcement of its order sanctioning a compromise or an arrangement?

(2) Who is a dissenting shareholder in case of ‘amalgamation’ of companies? Explain the provision of the Companies act with regard to the acquisition of shares of dissenting shareholders.

(3) Write a short note on ‘Amalgamation in public interest’.

LL.M. Part-1
PAPER CORPORATE LAW

Block II –Director And Managerial Personal
Unit 9- Winding Up, Meaning, Modes and Dissolution

STRUCTUR

9.1. **Introduction**

9.2. Objective

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- **9.3.1 Meaning of Winding Up**
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- **9.3.8 Winding Up subject to Supervision of Court**
- **9.3.9 Dissolution of Company**

9.4. Summary

9.5. Suggested Readings/Reference Material

9.6. Self Assessment Question

9.1. Introduction:

A company is an artificial person created by a legal process known as incorporation. Its existence is distinct from that of the members who compose it. Therefore events affecting individual members such as death, lunacy or insolvency etc. do not affect the existence of a company and it continues until its dissolution is brought about by any of the following methods:

1. By removal of the name of the company from the Register when it becomes a defunct company. (Sec. 560).
2. By an order of the Court, without winding up, under a scheme of arrangement as provided by Sections 391 and 394 of the Companies Act.
3. By winding up when the purpose of the company has been accomplished or may have become impossible or in the event of insolvency or liquidation of the company.

9.2. Objective:

The objective of this lesson is to apprise the students about the meaning, methods and process of winding up, along with the appointment, powers and functions of liquidator with the help of statutory laws and relevant case laws.

9.3.1 Meaning of winding up:

"Winding up" is a term commonly associated with the ending of a company's existence. In fact winding up or liquidation[524] is a process by which the assets of the company are collected in and realized, its liabilities are discharged and the net surplus, if there is any, distributed in accordance with the company's articles of association.[525]

Gower has defined winding up of a company as "a 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 who takes control of the company, collects its assets, pays its debts and finally

[524] *Winding Up' and 'Liquidation '* are synonymous terms and therefore they maybe interchangeably used for one another.

[525] Sengupta, B.K. : *Company Law, (2nd Ed, 1990.) p 598*

distributes any surplus among the members in accordance with their rights."[526]

It must, however, be pointed out that a company is not dissolved immediately at the commencement of winding up. Its corporate status and powers continue during the process of winding up. In fact "winding up precedes dissolution".[527] When the winding up of a company commences, it is said to be in liquidation, but it does not cease to exist, until dissolved.

The object of winding up a company is to realise the assets and pay the debts of the company expeditiously in a fair manner in accordance with the law.

Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator, called a 'liquidator', is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their respective rights. In the words of Pennington winding up or liquidation is the process by which the management of a company's affairs is taken out of its directors hands, its assets are realised by a liquidator, and its debts and liabilities are discharged out of the proceeds of realisation and any surplus of assets remaining is returned to its members or shareholders. At the end of the winding up the company will have no assets or liabilities, and it will therefore be simply a formal step for it to be dissolved, that is, for its legal personality as a corporation to be brought to an end.

Winding up of a company differs from insolvency of an individual in as much as a company cannot be made insolvent under the insolvency law. Besides, even a solvent company may be wound up.

9.3.2 Modes of winding up:

A company may be wound up in any one of the following three ways**:**

(1) by the Court[528] making a winding up order (compulsory winding up);

(2) by passing of an appropriate resolution for voluntary winding up at a general meeting of members (voluntary winding up);[529]

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[526] Gower ; *the principles of Modern Company Law, (4 th Ed.) p.719*

[527] Bechawat, J. *in Pierce leslie & Co. v. V.O. wapshire, AIR 1969 SC 843.*

[528] The Word 'Court' has been substituted by the word 'Tribubal' by the Company (Second Amendment) Act, 2002 – Yet to Court into Force.

[529] Voluntary winding up may take two forms – Members' voluntary winding up and creditors' voluntary winding up – discussed in details later.

(3) by a voluntary winding up which the court orders to be continued subject to the supervision of the court".[530]

9.3.3 Grounds for compulsory winding up (Section 433):

Section 433 provides for circumstances in which a company may be wound up by court. The Section reads:

A company may be wound up by the court:

(a) if the company has, by special resolution, resolved that the company be wound up by the court;

(b) if default is made in delivering the statutory report to the Registrar or in holding the statutory meeting ;

(c) if the company does not commence its business within a year from its incorporation, or suspends its business for a whole year;

(d) if the number of members is reduced, in the case of a public company below seven, and in the case of a private company, below two;

(e) if the company is unable to pay its debts;

(f) if the court is of opinion that it is just and equitable that the company should be wound up;

(g) 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;

(h) if the company has acted against the interests of sovereignty and integrity of India, the security of the State, the friendly relations with foreign States, Public order, decency or morality.

(i) if the Tribunal is of the opinion that the company should be wound-up under the circumstances specified in section 424G.[531]

Provided that the Tribunal (real court) shall make an order for winding of a company under clause (h) on application made by the Central Government or a State Government.

1. <u>Special Resolution:</u>

A company may be wound up if a special resolution for its winding up by the Company has been passed. The Court is, however, not bound to order

[530] "Voluntary Winding Up Subject to Supervision of Court" has been removed by the Companies (Second Amendment) Act, 2002- yet to take effect.

[531] Clause (g), (h), & (i) have been added to section 433 by the Companies (second Amendment) Act, 2002 – Yet to get effect.

winding up simply because the company has so resolved.[532] 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. It must, however, be pointed out that winding up by a special resolution is not a common feature because of the fact that companies generally have a very large number of shareholders and if they want the company to be wound up, they would prefer its voluntary winding up which is comparatively cheaper and less time-consuming. It is quite often noticed that companies which are in very bad financial position and confronted with the problems of income tax or sales tax defaults, protracted litigation with creditors and prosecution by Registrar of Companies etc., prefer compulsory winding up by the Court by passing special resolutions so that all these problems are passed on to the Official Liquidator and the Court at no cost whatsoever.

2. 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.[533] The petition on this ground can be presented either by the Registrar of Companies with the previous sanction of the Central Government or by a contributory. If the petition on this ground is brought by any other person such as creditor etc., then it must be presented before the expiration of fourteen days of the last day on which the statutory meeting ought to have been held.[534] 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 order, then the Court may order winding up of the company.[535]

3. 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.[536] 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

[532] Sec. 433 (a)
[533] Sec. 433 (b)
[534] Sec. 439 (7)
[535] Sec.443(3)
[536] Sec.433(c)

business could not be commenced or resumed for a valid reason. The case of *Murlidhar* v. *Bengal Steamship co.*[537] is an illustration on this point.

In this case the company employed a steamer and two flats to carry on its business. These two flats were acquired by the Government during the First World war and the company could not replace them due to hike in prices. As a result of this, the company's business remained suspended for more than a year and a petition for winding up was brought against the company. The Court refused to order winding up on the ground that the suspension of business for a whole year was sufficiently accounted for and gave no indication that the company had no intention to carry on the business.

Again, in *Mohanlal Saraf* v. *Cuttuck Electric Supply Co*[538] the suspension of business due to acquisition was held not to be a sufficient to order winding up of the company.

Where a company ceases to do any business but is a holding company of subsidiaries engaged in pursuit of business which it was previously carrying on, it cannot be said that the company has suspended its business.[539]

In order to attract this provision, the suspension must be of the entire business and not only a part of it. Thus, where a company having several business units closes one of them it cannot be said to have suspended its business and the Court rightly refused to order it's winding up.[540] The Court in this case further observed that even if the business in all the units of the company was suspended, it would be still open to the court to examine whether it would be possible for the company to resume its business or not.

In *Rupa Bharti Ltd.* v. *Registrar of Companies*[541] the company failed to resume business for five years and the prospects also seemed dim, therefore the Court ordered the company to be wound up.

Again, In Re *Orissa Trunks & Enamel Works Ltd.*[542] the company's business remained suspended continuously for ten years since its capital was lost in misappropriation and the Government of Orissa, which was the major contributory, having refused to help, the Court ordered winding up.

[537] AIR 1920, Cal. 722

[538] (1964) 1 Comp LJ 58 Ori.

[539] *In Re Eastern Telegraph Co. ,* (1947) All ER 104

[540] *Paramjit Lal Bhadwar v. Spinning & Weaving Mills, (1986) 60 Comp Cas 420 All*

[541] (1969) 1 Comp. L.J 296.

[542] (1973) 43 Comp. Cas. 503 (Ori)

Suspension of the business by a company for a whole year is usually deemed to be a sufficient indication of absence of intention to carry on the business, unless it is sufficiently accounted for.[543]

4. Reduction in Membership below Statutory Limit:

If the number of members of a company is reduced below the prescribed statutory limit, namely, in the case of a public company, below seven and in the case of a private company below two, the company may be ordered to be wound up.[544] The term 'members' in this clause refers to actual members, and does not include past members or legal representatives of deceased member or assignees of insolvent members.[545] The court usually does not order winding up on this ground but leaves it to the company to go into voluntary winding up. This ground for winding up is meant to enable a member to escape personal liability for the company's debts which he would otherwise incur if the membership remains below the statutory minimum for more than six months as provided in Section 45 of the Companies Act.

5. Inability to Pay Debts:

A company may be ordered to be wound up if it is unable to pay its debts.[546] 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.[547] 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. The debt must, however, be really due and not under dispute. Thus, where a financially sound company disputed the claim on *bonafide* grounds that was held not to be neglect to pay and the Court refused to make an order for winding up of the company.[548]

In *P. Satya Raju* v. *Guntur Cotton, Jute & Paper Mills,*[549] the Court found that the object of the petition to wind up the Company was motivated by bringing pressure upon the company to pay off the debt expeditiously when the company wanted to dispute the debt in a civil Court. The petition was held to be abuse of legal process and was therefore dismissed. It has

[543] *O.P.Barra V. Kaithal Cotton and General Miels Ltd.* (1961) 31 Comp. Cas. 461.
[544] Section 433(d)
[545] In Re: Bowling & Welby is Contract (1895) 1 Ch 663 (CA)
[546] Sec. 433 (e)
[547] *Baburam V. Krishna Bhardwaj Cold Storage & General Mills Co. (P) Ltd.,* (1962) 2 Comp LJ 215.
[548] *New Era Furnishers (P) Ltd. V. Indo-Continental Hotels & Reports Ltd.,* (1990) 68 Comp.Cas 2008 Raj..
[549] AIR 1955 Mad. 199.

now been well settled that "petition for winding up is not to be sought for as a short cut and cheap device to coerce payment and stiffle contest."[550]

In fact, if there is a reasonable prospect of resurrection and revival of a company and its effective and commercially successful functioning, the Court may not pass winding up order. However, there may be instances where winding up may be a more effective way of settlement for the creditors and even the shareholders to recover whatever could be salvaged from the assets of the company. That will really be so in the case of companies whose continuance would not be commercially viable and may result in incurring further commitments by way of avoidable overheads. In such a case, there would be no purpose in trying to keep alive the company and allow it to continue its uneconomic functioning. That may only result in creating further liabilities against the company necessarily causing corresponding reduction in the distributive assets.

The Kerala High Court in *Sudarshan Chits (India) Ltd.* v. *O. Sukumaran Pilla*[551] examined another aspect of the situation where a company at that moment was in adversity and was passing through evil days and could be revived by reason of change of circumstances and on account of factor which made it possible for the company to function economically, once it revived. Commenting on this situation the Supreme Court observed:

> "It is easy for a court merely finding that a company is unable to pay its debts to bury it deep and distribute its assets, whatever, is available to the creditors standing in the queue, but it will not only be more equitable, fair and just, but indeed the Court's duty to make an earnest study of the prospect of the company being brought back to file, put on its feet again and provided with congenial circumstances under which it could begin once again to throb with life."

In this case the winding up order was readily recalled as the debt of the petitioning creditor was paid off and no other creditor either asked for winding up or opposed recalling of the winding up order.

It must, however, be stated that the Court is not expected to direct continuance of the functioning of the company in each and every case. The matter has to be decided applying the following tests:

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[550] *Chellaradh & Co. V. Sundram,* AIR 1955 Mys. 122; See also *Godauribai V. Amalgamated Commercial Traders.,* (1965) 2 Comp LJ 272.

[551] *(1985) 58 Comp Cas 633 SC.*

1. Whether continuance of the functioning of the company would be in the best interests of the creditors primarily.
2. Whether revival and resurrection of the company would be possible especially taking into consideration the circumstances such as (i) degree of solvency; (ii) likelihood of confidence of customers in view of its past performance etc.
3. Whether the continued functioning would not result in reducing the reliable assets, but would enable the company to function normally and economically.
4. If there is a scheme before the Court and whether it could be implemented and feasibility of its success.
5. If resurrection is proposed, the initial outlay and recurring expenditure on that account and the availability of resources for the same and whether such recommencement of business of the company is likely to further reduce distributable assets of the company.

The Supreme Court in *M/s. Uniplas India Ltd.* v. *State of Delhi & another*[552] has made it clear that Sections 433 and 434 of the Companies Act are provisions dealing with cases in which a company may be wound up by the Court. Clause (2) of Section 433 contains one of the six clauses for which the company can be wound up by Court *(i.e.* if the company is unable to pay the debts). What is provided in Section 434 is that a creditor should make a demand requiring the company to pay the amount due to the creditor.

The mode of making such demand is also delineated in the section. Likewise Section 138(b) of the Negotiable Instruments Act, 1881 also contemplates the making of a demand for payment of cheque amount as an indispensable step to initiate cause of action. Therefore, if any notice is issued under Section 434 of the Companies Act within fifteen DAYS of the information from the bank regarding return (dishonour) of the cheque drawn by a company as unpaid, such a notice would as well be good enough under clause (b) of Section 138 of the Negotiable Instruments Act.

In the instant case, the notice under Section 434 of the Companies Act was not issued within 15 days of the earlier dishonour of the cheque, hence dishonour remained without any further escalation and it did not give rise to a cause of action since the notice as issued by appellants only after the expiry of 15 days from the receipt of the reformation from bank regarding dishonour of cheque.

[552] AIR 2001 SC 2625

Thus the Court ruled that the dishonour remained without any further escalation and need not snowball into a cause of action. Its corollary is that the appellant was not prevented from presenting the cheque once again within the permitted period and make use of such presentation and the subsequent dishonour for a cause of action to be founded for launching a complaint. The Court, therefore, dismissed the appeal.

From the foregoing analysis it may be summed that inability to pay debts on the part of the company is usual ground for filing the petition for winding up of a company. However, every debt cannot be a ground for winding up of a company. A company may be wound up on the ground of being unable to pay its debts only when the following conditions exist:

(a) the amount of debt exceeds five hundred rupees ;
(b) the sum must be definite, presently payable and there should be no *bonafide* dispute about the debt;
(c) the creditor makes a written demand of payment;
(d) the demand is signed by the creditor or his agent or legal adviser duly authorised on this behalf;
(e) the demand has been served by causing it to be delivered at the registered office by registered post or otherwise ; and
(f) the company must have neglected to pay the demanded sum or to secure or compound the same to the satisfaction of the creditor for three weeks.

Just and Equitable: [Section 433(f)] - The court may also order for the winding up of a company if it is of the opinion that it is just and equitable that the company should be wound up. This is a separate and independent ground for a winding up order, and for a case to be made out under it, it is not necessary that the circumstances should be analogous to those which justify an order on one of the five other specific grounds already dealt with. In exercising its power on this ground, the court shall give due weightage to the interest of the company, its employees, creditors and shareholders and the interest of the general public. The relief based on the just and equitable clause is in the nature of a last resort when the other remedies are not efficacious enough to protect the general interests of the company.

In Gangadhar Dixit v. Utkal Flour Mills (Pvt.) Ltd.[553] The Gujrat High Court held a similar view in *Kiritbhai R. Patel* v. *Lavina Construction, Ltd.*[554] The Madras High Court in S. *Palaniappan* v. *Tirupur Cotton Spg. & Wvg. Mills Ltd.*[555] also followed the above principle and dismissed the winding up

[553] (1989) 66 Comp. Cas. 188 (Ori.).
[554] (1999) 20 SCL 158
[555] (2004) 50 SCL 293

petition. While in the foregoing five grounds for winding up definite conditions should be fulfilled, in the just and equitable' clause entire matter is left to the 'wide and wise' direction of the court in *Hind Overseas PVT.* v. *R.P. Jhunjhunwala*[556] The winding up must be just and equitable not only to the persons applying but also to the company and to all its shareholders. Same view has been expressed in *Prem Seth* v. *National Industrial Ltd.*[557] A few examples of 'just and equitable' ground on the basis of which the court may order the winding up are given below:

1. *Disappearance of substratum:* - A company's substratum is the purpose or group of purposes which it was formed to achieve (in other words, its main objects). If the company has abandoned all of its main objects and not merely some of them, or if it cannot achieve any of its main objects, its substratum is gone, and it will be wound up.

A company may lose the ability to achieve its main objects in a variety of ways. It will do so if it fails to obtain a patent for an invention which it was formed to exploit on assumption that the patent would be granted', or if it fails to acquire the business which it was formed to purchase, or if it fails to obtain the necessary approval of a authority for the erection of the building which it was formed to erect.

The fact that the company is exercising some of the ancillary powers conferred by its memorandum of association will not save it, because these powers are intended merely to aid it in achieving its main objects, and not to enable it to carry on a different kind of business or to preserve some appearance of activity. If the company's memorandum of association provides that each of the powers conferred by the objects clause shall be a main object, the court will nevertheless determine the purposes for which the company was really formed, and will wind it up if it has abandoned them.[558]

The Madras High Court in *K.S. Mothilal* v. *K.S. Kasimaries Ceramique (P) Ltd.*[559] has held that winding up proceedings are not meant for settling personal scores among family members. The court rejected the petition as the company's liability was marginal compared to its net worth and the company can very well proceed with one or more objects stated in the memorandum even though its major business has been stopped. This does not suggest that company's substratum is lost.

2. *Illegality of Objects and Fraud* - If any of a company's objects are illegal, or apparently, if they become illegal by a change in the law, the

[556] (1977) ASIL XIII.
[557] (2002) 35 SCL 636 (Delhi).
[558] *Cotman v. Brougham (1918) AC 514 at 520, per Lord Parker.*
[559] (*2004*) 50 SCL 116

court will order the company to be wound up on the ground that it is just and equitable to do so.[560]

Similarly, if a company is promoted in order to perpetrate a serious fraud or deception on the persons who are invited to subscribe for its shares, the court will wind it up. Thus, a winding up order was made when the company's prospectus stated that it had agreed to purchase the business of an existing firm, together with the right to use the firm's name, for a very substantial sum, and subscribers for the company's shares were intentionally misled by the name and the amount of the purchase price in to thinking that the firm was a different and reputable concern, whose business name the vendor firm had, in fact, successfully but illegally imitated for a number of years.[561] Again, a winding up order was made against a company whose promoters sold a business to them at a gross overvalue, and when the deception was discovered, bought up at a very low price most of the shares subscribed for by the public, so as to prevent the company from suing them for their misfeasance, and so as to wind the company up voluntarily and distribute its assets among themselves.[562]

However, for winding up on this ground, fraud in the prospectus or in the manner of conducting company's business is not sufficient. It must be shown that the original object of creating the company was fraudulent or illegal.[563]

3*. Deadlock in management -* If it becomes impossible to manage a company's affairs because the voting power at board and general meetings is divided between two dissenting groups, the court will resolve the deadlock by making a winding up order. The most obvious kind of deadlock is where the company has two directors who are its only shareholders and who hold an equal number of voting shares, if they disagree on major questions in respect of the management of the company, their disagreement cannot be resolved at a board meeting or by a general meeting, and management decisions will cease to be made. In this situation the court will make a winding up order, even though there is a provision in the company's articles that one director shall have a casting vote at board meetings[564], or that disputes shall be settled by arbitration.[565]

There may also be a deadlock even though the voting power is not equally divided between the dissenting groups. Thus, where there were three

[560] *Princess Resuss v. Bos [1871] LR 5 HL 176; Re International Securities corpn.[1908] 25 TLR*

[561] Re Thomas Edward Brinsmead & Sons Ltd. [1897] 1 Ch. 45.

[562] *Re West Surrey Tanning Co. [1866] LR 2 Eq 737*

[563] Re *T.E. Brismead & Sons Ltd.* (1897) 1 Ch. 45, 406 (C.A.).

[564] Re *Davis and Collett Ltd.* [1935] Ch. 693, [1935] All ER Rep. 315.

[565] Re *Yenidje Tobacco Co. Ltd.* [1916] Ch. 426.

shareholders with equal shareholdings, and two of them were the company's directors, one of the director-shareholders was held entitled to a winding up order when the other persistently refused to attend board meetings and make up a quorum to transact business. The lesson for the other director's absence was his fear that the petitioner would insist on a general meeting being called at which, by the terms of the articles, the petitioner could require the other shareholders to purchase his shares, or if they were unwilling to purchase them, to join with the petitioner in passing a resolution to wind up the company voluntarily. It was held that the company's business could not be carried out at all and for this reason the court made a winding up order.[566]

Plea for dead lock in management disallowed-In KapilN. Mehtav. Shree Laxmi Motors Ltd.[567], the Gujarat High Court disallowed a petition for winding up pleading *inter alia* deadlock in management. In this case the petitioners managed the company before their displacement, for about twenty years and were facing charges in misappropriation of company's funds and mismanagement. The plea for winding up was viewed by the Court as a plea in despair. According to the judgment provision of section 443(2) is mandatory and alternative remedy should be availed of instead of coming for winding up. In this case, alternative remedy was available u/s 402 i.e. approach to CLB under sections 397 and 398.

Since a petitioner should not have done anything to prejudice the company and create a deadlock, his petition would not be approved as he was found to have done the same.[568]

Plea for deadlock in management allowed- In *Brown Forman Mauritius Ltd. V. Jagatjit Brown Forman (I.) Ltd.*[569], the court was convinced that deadlock in management was evident as the company was in a loss and there was need for fresh capital infusion and neither of the parties owning this joint venture company came up with any proposal to resolve the problems. Also neither was interested in buying the shares held by the other and the two parties were bogged down in litigations against each other. Also *see Draegerwerk AkkungesellsChaff v. Usha Drager (P) Ltd.*[570]. In this case *animosity between* contesting groups reached a stage beyond repair and criminal case was filed by one of the groups against the other.

[566] Re *American Pioneer Leather Co.* (1918) 1 Ch. 556.
[567] (1999) 19 SCL 420
[568] *Vishnu Kumar Agarwalla V. Sreelall Foreign Money* (2008)88 SCL 246 (Cal).
[569] (2004) 51 SCL 214 (Delhi)
[570] (2007) 75 SCL 355 (Delhi)

4. *When the company is a 'bubble',* i.e., *it never had any real business - Re London and County Coal Co.*[571]. Such companies are commonly called as ‘ fly by-night' companies.

5. *Oppression - A* winding up petition may lie where the principal shareholders have adopted an aggressive or oppressive policy towards the minority.[572]

A winding up order will be made if the persons who control the company have been guilty of oppression toward the minority shareholders, whether in their capacity of shareholders or in some other capacity (e.g., as director). Thus, a company was wound up on the petition of minority shareholders when the director, who held a majority of the issued shares, had persistently refused to call annual general meetings, or to submit accounts to the petitioners, or to have appointed, or to give the petitioners any information about the company's affairs, all these being part of a scheme to coerce the petitioners into selling their share a price somewhat less than quarter of their real worth. Similarly, in Scotland winding up order was made at the instance of a minority shareholder who was a director, when the majority shareholder, who was the other director, excluded the petitioner from taking any part in the management of the company, refused to allow him to inspect the company's books and denied him any information relating to its affairs, and generally managed the company's undertaking as though it were the majority shareholder's own property. In these two cases, the persons responsible for the oppression obviously knew that their conduct was improper, but malevolence or a desire on their part for an improper gain at the expense of the petitioner is not an essential part. Thus, a winding up order was made when the petitioner merely showed that for several years no annual general meeting had been held and no annual audits had taken place and that asset which the company had bought from the majority shareholders had not been transferred to it. The court reasoned that every shareholder is entitled to have the company's business managed properly according to law, and if the persons who control the company show a persistent unwillingness to do this any minority shareholder is entitled to have the company wound up.

However, the court will order winding up only when it is satisfied that it is impossible for the business of the company to be carried on for the benefit of the company as a whole because of the way in which voting power is held and used. However, when factual matrix and circumstances, that were manifest from record, *prima facie,* went against petitioner's case and

[571] (18670 L.R. 3 Eq. 365

[572] *R.S. Sbapathy Rao V. Sabapathy Press Ltd.* AIR 1925 Mad. 489.

he could not invoke equitable jurisdiction seeking relief for winding up, the petition is liable to be dismissed. [573]

6. If the Board of Industrial and Financial Reconstruction (BIFR) created under the Sick Industrial Companies (Special Provision) Act, 1985 expresses the opinion that the sick company should be wound up on just and equitable ground and forwards that opinion to the High Court, ordinarily and unless an appeal has been made against the opinion to the appropriate appellate authority under the above Act, the High Court will order winding up. However, the Appellate Authority under the above Act has the power to order any way it considers fit and the High Court cannot interfere with the same except on a writ filed before it. However, the Karnataka High Court in *Loharu Steel Industries Ltd. V. DCM Ltd.*[574]has held that while the opinion of the BFIR is an important material before the company court, the same is not conclusive and binding on the company court.

A company in huge debt burden could not come up with any viable scheme for rehabilitation before the BIFR but kept on prolonging the proceedings under one pretext or the other simply to keep the creditors at bay. Ultimately the BIFR opined that it is just, equitable, and in public interest that the company be wound up on just and equitable ground. The P&H High Court upheld the opinion of the BIFR-Haryana *Petrochemicals Ltd* v. *AAIFR.*[575] When a company judge orders winding-up, in view of opinion forwarded by the BIFR, without following company (Court) Rules, 1959 to satisfy that it was just and equitable to wind up the company, the order is to be set aside - *A Rama Goud* v. *Omnitrode Aditya Electrodes (P) Ltd.*[576]

Company in the process of implementation of a revival scheme sanctioned by BIFR - While sanctioning the scheme, the BIFR directed that the company should make payment to secured creditors over a period of seven years. The company neglected to make payment and the petitioner-creditors for supplies filed the petition for winding-up. It was held that the time allowed for making payments was only directory and not mandatory and implementation of the revival scheme is a continuous process. Merely because the time allowed for making payment was over, the protection under section 22 (1) of the SICA was not taken away. As revival scheme was on, the winding-up petition was dismissed. The creditors may individually seek extension of time (so that their claim does not get barred) from the BIFR - Hyderabad *Abrasives and Minerals (P)*

[573] *M.Mohan Babu V. Heritage Foods (p) Ltd.* (2002) 37 SCL 490 (AP).
[574] (2002) 39 SCL 114.
[575] (2002) 40 SCL 795
[576] (2003) 47 SCL 775 (AP)

Ltd. v. *Andhra Cements Ltd.*[577] In another case, the Allahabad High Court upheld the opinion of the BIFR for winding up of the company on just and equitable ground on the premises that secured creditors and the operating agency had no objection to winding up while promoters had left the country.[578]

Jurisdiction of BIFR extends only to industrial companies – the Bombay High Court in *Apple Finance Ltd* v. *Mantri Housing and Construction Ltd.*[579] *has* held that since the company concerned did not own any industrial undertaking, its reference to BIFR is a nullity. Once a matter has been registered with the BIFR for enquiry, the issue that the company is or is not an industrial company rests with the BIFR and by operation of section 22(1) of the SICA, proceedings including winding up proceedings pending before company court have to be stayed.[580]

6. Need for leave of company court for disposal of assets. - The Karnataka High Court in the case of *Karnataka Industrial Investment & Development Corpn. Ltd v.Intermodel Transport Technology Systems (Karnataka) Ltd* held that leave of Company Court is necessary for disposal of the asset of the company on the order of the BIFR when winding up proceedings have started. If without leave of the company court the assets are sold on the strength of the BIFR order, the sale will be void. However, the Court held that there is no conflict between the provisions of the Companies Act and the provision of section 20(4) of the SICA which empowers the BIFR to cause sale of the assets of the sick company before it. If such sale takes place, the Sale proceeds are to be forwarded to the concerned High Court for order of distribution under the applicable provisions of the Companies Act [*Vide* the above named case in [2000] 24 SCL 200].

Reconsideration of BIFR opinion in favour of winding up after the BIFR opinion was upheld by Appellate Authority and the opinion was referred for consideration of the court the court may remand the matter to BIFR for looking afresh taking cognizance of significantly changed circumstances.[581]

7. *Grounds Analogous to dissolution of Partnerships*- If the company is a private one and its share capital is held wholly or mainly by its directors, it is in substance a partnership in corporate form, and the court will order its

[577] (2003) 42 SCL 748 (AP)
[578] *Chandra Synthetics Ltd.,*[578] *In re:* (2002) 38 SCL 77.
[579] (2002) 37 SCL 713
[580] *Muhd. Nizamuddin v. Shri Shakti L.P. G. Ltd.* (2003) 46 SCL 561 (AP).

[581] *B.R. Steel Products Ltd, In re* (1999) 21 SCL 31 (Bom.).

winding up in the same situations as it would order the dissolution of a partnership on the ground that it is just and equitable to do so[582].

In *Official Liquidator* v. *Ram Swarup*[583], the Allahabad High Court observed that the fact that a pre-existing firm had been converted into a private limited company comprising of the same persons who were partners in the firm, as directors of the newly formed company, did not mean that the company still retained its character as a partnership. When it becomes a company, it acquires a distinct legal personality of its own. The firm having been dissolved on the formation of the company, there was no longer any link between the company and the firm unless it could be established that the rights of the former partners as regards management of the affairs of the company remained unaltered and preserved.

In *Re Davis and Coltett Ltd*[584] one member improperly excluded the other who held half the shares from taking part in the company's business. Held, the company be wound up.

But a winding up order will not be made because a controlling director, who has by tacit consent always managed the company's business alone, refuses to allow a fellow "director to participate in day-to-day management as distinct from attending and taking part in board meetings.[585] However, the exclusion of a fellow director who has taken a part in managing the company's business from doing so any longer will be cause for winding the company up if the company was formed on the understanding that he should participate in managing its business.[586] Likewise, the failure of the majority shareholders to appoint the petitioner to be a director when he subscribed for shares in the company on the understanding that he would be director, will justify a winding up order.[587]

8.*Requirements for investigation* - Where directors were making allegations of dishonesty against each other in respect of defalcations of the funds of the company, the company was ordered to be wound up on the ground that it was a case in which the conduct of some of the officers of the company required an investigation which could only be obtained in a winding up by the Court .[588]

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[582] *Re Yenidje Tobacco Co. Ltd.* (supra).
[583] AIR 1997 All 72
[584] AIR 1935 Ch. 693.
[585] Re Fildes Bros. Ltd. [1970] 1 All ER 923 (Ch.D); (1970) 1 WLR 592; (1970) 2 Comp. LJ 173
[586] Ebrahimi v. Westbourne Galleries Ltd. (1973) AC 360, [1972] 2 All ER 392
[587] (1986) 1 Comp LJ 278
[588] *Re Variejies Ltd.* [1893] *2 Ch.235.*

9.Broad democratic legal principles of fairness - In considering a petition on just and equitable ground, the Court will have regard to broad democratic legal principles[589]. Windling up petition filed under sections 433(e) and 433(f) read with sections 439 and 443, by the sole petitioner (shareholder), as also seeking stay on proceedings for sale of one of the properties of the company to meet financial liabilities, was entertained by the company court and various reliefs were granted to the petitioner though opposed by the company which had adequate assets but not sufficient cash. It was held on appeal that the company judge failed to correctly consider the company's contentions and the winding up petition was not liable to be admitted on petition of a solitary shareholder.

10. Company lacking in commercial morality or incapable of maintaining or producing relevant records.[590]

The company judge was not justified in interfering with Board of Directors's decisions to sale the company property to discharge its debts, which could be done only after getting further orders of the Debt Recovery Tribunal. The company court, as a rule cannot adjudicate upon commercial judgment of the Board of directors and interfere with internal management of the company.[591]

Company making default in filing with the Registrar its Balance Sheet and Profit and Loss Account or Annual returns for any five consecutive financial years [Section 433(g)][592] - This ground has been added by the Companies (Second Amendment) Act, 2002 presumably to induce discipline and accountability on the companies. It may be recalled that section 274 was amended by the Companies (Amendment) Act, 2000 to bring in a new disqualification for directors, *inter alia, on these* grounds. It is a welcome feature as non-accountability and indiscipline in running the affairs of the company is widespread and chronic and Government companies are no exceptions. However, to what extent the danger of being wound up will discourage rampant indiscipline by corporate management in this regard is a matter of conjecture specially the time frame of five consecutive years is too long a period to inflict considerable damage to the corporate viability. This clause contains two distinct non-compliances (i) non-filing of the balance sheet and the profit and loss account and (ii) non-filing of annual return. The balance sheet and the profit and loss account constitute the composite document known as annual accounts while annual return is a distinctly separate document. If

[589] *N. Sundaraswamyv. Bangalore Turf Club Ltd* [1999] 21 SCL 90

[590] *Howrah Mills Co. Ltd* and *Jardine HendersonLtd, In re [2011]* 105 SCL (Cal.).

[591] *Cochin Malabar Estates & Industries Ltd.* v. *P.V. AbdulKhader* [2003] 45 SCL 170 (Ker.).

[592] Not yet in force

default is made in respect of either (for consecutive five financial years), this clause for winding up can be invoked. It is not necessary that default has to be for both annual accounts and annual return. If annual accounts are filed regularly but annual return has not been filed for five consecutive years, the clause becomes applicable. If converse is the case then also it becomes applicable. The test of its applicability lies in default in either matter for consecutive five financial years. However, say default in filing annual accounts is for two years and the same for annual returns is for three years, then this clause cannot be invoked. It is not clear why the legislature has included the word "any" to precede the words "five consecutive financial years". It leaves scope for default going unnoticed by the corporate regulator/monitor and being taken up after a number of YEARS since default was committed. It is also possible that while a default for consecutive five years was committed in the past, no such default was made for recent years. In that event to invoke this clause will be unfair.

Company acting against the interests of sovereignty and integrity of India, the security of the State, the friendly relations with foreign states, public order, decency or morality [Section 433(h)][593]*:* This is also a new ground embodying in itself several grounds, introduced by the Companies (Second Amendment) Act, 2002. While grounds like acting against the interests of sovereignty and integrity of India or of the security of the State or even of the friendly relations with foreign States are understandable given the prevailing geo-political scene and its contours, the remaining-grounds of public order, decency and morality, do not appear to belong to the same strain. How they have been combined together with the former three grounds and what precisely they stand for, need clarification. How a corporate entity can affect public order, decency and morality need explaining. Is it that a corporate entity engaaged in media related activities or in advertisement and publicity, producing obscene literature or graphics is to be wound up under this clause? For these, other regulating agencies are there to control these activities like the Press Council, Censor board and the Police. It is also possible that the Press Council does not hold an article in a magazine as against public order but a State administrator files winding up petition on this ground with the Tribunal and the Tribunal upholds the prayer in the petition. The company publishing the magazine would then be wound up. But would it be fair? Corporate matter should remain encompassed by activities that make corporate entities and abstract individualistic propositions, in fairness, should not find place in corporate legislation. Even a conflict based on fundamental rights enshrined in the Constitution of India can arise; further it has a damaging potential of stifling an individual or a group of individuals working perfectly

[593] Yet not in force

legally when he or they earn the wrath of ruling political group and/or the ruling bureaucracy. A public debate on this clause is very much an urgent necessity before it inflicts damage to responsible freedom in the society.

The 'Tribunal will entertain petition under this clause only from the Central Government or a State Government and it appears from the language used in proviso to this section that Tribunal will order winding up on receipt of the petition.

Tribunal is of the opinion that the company should be wound up under circumstances stated in Section 424G [Section 433(i)][594]Section 424G relates to winding up of a sick industrial company. When the Tribunal, after carrying out necessary inquiry under section 424B, is of the opinion that a sick industrial company is not likely to become viable in future and it is just and equitable that the company should be wound up, it may order winding up of the company after recording its findings. Section 433(f) of the Act only mentions of winding up order under section
424G. However, the process and procedure for winding up will be same as per other grounds in section 433 of the Act. In fact, it is not a new ground. Section 433(f) covers it.

Inherent powers of court under section 433- The Company (Court) Rules shall in no way affect or limit or abridge inherent powers of court to give such directions or pass such orders as may be necessary for meeting ends of justice or to prevent abuse of process of court. In case of a company in respect of which winding up petition has been admitted and stage for evidence is reached, the applicant company can produce documents which were not produced at the time of filing of plaint or written statement.[595]

9.3.4 Who can make petition [Section 439]

A petition for the compulsory winding up of a company may be presented by:

1. the company; or
2. any creditor or creditors, including any contingent or prospective creditor or creditors; or
3. a contributory or contributories; or
4. any combination of creditors, company or contributories acting jointly or separately; or
5. the Registrar; or

[594] Yet not in force

[595] Cable Corporation of India Ltd. V. Sanghi Industries Ltd, (2003) J 44 SCL 15 (AP)

6. any person authorized by the Central Government, as per section 243 (in consequence of investigation under section 237 of the Act);
7. the official liquidator in a voluntary winding up. [Section 440].
8. In a case falling under clause (h) of section 433 by the Central Government or a State Government. (Would become applicable when Companies (Second Amendment) Act, 2002 comes to effect.)

1. Petition by the company [Sec. 439 (1) (a)] - A company may itself present a petition to the Court for winding up after it has passed a special resolution.

A company does not often present a petition to have itself wound up by the court as it can achieve this object more conveniently by passing a special resolution to wind up voluntarily. In *Patiala Banaspati & Allied Products Co. Ltd. Re,*[596] where an application for the winding up of a company was made by its managing director, it was rejected on the ground that the managing director or directors do not constitute the company for the purpose of winding up and the "petition by the company must have behind it decision of the general meeting,"

2. Petition by any creditor or creditors [Sec. 439 (1) *(b)* - A petition to the court for the winding up of a company may be filed by any creditor or creditors. The term 'creditor' is not limited to one to whom a debt is due at the date of the petition and who can demand immediate payment. Every person having *a* pecuniary claim against the company whether actual or contingent is a creditor and such a person is competent to file a petition for the winding up of the company.

Where a company is unable to pay its debts and after the filing of a petition for its winding up, the company pays the principal amount due to the creditor during the pendency of the petition but does not pay the interest on the principal amount, the company can still be ordered to be wound up.[597]

Persons included in the category of creditors,- (a) A contingent or prospective creditor. This includes holder of a bill of exchange not yet due or a holder of debentures not yet payable. But before a petition for winding up a company presented by a contingent or prospective creditor is admitted, the leave of the court shall be obtained for the admission of the petition. Such leave shall be granted if -

[596] A.I.R (1953) Pep. 195.

[597] Delhi Cloth ICO. Ltd. v. Stepan Chemical Ltd., (1986) 60 Comp. Cas. 1046 (P.&H.

(i) in the opinion of the Court, there is a *prima facie* case for winding up of company ; and

(ii) a reasonable security for costs has been given,

(b) A secured creditor. A secured creditor is as much entitled to file a petition for the winding up of a company as an unsecured creditor. It is not necessary for a secured creditor to give up his security, or to sell or value the security and claim a balance before presenting the petition for winding up.

(c) A debenture-holder. Where any trustees have been appointed in respect of debentures, such trustees for the debenture-holders are also deemed to be creditors.

(d) Any person who has a pecuniary claim against the company actual or contingent.

(e) The legal representatives of a deceased creditor.

(f) The Central or a State Government or a local authority to whom or other public charge is due.

Disputed debt: *A* creditor, whose debt is disputed, cannot get a winding up order. The Court may either order the petition to stand over until the validity of the debt can be determined or may dismiss the petition. It may restrain a creditor by injunction from bringing a threatened petition.

In *Niger Merchants Co.* v. *Capper,*[598] *C* claimed $500 from a company for services rendered to it. The company said it owed C $ 200 only. *C* threatened to file petition for winding up the company if he was not paid. The company was solvent. The Court granted injunction to the company to restrain C from bringing the petition.

Court's discretion: Any creditor who is able to satisfy the Court that there are good grounds for a winding up order is *prima facie* entitled to an order; but the Court may refuse the order if it is opposed by a majority in value of the creditors.[599]

In *B. Karsug Ltd., Re,*[600] A company was already in the course of voluntary winding up. Two creditors presented a petition for a compulsory winding up; but the overwhelming majority of the creditors opposed the making of a winding up order. The petitioning creditors could not show any grounds of hardship or injustice on

[598] (1877) 18 Ch. 577.
[599] Chapel House Colliery Co., Re (1883) 24 Ch. D. 259.
[600] (1955) ALL E.R. 854.

which the Court could exercise its discretion. The petition was disallowed.

The Court may, in its discretion, refuse the order or direct meeting of the creditors to be held to ascertain their wishes. The wishes of the majority are however, not conclusive and the Court may for good reason decline to follow them. But if the company is commercially insolvent and the object of trading at a profit cannot be attained, winding up order would follow.[601]

3. Petition by any contributory or contributories [Sec. 439 (1)-A contributory means a person liable to contribute to the assets of the company on the event of its being wound up and includes the holder of shares which are paid-up. He can present a petition for winding up a company, even though he may be the holder of fully paid-up shares or that the company may have no assets at all, or may have no surplus assets left for distribution among shareholders, after the satisfaction of its liabilities.

Where a fully paid-up shareholder has made out a case for the winding up a company, the petition should not be dismissed merely on the ground that he has not established that there will be surplus assets available for distribution.

Grounds - *A* contributory can present a winding up petition if—
(a) the membership is reduced below the *statutory minimum* ; or
(b) he is an *original allottee* of shares ; or
(c) he has *held his shares* for any 6 out of the previous 18 months ; or
In *Gattopardo Ltd., Re,*[602] A petition for the winding up of a company was presented in December 1968. The transfer of shares had been executed, stamped and dated in June 1968, but the company registered the transfer in its books in October 1968. *Held,* the petitioner was not entitled to present the petition as he had not held shares for the 6 out of the previous 18 months.

(d) the shares have *devolved* on him through the death of a former holder.

The grounds (b) and (d) are designed to prevent a person from buying shares in a company with the sole intention of qualifying for the purposes of bringing a winding up petition.

Special case to be made out - Where a petition is made by a contributory, a special case has to be made out for a winding up by the Court such as that the substratum of the company has gone or

[601] *Bengal Flying club, Re* (1966) 2 Comp. L.J. 213.
[602] (1969) 2 ALL E.R. 344.

the number of members is reduced below the statutory minimum. This is in view of the reason that the shareholders of the company can determine its fate by passing the necessary resolution. The Court will not grant an order for winding up unless the petitioner can satisfy the Court that the right of the contributories will be prejudiced by a voluntary winding up. Further the Court ought not to disregard wishes of a large majority of the shareholders opposing the winding up, the Court sees in their conduct something unreasonable, something like tyranny, something amounting to an injury of which minority have a right to complain.[603]

Holder of forfeited shares - The holder of forfeited shares may apply for the winding up of a company within 1 year of the forfeiture of his shares provided he has held the shares for 6 months during the 18 months preceding the commencement of winding up.[604]

Personal representative - The personal representative of a deceased shareholder is a contributory for the purpose of Sec. 439.

Where shares are held jointly by two persons, and one of them dies, interest of the deceased shareholder passes to the survivor and not to the heirs of the deceased shareholder. In such a case only the surviving shareholder is a contributory and is entitled to present petition for winding up.[605]

Claimant for dividend - *A* petition for winding up also lies for dividend declared which is regarded as a debt due by the company.

Contributory whose call is in areas - He may not be permitted to present a winding up petition unless he pays the call.

(4) Petition by all or any of the prior parties whether together or separately -

Section 439(1)(d)*: A* petition for the winding up of a company under Sec. 433 may be presented by all or any of the parties, namely, the company, the creditors or the contributories specified in Sec. 433 (a), (b) and (c) whether together separately.

(5) Petition by the Registrar [Sec. 439 (1) (e)]. The Registrar can present a petition for winding up a company on the following grounds only, viz.,

(a) If default is made by the company in delivering the statutory report to the Registrar or in holding the statutory meeting.

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[603] Middlesborough Rooms Assembly Co., Re (1880) 14 Ch. D. 104.

[604] *Mumtaz Bank Ltd., Re* (1932) 2 Comp. Cas. 350.

[605] *Ram Govind Misra v. Allahabad Theatres (Pvt.) Ltd.,* (1989) 66 Comp. Cas 358 (All.).

(b) If the company does not commence its business within a year from its incorporation, or suspends its business for a whole year.

(c) If the number of members is reduced in the case of a public company below 7 and in the case of a private company below 2.

(d) If the company is unable to pay its debts.

(e) If the Court is of opinion that it is just and equitable that the company should be wound up.

The Registrar shall be entitled to present a petition on ground (d) if it appears to him from the financial condition of the company as disclosed in its balance sheet or from the report of a special auditor (appointed under Sec.233-A) or an inspector (appointed under Sec. 235 or 237) that the company is unable to pay its debts. Where a petition for winding up was filed by the Registrar without informing himself of the true position of the company, he was made to pay the costs of the respondent,[606] but before the Registrar can present a petition, he shall obtain the previous sanction of the Central Government. Before according its sanction, the Central Government shall afford an opportunity to the company of making its representations, if any. After accord of the sanction, the petition must be filed by the Registrar within a reasonable time otherwise the Court will not recognize the sanction as valid.

A petition for winding up a company on the ground that a default is made by the company in delivering the statutory report to the Registrar or in holding the statutory meeting shall not be presented except by the Registrar or by a contributory. Such a petition shall be presented before the expiration of 14 days after the last day on which the statutory meeting ought to have been held.

6. Petition by the Central Government [Sec. 439 (1) (f)] - Under sec.243 the Central Government may cause to be presented to the Court (by any person authorised by it in this behalf) a petition for the winding up of a company where it appears from the report of Inspectors appointed to investigate the affairs of the company under Sec. 235 that—

(1)the business of the company is being conducted with intent to—

*(a)*defraud its creditors, members, or any other persons, or

*(b)*otherwise for a fraudulent or unlawful purpose, or

(c) in a manner oppressive of any of its members, or

(d) that the company was formed for any fraudulent or unlawful purpose ; or

606 *Registrar of Companies, Punjab v. Suraj Bachat Yojna (Pvt.) Ltd.,* (1973) 43 Comp. Cas, 363],

(2)persons concerned in the formation of the company or the management of its affairs have been guilty of fraud, misfeasance or other misconduct towards the company or towards any of its members.

Petition where company is being wound up voluntarily or subject to Court's supervision (Sec. 440). Where a company is being wound up or subject to the supervision of the Court, a petition for its winding up by the Court may be presented by —

(a) any of the persons authorised to do so under Sec. 439 ; or

(b) the Official Liquidator.

The Court shall not make a winding up order on a petition presented to it unless it is satisfied that the voluntary winding up subject to the supervising of the court cannot be continued with due regard to the creditors or contributories or both.

Whether workers entitled to be heard in a winding up petition?

The interest of the workers of a company has also to be taken into consideration while admitting a petition for winding up the company. In *National Textile Workers' Union* v. *P.R. Ramakrishnan,*[607] the Supreme Court in a majority judgment held as follows:

(1) The workers are entitled to appear at the hearing of the winding-up petition: whether to support or to oppose it so long as no winding up order was made by the Court. The workers have a *locus* to appear and be heard in the winding up petition both before the winding up petition is admitted and an order for advertisement is made as also after the admission and advertisement of the winding up petition until an order is made for winding up. If a winding up is made and the workers are aggrieved by it, they would also be entitled to prefer an appeal and contend in the appeal that no winding up order should have been made by the company judge.

(2) The workers have a right to be heard before the provisional liquidator is appointed: by the company judge but the circumstances that the workers are not heard would not have the effect of vitiating the order appointing the provisional liquidator. It is open to the workers to apply to the Court for vacating that order and it would be for the Court after considering the material produced before it and hearing the parties to decide whether that order should be vacated or not.

(3) The workers of the company have the same locus standi as that of the shareholders: and, therefore, they have an equal right

[607] (1983) 53 Comp. Cas. 184.

to appear and oppose the winding up of the company, as the workers are not mere vendors of toil and they are not a marketable commodity to be purchased by the owners of capital, they are producers of wealth as much as capital.

Applying the concept that a company is not the exclusive property of the shareholders as propounded in *National Textile Workers Union's Case,* it has been held in *Kilpest Pvt. Ltd.* v. *Shikkhar Mehra,*[608] that a petition filed under Sec. 433 *(f)* for the winding up of a company without the active representation of the workers of the company is not at all maintainable and no order for its winding up could be passed without the express consent of the workers of the company.

Right of any other person to be heard: In *Keerat Kaur* v. *Patiala Exhibition (Pvt.) Ltd.,*[609] the Punjab and Haryana High court has held that the Court has the discretion in a petition for winding up a company to hear any person other than the parties to the petition who may be interested in the winding up on public grounds or otherwise. This discretion may be exercised by the Court even at the stage of admission of petition.

9.3.5 Procedure of Winding Up by the Court:

Official Liquidator (Sec. 448): For the purpose of winding up of companies by the Court:

(a) there shall be attached to each High Court an *Official Liquidator* by the Central Government. The Official Liquidator shall be a whole-time officer. If the Central Government considers that there will not be sufficient work for a whole-time officer, it may appoint a part-time officer to act as official Liquidator;

(b) the *Official Receiver* attached to a District Court for insolvency purposes shall be the Official Liquidator attached to the District Court. If there is no Official Receiver attached to a District Court, then, such person as the Central Government may, by notification in the Official *Gazette,* appoint for the purpose shall be the Official Liquidator attached to the District Court.

The Central Government may also appoint one or more Deputy or Assistant Official Liquidators to assist the Official Liquidator in the discharge of his functions.

[608] (1987) 62 Comp. Cas. 717 (M.P.)
[609] (1991) 70 Comp. Cas. 728 (P. & H.)

Liquidator (Sec. 449): On a winding up order being made in respect of a company, the Official Liquidator shall, by virtue of his office, become the liquidator of the company.

Style etc. of liquidator (Sec. 452): The liquidator shall be described by the style of 'the Official Liquidator' of the particular company in respect of which acts, and not by his individual name.

Fees to Central Government [Sec. 451 (2)]: Where the Official Liquidator becomes or acts as liquidator, there shall be paid to the Central Government out of the assets of the company such fees as may be prescribed.

Provisional liquidator (Sec. 450): At any time after the presentation of a winding up petition and before the making of a winding up order, the Court may appoint the Official Liquidator to be the liquidator provisionally.

A provisional liquidator is as much a liquidator in winding up ; in fact, the name provisional liquidator is only a convenient label …... he has the same powers and to the extent these powers imply duties, the same duties as a liquidator in a winding up. The Court may limit and restrict his powers by the order appointing him or by a subsequent order. Otherwise, he has the same powers as a liquidator has.

Appointment of a provisional liquidator is a drastic measure: It should not be resorted to except in special circumstances, *i.e.,* in cases of urgency. Though Sec. 450 does not lay down any criteria, the principles governing the subject are well settled. In *re London, Hamburg & Continental Exchange Bank*,[610] Lord Romilly, in a much quoted passage, stated:

"It is perhaps convenient that I should state what my practice is with reference to the appointment of provisional liquidators. Where there is no opposition to the winding up, I appoint a provisional liquidator of course, on the presentation of the petition. But where there is an opposition to it, I never do, because I might paralyse all the affairs of the company, and afterwards refuse to make the winding up order at all. But when the directors themselves apply, or do not oppose the winding up,then I appoint the provisional liquidator."

The dictum of Lord Romilly has stood the test of time and is taken to be the law on the subject. In *Virendra Singh Bhandari* v. *Nandlal Bhandari & Sons (Pvt.) Ltd.*,[611] A. P. Sen J. observed as follows:

"The Court will not take a drastic step like the appointment of a provisional liquidator for a company which is carrying on business

[610] (1866) L.R 2 Eq. 231.

[611] (1979) 49 Comp. Cas. 532 (M.P.)

and functioning as it would in effect put a stop to the business, though ultimately, the Court may refuse winding up, unless it is satisfied that such an order is absolutely necessary. Both on authority and principle, a provisional liquidator is not, in general, appointed before the hearing of petition for winding up unless the company is shown to be insolvent or unless the petition is presented by the company itself or the petition is unopposed."

Notice to company before appointment of provisional liquidator: - Before appointing a provisional liquidator, the Court shall give notice to the company and give a reasonable opportunity to it to make its representations. If the court thinks fit, it may dispense with such notice; but in that case, it shall in writing record the special reasons for not giving the notice.

On a winding up order being made by the Court, the Official Liqudator shall cease to hold office as provisional liquidator and shall become the liquidator of the company.

Duties of liquidator:

(1)Proceedings in winding up [Sec. 451 (1) and (3)]: The liquidators conduct the proceedings in winding up the company and perform duties imposed by the Court. He shall not make any secret profit out of his office as he occupies a fiduciary position *[Silkstone etc. Coal Co.* v. *Edey,*[612] The acts of the liquidator shall be valid notwithstanding any defect that may afterwards be discovered in his appointment or qualification. Acts done, after his appointment has been shown to be invalid, shall not be deemed to be validly done.

(2) Report [Sec. 455 (1)]: (1) The Official Liquidator shall as soon as practicable after receipt of the statement of affairs of the company (to be submitted under Sec. 454), and not later than 6 months from the date of the order of winding up, submit a preliminary report to the Court. The report shall contain particulars —

(a) as to the amount of the capital issued, subscribed, and paid-up, and the estimated amount of assets and liabilities. The assets shall be stated under the following headings:

(i) cash and negotiable securities, (ii) debts due from contributories, (iii) debts due to the company and securities, if any, available in respect thereof, (iv) movable and immovable properties belonging to the company, and (v) unpaid calls;

(a) if the company has failed, as to the causes of the failure; and

612 (1900) 1 Ch. (167)

(b) Whether, in his opinion, further inquiry is desirable as to any matter relating to the promotion, formation, or failure of the company, or the conduct of business thereof.

The court may extend the period of 6 months for the submission of the above report by the official liquidator. It may also order that no such statement need be submitted.

2.1 Additional report: the official liquidator may, if he thinks fit, make further reports stating the manner in which the company was promoted or formed. He may further state if any fraud has been committed by any person in company's promotion or formation, or since the formation thereof. He may also state any other matters which it is desirable to bring to the notice of the court. If in any further report the official liquidator states that a fraud has been committed, the court shall have the further powers provided in section 478 as to the public examination of promoters and officers.

(3) Custody of company's property (section 456): Where a winding up order has been made or where a provisional liquidator has been appointed, the liquidator/provisional liquidator shall take into his custody all the property, effects and actionable, all the property and effects of the company shall be deemed to be in the custody of the court.

Section 456 further enables the liquidator to obtain possession of properties, effects or actionable claims, books of account or other documents belonging to the company with the assistance of the chief presidency magistrate or District magistrate, as the case may be.

(4) Exercise and control of liquidator's power (section 460):

The liquidator shall, in the administration of the assets of the company and the distribution thereof among creditors, have regard to any directions which may be given by resolution of the creditors or contributories at any general meeting or by the committee of inspection. Any directions by the creditors or contributories at any general meeting shall override any directions given by the committee of inspection.

Meeting of creditors and contributories: the liquidator may summon general meeting of the creditors or contributories whenever he thinks fit for the purpose of ascertaining their wishes. He shall summon such meetings at such time as the creditors or contributories may by resolution direct, or wherever requested in writing to do so by not less than $1/10^{th}$ in value of the creditors or contributories, as the case may be.

Directions from the court: the liquidator may apply to the court for directions in relation to any particular matter arising in winding up. He shall

also use his own discretion in the administration of the assets of the company and in the distribution thereof among the creditors.

Any person aggrieved by any act or decision of the liquidator may apply to the court. The court may confirm, reverse or modify the act or decision complained of, and makes such order as it thinks just in the circumstances. A '*Person aggrieved'* means a person who has suffered a legal grievance against whom a decision has been pronounced which has wrongfully deprived him of something or wrongfully refused him something which he has a right to demand or wrongfully affected his title to something.[613]

(5) Proper books (Sec. 461). The liquidator shall keep proper books for making entries or recording minutes of the proceedings at meetings and such other matters as may be prescribed. Any creditor or contributory may, subject to the control of the Court, inspect any such books personally or by his agent.

(6) Audit of accounts (Sec. 462). The liquidator shall, at such time as may be prescribed but at least twice each year during his tenure of office, present the Court an account of his receipts and payments as liquidator. The account shall be in the prescribed form, shall be made in duplicate, and shall be duly verified. The Court shall cause the account to be audited. For the purpose audit the liquidator shall furnish the Court with such vouchers, information and the books as the Court may require. One copy of the audited accounts shall be filed and kept by the Court. The other copy of the account shall be delivered to the Registrar for filing. Each copy shall be open to the inspection of any creditor, contributory or person interested. Where an account relates to a Government company in liquidation, the liquidator shall forward a copy thereof—

(a) to the Central Government, if that Government is a member of the Government company ; or

(b) to any State Government, if that Government is a member of the Government company ; or

(c) to the Central Government and any State Government, if both the Governments are members of the Government company.

The liquidator shall cause the audited account or its summary to be printed. He shall send a printed copy of the account or its summary

[613] *Jagannath v. Lockras* A.I.R. (1951) Nag. 275.

by post to every creditor and to every contributory. The Court may dispense with compliances with this provision.

(7) Appointment of committee of inspection (Sec. 464). The court may at the time of making an order for the winding up of a company, or at any time thereafter, direct that there shall be appointed a committee of inspection to act with the liquidator. The liquidator shall, within 2 months from the date of direction by the Court, convene a meeting of the company's creditors to determine the members of the committee of inspection. He shall also, within 14 days from the date of the creditors' meeting, convene a meeting of the contributories to consider the decision of the creditors' meeting with the membership of the committee. It shall be open to the meeting with respect of the contributories to accept the decision of the creditors' meeting with or without modifications or to reject it.

(8) Pending liquidation (Sec. 551). The liquidator shall, within 2 months of the expiry of each year from the commencement of winding up, file a statement duly audited by a qualified auditor of the company, with respect to the proceedings in, and position of, the liquidation. The statement shall be filed -

(a) in the case of a winding up by or subject to the supervision of the court, in Court ; and

(b) in the case of a voluntary winding up, with the Registrar.

When the statement is filed in Court, a copy shall simultaneously be filed with the Registrar and shall be kept by him along with the other records of the company.

Powers of liquidator:

The powers of a liquidator in a winding up are divisible into 3 main groups according to whether he acts —

1. with the sanction of the Court [Sec. 457 (1)] ; or
2. without the sanction of the Court [Sec. 457 (2)] ; or
3. with the leave of the Court in case of onerous contracts (Sec. 535).

1. **Powers exercisable with the sanction of the Court [Sec. 457 (1)].** The liquidator in a winding up by the Court shall have power, with the sanction of the Court,—

(1) To institute or defend suits and other legal proceedings, civil or criminal, 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.

In Wreck Recovery & Salvage Co., Re,[614] A company was being wound up. *L,* one of the shareholders who believed in the value of the company's patents, made a contract with the liquidator whereby he was to have the use of the plant of the company to raise 3 sunken vessels at his own expense, the profit (if any) to go to the company. *Held,* the contract was bad, as it was not for the purpose of beneficial winding up, but to resuscitate the company.

When a liquidator carries on the business of the company he does so as an agent of the company and is not personally liable on contracts which he enters into as liquidator.

In *Stead Hazel & Co.* v. *Cooper,*[615] *S* had entered into a contract with a company to deliver cotton in monthly installments from November 1929 to August 1930. The company went into liquidation and *C* was appointed liquidator by the Court in May 1930. *C* did not disclaim the contract, and arranged with S that the payment would be made after and not before delivery. The goods were delivered but not accepted by *C. Held, C* was not personally liable for damages for non-acceptance.

(3) To sell the immovable and movable property and its actionable claims with power to transfer the whole or sell the same in parcels.

(4) To raise money on the security of the company's assets. The assets include all contributions which the liquidator is entitled to get from the members, past or present, as well as all assets which have been misappropriated as against creditors.[616]

(5) To do all such other things as may be necessary for winding up the affairs of the company and distributing its assets.

Provision for legal assistance to liquidator (Sec. 459): The liquidator may, with the sanction of the Court, appoint an advocate, attorney or pleader entitled to appear before the Court to assist him in the performance of his duties.

Discretion of liquidator (Sec. 458): The Court may permit the exercise of any of the above powers by the liquidator without its sanction but subject to its control.

2. Powers exercisable without the sanction of the Court [Sec. 457 (2)]. The liquidator in a winding up by the Court shall have power, without the sanction of the Court,-

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[614] (1880) 15 Ch. D. 353.
[615] (1933) 1 K.B. 840.
[616] *Stringers Case,* (1869) 4 Ch. App. 45.

(1)to do all acts and to execute documents and deeds on behalf of the company under its seal ;

(2)to inspect the records and returns of the company or the files of the Registrar without payment of any fee ;

(3)to prove, rank and claim in the insolvency of any contributory for any balance against his estate and to receive dividends ;

(4)to draw, accept, make and endorse any bill of exchange, hundi or promissory note on behalf of the company in the course of its business

(5)to take out, in his official name, letters of administration to any deceased contributory, and to do any other act necessary for obtaining payment of any money due from a contributory or his estate ;

(6)to appoint an agent to do any business which he is unable himself.

Powers subject to control by the Court [Sec. 457 (3)]: The exercise of the powers by the liquidator under Sec. 457 shall be subject to the control of the Court. Any creditor or contributory or aggrieved person may apply to the court with respect to the exercise or proposed exercise of these powers.

3.Powers exercisable in case of onerous contracts Sec.457 (3): the term
'onerous' means a right to property, *e.g.,* a lease, in which the obligations attaching to it exceed the advantage to be derived from it. The liquidator may, with the leave of the Court, disclaim onerous contracts, and properties. This shall be done within 12 months after the commencement of the winding up, unless the Court extends time.

Control of Central Government over liquidators (Sec. 463)

The Central Government shall take cognizance of the conduct of liquidators of companies which are being wound up by the Court. If a liquidator does not faithfully perform his duties and duly observe all the requirements imposed on him by the Statute, or if any complaint is made to the Central Government by any creditor or contributory in regard thereto, the Central Government shall inquire into the matter, and take such action thereon as it may think expedient.

The Central Government may at any time require any liquidator of a company which is being wound up by the Court to answer any

inquiry in relation to the winding up. It may also apply to the Court to examine him or any other person on oath concerning the winding up. It may also direct a local investigation to be made of books and vouchers of the liquidators.

Is liquidator an officer? A liquidator, while dealing with the liquidation proceedings, represents the company, which does not lose its identity as a company till it is dissolved. He alone can act for and on behalf of the company. He can, therefore, be said to be an officer of the company though not specifically mentioned in Sec. 2 (30) of the Companies Act, 1956.[617]

Liabilities of liquidator

A liquidator of a company is liable for negligence —

(a) if he distributes its assets without making due provision for liabilities or contingent claims of which he has notice, *e.g.,* where the company having assigned a lease is under a contingent liability for the rent, or where he knows of possible claims by workmen for injuries not covered by insurance.[618]

(b) if he applies the company's assets in paying a doubtful claim without taking proper legal advice or direction from the Court.[619]

(c) if there is a breach of any of his statutory duties. In such a case he is liable in damages to a creditor or a contributory for injury to him.

In *Pulsford* v. *Devenish,*[620] A liquidator distributed the assets of a company without paying *X,* a creditor, but the liquidator made no attempt to communicate with him beyond issuing an insufficient advertisement for creditors. *Held,* the liquidator was liable in damages to *X*.

A liquidator is trustee for the company's funds and property in his hands for the creditors: But the liquidator is not a trustee in the full sense of the word, for the property in the assets is vested in the company, and when he makes contracts he does so in the company's name. He is not a trustee for each creditor and

[617] Official Liquidator, Baroda Batteries Ltd. v. Registrar of Companies, (1978) 48 comp. Cas. 120 (Guj.)
[618] *Armstrong Whitworth Securities Co. Ltd., Re* (1947) 1 Ch. 673.
[619] Home & Colonial Insurance Co. Ltd., Re (1930) 1 Ch. 102.
[620] (1903) 2 Ch. 625.

contributory so as to be liable in his capacity of trustee for negligence.

In Knowles v. Scott.,[621] There was some delay in handing over to a contributory his proportion of the surplus assets of the company. A claim was made by the contributory for damages for the delay. *Held,* in the absence of fraud, bad faith or personal misconduct on his part, the liquidator was not liable for the delay.

9.3.6 Voluntary Winding Up:

'Voluntary winding up' means winding up by the members or creditors of a company without interference by the Court. The object of a voluntary winding up is that the company, *i.e.,* the members as well as the creditors, are left free to settle their affairs without going to the Court. They may, however, apply to the Court for any directions, if and when necessary.

Circumstances in which a company may be wound up voluntarily (Sec.484):

A company may be wound up voluntarily —

(1) **By passing an ordinary resolution**. When the period, if any, fixed for the duration of a company by the Articles has expired, the company in general meeting may pass an ordinary resolution for its voluntary winding up. The company may also do so when the event, if any, on the occurrence of which the Articles provide that the company is to be dissolved, has occurred.

(2) By passing a special resolution*.* A company may at any time pass a resolution that it be wound up voluntarily. No reasons need be given where members pass a special resolution for the voluntary winding up of the company. Even the Articles cannot prevent the exercise of these statutory rights.

Commencement of voluntary winding up (Sec. 486): A voluntary winding up shall be deemed to commence at the time when the resolution (ordinary or special, as the case may be) for its voluntary winding up is passed.

Advertisement of resolution (Sec. 485): Within 14 days of the passing of the resolution for voluntary winding up of the company, the company shall give notice of the resolution by advertisement in the Official *Gazette,* and also in some newspaper circulating in the district of the registered office of the company.

[621] (1891) 1 Ch. 717.

Types of Voluntary Winding Up:

A voluntary winding up may be a

1. members' voluntary winding up, or
2. Creditors' voluntary winding up.

1. Member's voluntary winding up:

Declaration of solvency (Sec. 488): In a voluntary winding up of a company if a declaration of its solvency is made in accordance with the provision of sec. 488, it is a members' voluntary winding up. The declaration shall be made by a majority of the directors at a meeting of the Board that the company has no debts or that it will be able to pay its debts in full within 3 years from the commencement of the winding up. The declaration shall be verified by an affidavit.

The declaration shall have effect only when it is —

(a) made within five weeks immediately before the date of the resolution, and delivered to the Registrar for registration before that date ;

(b) accompanied by a copy of the report of the auditors of the company on (i) the profit and loss account of the company from the date of the last profit and loss account to the latest practicable date immediately before the declaration of solvency, (ii) the balance sheet of the company, and (iii) a statement of the company's assets and liabilities as on the last mentioned date.

Any director making a declaration of the solvency without having reasonable ground for the opinion that the company will be able to pay its debts in full within the period specified in the declaration, shall be punishable with imprisonment up to a period of 6 months, or with fine up to Rs.50,000, or with both up with both.

A winding up in the case of which a declaration has been made and delivered is referred to as a members' voluntary winding up, and a winding up in the case of which a declaration has not been so made and delivered is referred to as a creditors' voluntary winding up.

Provisions applicable to a members' voluntary winding up:

Sections 490 to 498 shall apply in relation to a members' voluntary winding up |Sec. 489). The provisions of these Sections are as follows:

1. **Appointment and remuneration of liquidators (Sec. 490).** The company in general meeting shall appoint one or more liquidators for the purpose of winding up its affairs and distributing its assets. It shall also fix the remuneration, if any, to be paid to the liquidator or

liquidators. Any remuneration so fixed shall not be increased in any circumstances. The liquidator shall not take charge of his office before his remuneration is fixed as aforesaid.

2. **Board's powers to cease on appointment of a liquidator (Sec. 491).** On the appointment of a liquidator, all the powers of the Board of directors, the managing or whole-time directors, and manager, shall cease except when the company in general meeting or the liquidator may sanction them to continue.

3. **Power to fill vacancy in office of liquidator (Sec. 492).** If a vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, the company in general meeting may fill the vacancy. For this purpose a general meeting may be convened by any contributory or by the continuing liquidator or liquidators, if any.

4. **Notice of appointment of liquidator to be given to Registrar (Sec. 493).** The company shall give notice to the Registrar of the appointment of a liquidator or liquidators. It shall also give notice of every vacancy occurring in the office of liquidator and of the names of the liquidators appointed to fill every such vacancy. The notice shall be given by the company within 10 days of the event to which it relates.

5. **Duty of liquidator to call creditors' meeting in case of insolvency (495).** If the liquidator is at any time of opinion that the company will not be able to pay its debts in full within the period stated in the declaration, he shall forthwith summon a meeting of the creditors. He shall lay before the meeting a statement of the assets and liabilities of the company. Therefore the winding up shall become creditors comply with this provisions, he shall be punishable with fine which may extend to Rs. 5,000.

Sec. 495 is complementary to Sec. 488 which deals with declaration of solvency in case of voluntary winding up. It imposes a statutory duty on the liquidator, when he has reason to believe that the company is insolvent, to summon a meeting of the creditors and lay the facts before them. The creditors then decide in the meeting whether or not they should exercise their right of petition for a compulsory winding up by the Court.

6. **Duty to call general meeting at the end of each year (Sec. 496).** In the event of the winding up continuing for more than 1 year, the liquidator shall call a general meeting of the company at the end of the first year from the commencement of the winding up. Likewise, he shall call a general meeting at the end of each succeeding year. He

shall lay before the meeting an account of his acts and dealings and of the conduct of the winding up during the year.

7. **Final meeting and dissolution (Sec. 497).** As soon as the affairs of the company are fully wound up, the liquidator shall make up an account of the winding up, showing how the winding up has been conducted and how the property of the company has been disposed of. He shall then call a general meeting of the company and lay before it the accounts showing how the winding up has been conducted.

The meeting shall be called by advertisement—

(a) specifying the time, place and object of the meeting ; and

(b) published not less than one month before the meeting in the official *Gazette,* and also in some newspaper circulating in the district of the registered office of the company.

Within one week after the meeting, the liquidator shall send to the Registrar and the Official Liquidator a copy each of the account and shall make a return to each of them of the holding of the meeting and of the date thereof. If a quorum is not present at the final meeting, the liquidator shall make a return that the meeting was duly called but could not be held for want of quorum.

The Registrar on receiving the account and return shall register them. The Official Liquidator, on receiving them, shall make a scrutiny of the books and papers of the company. The liquidator of the company and present officers shall give the Official Liquidator all reasonable facilities to make the scrutiny. On such scrutiny the Official Liquidator shall make a report to the Court. If the report shows that the affairs of the company have been conducted in a manner not prejudicial to the interests of its members or to public interest, then from the date of the submission of the report to the Court, the company deemed to be dissolved.

If the report shows that the affairs of the company have been conducted in a manner prejudicial to the interests of the members or the public interest, the Court shall direct the Official Liquidator to make a further investigation of the affairs of the company. The Court shall also invest him with all such powers as it may deem fit. On receipt of the report of the Official Liquidator on such further investigation, the Court may make an order that the company shall stand dissolved. The Court may also make such order as the circumstances of the case brought out in the report permit.

9. Provisions as to annual and final meeting in case of insolvency (Sec.498): If in the case of a members' voluntary winding up, the liquidator finds that the company is insolvent, Sections 508 and 509 which deal with the duty of the liquidator to call a meeting of the company and of creditors

at the end of each the year (Sec. 508) and final meeting and dissolution (Sec. 509) in case of a creditors' voluntary winding up] shall apply as if the winding up were a creditors' voluntary winding up and not a members' voluntary winding up. It should be noted that in such a case Sections 508 and 509 shall apply to the exclusion of Sections 496 and 497.

2. Creditors' Voluntary Winding Up:

A voluntary winding up of a company in which a declaration of its solvency is not made is referred to as a creditors' voluntary winding up.

Provisions applicable to creditors' voluntary winding up:

Sections 500 to 509 shall apply in relation to a creditors' voluntary winding up (Sec. 499). The provisions of these Sections are as follows:

1. *Meeting of creditors (Sec. 500)*. The company shall call a meeting of the creditors of the company on the day on which there is to be held the general meeting of the company at which the resolution for voluntary winding up is to be proposed, or on the next day. It shall send notices of the meeting to the creditors by post simultaneously with the sending of the notices of meeting of the company. It shall also cause notice of the meeting of the creditors to be advertised once at least in the Official *Gazette* and once at least in 2 newspapers circulating in the district of the registered office-of the company.

The Board of directors of the company shall cause a full statement of the position of the company's affairs together with a list of the creditors and the estimated amount of their claims to be laid before the meeting. It shall also point one of their members to preside at this meeting. It shall be the duty of a director so appointed to attend the meeting and preside thereat.

If the meeting of the company at which the resolution for voluntary winding up is to be proposed is adjourned and the resolution is passed at an adjourned meeting, any resolution passed at the meeting of the creditors shall [have effect as if it had been passed immediately after the passing of the resolution for winding up the company.

2. *Notice of resolution to be given to Registrar* (Sec. 501). Notice of any resolution passed at the creditors' meeting shall be given by the company to the Registrar within 10 days of the passing thereof.

3. *Appointment of liquidator* (Sec. 502). The creditors and the members at their respective meetings may nominate a liquidator. If

they nominate different persons, the creditors' nominee shall be the liquidator. But any director, member or creditor of the company may apply to the Court for an order that the person nominated as liquidator by the company or any other person shall be the liquidator. The application shall be made to the Court within 7 days after the date on which the nomination was made by the creditors.

If no person is nominated by the creditors, the person nominated by the members shall be the liquidator. Likewise, if no person is nominated by the company, the person nominated by the creditors shall be the liquidator.

4. *Appointment of committee of inspection* (Sec. 503). The creditors at their meeting may, if they think fit, appoint a committee of inspection consisting of not more than 5 persons. If such a committee is appointed, the company mav also at a general meeting appoint not more than 5 members to the committee. However, the creditors may, if they think fit, resolve that all or any of the persons appointed by the company ought not to be members of the cornmittee of inspection. If the creditors and members do not agree on a common list, the Court may constitute a committee of inspection.

5. *Liquidator's remuneration* (Sec. 504). The committee of inspection, or if there is no such committee, the creditors, may fix the remuneration of the liquidator. Where the remuneration is not so fixed, it shall be determined by the Court. The remuneration shall not be increased in any circumstances.

6. *Board's powers to cease on appointment of liquidator* (Sec. 505). On the appointment of a liquidator, all the powers of the Board of directors shall cease. But the committee of inspection, or if there is no such committee, the creditors, in general meeting, may sanction the continuance of the Board.

7. *Power to fill vacancy in office of liquidator* (Sec. 506). If a vacancy occurs by death, resignation or otherwise, in the office of a liquidator (other than a liquidator appointed by, or by the direction of, the Court), the creditors in general meeting may fill the vacancy.

8. *Power of liquidator to accept shares etc., as consideration for sale of property* (Sec. 507). The provisions of Sec. 494 shall apply in the case of a creditors' voluntary winding up. However the powers of the liquidator under Sec. 494 shall not be exercised except with the sanction either of the Court or of the committee of inspection.

9. *Duty of liquidator to call meeting at the end of each year* (Sec.508): the liquidator shall call a general meeting of the company and a meeting of the

creditors every year, within 3 months from the close of every year. This will be so if the winding up continues for more than 1 year. He shall lay before the meeting an account of his acts and dealings and of the conduct of winding up during the preceding year and position of the winding up.

10. *Final meeting and dissolution* (Sec. 509). As soon as the affairs of the company are fully wound up, the liquidator shall make up an account of the winding up showing how the winding up has been conducted and how the property of the company has been disposed of. He shall then call a general meeting of the company and a meeting of the creditors for the purpose of laying the account before the meeting and giving explanation therefor. Thereafter the procedure shall be the same as laid down in Sec. 497.

The liquidator becomes *functus officio* on the dissolution of the company. But he holds himself liable for his acts and omissions in his capacity as liquidator before the dissolution of the company.[622]

Members' and creditors' voluntary winding up compared:

1. *Declaration of solvency.* In case of a members' voluntary winding up, there is declaration of solvency. In case of a creditors' voluntary winding up, there is no such declaration.

2. *Control of winding up.* In a members' voluntary winding up, the members' control the winding up of the company and the creditors do not participate directly as the company makes a declaration of solvency. In a creditors' voluntary winding up, the creditors control the winding up of the company as the company is deemed to be insolvent.

3. *Meetings.* In a members' voluntary winding up, there is no meeting of creditors. In a creditors' voluntary winding up, whenever there is a meeting of contributories, there is a corresponding meeting of creditors.

4. *Appointment of liquidator.* In a members' voluntary winding up, the liquidator is appointed by the company and his remuneration is fixed by the company. In a creditors' voluntary winding up, he is appointed by the creditors and his remuneration is fixed by the committee of inspection or, if there is no such committee, by the creditors.

5. *Committee of inspection.* There is no committee of inspection in a members' voluntary winding up ; in a creditors' voluntary winding up the creditors may appoint a committee of inspection.

(6)Powers of liquidator. In a members' voluntary winding up, the liquidator can exercise certain powers with the sanction of a special resolution of the company; in a creditors' voluntary winding up, he can do so with the

[622] *Income-tax Official Liquidator,* (1977) 47 Comp. Cas. 54

sanction of the Court or the committee of inspection or of a meeting of the creditors.

Liquidators in Voluntary Winding Up:

Appointment of liquidator:

(1) *Appointment in case of a members' voluntary winding up* (Sec. 490). In the case of a members' voluntary winding up, the company in general meeting shall appoint one or more liquidators for the purpose of winding up the affairs and distributing the assets of the company. But a liquidator shall not take charge of his office till his remuneration is fixed.

***Vacancy* (Sec. 492):** If a vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, a general meeting of the company may be convened by any contributory or by the continuing liquidator, if any, to fill the vacancy.

***Notice of appointment to Registrar* (Sec. 493**): (1) A company shall give notice to the Registrar within 10 days of any of the following events:

(c) Appointment of a liquidator by the company in general meeting ;

(d) Name of the liquidator appointed to fill the vacancy.

(2) *Appointment in case of a creditors' voluntary winding up* (Sec. 502). In the case of a creditors' voluntary winding up, the creditors and members may each nominate a liquidator. If they nominate different persons, the person nominated by the creditors shall be the liquidator.

Where a person has been nominated or appointed liquidator by the members of the company, and the creditors have not brought his appointment to an end, he is to be regarded as the liquidator of the company.[623]

(3) *Appointment by Court* (Sec. 515). If from any cause, whatever, there is no liquidator acting, the Court may appoint the Official Liquidator or any other person as liquidator. The Court may also appoint a liquidator on the application made by the Registrar in this behalf.

Body corporate not to be appointed as liquidator (Sec. 513): A body corporate shall not be qualified for appointment as liquidator of a company in a voluntary winding up. Any appointment made in contravention of this rule shall be void. Any body corporate which acts as a liquidator of a company, and every director or manager thereof, shall be punishable with fine which may extend to Rs. 10,000.

[623] *Centrebind Ltd., Re* (1966) 3All E. R. 889

Corrupt inducement affecting appointment as liquidator (Sec. 514): Any person who gives, or agrees to give, to any member or creditor of a company any gratification whatever with a view to—

(a) Securing his own appointment or nomination as the company's liquidator; or

(b) Securing or preventing the appointment or nomination of some person
other than himself as the company's liquidator; shall be punishable with fine which may extend to Rs. 10,000.

Notice by liquidator of his appointment (Sec. 516): The liquidator shall within 30 days after his appointment publish in the Official Gazette to the Registrar for registration, a notice of his appointment in the form prescribed. If he fails to comply with this provision, he shall be punishable with fine which may extend to Rs. 500 for every day during which the default continues.

Removal of liquidator [Sec. 515 (2) and (3)]

In either kind of voluntary winding up, the Court may, on cause shown, remove a liquidator and appoint the Official Liquidator or any other person as a liquidator in his place. The Court may also remove a liquidator on the application made by the Registrar in this behalf. The words ‘on cause shown’ mean justifiable reason. It is not restricted to personal unfitness of the liquidator. He may be removed, for example, where —

(a) he does not deposit certain amounts in a scheduled bank as required by Sec. 553 of the Act ;

(b) he is not co-operative and is defiant regarding the recovery of the company's claim ; and

(c) the process of liquidation is a collusive affair between him and some director.

In Sir John Moore Gold Mining Co., Re[624] The secretary of a company was appointed liquidator of the company. He was intimate with the directors and to some extent jointly interested with them and there was strong proof that he took their side very strongly. A contributory initiated proceedings against the liquidator and two directors for an order compelling them to pay money for which they were liable as fiduciaries. *Held,* there was sufficient cause for the removal of the liquidator.

[624] (1879) 12 Ch.D.325(C.A).

Similarly, in *Charterland Goldfields Ltd., Re*[625] in a voluntary winding up of a company, the liquidator was shown to have intimate business relationship with the directors of the company. These directors were also directors of other companies, between which and the company in liquidation there had been dealings requiring investigation. Held, the liquidator could not act without prejudice in making the investigations, and that he should be removed.

Remuneration of liquidator: In a members' voluntary winding up the company in general meeting shall fix the remuneration, if any, to be paid to the liquidator. In a creditors' voluntary winding up, the committee of inspection if there is no such committee, the creditors, may fix the remuneration to be paid to the liquidator. Where the remuneration is not so fixed, it shall be determined by the Court. Any remuneration once fixed shall not be increased in any circumstances.

9.3.7 Provisions Applicable To Every Voluntary Winding Up:

The provisions contained in Sees. 511 to 521, both inclusive, shall apply to both members' and creditors' voluntary winding up (Sec. 510)

Distribution of property of company (Sec. 511): Subject to the provision of the Act as to preferential payments, the assets of a company shall, on its winding up, be applied in satisfaction of its liabilities pari passu (i.e rateably). If there is any surplus, unless the Articles otherwise provide, it shall be distributed among the members according to their rights and interest in the company.

Statement of affairs to be made to liquidator (Sec. 511-A): The provisions of Sec. 454 (dealing with statement of affairs to be made to the Official liquidator in case of winding up by the Court) shall apply, so far as may be to voluntary winding up as they apply to the winding up by the Court :- that references to—

(a) the Court shall be omitted ;

(b) the Official Liquidator or the provisional liquidator shall be construed as references to the liquidator ; and

(c) the'relevant date' shall be construed as reference to the date of commencement of the winding up.

<u>Powers of liquidator in voluntary winding up (Sec. 512):</u>

[625] 1909) 26 T.L.R. 132.

The powers of a liquidator in a voluntary winding up shall be the same as those of the Official Liquidator in winding up by the Court but with one difference. In case of a winding up by the Court, the Official Liquidator has to obtain the sanction of the Court to exercise certain powers. In a members' voluntary winding up, the liquidator can exercise those powers with the sanction of a special resolution of the company. In a creditors' voluntary winding up, the liquidator has to obtain the sanction of the Court or the committee of inspection or, in its absence, of a meeting of the creditors.

Powers exercisable with sanction: The liquidator may exercise the following powers, in the case of a members' voluntary winding up, with the sanction of a special resolution of the company. In the case of a creditors' voluntary winding up, the liquidator can exercise these powers with the sanction of the Court or the committee of inspection or in its absence, of a meeting of the creditors:

(a)To institute or defend any suit or civil or criminal proceeding in the name and on behalf of the company.

(b) To carry on the business of the company so far as may be necessary for the beneficial winding up of the company.

(c) To sell the immovable and movable property and actionable claims of the company by public auction or private contract.

(d) To raise money on the security of the assets of the company.

The exercise of these powers by the liquidator shall be subject to the control of the Court. Any creditor or contributory may apply to the Court with respect to any exercise or proposed exercise of any of these powers.

Powers exercisable without sanction: The liquidator in a voluntary winding up may exercise certain powers without any sanction because these relate to matters of a routine nature. These include the following powers, *viz.,*

*(a)*To do all acts and to execute deeds and other documents in the name and on behalf of the company, under its seal.

(b)To inspect the records and returns of the company on the files of Registrar without payment of any fee.

(c) To prove, rank and claim in the insolvency of a contributory for any balance against his estate.

(d) To draw, accept, make and endorse any bill of exchange, *hundi or* promissory note in the name and on behalf of the company.

(e) To take out, in his official name, letters of administration to any
deceased contributory, and to do any other act necessary for

obtaining payment of any money due from a contributory or by his estate.

(f) To appoint an agent to do any business which he cannot do himself.

The liquidator may also do all other things as are necessary for winding up the affairs of the company and distributing its assets.

In addition to the above powers, the liquidator can, without obtaining the sanction, exercise the following powers, *i.e.,*

1.The power of the Court of settling a list of contributories (which shall be *prima facie* evidence of the liability of the persons named therein to be contributories).

2.The power of the Court of making calls.

3.The power of calling general meetings of the company for the purpose of obtaining the sanction of the company by ordinary or special resolution or for any other purpose.

Powers exercisable with sanction of special resolution subject to control of Court: The liquidator can exercise the following powers with the sanction of a special resolution of the company subject to the control of the Court:

(a)To pay any class of creditors in full.

(b)To make a compromise or arrangement with the creditors of the company.

(c)To compromise calls, debts and other pecuniary liabilities with contributories or debtors, accept any security in discharge of such a claim, and give a complete discharge in respect thereof.

Duty of liquidators [Sec. 512 (3)]: It shall be the duty of the liquidator to pay the debts of the company and adjust the rights of the contributories among themselves.

Arrangement when binding on company and creditors (Sec. 517): Any arrangement entered into between a company about to be, or in the course of being, wound up and its creditors shall be binding on the company and on the creditors if it is sanctioned by a special resolution of the company and acceded to by $3/4^{th}$ in number and value of the creditors. This shall, however, subject to the right of appeal. Any creditor or contributory may, within 3 weeks from the completion of the arrangement, appeal to the Court against it. The Court may, as it thinks just, amend, vary, confirm or set aside the arrangement.

Application to Court to have questions determined (Sec. 518): The liquidator or any contributory or creditor may apply to the Court— to determine any question arising in the winding up of a company; or

to exercise as respects the enforcing of calls, the staying of proceedings, or any other matter, all or any of the powers which the Court might exercise if the company were being wound up by the Court ; or

for an order setting aside any attachment, distress or execution put into force against the estate or effects of the company after the commencement of winding up.

The Court may, if satisfied, accede wholly or partially to the application on such terms and conditions as it thinks fit or may make such order as it thinks just.

A copy of the order staying the proceedings in the winding up shall forthwith be forwarded by the company to the Registrar who shall make a minute of the order in his books relating to the company.

Public examination of promoters, directors, etc. (Sec. 519).

During the course of winding up, the liquidator may make a report to the Court stating that in his opinion a fraud has been committed by a person in the promotion of the company or by an officer of the company in relation to the company since its formation. In such a case the Court may, after considering the report, direct that person or officer shall attend before the Court on an appointed day and be publicly examined as to the promotion or formation or the conduct of the business of the company or as to his conduct and dealings as officer thereof.

The provisions of Sec. 478 (dealing with public examination of promoters, directors, etc., in compulsory winding up) shall also be applicable in case of public examination of such persons in a voluntary winding up, with the difference that references to the Official Liquidator in Sec. 478 shall be construed as references to the liquidator.

Costs of voluntary winding up (Sec. 520):

All costs, charges and expenses properly incurred in the winding up, including the remuneration of the liquidator, shall be payable out of the assets of the company in priority to all other claims. This shall, however, be subject to the rights of secured creditors.

9.3.8 Winding up subject to Supervision of Court:

Power of Court to order winding up subject to supervision by Court (Sec522). Winding up subject to the supervision of the Court presupposes

a voluntary winding up of a company. At any time after a company has passed a resolution for voluntary winding up, the Court may make an order that the voluntary winding up shall continue, but subject to the supervision of the court. The Court may give such liberty to creditors, contributories or others to apply to it as it thinks just. A supervision order shall not, as a rule, be made on the application of a contributory unless the winding up resolution has been passed fraudulently, or creditors appear to support the petition. But on an application by a creditor for a supervision order, the Court will always be in favour of making the order[626] Again, the Court shall not make an order on members' petition against the wishes of the majority of the members unless the majority is playing a fraud on the minority.[627]

Right to present winding up petition (Sec. 440): Where a company is being wound up voluntarily or subject to the supervision of the Court, a petition for its winding up by the Court may be presented by—

(a) any person authorised to do so under Sec. 439 (which deals with provisions as to applications for winding up) ; or

(b) the Official Liquidator.

The Court shall not make a winding up order on the petition presented to it unless it is satisfied that the voluntary winding up or winding up subject to the supervision of the Court cannot be continued with due regard to the interests of creditors or contributories or both.

Effect of petition for winding up (Sec. 523): A petition for the continuance of a voluntary winding up subject to the supervision of the Court shall be deemed to be a petition for winding up by the Court.

Power of Court to appoint or remove liquidators (Sec. 524): Where an order is made for a winding up subject to supervision of the Court, the court may, by that or any subsequent order, appoint an additional liquidator liquidators. The Court may remove any such liquidator and fill any vacancy occasioned by the removal, or by death or resignation.

The Court may appoint the Official Liquidator as a liquidator. It may also appoint or remove a liquidator on an application made by the Registrar.

Powers and obligations of liquidator (Sec. 525): A liquidator appointed by the Court shall have the same powers, shall be subject to the same obligations, and in all respects shall stand in the same position, as if he had been duly appointed in accordance with the provisions of the

[626] *Nabor Habi Tea Co., Re* (1869) 3 B.L.R. App. 11
[627] *Varieties Ltd., Re* (1893) 2 Ch. 235

Companies Act with respect to the appointment of liquidators in voluntary winding up.

Effect of supervision order (Sec. 526)

Subject to such restrictions as the Court may impose, the liquidator may exercise all his powers, without the sanction or intervention of the Court, in the same manner as if the company were being wound up altogether voluntarily.

any order made by the Court for a winding up subject to the supervision of the Court shall, for all purposes, including the staying of suits and other , proceedings, be deemed to be an order of the Court for winding up the company by the Court ;

The order made by the Court shall empower it to make calls or to enforce calls made by the liquidators and to exercise all other powers which it might have exercised if an order had been made for winding up the company by the Court.

Appointment of voluntary liquidators (Sec. 527):

Where an order has been made for winding up a company subject to supervision, and an order is afterwards made for winding up by the court, the Court may appoint any person or persons who are then liquidators, either provisionally or permanently, to be liquidator or liquidators by the Court. Their appointment will be in addition to. And subject to the control of, the Official Liquidator.

Advantages of order of supervision:

1.After the order is made, suits and other actions against the company are automatically stayed as in a winding up by the Court. The attachments and
executions against the company also become void and inoperative.

2.The Court controls the appointment and removal of liquidators.

3.The Court can make calls or enforce calls made by the liquidators.

4.The Court can exercise all other powers which it might have exercised if an order had been made for winding up the company by the court.

5. The Court may lay down such terms and conditions as will safeguard the interest of the creditors and the contributories.

9.3.9 Dissolution of Company (sec. 481):

Dissolution puts an end to the existence of a company. A company which has been dissolved no longer exists as a separate entity capable of holding property or of being sued in the Court.[628]

Grounds for dissolution: The Court shall make an order for the dissolution of a company —

When the affairs of the company have been completely wound up, or

When the Court is of opinion that the liquidator cannot proceed with the winding up for want of funds and assets, or for any other reason;

The Court shall make an order for the dissolution of the company only when it is just and reasonable in the circumstances of the case that such an order should be made. The company shall be dissolved from the date of the order of the Court. Within 30 days of the order of the Court, the liquidator shall send a copy of the order to the Registrar who shall make in his books a minute of the dissolution of the company.

Penalty: If the liquidator makes default in forwarding a copy of the order of the Court to the Registrar, he shall be punishable with fine which may extend to Rs. 500 for every day during which the default continues.

Dissolution can be declared void within 2 years (Sec. 559): Where a company has been dissolved, the Court may, at any time within 2 years of the date of dissolution, on application by the liquidator of the company or by any other person who appears to the Court to be interested, make an order declaring the dissolution to have been void. On such an order being made by the court such proceedings may be taken as might have been taken if the company had not been dissloved. Within 30 days after the making of the order by the Court, the person on whose application the order was made shall file a copy of the order with the Registrar who shall register the same. If such person fails to file a copy of the order, he shall be punishable with fine which may extend to Rs. 500 for every day during which the default continues.

The effect of an order under Sec. 559 is that it makes the dissolution void *ab initio* and all consequences resulting from the dissolution are avoided including proceedings taken during the interval between the date of dissolution and the date of the order.[629]

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[628] *Employers' Liability Assurance corpn, v. Sidgwick Collins & Co.,* (1927) A.C. 95
[629] *Morris* v. *Harris,* (1927) A.C. 252

9.4. SUMMARY:

Winding-up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator, called a 'liquidators', is appointed and he takes control of the company. The liquidator collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their respective rights.

Modes of winding-up – A company may be wound-up in any one of the three ways, namely, (i) compulsory winding-up;(ii) voluntary winding-up;(iii) voluntary winding-up subject to the supervision of the court (now omitted).[630]

Section 433 provides that a company may be wound-up by the Court (now Tribunal) : (a) if the company has ,by special resolution, so resolved; (b) if default is made in delivering the statutory report to the registrar or in holding the statutory meeting, where applicable; (c) if the company does not commence its business within a year from its incorporation, or suspends its business for a whole year; (d) if the number of members is reduced, in the case of a public company, below 7, and in the case of a private company, below 2; (e) if the company is unable to pay its debts; (f) if the court (now tribunal) is of the opinion that it is just and equitable that the company should be wound up. Disappearance of substratum, objects of the company becoming illegal, formation of a company to perpetrate a fraud, deadlock in management, where company never had any real business, oppression of the minority have been held to be falling under just and equitable ground contemplated under section 433.

At any time after the presentation of a winding-up petition and before the making of a winding up order, the court (now tribunal) may appoint the official liquidator to be the liquidator provisionally. On such appointment, he is called the provisional liquidator. On a winding-up order being made, the official liquidator shall become the liquidator of the company. He shall cease to hold office as provisional liquidator.

Voluntary Winding up: - Winding-up by the members or creditors without any intervention of the court (now tribunal) is called voluntary winding-up. In voluntary winding-up, the company and its creditors are left free to settle their affairs without going to the court

[630] Vide Companies (Second Amendment) Act, 2002

(now tribunal). They may, however, apply to the court for any directions, if and when necessary. Company may be wound-up voluntarily by passing an ordinary resolution in general meeting where either the period fixed by the articles for the duration of the company has expired or the event has occurred on which under the article the company is to be dissolved. In any other case, the company may resolve to be wound-up voluntarily by passing a special resolution in general body meeting of shareholders.

Appointment and remuneration of liquidators: - section 490 requires that company to appoint one or more liquidators for the purpose of winding-up the affairs and distribute the assets of the company. The appointment is to be made by shareholders in general meeting. The meeting must also fix the remuneration, if any, to be paid to the liquidator or liquidators. It may be noted that any remuneration so fixed cannot be increased in any circumstances whatever, whether with or without the sanction of the court (now tribunal).

9.5. Suggested Readings/Reference Material

Avtar Singh : Company Law.
N.D. Kapoor : Elements of Company Law.
N.V. Paranjape : Company Law.
Taxmann : Company Law.
Gower, L.C.B. : Principles of Moderen Company Law.
Ramiya : Guide to the Companies Act.

9.6. Self-assessment question:-

1. What do you understand by winding-up of a company? What are the various modes of winding-up?

2. What are the effects of voluntary winding-up of a company?

3. Describe in brief, the provision of the companies Act relating to members voluntarily winding-up of a company?

4. What are the duties and powers of the official liquidator under the companies Act?

LL.M. Part-1

PAPER CORPORATE LAW

Block III– CORPORATE FINANCE

Unit 10-Corporation Finance - Meaning, scope and objectives

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10.2 Scope and Objectives

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10.1 Introduction

Finance, as we all know, is essential for establishing and running a business. It is needed for buying the whole variety of assets. Be these tangible assets like machinery, factories, buildings, offices; or intangibles such as trademarks, patents, technical expertise, etc. Also, finance is central to running day to day operations of business like buying supplies, paying bills, salaries, collecting cash from customers, etc. Success of business depends considerably on how effectively the funds are deployed in assets and assets and how timely and economically the finances are arranged, from outside or from within the business. Corporation finance is essentially concerned with issues relating to these aspects of business. To begin our study of corporation finance, we will address two central issues: First, what is corporation finance? Second, what is its objective?

The object of the Corporate Finance is the acquisition and allocation of corporate funds or resources with the aim of maximizing shareholders wealth. In the financial management of a corporation funds are generated from various sources and allocated or invested for desired assets. The primary function of corporate finance is resource acquisition, refers to the generation of funds from both internal and external sources at the lowest possible cost to the corporation. There are two main categories of resources are equity (shares) and liability (Borrowings). The equities are proceeds from the sale of stock, returns from investments and retained earnings. Liabilities include bank loans or other debts, accounts payable, product warranties and other types of commitments from which an entity derives value. The second function of corporate finance is resources allocation and investment of funds with the intent of increasing share holders wealth over a period of time. There are two basic categories of investments viz. current assets and fixed assets. Current assets include cash, inventory and accounts receivable. The fixed assets are buildings, real estate and machinery. In addition, the resource allocation function is concerned with intangible assets such as goodwill, patents and brand names.

It is the duty of financial manager of a corporation to conduct the above functions in a manner that maximizes shareholders wealth or stock price and he must balance the interests of owners or shareholders and creditors including banks and bondholders and other parties, such as employees, suppliers and customers. For example a corporation may choose to invest its resources in risky ventures in an effort to offer its share holders the potential for large profit. However, risky investments may reduce the perceived security of the companies bond, thus decreasing their value in the firm must pay to borrow money in the future. Conversely, if the corporation invests too conservatively, it could fail to maximize the value of its equity. If the firm performs better than other companies its stock price will rise, in theory, enabling it to raise additional funds at a lower cost, among other benefits. Practical issues and factors influenced by corporate finance include employee's salaries, marketing strategies customer credit and the purchase of new equipment.

The Financial decision affects both the profitability and risk of a firm's operation. An increase in cash holdings, for instance risk, but, because of cash is not an earning asset, converting other types of assets to cash reduces the other firm's profitability. Similarly, the use of additional debt can raise the profitability of a firm, but more debt means more risk. Striking a balance between risk and profitability that will maintain the long term value of a firm's securities in the large of finance.

10.1 Meaning

To understand what is financial management, imagine that you what to start a new business. No matter what type of business you choose, you will have to address the following questions :

(i) What long term investments will you undertake? That is, which line of business you will like to be in and which machinery, equipment building, etc. you will buy.

(ii) How will you raise finance to pay for the long term investments? Will you borrow money for this purpose or share the ownership with others by issuing equity.

(iii) How will you manage flow of finance in respect of day to day operations of business, such as collecting cash from debtors, paying the creditors, maintaining appropriate cash balances so that neither there is excess nor shortage of liquidity.

(iv) How will you reward the investors who hold equity shares of the business? You must decide whether the whole or a part of profits shall be distributed as dividends.

Thus, corporate finance is concerned with efficient acquisition, allocation and utilization of funds. In operations terms, it is concerned with management of flow of funds and involves decisions relating to procurement of funds, investment of funds in long term and short term assets and distribution of earnings to owners. In other words, focus of financial management is to address four major financial decision areas namely, investment, financing, operating and dividend decisions.

10.2 Scope and Objectives

Corporation Finance is concerned with making decisions relating to investment in long terms assets, working capital, financing of assets and so on. These decisions must be efficient if the businesses have to survive and grow. For this purpose a clear understanding of what these decisions must seek to achieve is imperative. That is to say, the financial manager must have a clear vision with respect to the objectives to be achieved through corporation finance. The objectives provide a framework within which financial decision making takes place. The term ‘objectives’, in the present context, is used in a very specific and limited sense. It is the sense of the decision criterion or standard for various decisions involved in financial management.

Traditionally, one of the prime objectives of corporation finance is maintenance of liquid assets and maximization of the profitability of the firm as a business firm is a profit seeking organization. However, profit maximization cannot be the sole objective of a company. It is at best a limited objective. Giving undue importance to profit maximization will create a number of problems as enumerated below:

(i) The term profit is vogue. It conveys a different meaning to different people e.g. short term profit, long term profit, total profit or rate of profit etc.

(ii) There is a direct relation between risk and profit. If profit maximization is the only goal, then risk factor is totally ignored.

(iii) The sole objective of profit maximization does not consider time pattern of returns.

(iv) Profit maximization as an objective is too narrow. It does not take into account the social considerations and obligations to protecting the interests of society, workers, consumers as well as ethical trade practices. Ignoring these factors, a company cannot survive for long.

Thus it is clear that for maximizing its profits a company may adopt policies that may give high profits in the short run but which are unhealthy for the growth, survival and overall interests of the business. Hence it is commonly agreed that objective of the firm should be to maximize its value or wealth. According to Prof. Van Horne, value of a firm is represented by the market price of the company's common stock. It takes into account present and future earnings per share, the timing and risk of these earnings, the dividend policy of the firm and many other factor that bear upon the market price of the stock. The market price serves as a performance index of the firm's progress.

Though, prices in the share market at a given point of time are a result of many factors like general economic outlook, particular outlook of the companies under consideration, technical factors and even mass psychology. However taken on a long term basis, the market prices of a company's share do reflect the value which the various parties put on a company. Normally, this value is a function of two factors:

(i) the likely rate of earnings per share of the company; and
(ii) the capitalization rate.

Thus capitalization rate is the cumulative result of the assessment of the various shareholders regarding the risk and other qualitative factors of a company.

The financial manager in a company makes decisions for the owners, i.e. the shareholders of the firm. He must implement financial decisions which will ultimately prove gainful from the point of view of shareholders. The shareholders gain if the value of shares in the market increases. A financial decision can be considered efficient from the point of view of shareholders if it increases the price of shares. Poor decisions are those which result in decline in the share price. Thus, we can clearly state the objective of financial management as follows:

The objective of financial management is to maximize the current price of equity shares of the company. In other words, the objective of financial management is to maximize the wealth of the owners of the company, i.e. the shareholders.

Normally, share price is expected to increase with the rise in gain available to shareholder and vice versa. We known that equity owners are the residual owners in the sense that they get paid only after the claims of all others, such as employees, suppliers, tenders, creditors and any other legitimate claimants, have been duly paid. If any of these groups remain unpaid shareholders are not entitled to anything. Therefore, if shareholders are gaining, it automatically implies that all other claimants are also gaining.

Thus, the goal of financial management is to maximize the equity share price. The financial manager must identify those avenues of investment, modes of financing, ways of handling various components of working capital which ultimately will lead to an increase in the price of equity share. It must be noted

that the objective of maximizing the price of equity shares does not imply that the financial manger should have recourse to manipulating the share price.

10.3 FINANCE FUNCTION

The finance function relates to three major decisions which the finance manger has to take : (i) Investment decision; (ii) Finance decision; (iii) Dividend decision and (iv) operating decision.

(i) Investment decision: This decision relates to the careful selection of assets in which funds will be invested by the firm. The decisions may relate to investment in assets which are long term or short term. Decisions relating to the former are referred to as capital budgeting, and those relating to the latter are referred to as working capital decisions. A business needs to invest financial resources for setting up new business, for expansion and modernization. To expand, it undertakes investment in different projects. To modernize, it replaces existing plants, machinery, buildings etc. with new ones.

This decisions is taken after careful financial security of various alternative available. For example, say a manufacture of compressor used by air conditioning manufactures is considering adding new machines. He obtains information from various machine manufactures and shorts lists two types of machines which have different features, prices and operating costs. The fiancé manager will evaluate the financial implication of both in terms of their price, expected operating costs and expected costs inflows. The machines with higher expected economic benefits will be selected.

Investment decisions are crucial for business because of the following reasons:

- They are long term investments and therefore considered irreversible. Once implemented, they can be scrapped only at huge costs to the company.
- They generally involve commitment of huge funds.
- They have an important bearing to the profitability and future of the company.

(iii) Financing decisions: This decision relates to the composition of relative proportion of various sources of finance. While taking this decision, the financial management weights the advantages and disadvantages of the different sources of finance. The business can either finance from its shareholders funds which can further be subdivided into equity share capital, preference share capital and the accumulated profits. Borrowings from outsiders include borrowed funds like debentures and loans from financial institutions.

(iv) The business has to decide the ratio of borrowed funds and owned funds. The borrowed funds have to be paid back with interest and there are delay or default risks involved if the principal amount and interest is not paid. Ownership securities such as equity have no fixed commitment regarding payment of dividends of principal amount and therefore, there is no delay on default risk. However, such sources of finance dilute the controlling rights of existing investors and may these pose takeover risk. However, most businesses employ a judicious mix of both borrowed funds as well as shareholders funds to use a combination of borrowed and shareholders' funds, and determination of their precise ratio is called the financing decision.

(iii) Dividend decision : This decisions relates to the appropriation of profits earned. The two major alternatives are to retain the profits earned or to distribute these profits to shareholders. When shareholders invest in businesses they expect a return in the form of dividend. The business has to decide how much profit to distribute as dividends and how much to retain for reinvestment in the business. Paying out higher dividends will satisfy shareholders expectations but at the same time leave less for reinvestment which may imply a slower growth for the business. Therefore, if a company has reinvestment opportunities which may give higher rate of return to the shareholders in future the company may decide to retain the profits and reinvest. Experience suggests that by and large shareholders prefer to receive cash dividends.

(iv) Operating decisions: Such decision relates to the management of flows of funds arising on account of day to day operations of business.

10.4 Capital Structure :

One the important decisions relating to financial management is the financing decision which deals whit the financing pattern of the business. A business has to decide how to raise resources. There are mainly two major sources of funds – shareholders funds and borrowed funds. Shareholders' funds may consist of equity share capital and preference share capital and reserves and surpluses. Borrowed funds may consist of debentures and long term debt. The assets of a company can be financed either by owners' funds or borrowed funds. The appropriate mix of long term sources of funds such as equity and preference share capital and reserves and surpluses and debentures and long term debt is called the capital structure of a company.

Meaning: The capital structure means the proportion of debt and equity used for financing the operations of a business. The right proportion of debt and equity is desired to maximize profit or value of the business firm. A capital structure will be said to be optimal when the proportion of debt and equity is such that it results in increase in the shareholders value of the share. What kind of capital structure is best for a firm is very difficult to define. Basically, the right proportion or the appropriate mix of debt and equity should increase the market value of share held by shareholders. This means that all decisions relating to capital structure should emphasis on increasing the shareholders wealth.

Features of Appropriate Capital Structure:

The financing of capital structure decisions is a crucial managerial decision. The capital structure should be planned generally keeping in view the interests of the shareholders and the financial requirements of the company. Basically, an appropriate capital structure should have certain features.

(i) **Return:** The capital structure should give maximum return to the shareholders.

(ii) **Risk :** The use of debt adds to the risk of the company and shareholder. Therefore, it should be used cautiously with equity.

(iii) **Flexibility :** The company should be able to change the proportion of debt and equity in the capital structure, if required depending on changing conditions.

(iv) **Capacity :** The company should have the capacity to repay long term debt and its interest obligation. This will depend on the company's ability to generate future cash flow.

(v) **Control :** The capital structure should not involve loss of control of the shareholders. If there is too much debt then shareholders are likely to lose control to debenture holders.

Financial leverage :

The capital structure of a company may consist of debt, preference shares or equity shares. Debt is usually in the form of debentures and long term loans with a fixed financial change rate of interest. Preference shares also have a fixed rate of dividend but they are paid only if the company earns profits. Since, money return on preference shares and debt instruments are fixed which are known as fixed charge securities. The equity shareholders are entitled to the remaining profits after paying out interest and taxes. The rate of dividend is not fixed on equity shares and depends on the dividend policy of the company. Equity is known as variable return security as dividend on it may vary from year to year.

The use of debt and preference shares which have a fixed financing cost along with equity shares in the capital structure with a view of increase earnings available to shareholders (earnings per share) is called financial leverage or capital gearing or trading on equity. The equity shares are used as a base to raise loans and debentures i.e. the equity is traded upon, hence, the term trading on equity.

Just as a lever is used to lift something heavy by applying less force than required otherwise, in the same way fixed return bearing securities like debt and preference shares are used to increase the earnings and return to equity owners without increasing the operation income of the business. That is why, use of debt and preference capital in the capital structure is known as financial leverage. Having understood the meaning of financial leverage or gearing, let us understand how financial gearing works.

10.4.1 Factors Determining Capital Structure

Determining capital structure of a firm essentially involves deciding the relative proportion of various sources of funds. A number of factors influence the decisions which are discussed below :

(i) Financial leverage : The most important factor in deciding capital structure is the impact of financial leverage or capital gearing on the owners of the company. A financial manger must examine in detail how the use of proposed financing mix will affect the risk and return of the owners.

Loans and debentures have a risk factor attached to them as interest has to be paid irrespective of profits earned by the company. Preference shares are less risky as dividends are fixed but only payable out of profits. Equity shares bear not risk at all from the company's point of view. The financial leverage employed by the company will depend on the amount of risk the company would like to take. More debentures and preference shares would mean higher returns of equity shareholders but at the same time risk increases. Therefore, the composition of capital structure depends upon the financial leverage employed and the risk factor involved. The main purpose of using financial leverage is to increases the shareholders return of earnings per share. This is possible only if the rate of interest on debt is less than the rate return on investment. The difference between the earnings of the firm and the cost of debt i.e. interest, is distributed to the shareholders thereby increasing their earning per shares. The earnings per

share also increases when preference shares are used in the capital structure as dividend on preference shares is fixed.

When debt and preference capital is used in the capital structure the leverage effect increases because of two reasons :

(a) The rate of return on investment is more than the rate of interest and dividend on debt and preference capital respectively.

(b) The interest paid on debt is tax deductible.

Companies by using more debt i.e. a high degree of leverage can increase the return on the shareholders equity. This is possible only when the company has a high level of earnings before interest and taxes i.e. EBIT. Alternative methods of financing may be considered by the company and their impact on the earnings per share must be studied and analyzed before taking a decision.

The only disadvantage of using debt in it's capital structure is the financial risk involved and the threat of insolvency. Interest on debt has to be paid even when the company is not making sufficient profits. Debentures usually have a charge on the assets of the company and sue for recovery of their capital and interest. Thus the threat of insolvency is also there when too much debt is used in the capital structure.

But, the financial risk can be avoided by not employing debt and financing the business with equity capital. There is no financial risk involved as interest does not have to paid and hence, there is no threat of insolvency. But at the same time the earnings per share decreases as the same earnings have to be divided amongst a large number of shares. Therefore, the shareholders are not able to get the benefit of the expected increases in EPS. These are the two criteria which the company has to consider i.e. the return and the risk involved. Basically it's a trade off between return and risk.

(ii) Cash Flow Ability : The decision relating to composition of the capital structure also depends upon the ability of the business to generate enough cash flows to meet its fixed commitments. The fixed charges are the interest on debt, dividend on preference capital and principal amount of loan which have to be paid. The company may be making sufficient profits but it may not be generating cash inflows at the time of payment of interest. The expected future cash flow should be analyzed and synchronized with the payment of interest.

The company is under a legal obligation to pay interest and return the principal amount of debt. If the company is not able to meet its fixed commitment it may have to face insolvency.

A company usually would employ debt in the capital structure if it is sure of its ability to generate cash inflow to meet its interest obligations. It would be quite risky to employ too much debt if its cash flow were unstable and unpredictable. Cash shortages are likely to occur in highly profitable companies also if its working capital management is poor. The company should analyze its liquidity position and prepare projected cash flow statements. These statements should give the company a clear indication of its ability to generate cash flow to meet its fixed financial obligations.

(iii) Control: The equity shareholders have a say in the management of a company. The debenture holders do not have a right to manage the affairs of the business. The preference shareholders have a limited rights to vote in Annual General meeting on resolutions where their payment of divided is affected. The existence of preference share capital and debt capital as such do not affect the controlling powers of equity holders but use of equity dilutes controlling rights of existing shareholders. If the owners are concerned with maintaining tight control over the company it will prefer to employ debt and preference capital in its capital structure. The control will be dilute if additional funds are raised through issue of equity as equity shareholders have a right to vote.

The equity shareholders elect the directors who constitute the Board of Director and are entrusted with the responsibility of managing the business. This consideration of maintaining control of the company become significant in companies which do not have many shareholders i.e. in closely held companies. If additional shares are issued then another shareholder or group of shareholders may purchase a major chuck and gain control over the company. To avoid the risk of losing control or interference by other shareholders certain companies prefer to raise capital by issuing preference shares or debentures.

Debt suppliers do not generally have voting rights but when a company uses a large amount of debt then there are certain terms and conditions in the loan agreements specially when financial institutions give loans to companies. These terms and conditions stipulate that these providers of debt have some say in the management of the company. These conditions at time require their representative to be on the board of directors, restrict the payment of dividends, undertaking new long term investment, maintaining a specific level of liquidity etc.

Types of debentures of the issues also have implication for the degree of control enjoyed by equity holders. If the company issues convertible debentures which get converted into equity shares at a predetermined point of time tin future then there is a dilution of control.

(iv) Flexibility: A company should be able to adapt its capital structure to changing conditions when required. The capital structure should be flexible enough to raise additional funds without undue delay and cost. Additional funds may be raised in the from of debt or share capital. The company should be able to borrow from the capital market whenever required. But if the capital structure has too much debt already then lenders may not be willing to give more loans to the company. The composition of the capital structure should be flexible enough to change as per the company's requirements and operations. The shares or debt may be substituted depending upon the conditions in the capital market or the company's need.

The terms and conditions in the loan agreements may restrict the company's flexibility in dealing with financial matters. The terms may include restrictions on distributing cash dividends, investing in new projects, or maintaining a particular liquidity position. These restrictions protect the interest of lenders but at the same time restrict the company to operate freely. Therefore, while raising debt a company should ensure there are a minimum of restrictive clauses.

(v) Market Conditions : The conditions in the capital market to some extent influence the capital structure decisions. They may not affect the initial capital structure but when the company requires additional funds then the appropriate time for issuing shares or debentures is an important consideration. Depending on the economic conditions, investors may be cautious in their dealings and not be ready to take unnecessary risks by purchasing shares. At this time a debenture issue may be appropriate as it assures a fixed rate of interest to the investor.

Depending upon the conditions in the capital market, the mood of the investor and the internal conditions of the company, the company should decide on the alternative methods of financing and choose an appropriate mix.

If there is a depression in the market then equity shares should not be issued as they have a risk element attached to them, and investors may not be in a mood to take risks. The company should wait till there is a revival of the share market. At this time it would be advisable for the company to issue debentures. But if there is a boom period i.e. the market is in a highly volatile state where investors are ready to purchase and anything sells. During this period the company may be able to issue shares and that too at a premium. At the same time the company is able to keep its dept capacity unutilized i.e. it may issue debentures at a later stage, when required.

The company may find it difficult to raise additional debt from the market because of its internal conditions also. If it is highly levered company, i.e. it has high debt employed in its capital structure; it may find it difficult to raise funds from the

market. Restrictive clause in loan agreements like dividend payout etc may also hinder its capacity to raise funds. All these give the company a low rating in the capital market.

(vi) Floatation costs : Flotation costs are the costs involved in the issue of shares or debentures. These costs include the costs of advertisement, underwriting statutory fees, printing prospectus and other miscellaneous expenses. It must be noted that this is not a major consideration while deciding on the matter of issuing shares or debentures in case of large companies. In small companies, however this may be a major factor while considering a debenture or share issue. Even large companies cannot afford to make frequent issue of debentures and equity shares. There are a number of legal formalities to be completed and miscellaneous expenses can add up substantial amounts. At times a company may decide to raise capital at one time only to avoid incurring flotation costs again at a later state. it also depends upon the underwriters willingness and the commission they are likely to charge. Therefore, while deciding on the size and type of security to be issued along with the other factors, this factor though relatively less important must be considered. It may be pointed out here that in view of unprecedented size in these costs involving huge sums of money extending up to crores of rupees, this factor is increasingly gaining in importance.

(vii) Legal framework : A company has to operate in the framework provide by Law. The finance manager must be aware of all the rules and regulations pertaining to issue of shares and debentures to the public. The Companies Act and the Securities and Exchange Board of India (SEBI) provide guidelines from time to time regarding the raising of funds from the public. Approval from SEBI is required on certain issues. A company must carefully consider all these rules before taking a decision on whether it would like to issue shares and debentures or take loan from a financial institution. These laws have been formulated to protect the interest of the public from frauds committed by companies.

10.5 Capitalization

Capital is the basis of all financial decisions and the term capitalization had been derived from it. Capital means – the total funds invested in the business and includes owners' funds, long term loans and other reserves which are represented by assets. Capitalization is the valuation of this capital and will include owners' funds, borrowed funds, long terms loans reserves and any surplus earnings. The surplus earnings are the accumulation of net earnings which are not distributed to owners and are allowed to remain in the business. Since, these earnings are not meant for distribution to shareholders they are in the nature of free reserves and are included in the valuation of capital.

The valuation of capital depends upon earnings of a company. Therefore, the amount of capitalization which a company should have is closely connected with the earning capacity of the business. In other words, the total capital invested in the assets of the business should be justified by its expected earnings. A business is expected to earn at least as much as similar business firms in the same industry are earning. The rate of earning of the business should be similar to other businesses in that industry. There are three possible situations :

(i) Fair or Normal capitalization : Business employs correct amount of capital.

(ii) Over capitalization : Business employs more capital than warranted.

(iii) Under capitalization : Business employs less capital than warranted.

Suppose the average rate of earnings of an industry is say, 10 per cent per annum. A company has invested Rs. 10,00,000 in a business and its net earnings are Rs. 1,00,000. The rate of earnings of this company is 10 per cent per annum. This means that this company is able to earn what other business firms are earning. The company can be said to have a normal capitalization. In case this company had invested Rs. 12,00,000 and its earnings were Rs. 1,00,000 (Same as above) then the rate of earnings would have been 8.33 per cent which is less than the industry's average of 10 per cent. On an investment of Rs. 12 lacs its earnings should have been Rs. 1,20,000. Since the company

would be using greater amount of capital than needed to generate the earnings of Rs. 1,00,000, the company will be regarded as over capitalized.

Let us take another situation. Suppose the company had invested Rs. 8,00,000 and its earnings were Rs. 1,00,000 the rate of earnings would be $\frac{1,00,000}{8,00,000} \times 100 = 12.5$ per cent which is more than the industry's average of 10 per cent. The company is able to earn more on less capital invested. The company is characterized by under capitalization.

Thus, the phenomenon of fair, over and under capitalization is based on rate of return on capital employed by a company compared to the rate of return of the industry as a whole to which the company belongs.

There are three main indicators of over capitalization.

(i) When the amount of capital invested in the business exceeds the real value of its assets.

(ii) When the earnings are not justified by the amount of capitalization, i.e. a fair return is not realized on capital employed.

(iii) When a business has more net assets than it requires.

It is true that an over capitalized company has more capital than what is justified by its earnings. But this does not mean that the business has an excess of capital or abundance of capital. It simply means that capital is not being efficiently utilized and the earnings are less than what is warranted by the capital employed. The earning capacity does not justify the amount of capitalization and, therefore, the company becomes over capitalized. The correct indicator of over capitalization is the level of earnings of a company. If the earnings of a company are not sufficient to pay its fixed interest charges and dividends to shareholders over a period of time, then the company is over capitalized.

Cause of over capitalization

Causes of over capitalization are mentioned below :

(i) High promotion costs : At the time of promotion many companies incur heavy preliminary expenses such as promoters' fees, brokerage and underwriting commission, purchases of patents and goodwill. Some of these expenses are not productive and sometime the purchase of goodwill or patent rights does not enhance the earning capacity of the business. Therefore, capital becomes excessive and the earnings are not above to justify the amount of capital employed.

(ii) Unduly high price paid for assets: Sometimes partnerships or private companies are converted into public limited companies are converted into public limited companies and assets are transferred at inflated prices or land and building are purchased at very high price. These assets do not give commensurate returns or contribute to the earning capacity of the business.

The inflated asset values are not reflected in the earnings of the company. This leads the company to become over capitalized.

(iii) Inflationary conditions during a boom period : Flotation of a company during boom period leads to assets being acquired at inflated prices. But it is not able to increase its earnings accordingly and hence becomes over capitalized.

(iv) Inadequate provisions of depreciation: Sometimes a company may not provide for sufficient depreciation of assets at an appropriate rate. As a result the written down value of assets are shown at higher values than what they should be and fund are not available when the assets has to be replaced. The amount of capital invested is not justified through the earnings of the company and therefore, the company may become over capitalized.

(v) Liberal dividend policy: Some companies distribute dividends liberally out of profits instead of being retained and reinvested in the business. As a result, reserves which enhance the earning capacity of the company are not created. To make up the deficiency, the company borrows from the external sources and

raises capital through issue of shares. This proves to be costlier affairs in terms of the earnings not being able to justify the high amount of capital raised. In such a situation the company finds itself over capitalized.

(vi) Shortage of capital: If capital is inadequate due to inaccurate financial planning then the company has to depend on borrowings from external sources at high rates of interest. Working efficiency is affected adversely because of shortage of capital.

Effect of Over Capitalization

These can be studied from the point of view of the company, shareholders and the society.

On the Company

(i) The market value of the shares of a company falls drastically because of its reduced earning capacity.

(ii) It becomes difficult for such a company to raise loans since its credit standing is adversely affected.

(iii) Since earnings are low the company cuts down the expenditure on maintenance, replacement of assets and adequate provision for depreciation.

(iv) The company resorts to manipulation of accounts to show profits, sometimes dividends are paid even if there are no profits.

(v) The reputation of a company is affected and goodwill is lost. The company has to go in for capital reorganization.

On Shareholders

(i) The market value of share falls and their capital is depreciated. They incur huge loss at the time of selling the shares.

(ii) Since earnings of the company are reduced, their dividends are also affected which become uncertain and irregular.

(iii) The shares of such companies are not accepted as security for advance and loans. These shares instead of being an asset become a liability.

(iv) In case, reorganization of the company takes place the shareholder have to bear the brunt because the face value of their shares is brought down.

On Society

(i) Since, profit are falling, an over capitalized concern resorts to tactics like increase is prices are reducing the quality of products.

(ii) Expenditure on wages is curtailed which leads to labour unrest and strikes.

(iii) Creditors of the company are affected because of irregular payment of interest.

(iv) Over capitalized companies because of their inability to earn adequate returns on capital employed become a drain on the resources of society which are extremely limited and scarce.

Under Capitalization

Under capitalization is the reverse of over capitalization. A company becomes undercapitalized when :

- The future earnings are under estimated at the time of promotion.
- Unforeseen increase in earnings.

As a result of the above, an undercapitalized company is able to meet its fixed interest charges and is able to pay a higher rate on its shares than the existing rate on shares of similar business units. In other words, the rate of profits earned on capital invested in the company is higher than the prevailing rate of other business firms in the same industry.

Under capitalization should not be confused with inadequacy of capital or shortage of funds. As explained earlier, if the normal capitalization is Rs. 10,000,000 and earnings are Rs. 1, 00,000 at 10 per cent per annum then any company which has invested less than Rs. 10,00,000 and is earning Rs. 1,00,000 is said to be undercapitalized.

in the same example, the company had invested Rs. 8,00,000 and was earning Rs. 1,00,000 which was 12.5 per cent on capital. This does not mean that this company is short of capital of Rs. 2, 00,000. In fact this company has been able to earn more on a lesser amount of capital invested, hence utilizing its funds more efficiently.

Causes of under Capitalization

Causes of under capitalization are mentioned below :

(i) **Underestimation of earnings**: Capitalization is based on the earnings estimated. If the earnings estimated are lower than the capitalization figure is also lower. Sometimes the earnings prove to be much higher and the capitalization figure previously calculated is lower.

(ii) **Flotation of company during depression:** Sometimes the company acquires assets or is promoted when the economy is in recession. Assets are purchased at low prices. During the boom period the earnings may appears to be disproportionately high relatives to the capital employed.

(iii) **Conservative dividend policy:** The Company might have not distributed dividends freely in the initial years of its existence. Profits are retained in the business and reserves are created or reinvested in the business. This results in higher earnings on the capital employed and hence under capitalization.

(iv) **High efficiency:** If assets are used and maintained properly, costs are reduced. A higher level of vigilance and efficiency leads to improvement in productivity and profitability which is relates to the amount of capital employed.

Effect of Under Capitalization

On the Company

(i) The market value of shares goes up since earnings are high.
(ii) Secret reserves are built up.
(iii) Government intervention in the form of higher taxes.
(iv) The high rate of earnings may encourage outsiders to enter the field and increase competitions.
(v) The employees demand higher salaries and wages and this may lead to dissatisfaction and labour tension.

On Society

(i) Under capitalization means higher prices of shares on the stock exchange. This encourages unhealthy speculation. The investment climate in the stock exchanges is adversely affected.

(ii) Consumers feel exploited since profits are high. They may feel it is due to higher prices charged for products.

Under capitalization is a condition which cannot exist for long. Higher earnings attract competition, government intervention in the form of taxation and so ultimately the profits come down. The economy takes care of an undercapitalized company and because of its pulls and pressures, the company may have to go in for a complete reorganisation in which the shareholders and creditors often suffers. Both under capitalization and over capitalization are evils but under capitalization is a lesser evil. Therefore, companies should strive to target at fair capitalization.

10.6 Summary

Finance, as we all know, is essential for establishing and running a business. Finance is central to running day to day operations of business like buying supplies, paying bills, salaries, collecting cash from customers, etc. Success of business depends considerably on how effectively the funds are deployed in assets and assets and how timely and economically the finances are arranged, from outside or from within the business. Corporation finance is essentially concerned with issues relating to these aspects of business. Corporation Finance is concerned with making decisions relating to investment in long terms assets, working capital, financing of assets and so on.

10.7 Check Your Progress

1. What is the scope and objective of Corporation Finance?

2. What do you understand by capitalization? Discuss the concept of

   overcapitalization and undercapitalization.

3. What are the various effects of overcapitalization and undercapitalization?

LL.M. Part-1

PAPER CORPORATE LAW

Block III– CORPORATE FINANCE

Unit 11- Equity Finance - Shares & stock, kinds of shares, Issue of shares, Sweat Equity, Buy back, certificate and warrants

STRUCTURE

11.0 Introduction.

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11.4 Kinds of preference shares.

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11.10.2 Transfer of certain sum to 'Capital Redemption Reserve Account'

11.10.3 Conditions to be fulfilled before resorting to buy-back

11.11 Share certificate and share warrants.

11.12 Summary

11.13 Check Your Progress

11.0 Introduction:

A share in a company is one of the units into which the total capital of the company is divided.

Section 2 (46) of the Companies Act defines shares "as a share in the share capital of company and includes stock except where a distinction between stock and share is expressed or implied."

A share is a fractional part of the capital of the company which forms the basis of ownership of certain rights and interests of a subscriber in the company. It is not a sum of money but an interest or right measured in a sum of money to participate in the profits of the company, or in the assets of the company when it is wound up. The members does not own an identified part of the company's undertakings. His interest is something he owns. Share holders are not part owners of the undertaking (in the eye of law). The ownership of the assets rests in the corporate body and not in the members composing it. A share secures to its owners certain rights and liabilities e.g. right to dividend, right to vote, and liability to pay

unpaid balance (if any) and to be bound by the provisions of the article and memorandum.

11.1 Share and share capital.

We shall first have a brief understanding of the concept and nature of shares and stock and the distinction between the two. We shall also have a brief discussion about share capital and different kinds of share capital.

11.1.1 Legal Nature of Share –

As far as legal nature of shares is concerned, a share is regarded as 'goods' in India. According to section 82 the shares of any members or debentures in a company shall be movable property, transferable in the manners provided by the Article of the company. Share is brought into existence by legislative enactment (difference with other commodities).

Share is incorporeal in nature and it consists of merely a bundle of rights and obligations. As such the share cannot be transferred by mere delivery as in the case of movable property, but are transferred in the manner provided in the Companies Act and the articles of the company which may lay down certain restrictions in this respect.

Each share in a company having a share capital must have a nominal value. Each share must bear a distinctive number, but this requirement of distinctive numbers shall not apply to share held with a depository (as per section 83).

11.1.2 Stock

Stock in a company means a bundle of fully paid shares put together for convenience so that it may be divided into any amount and transferred into any fractions and sub-divisions without regard to the original face value of the shares.

A company cannot issue stock originally and the stock can only be obtained by conversion by an ordinary resolution by members-

(i) if shares are fully paid,

(ii) Article empowers company to do so.

Stock may be reconverted into shares again by ordinary resolution.

A stockholder enjoys the same right and privileges as that of shareholder.

Company has to give notice of conversion and re-conversion to Registrar within 30 days of such conversion or reconversion.

11.13 Distinction between Stock & Shares

1Stock cannot be originally issued but only fully paid shares are converted to stock.

(1) Shares may be fully paid or partially paid, stock must be fully paid.

(2) Shares are always of fixed denomination, stock has no fixed denomination.

(3) Shares have distinct / definite numbers, Stock has no such number.

(4) Registration of shares capital with registrar is compulsory before issuing shares.

Stock can be issued by passing ordinary resolution if Article permit or by passing special resolution, if article don’t permit, and filing notice of conversion with registrar.

(5) Stock is divisible into any amount, even fractional amount.

Share can be transferred in its entirely or in its multiple only.

11.1.4 Share Capital:

Share capital denotes the amount of capital raised or to be raised by the issue of shares by a company.

Kind of Share Capital :

1. **Authorized capital** : Maximum amount of share capital stated in a companies memorandum, which the company is authorized to raise. As the memorandum is registered with the Registrar, it is also called 'Registered Capital'. Also known as 'nominal capital'.
2. **Issued Capital** : Means nominal value of that part of the authorized capital which is allotted for cash or for consideration other than cash and includes shares subscribed by signatories to memorandum.

3. **Subscribed capital** : Paid up value of that part of the authorized capital which is allotted for cash or for consideration other than cash and includes the shares subscribed by the signatories to the memo.

   If shares are fully paid up, then–

   Subscribed capital = Issued capital

   Thus subscribed capital = Paid up value of issued capital.

Share capital of Co. to be exhibited in balance sheet under above three heads.

Other prevalent terms relating to share capital are:

Called up capital – It is that part of the allotted share capital which has been called up to the Company.

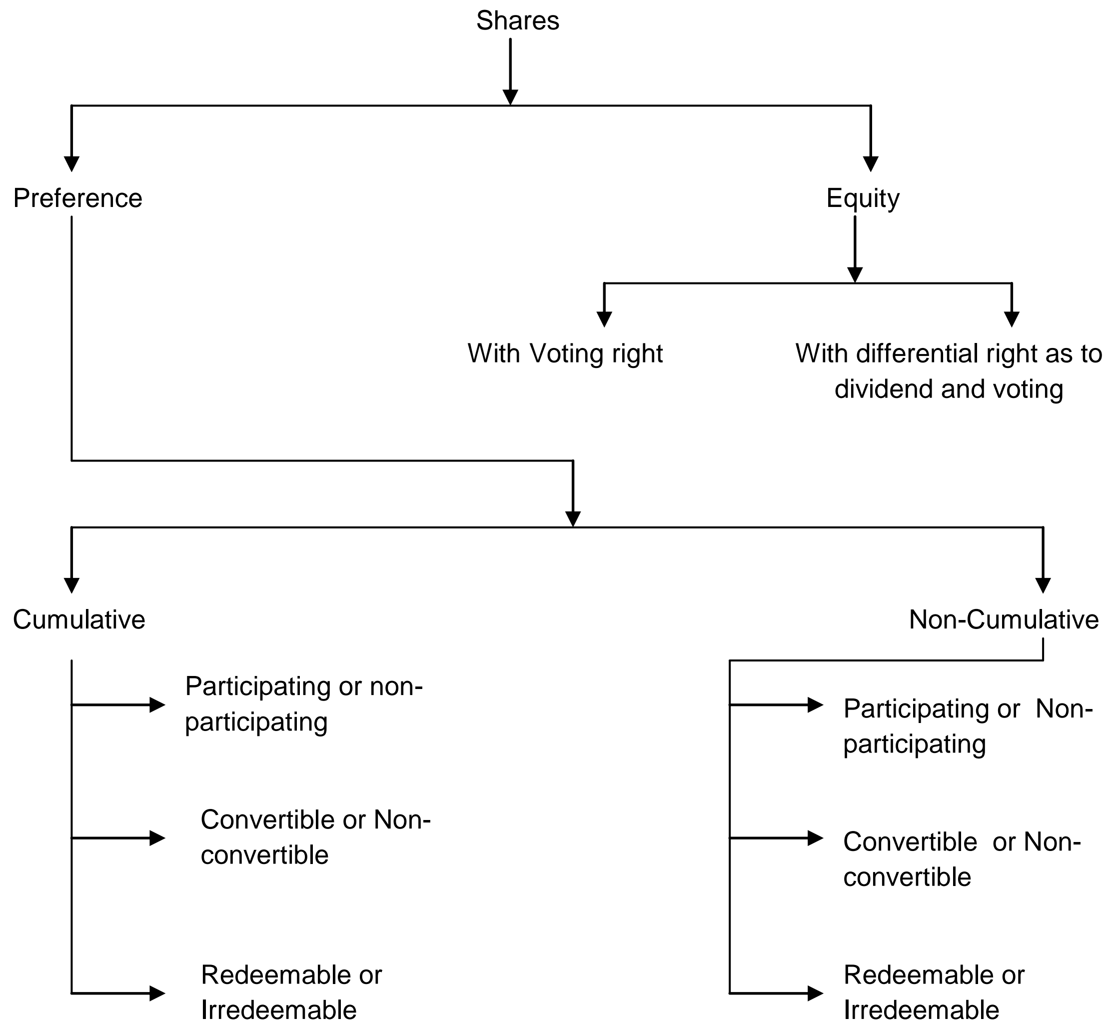
Uncalled capital : It is that part of the allotted share capital which has not been called up the Company.

Paid up capital : Called up capital minus calls in arrears.

Reserved capital : It is that part of uncalled capital which has been reserved by the Company to be called in the event of its winding up.

Section 99 states that a Limited Company many make a provisions for reserve capital by special resolution. Reserve capital cannot be charged as security for loans unlike the uncalled capital. Reserve capital cannot be turned into ordinary capital without leave of the Court nor can it be canceled in reduction of capital.

11.2 Kinds of Shares



11.3 Preference Shares

According to section 85(1) ,such shares enjoy preferential rights –

(a) as to payment of dividend at a fixed rate during the life time of Company, and

(b) as to return of capital on winding up of the company.

If any shares carry only one of these two preferential rights, they will be treated as equity shares.

Right to dividend of preference share holders-

The holder of preference shares enjoys only a preferential right over the equity share holder. He will service dividend at a fixed rate e.g. 13% if a dividend is declassed. He is only entitled to income form his investment if a distributable prompt is available. His right is not to dividend but to preferential treatment as and when dividend is distributed.

Right to voting of preference share holders-

They do not enjoy normal voting right as equity shares with voting rights do.

They are entitled to vote in two cases-

i. When any resolution directly affecting their rights is to be passed. e.g. resolution for winding up of the Company or for the repayment of reduction of share capital.

ii. When the dividend due on their preference shares has remained unpaid.

In case of cumulative shares – for an aggregate period of not less than 2 years immediately proceeding the date of meeting.

In case of non-cumulative shares – for a period of 2 consecutive years or

for an aggregate of greater than or equal to 3 years in the last 6 financial years.

As per section 90 (2) above provisions relating to voting rights of preference share holders do not apply to a Private Company. Such a Company can issue preference shares carrying normal rights or even disproportionate voting rights.

11.4 Kinds of Preference Shares

Preference shares may be of various kinds depending upon terms of issue defined either in Article or in Prospects.

1.Cumulative – In cumulative preference shares arrears of dividends are accumulated and shall be paid, if any dividend is declared in subsequent years, before any dividend is paid to the equity shareholders.

If the company goes into liquidation, no arrears of dividends are payable unless either the Articles contain an express provisions or such dividends have been declared.

Arrears of undeclared dividend shall be payable out of the surplus left after returning in full the preference and equity shares capital.

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

2. Non-Cumulative – Non cumulative preference shares do not carry the right to receive arrears of divided in a particular years, if the Company fails to declare dividends in previous year(s).

If no dividend is paid in any particulars year, it lapses.

3. Participating Preference Shares - These are preference shares which receive their fixed dividend in normal way, but which then participate further in distributed profits along with the equity shares after a certain fixed percentage has been paid on them as well. The holders of such shares may also be entitled to get a share in the surplus assets of the company on its winding up, if specially provided by Article.

4. Non – Participating - Non participating preference shares are entitled only to fixed rate of divided and do not participate further in surplus profits. All preference shares are deemed to be non-participating unless stated otherwise in article or terms of issue.

5. Convertible – They bear the right to convert preference shares into equity shares after certain period of time.

6. Non Convertible - Non-convertible preference shares have not been given right of conversion into equity shares.

All preference shares are deemed to be non-convertible unless contrary has been stated in Article or terms of issue.

7. Redeemable – 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 Companies Act, authorizes 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 company. The paying back of the capital is called the redemption.

Only such preference shares as are redeemable within 20 years (instead of entitled 10 years) from the date of issue can be issued (Comp. Amend. Act, 1996).

The company must comply with the following conditions in relation to redemption of shares –

(i) There must be authority in the Articles to make the issue,

(ii) The shares may only be redeemed if they are fully paid up.

(iii) The shares may only be redeemed either out of distributable profits of the company accumulated for the Purpose into a "Capital Redemption Reserve A/c" or out of the "proceeds of a fresh, issue of shares" including the amount of premium received, if any, made for the purpose.

The "Capital Redemption Reserve A/c" is a special type of reserve account and is to be treated as share capital for reduction purposes. This reserve may however be utilized for the issue of fully paid bonus shares.

The rationale behind the imposition of above restrictions is that since basic objective of company law is 'preservation of subscribed share capital' for the benefits of creditors. The companies Act attempts to

keep intact even the redeemable preference share capital by not allowing its outright redemption. It only allows the replacement of redeemable preference share capital either by 'fresh share capital' or by 'Capital Redemption Reserve Account'.

(iv) If any premiums is payable on redemption the amount must have been provided for, either out of the profits of the company or out of the company's "Securities Premium Account' before the shares are redeemed. "

Section 80 further provides that –

(a) redemption of preference shares is not taken as 'reduction of capital'

(b) the issue of new shares for the purpose of redemption should not amount to 'increase of capital' for stamp duty purposes. Provided the redemption takes place within one month after the making of the fresh issue'.

(c) In contravention of above provisions a fine up to Rs. 10,000 may be imposed.

The particulars of redeemable preference shares must be disclosed in the prospects / balance sheet (section 56).

Any redemption should be notified to the registrar within 1 month of redemption (section 95).

Irredeemable: Repayment on winding up only. After Companies Amendment Act, 1988, issue of any further irredeemable preference shares is prohibited [Sec. 80 (5A)].

Preference shares are deemed to be – Cumulative ,

– Non-participating,

– Non – Convertible

11.5 Equity Shares

Equity shares mean those shares which are not preference shares [sec. 85(2)]. These shares carry the right to receive the whole of surplus profits after the preference shares have received their fixed dividend. If not profits are left after paying fixed preference dividends, the holders of equity shares get no dividend, same is the case with regard to return of capital on winding up of the company.

Directors have the sole right of recommending dividends to such shares and, therefore they may not get any dividends in case the directors so choose, in spite of huge profits. Therefore Share capital raised through such shares is called 'Risk Capital'.

Sources out of which dividend may be declared (sec. 205)-

(1) Current profits

(2) Past reserves created out of profit

(3) Credit balance in Profit and Loss Account brought forward

(4) Out of money provided by Government (if any).

11.6 Kind of Equity shares :

1.Equity shares with voting rights-

These shares carry normal voting rights on every resolution placed before the company at any general meeting.

It is these shareholders who control the management of the company. Such shares are generally known as 'equity shares'.

2.Equity shares with differential rights as to voting and dividend

These shares have differential rights as to dividend, voting or otherwise in accordance with such rules and subject of such conditions as may be prescribed by the central government.

According to Companies (Issue of Shares Capital with Differential Voting Rights) Rules 2001-

(I) Company limited by shares may issue equity shares with differential rights (as to voting & dividend) to the extent of 25% of the total share capital issued provided it has distributable profits in terms of sec. 205 for three financial years preceding year of issue and has not defaulted in repayment of its deposits or debentures.

(II) Issue must be authorized by Articles and approval of shareholders must be obtained in general meeting by ordinary resolution.

(iii) The Company will not be allowed to convert its equity capital with voting rights into equity share with differential rights and vise-versa.

(v) The holders of equity shares with differential rights as to voting or dividend shall be entitled to bonus shares and rights shares of the same class and shall enjoy all rights as a member of the company except right to vote as indicated above.

Therefore, Companies will now be allowed to issue equity shares with differential voting rights including non-voting rights (but carrying higher rate of dividend). A large number of small investors, who hardly exercises their voting rights, would find non- voting equity shares of financially sound companies an alternative instrument of saving. On the other hand, such non-voting equity shares will be a boon to existing management of Companies who can raise capital without diluting or reducing their control over the company.

11.7 Issue of "Securities" at a Premium

Normally securities are issued at 'par value' or 'face value'.

But sometimes companies with good prospects issues securities at price above par value i.e. at premium. There is no legal restriction in doing so.

A Company is also free to charge varying premiums in respect of the same class of shares/ securities.

Section 78 of the Companies Act lays down certain restriction upon the use of premium amount (in excess of par value) so collected. It says that the premium amount so collected must be transferred to the Securities Premium Account and this account is to be treated as share capital for reduction purpose except when it is to be used for the following purposes:-

(I)To issue fully paid bonus shares to members**. (ii**) To write off the preliminary expenses of the company. **(iii)** To write off the expenses of /commission paid/ discount allowed on any issue of shares or debenture of the company. **(iv)** To provide premium payable on redemption of redeemable preference shares or debentures. **(v)** For buy back of own securities u/s 77A.

When securities are issue at a premium for consideration other than cash, a sum equal to the amount of premium must be transferred to 'securities premium account'

The securities premium account is therefore strictly controlled by the Act. It must be disclosed in the balance sheet and must not be used for purpose other than mentioned above without observing the formalities necessary for reduction of capital. Section 78 applies to all companies public as well as private.

11.8 Issue of Shares at a discount

When shares are issued for consideration less than their par value, they are taken to be issued at discount.

A company is permitted to issue shares at discount in compliance with section 79 of the Companies Act. Section 79 provides certain conditions to be fulfilled for issue of shares at discount. They are:-

1.The shares must be of a class already issued. (i.e. no new class of shares)

2.At least 1 year elapsed since is has commenced business (no new company).

3.Issue must be authorized by an ordinary resolution in the general meeting which must state maximum rate of discount.

4.Issue must be sanctioned by Company Law Board(CLB). (No sanction if discount exceeds 10% unless CLB allows such issue considering special circumstances of the case).

5. Issue must be made within 2 months after receiving sanction of CLB or extended time by CLB.

Prospectus selecting to such issue shall contain particulars of the discount allowed.

Reasons for prescribing such strict restrictions for issuing shares at discount is that such a practice actually amounts to reduction of the capital.

Above restrictions don't apply in case of debentures, since they do not from part of the share capital of the company. However, debentures cannot be issued at the discount if the ultimate object is to convert them into shares.

Sec. 79 applies to public and private Companies both.

11.9 Sweat Equity Shares

Section 79A, inserted by the Companies Amendment Act, 1999, makes a provision for the issue of Sweat Equity Shares. Sweat equity shares means equity shares issued by the company to employees or directors at the discount (to market price) or for consideration other than cash for providing know-how or making available rights in the nature of Intellectual Property Rights or value additions etc.

Thus, sweat equity shares are not independent class of shares. They are a kind of equity shares and all provisions relating to equity shares shall be applicable to such shares.

A company may issue sweat equity shares if the following conditions are satisfied

(1) Shares must be of class already issued.

(2) At least 6 year must be elapsed since commencement of business by Company.

(3) Issue must be authorized by special resolution passed by the company in a general meeting

(4) Resolution must specify number of shares, their current market price, consideration (if any), and the class or classes of directors or employees for whom they are issued.

(5) The shares must be issued in accordance with SEBI guidelines [SEBI (Issue of Sweat Equity) Regulations, 2002] in case of listed shares or Central Govt. guidelines in case of unlisted shares.

Under writing Contract, Underwriting Commission & Brokerage

An underwriting contract has been defined as an agreement entered into before the shares are brought before the public, that in the event of the public not taking up whole of them, or the number mentioned in the agreement, the underwrite will for an agreed commission, take an allotment of such part of the shares as the public has not applied.

Brokerage is reward or commission paid to a sort of middlemen (broker) who merely acts as a connecting link between the company and the subscribers and helps in concluding a bargain.

Underwriting is regarded as an insurance against the risk.

Section 76 provides for the payment of commission to underwriter, brokers and also the persons taking shares or debentures, provided such shares or debentures are offered to the public (i.e. outside source) for subscription in the first instance, through a prospectus or otherwise.

According to section 76, following conditions must be fulfilled before the payment of under writing commission.

(i) Payment of commission must be authorized by articles.

(ii) Rate of commission should not exceed 5% (in case of shares) and 2½% (in case of debentures) of the price at which they are issued or the rate specified in the Article whichever is lesser.

(iii) The rate of commission agreed to be paid should be disclosed in the prospectus or statement on lieu of prospectus (for public companies) or it must be filed with the Registrar (for private companies).

(iv) Copy of contract to be delivered to Registrar.

11.10 Buy Back of Shares (Sec. 77 A, AA, B).

According to section 77 of the Companies Act, it is not open to a company, whether public or private to purchase its own shares, for its involves a permanent reduction of capital which is not allowed expect when the capital of the Company is legally reduced in pursuance of section 100 to 104 or section 402.

Under section 100-104 it is provided that a special resolution and sanction of the court are needed for any reduction of share capital.

Section 402 provides that a company can buy its own shares to relieve an oppressed part of members with a view of prevention of oppression under the orders of CLB.

Any seduction of capital contrary to these sections is illegal and ultra-vires since the preservation of capital is one of the most important aim of the Act.

An unlimited liability company is free from the restriction imposed by this section and it can purchases its own shares.

Procedures for Reduction of Share Capital –

Government has enacted Companies (Amend.) Act, 1999 which provides provisions permitting the companies to buyback their shares subject to certain restrictions.

Rationale for buy back-

- Assuming no dilution in the company's future earnings subsequent to the buyback, the re-purchase of shares, which are cancelled, reduces the number of shares outstanding and thus improve EPS (earnings per shares) which in turn will push up the market price of shares. Thus, there is enhancement of shareholders value as a result of buyback.
- A cash rich company may buy back its own shares at the market rate as a means of better investment.
- The buyback strategy may be used to reduce the floating stock from the market to prevent the hostile take over bid and thereby enabling the existing management to maintain the controlling interest using the company's money.

Buyback of shares should only be attempted when the future earnings are forecasted to be strong otherwise it may damage the shareholders’ interest.

Therefore, the buyback schemes are guarded by companies Act, SEBI guidelines (in case of listed public Cos) and Central Govt.

guidelines (in case of unlisted public companies & private companies).

Section 77 A (as further amended in 2001), 77 AA, & 77 B were introduced by the Companies (Amend) Act, 1999 to enable companies to purchase their own shares or other specified securities.

11.10.1 Funds out of which buyback may be financed [Sec. 77 A (1)]

A company may purchase its own shares or other specified securities out of –

(i) its free reserves, or

(ii) the Securities Premium Account, or

(iii) the proceeds of any shares or other specified securities.

But no buyback of any kind of shares or other specified securities shall be made out o the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities i.e. equity shares can be redeemed (buyback) out of an earlier preference shares or debentures issue but not out of an earlier equity share issue.

Explanation appended to section 77 A further defines-

(a) 'Specified securities' includes employees stock option or other securities as may be notified by central govt. from time to time.

(b) 'Free reserves' means those reserves which are free for distribution as dividend and shall include balance to the credit of the securities premium account but shall not include share application money (which is due for refund but has not been encashed).

11.10.2. Transfer of certain sum to 'Capital Redemption Reserve Account'

[Sec. 77 A].

Where a company purchases its owns shares out of 'free reserves', then a sum equal to the nominal value of the shares so purchased must be transferred to the 'Capital Redemption Reserve Account' and its details must be disclosed in balance sheet.

As per Sec. 80 (1) the 'Capital Redemption Reserve Account' is special type of reserve account and it is to be treated as share capital for reduction purposes. This reserve may be utilized for the issue of fully paid bonus shares.

Preservation of subscribed Share capital for the benefit of creditors has always been one of the basic objectives of Company Law. This Section, therefore, attempts to keep intact the equity shares capital by not allowing its outright redemption through the buyback operation. It only allows the replacement of brought back shares capital either by 'Capital Redemption Reserve Account' or by proceeds of any fresh issue of shares or other specified securities.

11.10.3.Conditions to be fulfilled before resorting to buyback [Section 77 A (2), (3)(4)].

1 . Articles must authorize buyback.

2. Special resolution must be passed in general meeting. (This requirement of special resolution has been relaxed by the Companies Amend. Act, 2001. Companies are now permitted to buyback shares & securities up to 10% of the total paid up equity capital and free reserves with the approval of BOD by resolution passed at Board's meeting, but only one buyback is permitted in one year).

3. Notice for convening general meeting at which special resolution is proposed is to contain explanatory statement as to material fact of buyback, class of securities to be purchased, amount involved and time limit for completion of buyback.

4. Amount involved in buyback should not exceed 25% of the total paid up capital and free reserves of the company.

Strict norm for Equity shares – But if the equity shares are to be bought back, the amount involved should not exceed 25% of the Companies total paid up capital in that financial year.

5.After the buyback - the ratio of Debt to Capital and free reserves should not be more than 2:1 (Central Government may provide higher ratio).

6.The shares or securities brought to be buy back should be fully paid up. 7.Buyback of shares must be completed within 12 months from the date of passing of resolution by board of directors.

11.11 SHARE CERTIFICATE AND SHARE WARRANT

Share Certificate :

A share certificate is a registered 'evidenced of title' to share, issued by the Co. under its common seal, duly stamped by the Company under its common seal, duly stamped and signed by one or more directors and countersigned by the secretary of the Company as per articles.

A shares certificate is not a document of title of the rights under it are not transferable by a more endorsement and /or delivery of the certificate. In order to transfer shares evidenced by a share certificate on 'instrument of transfer' duly competed must be logged with the Co. for approval by the BOD.

A shareholder is entitled to have one share certificate in respect of shares registered in his name from the Co. force of change, certifying that he is the holder if specified nominee of shares in the Co.

In case of joint holder of shares – Co. shall issue only one share certificate to the hinder first named in the register of members. the name of every holder of a shares certificate shall appear in the register of member of the Co.

<u>Details of shares certificate</u> –

1. Name of persons
2. Number & Class of shares
3. Distinctive no. of shares
4. Amp paid an each shares
5. Day and date issue
6. Certificate no.
7. Name and address of reg. office of Co.

Issue - The power to issue solve certificate is to be exercised by the directors in Board meeting only.

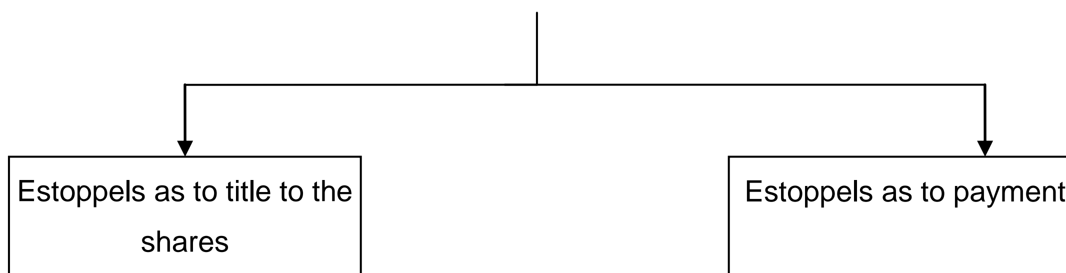
As per Sec. 113 (amend. 1988) – A share certificate must be issued/ despotized to the allotted within three months after the date of allotment or within two months after the application for the registration of the transfer.

CLB can extend the aforesaid period not exceeding 9 months. The Penalty for non-compliance is fine up to 5000/- per day till default continues.

Under the Securities Contract (Regulation) Rules, 1957, a listed Company is required to issue share certificate within one month after the application for the registration of the transfer is received by the Company.

Under 'Depository System' there is not need to issue share certificate for the shares registered in the name of the depository. Instead the Co. slowed intimates the details of allotment of shares to the depository immediately on the allotment of such shares. [New sub-Sec. (4) to sec. 113 inserted by the Depositories Act, 1996].

Legal effects of the issue of the Shares Certificate



1. Estoppels as to title to the shares : Share Certificate is prima facie evidence of title. It stops the company from denying the title of the persons to the shares, whose name is mentioned therein, provided he acquires the shares in good faith (i.e. without notice of forgery) for value and under a genuine transfer. It is not a 'conclusive evidence' of ownership – forged transfer conveys no title / forgery makes a contract a nullity.

2. Estoppels as to payment – If the shares certificate states that the full amount on the shares ahs been received, the company is estopped, as against a bona-fide purchaser of

shares for value, from alleging that the shares over not fully paid up.

Issue of duplicate Share Certificate

According to section 84(2) the directors are empowered to issue new duplicate shares certificate in place of original certificate if such certificate –

(a) is provided to have been lost or destroyed.

(b) having been defaced or mutilated or torn is surrendered to the company.

No duplicate certificate can be issue unless Board of Directors has issued a resolution of that effect.

As per section 84(3) ,if a company with intent to defraud renews a certificate or issue a duplicate thereof, the company shall be punishable with fine which may extend to Rs.10,000/- and every defaulting officer shall be punishable with imprisonment up to 6 months or fine up to one lakh rupees or both.

Share Warrant

A share warrant is a bearer 'document of title' to the shares. A share warrant is just like a negotiable instrument. The shares specified therein may be transferred by delivery of the warrant only and any bona-fide holder for value will obtain a perfect title to the share.

Issue of share warrants:

Section 111 Provides for issue of share warrants. It states that-

(1) Only a Public Co. Ltd. by shares can issue share warrants.

(2) The articles of association must authorize the issue of the share warrants

(3) Share currents cannot be issued originally. On shares certificate for fully paid shares can be converted into share warrants.

(4) Approval of central govt. must be obtained for issuing share warrants.

Effect of Issue of Share Warrants –

1. Company shall strike out the names of the members from the register of member as holding the shares specified in the warrant, just as if he had ceased to be a member and shall enter in that register the following particulars--

(a) the fact of issue of the warrant;

(b) a statement of the shares specified in the warrant distinguishing each shares by the number;

(c) the date of issue of warrant.

2. As per section 115(5) the bearer of a share warrant may not be granted all the rights of membership.

3. The share warrant will not constitute the qualification shares for the directors, i.e. holders of a shares warrant cannot qualify himself for the appointment of a director.

Share Certificate v/s. Share Warrant

	Share Certificate	Share Warrant
1	Both public as well as private Cos. can issue	Can be issued by public ltd. Cos. only
2	Can be issued originally and were with respect to partly pond up shares	Cannot be issued originally, only shares certificate for fully paid shares can be converted into shares warrant.
3.	No restriction for issue share certificates	Authority of Articles and approval of Central govt. is needed to issue share warrant.
4	Name / Address of shares certificate holder is entered into Register of member	No such details are entered in case of bearer share warrant.
5	Transfer requires registration of transfer with the Co.	Transfer complete merely by delivery
6	Prima facie evidence of title	Conclusive evidence of title for bona-fide holder for value.
7.	Share Certificate is not a negotiable instrument, therefore	Share Warrant is a negotiable instrument, thus a bona-fide

	bona-fide transferee for value does not have better title than transferor	transferee for value may have better title than the transferor
8	Holder has all normal rights of membership	May or may not have normal rights of membership
9.	Shares can be included in qualification of shares of directors	Shares evidenced by share warrant cannot be so included in qualification shares.
10	Dividend paid through dividend warrants posted at regd. address of members	Dividend paid through bearer dividend coupons.
11	Stamp duty payable on transfer shares	No stamp duty payable on transfer of warrant
12	Holder of share certificate can present a petition for the winding up of the company	Holder of share warrant connot petition for winding up of the company.

11.12 Summary

A share is a fractional part of the capital of the company which forms the basis of ownership of certain rights and interests of a subscriber in the company. A share secures to its owners certain rights and liabilities e.g. right to dividend, right to vote, and liability to pay unpaid balance (if any) and to be bound by the provisions of the article and memorandum. A share is regarded as 'goods' in India. According to section 82 the shares of any members or debentures in a company shall be movable property, transferable in the manners provided by the Article of the company. Stock in a company means a

bundle of fully paid shares put together for convenience so that it may be divided into any amount and transferred into any fractions and sub-divisions without regard to the original face value of the shares.

Share capital denotes the amount of capital raised or to be raised by the issue of shares by a company. The share capital may be of various kinds viz. authorized capital, issued capital, subscribed capital, called up capital, uncalled capital, paid up capital and reserved capital.

Shares may be classified as preference shares and equity shares. Preference shares may further be cumulative or non cumulative, participating and non-participating and redeemable and non-redeemable.

Equity shares mean those shares which are not preference shares. These shares carry the right to receive the whole of surplus profits after the preference shares have received their fixed dividend. Equity shares may be of two types- equity shares with voting rights and equity shares with differential rights as to voting and dividend.

Normally securities are issued at 'par value' or 'face value'. But sometimes companies with good prospects issues securities at price above par value i.e. at premium. When shares are issued for consideration less than their par value, they are taken to be issued at discount.

Section 79A, inserted by the Companies Amendment Act, 1999, makes a provision for the issue of Sweat Equity Shares. Sweat equity shares means equity shares issued by the company to employees or directors at the discount (to market price) or for consideration other than cash for providing know-how or making available rights in the nature of Intellectual Property Rights or value additions etc.

According to section 77 of the Companies Act, it is not open to a company, whether public or private to purchase its own shares, for its involves a permanent reduction of capital which is not allowed expect when the capital of the Company is legally reduced in pursuance of section 100 to 104 or section 402.

A share certificate is a registered 'evidenced of title' to share, issued by the Co. under its common seal, duly stamped by the Company under its common seal, duly stamped and signed by one or more directors and countersigned by the secretary of the Company as per articles. A shares certificate is not a document of title of the rights under it.

A share warrant is a bearer ‘document of title’ to the shares. A share warrant is just like a negotiable instrument. The shares specified therein may be transferred by delivery of the warrant only and any bona-fide holder for value will obtain a perfect title to the share.

11.13 Check Your Progress

1. Discuss the various kinds of share capital.

2. Define and distinguish between equity shares and preference shares.

3. When a company can issue shares at premium and at discount and how?

4. Distinguish between reduction of share capital and diminution of share capital.

5. What are the provisions of Companies Act regarding 'buy back' of shares?

6. Distinguish between share certificate and share warrant.

LL.M. Part-1

PAPER CORPORATE LAW

Block III– CORPORATE FINANCE

Unit 12- Debt Finance - Borrowings, security for borrowings, Debentures- Issue, classes, Public Deposits, Small Depositors, Investments, Inter-Corporate Loans

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12.13Check Your Progress

12.0 Introduction

When the company management does not wish to dilute its control over the affairs of the company, it resorts to debt financing rather than issuing equity shares. It may take the shape of borrowings, issue of debentures, public deposits, investments, inter corporate loans or any other instrument devised for the purpose. Though it contains more risk than equity as it carries a fixed cost in the form of interest on capital, but is preferred when the company is able to pay the interest irrespective of its own profit and does not wish to dilute its holding on the company.

12.1 Borrowings

A trading or commercial company has an implied power to borrow money to any extent for the purposes of its business and to charge its assets by way of security for the amount borrowed. This power may, however, be restricted by its memorandum or articles of association. Non-trading companies formed to promote commerce, art, science, religion, etc., which do not propose to pay dividends are not entitled to borrow money unless expressly authorised to borrow by their memorandum and articles of association.

A private company is entitled to exercise the borrowing powers immediately after its incorporation. But a public company cannot exercise its borrowing power until it secures the 'certificate to commence business' [Sec. 119(1)]. However, a simultaneous issue of shares and debentures just after incorporation is allowed in the case of public companies [Sec. 119(5)].

Subject to the restrictions placed by the memorandum or articles of association or by the statute, the power of the company to borrow is exercised by the directors who are free to exercise that power in any manner and upon any terms. In this connection Section 293(1)(d) providing certain restrictions, states that the directors of a public company shall not, except with the consent of such company in general meeting, borrow moneys which together with those already borrowed

(apart from temporary loans obtained from the company's bankers in the ordinary course of business) will exceed the aggregate of the paid-up capital of the company and its free reserves.

12.2 Ultra Vires Borrowing

Sometimes a company may resort to *ultra vires* borrowings, *i.e.,* borrowings which are not authorised. Such borrowings may be -

(1) borrowings which are *ultra vires* the company, i.e., beyond the authority given to the company by its memorandum and articles, or

(2) borrowings *ultra vires* the directors, i.e., beyond the authority of the directors.

We shall now see the legal effect of *ultra vires* borrowings in each of the above cases.

(1) **Borrowings which are ultra vires the company.** The basic principle of Company Law is that any act which is *ultra vires* the company is void. Therefore, in the eyes of law borrowings which are ultra vires the company, are not recognised as a debt against the company and the lender of money cannot sue the company for the excess credit in case of default, nor he can enforce any security given for such loan. But the following remedies shall be available to such a lender:

(i) If the company has not applied the money so advanced to any transaction so far, he may obtain an injunction order against the company restraining it from spending the amount and may recover the money as actually existing.

(ii) If the money has been expended in purchasing some particular asset which can be traced into the company's possession, he can obtain a *tracing order* and may claim that asset. Even if no specific asset could be earmarked, the lender is still entitled to have restored to him any increase in the assets which is shown to be due to the *ultra vires* borrowings, in the event of winding up of the company. In Sinclair vs. Brougham[(1911), A.C. 398],

Lord Parker has observed that- "Neither creditors nor contributories ought in equity be allowed to retain an advantage derived by reason of the misapplication by the company's agents of moneys which were in the position of trust moneys."

(iii) If the money so borrowed is applied in paying off lawful debts of the company, the lender is entitled to step into the shoes of the creditors who have been paid off and subrogate to their rights. He can thus rank as a creditor of the company to the extent to which the money has been so applied, for the simple reason that by treating him as a creditor in place of that who has been paid off the total indebtedness of the company remains the same. But the lender has no right to any securities held by such creditors (*Re Wrexham, Mold and Cannah's Quay Rly.* (1899), 1 Ch. 440).

The reasoning behind the above remedies is, as the *ultra vires* lending is *void ab initio*, the lender continues to be the owner of that money and he has the right to recover it under the equitable doctrine of restitution.

(iv) Finally, the lender may claim damages from the directors and sue them personally for a breach of *implied warranty of authority*, provided at the time of advancing the money he acted in good faith without knowledge of the fact that directors were borrowing in excess of maximum limits fixed by the Memorandum of Association *(Weeks* vs. *Propert* (1873), 42 L.J. (C.P.) 119*)*. But if the fact that the company has no powers to borrow was apparent upon reference to the company's memorandum and articles, the lender cannot claim damages from directors upon this ground as he was not misled because he will be deemed to have knowledge of these public documents *(Rashdall* vs. *Ford*(1866), L.R. 2Eq. Cas. 750*):*

It has been held in *Ashbury Railway Carriage Co. vs Riche* (1875), L.R. 7, H.L. 653*,* that if the borrowing is *ultra vires the memorandum* it is incapable of ratification by the company even with the assent of every shareholder *but* if the borrowing is *ultra vires the articles only,* members in the general meeting may ratify it by altering the articles.

(2) **Borrowings which are ultra vires the directors.** In case of borrowings *ultra vires* the directors but *intra vires* the company, the legal position is simple. The company may, if it wishes, in general meeting ratify such act of the directors, in which case the loan shall become perfectly valid and binding upon the company. Even if the company decides otherwise *(i.e.,* not to ratify the directors' act) the doctrine of "Indoor management" (as was laid in the case of *Royal British Bank* vs. *Turquand* (1856), 6 E & B. 327.*)* and the normal principles of agency will protect a lender who has lent money to the company provided he proves that he advanced the money in good faith and had no knowledge of the fact that the limit had been exceeded. Of course the company can claim an indemnity from the directors. Alternatively, the lender may sue the directors directly for breach of *implied warranty to authority* and make them personally liable. It is to be noted that if the lender knew at the time of lending that the loan shall be used for an unauthorised activity, he cannot recover the money lent from the company.

12.3 Security for Borrowing

The borrowing made by a company may be either unsecured or secured. When the debt is unsecured, the creditor, on default, has only a right to sue the company. Ordinary trade debts are usually unsecured. When the debt is secured, the creditor, on default, has a right to enforce his security. The position of a secured creditor is safer as he has a right to claim company's property which is given as security in addition to his right of action against the company. Long term borrowings are usually not possible without offering some security for the amount of loan. It is why; a company often mortgages or charges its property to its debenture-holders.

A trading or commercial company, as observed earlier, has implied powers to charge its assets by way of security for the amount borrowed. At the very outset it may be noted that the "reserve capital" (uncalled capital declared incapable of being called up except in the event of winding up) can in no case be mortgaged (Bartlett vs. Mayfair Property Co. (1898), 2 Ch. 28). The uncalled capital of the

company may, however, be charged provided the articles so permit (Bank of South Australia vs. Abrahams (1875), L.R. 6, P.C. 265).

The security given to debenture-holders may create either a fixed or specific charge or a floating charge.

12.3.1 Fixed charge.

A fixed mortgage or charge is one which is created on some definite or specific property of a permanent nature, e.g., building or heavy machinery and prevents the company from selling the property so mortgaged free from the burden of the mortgage debt. Such a mortgage may be either legal or equitable.

(A) *Legal mortgage,* Here the full legal ownership of the property is transferred to the creditor (*i.e.,* the mortgagee) without delivering possession of the mortgaged property and the borrower (*i.e.,* the mortgagor) reserves his right to regain the full legal ownership upon payment of the loan with interest. Such a mortgage is effected by executing a 'mortgage deed', and requires registration with the Registrar of Companies. When the amount secured is Rs. 100 or more a 'mortgage deed' is also to be registered under the Transfer of Property Act. In case of default the creditor is entitled to take possession and dispose of the mortgaged property without the intervention of the court. This type of mortgage is also known as English Mortgage.

(B) *Equitable mortgage*. It refers to a mortgage founded on the law of fair play and natural justice. Here the title deeds of the property are deposited with the creditor as security for payment without transferring legal ownership and possession of the mortgaged property to him. However, the mortgagor undertakes, through a memorandum of deposit, to execute a legal mortgage in case he fails to pay the mortgage money as agreed. Where the sum secured is Rs. 100 or more, the 'memorandum of deposit' of title deeds requires registration under Section 17 of the Registration Act, 1908, and it is only on such registration that the creditor acquires an *equitable* right to the mortgaged property. Such a mortgage is also to be registered with the Registrar of Companies under Section

125. In this case the creditor's security is not complete, for although the borrower cannot deal with such property without his concurrence, he is not entitled to dispose of the property in case of default without an order of sale by the court. This kind of security is very simple and helps to borrow quickly as there is no need of executing a 'mortgage deed'.

This type of mortgage is also called 'a mortgage by deposit of title deeds'.

12.3.2 Floating charge.

A company will not possibly like to create a fixed mortgage upon its circulating capital, e.g., stock-in-trade. For, under the terms of fixed mortgage the company can only deal with the asset subject to the charge. It was for this reason that a new type of charge known as 'floating charge' was invented.

A floating charge is an equitable charge on the assets for the time being of a going concern. It is a charge on the assets of the company in general. It covers all the assets whether subject to a fixed charge or not and keeps on floating with the property which it is intended to cover. in *Illingworth vs. Houldsworth* (1904), A.C. 355 Lord McNaughton has observed that- "a floating charge is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to affect until some event occurs or some act is done which causes is to settle and fasten on the subject of the charge within its reach and grasp." A floating charge does not attach to any specific property till the event on which it is to get fixed occurs. Neither ownership nor possession is passed to the lender under this type of charge.

The main merit of a floating charge is that the company can deal with its assets so charged in a way it thinks best until the charge crystallizes. It can even mortgage the assets charged so as to give a registered mortgagee priority over the floating charge holder. A floating charge can be created only by an incorporated body. It is created by a "deed" and requires registration with the Registrar of Companies under Section 125 of the Companies Act.

12.3.3 Crystallization of Charges.

A floating charge crystallizes and becomes fixed in the following circumstances:

(i) when the company goes into liquidation, or

(ii) when the company ceases to carry on business, or

(iii) when the debenture-holders, having become entitled to realise their security, intervene for the purpose, e.g., by appointing a 'receiver'.

Once a floating charge crystallises the creditors covered under the charge become entitled to be paid out of the assets comprised in the charge in priority to all other liabilities, except the following: *(i)* The preferential payments as detailed in Section 530, *e.g.,* rates, taxes, wages, etc., and *(ii)* A hire purchase Vendor until goods are paid for in full, even though the hire purchase agreement may have been entered into after the creation of the floating charge (Morrison Jones vs. Taylor Ltd. (1911), 1 Ch. 50).

Section 534 imposes an important condition for the validity of the floating charge created within 12 months immediately preceding the commencement of winding up. It provides that such a charge shall be invalid, except in the following cases -

(a) if the company immediately after the creation of the charge was solvent; or

(b) if the company received cash actually, at the time of grafter the creation recharge in consideration thereof The charge in this case shall he valid to the extent of amount of cash actually paid to the company with interest at 5 per cent per annum or any other rate notified by the rental Government.

The object of this provision is to prevent insolvent companies from creating floating charges to secure past debts.

It may be interesting to note that under a floating charge the interests of the creditors are tied up with the prosperity of the company almost to the same extent as those of shareholders - for, if the company trades unprofitably,

creditors' security will be placed in jeopardy, whereas, if it flourishes, their security will normally be enhanced.

12.3.4 Registration of Charges

For the purposes of registration the expression ‘charge’ also includes a ‘mortgage’ as per Section 124 of the Act.

As per the requirement of section 125(4) following charges must be registered with the Registrar -

(a) a charge for the purpose of securing any issue of debentures;

(b) a charge on the-uncalled share capital of the company;

(c) a charge on any immovable property, wherever situate, or any interest therein

(d) a charge on any book debts of the company;

(e) a charge, not being a pledge, on any movable property of the company;

(f) a floating charge on the undertaking or any property of the company including stock-in-trade ;

(g) a charge on calls made but not paid;

(h) a charge on a ship or any share in a ship;

(i) a charge on goodwill, on a patent or license under a patent, on a trade mark, or on a copyright or a license under a copyright.

The prescribed particulars of the charge together with the instrument by which it is created or a certified copy thereof, must be filed with the Registrar for registration within 30 days after the creation of the charge. The Registrar may, however, extend the period of 30 days by another 30 days on payment of additional fee, if the company satisfies him that it had sufficient cause for delay [Sec. 125(1)]. It is the duty of the company to send the above particulars to the Registrar, but registration may also be affected on the application of the creditor who may recover the registration fee from the company (Sec. 134).

Effect of non-registration: The consequences of non-registration of any registerable charge are:

(j) The charge would be void against the liquidator and any creditor of the company [Sec. 125(1)].

(ii) The debt, in respect of which the charge was given remains valid as an unsecured debt [Sec. 125(2)].

(iii) The money which the charge purports to secure becomes immediately payable [See. 125(3)].

(iv) A penalty up to Rs. 5,000 for every day during which the default continues may be imposed on the company and its every officer who is knowingly in default [Sec. 112(1)].

Property Acquired Subject to Charge (Sec. 127):-

Where a company acquires any property which is subject to a charge of any kind which, if created by the company after the acquisition, would have required registration, the company must file the prescribed particulars of the charge together with a copy of the instrument creating the charge with the Registrar for registration within 30 days after the acquisition is completed. In case of default, the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 5,000 [Substituted for “Rs. 500” by the Companies (Amendment) Act, 2000].

Register of Charges to be kept by Registrar:-

According to the Section 130, the Registrar shall cause to be kept a register, in respect of each company, containing the particulars of all the charges requiring registration. Every company shall forward to the Registrar for being entered in the register the particulars of all the charges requiring registration in the prescribed form *with* a fee of rupees ten. The Companies (Amendment) Act, 1988, has dispensed with the time consuming procedure of entering by hand the particulars of charges by providing that companies will henceforth file particulars

of charges in the prescribed form and manner. The particulars of charges shall relate to - (i) the date of creation of each mortgage or charge, (ii) the amount secured by the charge, (iii) short particulars of the property charged, and (iv) the names of the persons entitled to the charge. If the charge is one to which the *holders of a series of debentures* are entitled, then the particulars (as set out in Sections 128 and 129) of charges shall relate to - *(a)* the total amount secured by the whole series, *(b)* the dates of the resolutions authorising the issue of the series, *(c)* the date of the covering deed, if any, by which the security is created or defined, *(d)* a general description of the property charged, *(e)* the names of the trustees, if any, for the debenture-holders, and *(f)* the amount or rate per cent of the commission or discount, if any, paid to any person subscribing or procuring subscriptions for any debentures of the company. The pages of the register shall be consecutively numbered and the Registrar shall sign or initial every page of the register. Such a register shall be open to inspection to the public on payment of a fee of rupees ten for each inspection.

The Registrar is also required to keep a chronological index, in the prescribed form, of the mortgages and charges registered with him (Sec. 131).

The Registrar gives a certificate of the registration of any charge, and this certificate is conclusive evidence that the requirements of law as to the registration have been complied with (Sec. 132). The company must cause a copy of this certificate to be endorsed on every debenture or debenture stock certificate issued by it and the payment of which is secured by the charge so registered. A person who knowingly permits the delivery of any debenture without the required certificate endorsed upon it shall be punishable with fine which may extend to Rs. 10,000 (Sec. 133).

If any person gets a *"receiver"* appointed, he must give notice of the fact to the Registrar within 30 days of such appointment, and the Registrar shall enter the fact in the register of charges. Similarly, the *receiver* so appointed is required to give notice to the Registrar upon his ceasing to act as such and the Registrar shall enter the notice in the register of charges (Sec. 137).

The Memorandum of satisfaction:- The fact that any registered charge is satisfied in full must be notified by the company to the Registrar within 30 days of such payment, who shall, after giving a proper show cause notice to the holder of the charge, enter a memorandum of satisfaction in the register of charges (See. 138). The Registrar may also record memorandum of satisfaction even if no intimation has been received by him from the company, on getting evidence to his satisfaction that any registered charge has been satisfied in whole or in part (Sec. 139). When the Registrar enters a memorandum of satisfaction in whole or in part in pursuance of the above provisions, he shall furnish the company with a copy of the memorandum (Sec. 110).

The Company Law Board is empowered to extend time for the registration of the charge or to order that the omission or misstatement in the register of charges be rectified, if it is satisfied that the default was accidental or due to inadvertence or to some other sufficient cause or is not of a nature to prejudice the position of creditors or shareholders of the company, or that on other grounds it is just and equitable to grant relief. The company or any interested person may apply to the Company Law Board for such an order. It may be noted that where the Company Law Board extends the time for the registration of a charge, the order shall not prejudice any rights acquired in respect of the property concerned before the charge is actually registered.

Under Section 113, every company must keep a register of charges containing *(i) a* short description of the property charged, (ii) the amount of the charge, and *(iii)* the names of the persons entitled to the charge. Such particulars are to be given in respect of each charge, fixed or floating, separately. When the terms or conditions of any charge are modified they should be duly incorporated in this register and the Registrar must also be informed about the particulars of such modification (Sec. 135).

The above register and a copy of every instrument creating any charge requiring registration must be kept at the registered office of the company (Sec. 136). The register and the copies of instruments shall be open to inspection of any creditor

or member of the company without fee for at least two hours on each working day. To any other person it shall be open to inspection on payment of a fee of rupees ten for each inspection. If inspection is refused, the company and every defaulting officer shall be punishable with fine and the Company Law Board may also by order compel an immediate inspection of the said copies or register [Sec. 114, as amended by the Companies (Amendment) Act, 1988].

12.4 Debentures

It is difficult to give any precise legal definition of the term 'debenture' *(Levy* vs. *Abercorris Co.* (1887) 37 Ch. 260*).* In practice the use of the term 'debenture' is restricted to loans of some permanence generally secured by a mortgage on the property of the company. The issuance of the debentures by the company is perhaps the most convenient method of long term borrowings.

Section 2(12) defines, "debenture includes debenture stock, bonds and other securities of a company, whether constituting a charge on the assets of the company or not." The definition does not explain the nature of a debenture exactly. In simple language a debenture means 'a document containing an acknowledgement of indebtedness, issued by the company under its common seal, and giving an undertaking to repay the debt at a specified date or at the option of the company and in the meantime to pay interest thereon at a fixed rate and at intervals stated in the debenture'. *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.*

Denomination of Debentures

It has been decided-by the Government that henceforth the standard denomination or face value of debentures should be Rs. 100. Debentures which are not in denomination of Rs. 100 or of multiples of Rs. 100 should be converted into those of Rs. 100 latest by 31st December 1984. However, exemption may be granted to those companies which fulfill any of the following conditions :

(i) more than 50 per cent of the paid up value of the debentures is held by public financial institutions;

(ii) the debentures are redeemable before the close of the calendar year 1989.

The exemption will be subject to the condition that the company shall convert the debentures into those of prescribed denomination if such a request is made by any debenture holder.

As regards convertible debentures the face value should be such that in the case of those debentures having single point conversion, the non-convertible portion should result in the face value of Rs. 100. If the convertible debentures have, however, two points of conversion, the portion after the first point of conversion should have a face value of Rs. 100.

12.5 Issue of Debentures

Debentures can be issued at anytime by all companies, public or private. The power to issue debentures rests with the Board of Directors (Sec. 292). Debentures may be issued at par, at a premium or at a discount either privately or through a prospectus. The legal requirements for issue and allotment of debentures are similar to that adopted in case of issue and allotment of shares except the following:

(a) no requirement of (i) receiving at least 5% cash of the nominal value as application money, (ii) securing minimum subscription amount, and (iii) depositing the application money in a scheduled bank before allotment is there in case of allotment of debentures by a public company which invited public to subscribe;

(b) no legal restriction is placed on the issue of debentures at a discount;

(c) no return of debenture allotment is required to be filed with the Registrar.

The company is required to complete and despatch the debenture certificates within three months of allotment. However, the Company Law Board may grant extension for a period not exceeding nine months in appropriate cases (Sec. 113, an amendment by the Amendment Act, 1988). Further, in case of registered debentures, the company must prepare a *"Register of debenture holders"* containing the following particulars:

(i) the name and address, and the occupation, if any, of each debenture-holder;

(ii) the debentures held by each holder, distinguishing each debenture by its number, except where such debentures are held with a debenture, and the amount paid or agreed to be considered as paid on those debentures;

(iii) the date on which each person was entered in the register as a debenture-holder; and

(iv) the date at which any person ceased to be a debenture-holder.

If the number exceeds fifty, *index* of debenture-holders' register should also be made [Sec. 122 as amended by the Depositories Related Laws (Amendment) Act, 1977].

With the introduction of the 'Depository System', there is no need to issue debenture certificates for the debentures registered in the name of the 'depository'. Instead, the company is required to intimate the details of allotment of debentures to the depository immediately on allotment [New sub-section (4) of Section 113 inserted by the Depositories Act, 1996].

Debentures vs. Shares

The important differences between a debenture-holder and a shareholder should be noted:

(i) **Status:** A shareholder is a part-owner (loosely though) of the company but a debenture-holder is only a creditor.

(2) **Nature of security:** A share is an ownership security non-repayable during the life time of the company but a debenture is a creditorship security repayable during the life time of the company, or at its winding up if it occurs before the maturity date.

(3) **Income:** Income on debentures-is fixed and certain whether or not the company has made a profit, whereas income on shares is uncertain depending upon the profits and the discretion of the directors.

(4) **Rights:** A shareholder has normal rights of a member, *e.g.,* right to receive notices of general meetings, right to vote at general meetings, etc. A debenture-holder does not have any right to vote in the company meetings (Sec. 117).

(5) **Re-purchase:** A company may repurchase its own debentures, thus in effect redeeming them, whereas it is *not open* to a company to purchase its own shares as per Section 77. However; the Companies (Amendment) Act, 1999 has permitted companies to buyback their own shares after complying with the stringent conditions laid down, in newly introduced Sections 77A, 77AA and 77B.

(6) **Position at winding up:** In case of winding up debenture-holders have prior claim for the repayment, whereas shareholders can only obtain anything after all the outside creditors have been paid in full. Moreover, debentures are generally covered by a charge on the assets of the company. Hence debentures are more secured.

Debentures vs. Debenture Stock

Debenture stock means the borrowed capital consolidated into one mass. The difference between ‘debenture’ and ‘debenture stock’ is almost similar to the difference between 'shares' and ‘stock’. Like ‘share’, the 'debenture' is always of a fixed denomination indivisible and transferable in its entirety and like ‘stock’ the ‘debenture stock’ is not of any fixed amount, divisible to any extent and may be transferred even in fractional amount. There is, however, one important difference between ‘stock’ and ‘debenture stock’. Whereas ‘stock’ cannot be issued originally (only fully paid shares can be converted into stock later), ‘debenture stock’ can be so issued.

12.6 Classes of Debentures

In any company there may be more than one class of debentures each of which may have different rights as to security, transferability, repayment, etc. The main classes are:

(1) **Secured debentures:** They are those which are secured by some charge on the property of the company. The charge or mortgage may be 'fixed' or 'floating'. Hence there may be 'fixed mortgage debentures' or 'floating mortgage debentures' depending upon the nature of charge, under the category of secured debentures. From the commencement of the Companies (Amendment) Act, 2000 (*i.e., w.e.f.* 13th December, 2000), it is mandatory for any company making a public issue of debentures to issue only secured debentures.

(2) **Unsecured or naked debentures:** They are those that are not secured by any charge on the assets of the company. The holders of such debentures are just like ordinary unsecured creditors of the company. Such debentures are not common.

(3) **Registered debentures:** The names, addresses and particulars of holdings, of such debenture-holders are recorded in the Register of Debenture-holders of the company. The interest as well as the principal sum in respect of such debentures is payable to the registered holders and their transfer is to be registered with the company in accordance with the conditions of their issue endorsed on their back by means of a regular transfer deed. No restrictions, howsoever reasonable, can be placed on their transferability.

(4) **Bearer debentures:** The Company keeps no record of the debenture-holders in this case. Such debentures are similar to share warrants in that they too are negotiable instruments, transferable by mere delivery free from equities. The interest on them is paid by means of attached coupons which are cashed by the holder as each falls due. On maturity the principal sum is paid to the bearers.

(5) **Redeemable debentures:** They provide for the payment of the principal sum on a specified date or on demand or notice.

(6) **Irredeemable debentures:** In this case the issuing company does not fix any date by which they should be redeemed and the holders of such debentures cannot demand payment from the company so long as it is a going concern. Such debentures are also called perpetual debentures because usually they are repayable after a long period of time on the happening of a contingency, however remote, or on winding up (Sec. 120).

(7) **Convertible debentures:** Here, upon fulfillment of the specified conditions, the debenture-holders are given the option to convert either fully or partially their debentures into equity shares. This option is not contained in case of non-convertible debentures.

The terms and conditions on which debentures are issued are endorsed on their back. It may be noted that the two words 'Bonds' and 'Debentures' are used interchangeably in relation to company finance,

12.7 Protection of Interests of Debenture-holders

For the first time the Companies (Amendment) Act, 2000 seeks to protect the interests of debenture-holders by adding three new Sections 117A, 117B and 117C relating to debentures. The provisions of these Sections relate to format of debenture trust deed, appointment of debenture trustee, the duties and powers of debenture trustee, creation of debenture redemption reserve and protection of the interests of debenture-holders by enabling them to approach the Company Law Board in the event of default by a company in the redemption of debentures. It is now mandatory for any company making a public issue of debentures to issue only secured debentures and appoint debenture trustees. Earlier, there were no specific provisions for protection of interests of debenture-holders, though shareholders and depositors were protected under the Act.

Debenture Trust Deed: Secured debentures carry a charge, fixed or floating, on the company's property. In the case of secured debentures, the issuing company mortgages property with the ‘trustees’ through a ‘debenture trust deed’, for, it cannot possibly create a separate charge in favour of thousands of debenture-

holders. Thus, trustees are interposed between the company and the debenture-holders who hold the mortgaged property on trust for the benefit of the debenture-holders. The trust deed contains detailed conditions and stipulations safeguarding the interests of debenture-holders. It usually empowers the trustees to appoint a “receiver”, for enforcing the security in case the company makes a default in payment of the principal or interest.

A trust deed has two main advantages:

(1) It enables the company to give the debenture-holders (through the trustees) a specific legal mortgage on its fixed assets as well as an equitable floating charge on the remaining assets. In the absence of such arrangement a legal interest cannot be vested in thousands of debenture-holders.

(2) It provides a single small body of persons to keep a watch on the debenture-holders' interests and to take action for enforcing the security in case the company makes a default. It is obviously more satisfactory than leaving it to widely dispersed and fluctuating class of debenture-holders.

Section 117A stipulates that debenture trust deed shall be in such form and shall be executed within such period as may be prescribed. It also empowers any member or debenture-holder of the company to inspect the trust deed and obtain copies of the same on payment of the prescribed amount. In fact this provision shall run concurrently with Section 118 as per which the company is required to send a copy of the trust deed to any debenture-holder or member of the company within seven days of the request.

Appointment and Duties of Debenture Trustees: Section 117B states that before a prospectus or letter of offer in respect of an issue of debentures is issued, debenture trustee (s) has to be appointed and the fact of this appointment must be mentioned in the prospectus or the letter of offer, as the case may be. The Section further provides that a person cannot be appointed as a debenture trustee, if he -

(a) beneficially holds shares in the company;

(b) is beneficially entitled to moneys which are to be paid by the company to the debenture trustee;

(c) has entered into any guarantee in respect of principal debts secured by the debentures or interest thereon.

The Section further states that duties and functions of the debenture trustees shall generally be as follows:

(i) to protect the interests of debenture-holders which would include creation of securities within the stipulated time;

(ii) to redress the grievances of debenture-holders effectively;

(iii) to ensure that the assets of the company and each of the guarantors are sufficient to discharge the principal amount of the debentures at all times;

(iv) to ensure that the company does not commit a breach of terms of the Trust Deed, and

(v) to file a petition before the Company Law Board and obtain an appropriate order there from in the interest of the debenture-holders, if he is of the opinion that the assets of the company are insufficient or are likely to become insufficient to discharge the principal amount as and when it becomes due.

There exists a fiduciary relationship between the trustees and the debenture-holders. Therefore trustees must act with reasonable care and diligence in respect of their powers and duties as provided in the trust deed and the Act (discussed above). Any provision in the trust deed exempting them from, or indemnifying them against, liability for breach of trust shall be void (Sec. 119).

Debenture Redemption Reserve: Section 117C provides that in respect of debentures issued after the commencement of the Companies (Amendment) Act, 2000 (*i.e.,* 13th December, 2000), the company shall create a 'Debenture Redemption Reserve' (hereinafter referred to as DRR) for the redemption of such debentures. The company shall have to credit the DRR with adequate amounts

from out of its profits every year until such debentures are redeemed. The DRR shall be utilised by the company only for the purpose of redemption of debentures.

The Section further provides that in case of default, any or all the debenture-holders can make an application to the Company Law Board. The Company Law Board has been empowered to direct, after hearing the parties, by an order, the company to redeem the debentures forthwith. If there is default in compliance with the orders of Company Law Board, every officer of the company who is in default shall be punishable with imprisonment upto three years and shall also be liable to a fine of at least Rs. 500 for every day during which such default continues.

Power to Re-issue Redeemed Debentures (Sec. 121)

When debentures have been redeemed, the company has the right to keep the debentures alive for the purpose of re-issue, provided -

(a) there is no provision to the contrary, express or implied, in the articles or in any contract made by the company or in the conditions of issue ; and

(b) the company has not shown an intention to cancel them either by passing a resolution to that effect or by some other act.

In exercising the above right the company may either re-issue the same debentures or issue others in their place. Upon such re-issue, the persons entitled to debentures will have the same rights and priorities as if the debentures had never been redeemed. To put it differently, the company is not allowed to change the terms and conditions as governing the redeemed debentures while making a re-issue of such debentures. The re-issue will, however, be treated as a new issue for the purposes of stamp duty.

Debentures with 'Pari Passu' Clause

When debentures are issued creating a charge, it should be mentioned on the back of the debentures or in the trust deed that each debenture of the series issued is to rank *'pari passu' (i.e.,* equal as regards charge and repayment) with the others of that series. In the absence of *'pari passu'* clause the legal position will be that the debentures would be payable according to the date of issue, and if all of them were issued on the same date, according to consecutive numbers. Debentures are usually issued with this clause.

Remedies of Debenture-holders

If the company makes a default in payment of the interest or in repayment of the principal sum, the unsecured debenture-holders, like any other unsecured creditor, may sue the company for breach of contract or they may present a petition under Section 439, for the winding up of the company by the Court and may prove in the winding up for the amount due.

The secured debenture-holders, in addition to the above two remedies, possess the following special rights :

(1) They may exercise the powers which are conferred upon them by the terms of issue or the trust deed without applying lo the Court. Usually these include a power to appoint a 'receiver' of the company's profits and rents, to appoint a manager to manage the business and a power to take possession of the mortgaged property and through the trustees enforce its sales and distribute i lie proceeds among themselves.

(2) They may apply to the Court for the appointment of a *'receiver'* or for an order for sale of the property charged or for an order for foreclosure. The order for foreclosure debars the mortgagor of his right to redeem the mortgaged property.

If mortgaged properly is insufficient to meet their claim in full, secured debenture-holders have two alternatives -

(a) they may dispose of the security and prove for the balance before (he Court; or

(b) they may surrender the security and prove for the whole debt.

Alternative remedy has been made available to debenture-holders where instead of applying to the Court, they may approach the Company Law Board. Section 117C, added by the Companies (Amendment) Act 2000 through its sub-section (4) provides that where a company fails lo redeem the debentures on maturity date, any or all the debenture-holders may make a petition lo the Company Law Board. The Company Law Board has been empowered to direct, after hearing the parties, the company to redeem the debentures forthwith. Failure to comply with the orders of Company Law Board shall make every defaulting officer punishable with imprisonment up to three years and with fine of at least Rs. 500 for every day during which such default continues.

12.8 Public Deposits

With a view to controlling and regulating acceptance of deposits by companies other than banking companies and financial companies. Section 58A confers on the Central Government power to frame rules in consultation with the Reserve Bank of India, prescribing the limits up to which, the manner in which and the conditions subject to which, deposits may be invited or accepted by a company either from the public or from its members. It may be noted that pursuant to an amendment to the definition of a 'private company' by the Companies (Amendment) Act, 2000, private companies may accept deposits only from their shareholders directors and relatives of directors, and cannot accept deposits from the public.

Section 58 A(2) lays down that a company could invite or accept or allow any other person to invite or accept on its behalf deposits only in accordance with the Rules to be framed by the Government and by issuing an *advertisement* in the prescribed form, including therein a statement showing the financial position of the company. The Central Government has notified the Rules called "The Companies (Acceptance of Deposits) Rules, 1975. As per Section 58B, all the

provisions of the Act relating to a Prospectus will also, as far as practicable, apply to the said advertisement.

Section 58A(2) has been amended by the Companies (Amendment) Act, 1996 to provide that a company will not be permitted to raise finance through deposits if it has defaulted in the repayment of any deposit or part thereof and any interest thereupon in accordance with the terms and conditions of such deposit. The amendment thus seeks to protect the interests of those persons who would have otherwise deposited their money unaware of the default on the part of the company.

The Section also provides that where any deposit is accepted by a company after the commencement of the Companies (Amendment) Act, 1974, in contravention of the Rules made by the Central Government, the deposit must be refunded within thirty days from the date of acceptance of such deposit or within such further time, not exceeding thirty days, as the Central Government may allow.

It has further been provided that if a company fails to refund any deposit in accordance with the provisions indicated above, the company shall be punishable with a fine which shall not be less than twice the amount of such deposit and every officer of the company who is in default shall also be punishable with imprisonment for a term which may extend to five years and shall also be liable to fine. The depositor shall, however, be paid by the Court trying the offence out of fine, if realised. Penal provisions have also been provided for companies and their defaulting officers in case they accept deposits in contravention of the conditions prescribed under this Section. The Companies (Amendment) Act, 2000 has increased the quantum of fines. Accordingly, where contravention relates to the invitation of any deposit, the company shall be punishable with fine which may extend to Rs. 10 lakhs (as against Rs. 1 lakh earlier) but shall not be less than Rs. 50,000 (as against Rs. 5,000 earlier).

The Section also empowers the Central Government to give *total exemption* to any company or class of companies from the provisions of the Section, or to

grant *partial relaxation* like extension of time in deserving cases for the repayment of deposits, after consulting the Reserve Bank of India.

Section 58A has been amended by the Companies (Amendment) Act, 1988 to provide that in the event of the failure of a company to repay any deposits or part thereof in accordance with the terms and conditions of such deposit, the Company Law Board may either on its own motion or on the application of the depositor, by order direct the company to make repayment of such deposit subject to such conditions as may be prescribed in the order. Whoever fails to comply with any order made by the Company Law Board shall be punishable with imprisonment up to three years and shall also be liable to a fine of at least Rs. 500 for every day during which such non- compliance continues [Sub-sections (9) and (10) added by the Amendment Act, 1988], Accordingly, the Government has now set-up four offices in the four metropolises of New Delhi, Kolkata, Chennai and Mumbai to entertain complaints from aggrieved depositors.

As per Official clarification issued on 8th March, 1990, the aggrieved depositors, whose deposits have matured before or after 1st September, 1989 and who have not been repaid, may make an application (in triplicate) to the Company Law Board Bench (located at New Delhi, Kolkata, Chennai and Mumbai depending upon the registered office of the company) in the prescribed *Form No.* 11, along with an application fee of Rs. 50 by bank draft in favour of the “Pay and Accounts Officer, Department of Company Affairs”. The application may either be filed with the concerned Bench Office personally or sent by post.

The Companies (Amendment) Act, 1999 has provided nomination facility to the depositors by introducing a new sub-section (11) in Section 58A. It provides that a depositor may, at any time, make a nomination and the provisions of Sections 109A and 109B shall, as far as may be, apply to the nomination made under this sub-section. Nomination can be made at any time before the date of maturity of the deposit and this facility is available for deposits made even before the date on which Amendment Act, 1999 came into force, *i.e.,* 31-10-1998.

12.9 Protection of Small Depositors

With a view to protecting the 'interests of small depositors' the Companies (Amendment) Act, 2000 has inserted a new Section 58AA[1]. The term 'small depositor' has been defined to mean a depositor who has deposited in a financial year a sum not exceeding Rs. 20,000/- in a company and includes his successors, nominees and legal representatives.

Section 58AA provides that in addition to the provisions of Section 58A (discussed above), the following provisions shall also apply to deposits made by a 'small depositor':

(1) Every company which accepts deposits from 'small depositors' shall give an intimation *on monthly basis* to the Company Law Board (CLB) of any default made by it in repayment of any such deposits or part thereof or any interest thereupon. Such intimation shall be given within 60 days from the date of default and shall include the particulars in respect of names and addresses of each small depositor, the principal sum of deposit due to them and the interest accrued thereon. The Company Law Board shall, on its own, pass an appropriate order within 30 days from the date of receipt of intimation. It shall not be necessary for a small depositor to be present at the hearing of CLB proceedings.

(2) A company shall not accept further deposits from 'small depositors' unless each small depositor, whose deposit has matured, had been paid the amount of the deposit and the interest accrued thereon.

(3) Where a company has on any occasion defaulted in repayment of deposit or any interest thereon to a small depositor, it shall have to state in every future advertisement and application form for inviting deposits from the public, the complete details of default made including the fact of any waiver of interest accrued on the deposits of small depositors.

(4) Where a company has accepted deposits from small depositors and subsequent to this obtains funds by way of loan for working capital from any

bank, it shall first utilise such funds for the repayment of any deposit or interest thereon to the small depositor before applying such funds for any other purpose.

(5) Any person who knowingly fails to comply with the provisions of this Section or with any order of the Company Law Board shall be punishable with imprisonment upto three years and shall also be liable to fine of at least Rs. 500 for every day during which such non-compliance continues. In case of the defaulter being a company, every person who was a director at the time the contravention was committed as well as the company shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.

Default in acceptance or refund of deposits to be cognizable offence : [Sec. 58AAA inserted by the Companies (Amendment) Act, 2000]. Every offence connected with or arising out of acceptance of deposits under Section 58A or 58AA (discussed, above) shall be a cognizable offence under the Criminal Procedure Code 1973. With a view to avoid any misuse of power, it has further been provided that no court shall take cognizance of the offence except on a complaint made by the Central Government or any officer authorised by it in that behalf. The Central Government has notified [*Vide* the Companies (Acceptance of Deposits) Amendment Rules, 2001], that the Regional Director of the Department of Company Affairs shall be the authorised officer to make complaints relating to offence connected with acceptance of deposits. Cognizable offence is an offence in respect of which a police officer may arrest a person without an arrest warrant from a criminal court. Thus, if a complaint is made by the Regional Director of the Department of Company Affairs in this regard, the Inspector of Police can arrest without a warrant the directors of the company who have committed a default in the repayment of deposits or payment of interest thereon.

The Companies (Acceptance of Deposits) Rules, 1975:

In exercise of the powers vested under Section 58A, the Central Government, in consultation with the Reserve Bank of India, has framed the Companies

(Acceptance of Deposits) Rules, 1975 for governing the invitation and acceptance of deposits by companies from public, shareholders or directors. These Rules have since been amended several times; the latest amendment was made through the Companies (Acceptance of Deposits) Amendment Rules, 2003. These Rules, as amended, apply to all non-banking and non-financial companies both public as well as private.

Certain loans, deposits, etc., excluded: Under these Rules, for calculating whether the deposits exceed the prescribed limits, 'deposit' means any deposit of money with, and including any money borrowed by, a company, but the following types of loans, advances and deposits have, been excluded from the definition of 'deposits':

(i) Any loan received from or guaranteed by the Central or State Government and any amount received from a local authority or a foreign Government or foreign citizen or authority, or foreign person.

(ii) Any amount received as a loan from any banking company or the State Bank or its subsidiary banks or a nationalised bank or a cooperative bank.

(iii) Loans from financial institutions.

(iv) Any amount received by a company from any other company.

(v) Any amount received from an employee by way of security deposit.

*(vi)*Advances or security deposit from any purchasing agent, selling agent or other agent.

(vii) Amounts received by way of subscription for shares, bonds or debentures pending their allotment.

(viii) Any amount received in trust or any amount in transit.

(ix) Any amount received by a private company from its directors, relatives of its directors or members.

(x) Amounts raised by the issue of bonds and debentures secured by the mortgage of immovable property provided the amount of such bonds or debentures does not exceed the market value of the immovable property; and

amounts raised by the issue of unsecured bonds and debentures with an option to convert them into shares of the company.

(xi) Any amount brought in by the promoters by way of unsecured loans in pursuance of stipulations of financial institutions subject to the fulfilment of the following conditions, namely:

(a) the loans are brought in pursuance of the stipulation imposed by the financial institutions in fulfillment of the obligation of the promoters to contribute such finance;

(b) the loans are provided by the promoters themselves and/or by their relatives, and not from their friends and business associates; and

(c) the exemption under this sub-clause shall be available only till the loans of financial institutions are repaid and not thereafter.

(xii) Any amount received as loan from the National Dairy Development Board by the companies owned by it directly or through its subsidiary companies.

Restriction on public deposits: The Companies (Acceptance of deposits) Third Amendment Rules, 2001 have imposed an important restriction upon the companies intending to invite public deposits. The amending Rules, *inter-alia,* provide that on and from 28th November, 2001 (the date from which these Rules came into force), no company with a “net owned fund” of less than rupees one crore shall invite public deposits. It has been further provided that the phrase “net owned fund” has the same meaning as assigned to it in the Reserve Bank of India Act, 1934.

Limits of deposits: Under the Companies (Acceptance of Deposits) Rules, 1975, as amended from time to time, the limit upto which deposits can be accepted by non-banking and non-financial companies are:

(i) 25% of the aggregate of the paid up capital and free reserves from the public.

(ii) 10% of the aggregate of the paid up capital and free reserves as deposits against unsecured debentures, or any deposits from its shareholders (in case of a public company) or any deposits guaranteed by any director.

These two separate limits have been merged for the Government companies and such companies can accept deposits from the public upto 35% of the aggregate of the paid-up capital and free reserves.

For arriving at the aggregate of the paid up capital and free reserves for the purpose of computing the amount which can be accepted by a company as deposit under the above categories, the amount of the accumulated balance of loss, balance of deferred revenue expenditure and other intangible assets should, as disclosed in the latest audited balance sheet, be deducted from the aggregate of the paid up capital and free reserves. Further, for this purpose 'free reserves' will include the balance of share premium account, capital and debenture redemption reserve and any other reserves shown or published in the balance sheet and created out of the profits of the company, but does not include any reserve created for repayment of any future liability or for depreciation in assets or for bad debts, or created by revaluation of assets.

Thus under the Deposit Rules, any company can accept deposits under different categories up to a maximum of 35 percent of the aggregate of paid up share capital plus free reserves as reduced by the value of intangible assets, deferred revenue expenditure and accumulated losses. It has been further provided that after the commencement of these Rules no company can accept or renew deposits repayable on demand or on notice. The minimum period for which deposits could be accepted is normally six months but for meeting short-term requirements deposits repayable not earlier than three months from the date of such deposit or renewal may also be accepted in accordance with the limits stated above. The maximum period for which deposits can be accepted or renewed has been fixed at thirty-six months and the maximum rate of interest payable on any deposits has been fixed at 11% per annum. Once a deposit is taken for a specified period, it cannot be repaid before the expiry of the period of six months. After the said six months, it can be repaid earlier at the discretion of the company, but the rate of interest payable by the company must be reduced

by one per cent from the rate which the company would have paid had the deposit been accepted for the period which it had run.

The Companies (Acceptance of Deposits) Amendment Rules, 1997 provide that on and from 1st March, 1997. no company shall accept or renew any deposits in any form if it is in default in the repayment of any deposit or part thereof and any interest thereupon in accordance with the terms and conditions of such deposits.

Penal rate of interest: The Companies (Acceptance of Deposits) Third Amendment Rules, 2001, which have been made effective from 28th November, 2001, *inter-alia,* provide that a penal rate of interest of 18% shall be paid for the overdue period in case of public deposits matured and claimed but remaining unpaid. In case of deposits made by a small depositor, the penal rate of interest shall be 20% compoundable on an annual basis. The expression “a small depositor” means a depositor who has deposited in a financial year upto Rs. 20,000.

Maintenance of liquid assets: Under the Deposit Rules, every such company will also be under an obligation to maintain liquid assets, before 30 April, each year, to the tune of at least fifteen per cent of the deposits which mature for repayment within a year (between 1 April and 31 March next) in the form of current or other deposit account with any scheduled bank free from any charge or lien or investment in any unencumbered securities of Central or State Government or any Trust securities. Further, the amount deposited or invested, as the case may be, must not be utilised for any purpose other than for the repayment of deposits maturing during the year, provided that the amount remaining deposited or invested must not at any time fall below ten per cent of the amount of deposits maturing until the 31st day of March of that year.

Procedure for accepting deposits: A meeting of the Board of Directors of the company should be convened to pass a resolution for accepting deposits and decide the terms and conditions on which deposits are to be accepted. After the Board decides to invite and accept deposits from the public an *advertisement* in

at least one leading English newspaper and one vernacular newspaper circulating in the State in which the registered office of the company is situated must be issued. A copy of the advertisement should be registered with the Registrar of Companies on or before the date of its publication in the newspapers. The advertisement should be in the Form prescribed under Rule 4(2) of these Rules. Such advertisement must be issued on the authority, and in the name of the Board of Directors of the company, and must contain the conditions on which the deposits are accepted by the company, and also mention the date on which the directors have approved the text of the advertisement. The advertisement must contain, *inter alia,* information relating to the business of the company, its management, profits, dividends paid in the past three years, financial position of the company as in the two audited balance sheets immediately preceding the date of advertisement. The advertisement must also contain a statement that the company is not in default in the repayment of any deposit or part thereof and any interest thereupon in accordance with the terms and conditions of such deposits. The advertisement has to be signed by a majority of the directors. The advertisement, once issued, is valid until the expiry of six months from the date of closure of the financial year in which it is issued or until the date on which the Balance Sheet is laid before the company in the Annual General Meeting or when the Annual General Meeting of any year has not been held, the latest day on which that meeting should have been held, whichever is earlier. After the expiry of this period, the companies have to issue a fresh advertisement for inviting further deposits. Where a company intends to accept deposits without issuing an advertisement for the same, it will have to file a *'statement in lieu of advertisement'* with the Registrar before accepting any deposits. This document contains information similar to an 'advertisement inviting deposits' and is required to be delivered afresh likewise to the Registrar.

Notice/advertisement notifying merely alterations in the terms and conditions of deposits including change in the rates of interest from a particular date is an amendment to the statutory advertisement issued earlier and does not require to be in the form prescribed in Rule 4(2). While making announcement about

alteration in the terms and conditions including the change in rates of interest on deposits, if the company, *inter alia,* invites deposits by indicating, for example, that deposits were continued to be accepted, that the higher rates would be applicable in case the existing deposits were renewed or in case fresh deposits were made, the necessary application forms for accepting deposits were available with the company and/or its agents and so on, such announcement tantamount to invitation of deposits and require advertisement in the form prescribed in Rule 4(2), failing which the advertisement is construed to be not in conformity with the provisions of Section 58A(2) and penal provisions of Section 58A(6) read with Section 58B become attracted.

The companies should supply to the intending depositors the *Application Forms* accompanied by a statement containing the same particulars as prescribed for the advertisement referred to above. In the application form the depositor *inter alia* should make a declaration that he has not borrowed, or accepted deposits from any other person for making the deposit in question. On the acceptance or renewal of the deposit the companies should issue within a period of eight weeks from the date of realisation of cheques an *official receipt* to each depositor containing name and address of the depositor, the date and amount of deposit received, the rate of interest payable and the date on which deposit is repayable. The Deposit Rules also state that the company cannot reserve to itself either directly or indirectly a right to-alter, to the prejudice or disadvantage of the depositor, the terms and conditions of the deposit after it is accepted.

Further, the companies accepting deposits are required to keep at their registered office Register(s) of deposits showing details of the deposits and file an Annual Return with the Registrar of Companies in the prescribed form duly certified by the auditors on or before 30 June every year. The Return shou Id contain the information of the deposits as on 31 March of that year. A copy of the Return is also to be sent to the Reserve Bank of India, Department of Non-Banking Companies, Bombay,

Penalty: If a company or any other person contravenes any provision of these Rules for which no punishment is provided in the Companies Act, 1956, as amended, the company and every officer of the company who is in default or such other person shall be punishable with fine which may extend to Rs. 500 and Rs. 50 per day for continuing default.

Deposit Rules exemption to small units: In exercise of the powers conferred by sub-section (7) (a) of Section 58A of the Companies Act, 1956, the Central Government in consultation with the Reserve Bank of India has notified that the provision of Section 58A and the Companies (Acceptance of Deposits) Rules (discussed above) shall not apply to following companies:

Companies which are Small Scale Industrial Units and fulfil the following conditions, namely:

(a) paid-up capital of the company does not exceed Rs. 25 lakh; *(b)* the company accepts deposits from not more than 100 person^; *(c)* there is no invitation to public for deposits; and *(d)* the amount of deposits accepted by the company does not exceed Rs. 20 lakhs or the amount of its paid-up capital, whichever is less.

12.10 Investments

For the purposes of Companies Act the term 'investment' has been used in a restricted sense to mean the investing of money in shares, stock, debentures or other securities rather than including any property or right in which capital is invested.

According to section 49(1) of the Companies Act, investments made by a company (other than an investment company) on its own behalf shall be made and held by it in its own name. If the company makes investment on behalf of someone else, such investments need not be held in its own name. Also companies have now been allowed to hold investments in the name of a

depository when such investments are in the form of securities held by the company as a beneficial owner (vide Depositories Act 1996).

12.11 Inter Corporate Loans

Section 372A, inserted by the Companies (Amendment) Act, 1999, contains the consolidated provisions with respect to inter corporate loans. It provides as:

i. Restriction on loans and investments etc.: No company shall, directly or indirectly,
   - Make any loan to any loan to any other body corporate,
   - Acquire, by way of subscription, purchase or otherwise the securities of any other body corporate,

Exceeding 60% of its paid up share capital and free reserves , or 100% of its free reserves, whichever is more.

ii. Rate of interest: No loan to any body corporate shall be made at the rate of interest lower than the prevailing ‘bank rate’ i.e. at the rate at which the RBI lends to the Commercial banks.
iii. Unanimous resolution of the board and approval of the public financial institutions: No loan or investment shall be made unless the resolution sanctioning it is passed at the meeting of the Board with the consent of all the directors present at the meeting and where any term loan is subsisting, the prior approval of the public financial institution is obtained. Though, no approval of the public financial institution shall be obtained when loan etc. is within the alternative limit of 60% of the paid up capital or free reserves.
iv. Register of Investments and Loans: every company shall keep a register showing the particular in respect of every investment or loan made by it in relation to any body corporate as to the name of the body corporate, the amount, term and purpose of the loan and the date on which the loan has been made.

v. Defaults in repayment of Deposits etc.: No company which has defaulted in complying with the provisions of section 58A shall, directly or indirectly, make any loan as above if the default is subsisting.

vi. Exemptions: Nothing contained in section 372A shall apply to any loan made by-

a. a banking company, or an insurance company, or a housing finance company, or a company established with the objective of financing industrial enterprises, or of providing infrastructural facilities;
b. accompany whose principal business is the acquisition of shares, stock, debentures or other securiries;
c. a private company, unless it is a subsidiary of a public company;
d. the company allotting shares pursuant to section 81(1)(a) i.e. rights issues;
e. to any loan made by a holding company to its wholly owned subsidiary;

vii. Penalty: If default is made in complying with these provisions, the company and every officer of the company, who is in default, shall be punishable with imprisonment which may extend to two years or with fine which may extend to fifty thousand rupees.

12.12 Summary

A trading or commercial company has an implied power to borrow money to any extent for the purposes of its business and to charge its assets by way of security for the amount borrowed. Non-trading companies formed to promote commerce, art, science, religion, etc., which do not propose to pay dividends are not entitled to borrow money unless expressly authorised to borrow by their memorandum and articles of association. The security given to debenture-holders may create either a fixed or specific charge or a floating charge. A fixed mortgage or charge is one which is created on some definite or specific property of a permanent

nature, e.g., building or heavy machinery and prevents the company from selling the property so mortgaged free from the burden of the mortgage debt. Such a mortgage may be either legal or equitable. A floating charge is an equitable charge on the assets for the time being of a going concern. It is a charge on the assets of the company in general. It covers all the assets whether subject to a fixed charge or not and keeps on floating with the property which it is intended to cover. A floating charge crystallizes and becomes fixed in the following circumstances: (i) when the company goes into liquidation, or (ii) when the company ceases to carry on business, or (iii) when the debenture-holders, having become entitled to realise their security, intervene for the purpose, e.g., by appointing a 'receiver'. Certain charges are required to be registered with the Registrar of the Companies.

The term 'debenture' is restricted to loans of some permanence generally secured by a mortgage on the property of the company. A debenture is a certificate of loan issued by a company and it has nothing to do with security or lack of it. Debenture may be classified as secured debentures or unsecured or naked debentures, registered debentures, bearer debentures, redeemable or irredeemable debentures, convertible or non-convertible debentures. In the case of secured debentures, the issuing company mortgages property with the 'trustees' through a 'debenture trust deed', for, it cannot possibly create a separate charge in favour of thousands of debenture-holders.

With a view to controlling and regulating acceptance of deposits by companies other than banking companies and financial companies. Section 58A confers on the Central Government power to frame rules in consultation with the Reserve Bank of India, prescribing the limits up to which, the manner in which and the conditions subject to which, deposits may be invited or accepted by a company either from the public or from its members. The Central Government has notified the Rules called "The Companies (Acceptance of Deposits) Rules, 1975.

For the purposes of Companies Act the term 'investment' has been used in a restricted sense to mean the investing of money in shares, stock, debentures or other securities rather than including any property or right in which capital is invested.

Section 372A, inserted by the Companies (Amendment) Act, 1999, contains the consolidated provisions with respect to inter corporate loans.

12.13 Check Your Progress

1. What do you understand by the term 'charge'? Distinguish between a 'fixed charge' and a 'floating charge'.

2. What do you understand by redemption of debenture?

3. Discuss the provisions of the Companies Act, 1956 regarding inter-corporate loans.

LL.M. Part-1

PAPER CORPORATE LAW

Block III– CORPORATE FINANCE

Unit 13- Corporate Fund Raising

STRUCTUR

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13.11 Check Your Progress

13.0 INTRODUCTION

Ascertainment of the cost of project and means of finance is one of the most important considerations for an entrepreneur-company in implementing a new project or undertaking expansion, diversification, and modernization and rehabilitation scheme. There are several sources of finance/funds available to any company. An effective appraisal mechanism of various sources of funds available to a company must be instituted in the company to achieve its main objectives. Such a mechanism is required to evaluate risk, tenure and cost of each and every source of fund. The selection of the fund source is dependent on the financial strategy pursued by the company; the leverage planned by the company, the financial conditions prevalent in the economy and the risk profile of both the company as well as -the industry in which the company operates. Each and every source of fund has some advantages as well as disadvantages.

13.1 Objectives

- After studying this chapter, you will be able to understand the different sources of finance available to a business;
- Differentiate between the various long term and short term sources of finance;
- Understand the concept of Venture Capital financing;
- Understand the meaning and purpose of securitization and debt securitization;
- Understand the concept of lease financing;
- Understand the various financial instruments dealt with in the International market.

13.2. Financial Needs and Sources OF Finance of a Business

Business organisations need funds to meet their different types of requirements. All the financial needs of a business may be grouped into the following three categories:

(i) ***Long term financial needs:*** Such needs generally refer to those requirements of funds which are for a period exceeding 5-10 years. All investments in plant, machinery, land, buildings, etc., are considered as long term financial needs. Funds required to finance permanent or fixed working capital should also be procured from long term sources.

(ii) ***Medium term financial needs:*** Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years e.g. if a company resorts to extensive publicity and advertisement campaign then such type of expenses may be written off over a period of 3 to 5 years. These are called deferred revenue expenses and funds required for them are classified in the category of medium term financial needs. Sometimes long term requirements, for which long term funds cannot be arranged immediately may be met from medium term sources and thus the demand of medium term financial needs, are generated. As and when the desired long term funds are made available, medium term loans taken earlier may be paid off.

(iii) ***Short term financial needs:*** Such type of financial needs arise to finance in current assets such as stock, debtors, cash, etc. Investment in these assets is known as meeting of working capital requirements of the concern. Firms require working capital to employ fixed assets gainfully. The requirement of working capital depends upon a number of factors which may differ from industry to industry and from company to company in the same industry. The main characteristic of short term financial needs is that they arise for a short period of time not exceeding the accounting period, i.e., one year.

The basic principle for meeting the short term financial needs of a concern is that such needs should be met from short term sources, and for medium term financial needs from medium term sources and long term financial needs from long term sources. Accordingly, the method of raising funds is to be decided with reference to the period for which funds are required.

Basically, there are two sources of raising funds for any business enterprise viz. owner's capital and borrowed capital. The owner's capital is used for meeting long term financial needs and it primarily comes from share capital and retained earnings. Borrowed capital for all the other types of requirement can be raised from different sources such as debentures, public deposits, loans from financial institutions and commercial banks, etc.

Sources of Finance of a Business

(i) ***Long-term sources***

1. Share capital or Equity share
2. Preference shares
3. Debentures/Bonds of different types
4. Retained earnings
5. Loans from commercial banks
6. Loans from financial institutions
7. Venture capital funding
8. Asset securitization
9. International financing like Euro-issues, foreign currency loans

(ii) ***Medium-term sources***

1. Preference shares
2. Debentures/Bonds
3. Public deposits/fixed deposits for duration of three years
4. Commercial banks
5. Financial institutions

6. State financial corporations

7. Lease financing/Hire-Purchase financing

8. External commercial borrowings

9. Euro-issues

10. Foreign Currency bonds

(iii) Short-term sources

1. Commercial Papers

2. Trade credit

3. Advances received from customers

4. Accrued expenses and deferred income

5. Bank Advances

6. Inter Corporate Loans

8. Fixed deposits for a period of 1 year or less

It is amply clear that funds can be raised from the same source for meeting different types of financial requiremen

13.3 LONG TERM SOURCES OF FINANCE

There are different sources of funds available to meet long term financial needs of the business. These sources may be broadly classified into share capital (both equity and preference) and debt (including debentures, long term borrowings or other debt instruments).

In recent times in India, many companies have raised long term finance by offering various instruments to public like deep discount bonds, fully convertible

debentures etc. These new instruments have characteristics of both equity and debt and it is difficult to categorised these either as debt or equity.

The different sources of long term finance can now be discussed:

13.3.1 Equity Capital :

A public limited company may raise funds from promoters or from the investing public by way of owners capital or equity capital by issuing ordinary equity shares. Ordinary equity shares are a source of permanent capital. Ordinary shareholders are owners of the company and they undertake the risks of-business. They are entitled to dividends after the income claims of other stakeholders are satisfied. Similarly, in the event of winding up, ordinary shareholders can exercise their claim on assets after the claims of the other suppliers of capital have been met. They elect the directors to run the company and have the optimum control over the management of the company. Since equity shares can be paid off only in the event of liquidation,, this source has the least risk involved. This is more so due to the fact that equity shareholders can be paid dividends only when there are distributable profits. However, the cost of ordinary shares is usually the highest. This is due to the fact that such shareholders expect a higher rate of return on their investment as compared to other suppliers of long-term funds. Such behaviour is directly related to the risk undertaken by ordinary shareholders when compared to the providers of other forms of capital e.g. debt. Whereas, an ordinary shareholder shall take responsibility of losses incurred by the company by foregoing dividend or accepting a lesser amount, a debt holder shall be statutorily entitled to get regular payments as per the contract. Hence, when compared to those who have provided loan capital to the company, ordinary shareholders carry a higher amount of risk and so expect a higher return. Further, the dividend payable on shares is an appropriation of profits and not a charge against profits. This means that unlike debt, ordinary equity shares do not provide any tax shield to the company, thereby resulting in a higher cost.

Ordinary share capital also provides a security to other suppliers of funds. Thus, a company having substantial ordinary share capital may find it easier to raise further funds, in view of-the fact that share capital provides a security to other suppliers of funds.

The Companies Act, 1956 and SEBI Guidelines for disclosure and investors' protections and the clarifications thereto lay down a number of provisions regarding the issue and management of equity shares capital.

Advantages and disadvantages of raising funds by issue of equity shares are:

(i) It is a permanent source of finance. Since such shares are not redeemable, the company has no liability for cash outflows associated with its redemption.

(ii) Equity capital increases the company's financial base and thus helps further the borrowing powers of the company.

(iii) The company is not obliged legally to pay dividends. Hence in times of uncertainties or when the company is not performing well, dividend payments can be reduced or even suspended.

(iv) The company can make further issue of share capital by making a right issue.

Apart from the above mentioned advantages, equity capital has some disadvantages to the company when compared with other sources of finance. These are as follows:

(i) The cost of ordinary shares is higher because dividends are not tax deductible and also the floatation costs of such issues are higher.
(ii) Investors find ordinary shares riskier because of uncertain dividend payments and capital gains.
(iii) The issue of new equity shares reduces the earning per share of the existing shareholders until and unless the profits are proportionately increased.

(iv) The issue of new equity shares can also reduce the ownership and control of the existing shareholders.

13.3.2 Preference Share Capital

These are a special kind of shares; the holders of such shares enjoy priority, both as regards to the payment of a fixed amount of dividend and repayment of capital on winding up of the company.

Long-term funds from preference shares can be raised through a public issue of shares. Such shares are normally cumulative, *i.e.,* the dividend payable in a year of loss gets carried over-to the next year till there are adequate profits to pay the cumulative dividends. The rate of dividend on preference shares is normally higher than the rate of interest on debentures, loans etc. Most of preference shares these days carry a stipulation of period and the funds have to be repaid at the end of a stipulated period.

Preference share capital is a hybrid form of financing which imbibes within itself some characteristics of equity capital and some attributes of debt capital. It is similar to equity because preference dividend, like equity dividend is not a tax deductible payment. It resembles debt capital because the rate of preference dividend is fixed. Typically, when preference dividend is skipped it is payable in future because of the cumulative feature associated with most of **preference shares.**

Cumulative Convertible Preference Shares (CCPs) may also be offered, under which the shares would carry a cumulative dividend of specified limit for a period of say three years after which the shares are converted into equity shares. These shares are attractive for projects with a long gestation period.

Preference share capital may be redeemed at a pre decided future date or at an earlier stage inter alia out of the profits of the company. This enables the promoters to withdraw their capital from the company which is now self-sufficient, and the withdrawn capital may be reinvested in other profitable ventures. It may

be mentioned that irredeemable preference shares cannot be issued by any company.

Preference shares have gained importance after the Finance bill 1997 as dividends became tax exempted in the hands of the individual investor and are taxable in the hands of the company as tax is imposed on distributed profits at a flat rate. At present, a domestic company paying dividend will have to pay dividend distribution tax @ 12.5% plus surcharge of 10% plus an education cess equal to 2% (total 11.025%).

Advantages and disadvantages of raising funds by issue of preference shares are:

(i) No dilution in EPS on enlarged capital base - if equity is issued it reduces EPS, thus affecting the market perception about the company.

(ii) There is leveraging advantage as it bears a fixed charge. Non-payment of preference dividends does not force company into liquidity.

(iii) There is no risk of takeover as the preference shareholders do not have voting rights except in case where dividend-arrears exist.

(iv) The preference dividends are fixed and pre decided. Hence Preference shareholders do not participate in surplus profits as the ordinary shareholders.

(v) Preference capital can be redeemed after a specified period.

The following are the disadvantages of the preference shares:

(i) One of the major disadvantages of preference shares is that preference dividend is not tax deductible and so does not provide a tax shield to the company. Hence a preference share is costlier to the company than debt e.g. debenture.

(ii) Preference dividends are cumulative in nature. This means that although these dividends may be omitted, they shall need to be paid later. Also, if these dividends are not paid, no dividend can be paid to ordinary

shareholders. The non-payment of dividend to ordinary shareholders could seriously impair the reputation of the company concerned.

13.3.3 Debentures or Bonds

Loans can be raised from public by issuing debentures or bonds by public limited companies. Debentures are normally issued in different denominations ranging from Rs. 100 to Rs. 1,000 and carry different rates of interest. By issuing debentures, a company can raise long term loans from public. Normally, debentures are issued on the basis of a debenture trust deed which lists the terms and conditions on which the debentures are floated. Debentures are either secured or unsecured.

As compared with preference shares, debentures provide a more convenient mode of long-term funds. The cost of capital raised through debentures is quite low since the interest payable on debentures can be charged as an expense before tax. From the investors[1] point of view, debentures offer a more attractive prospect than the preference shares since interest on debentures is payable whether or not the company makes profits.

Debentures are thus instruments for raising long-term debt capital. Secured debentures are protected by a charge on the assets of the company. While the secured debentures of a well-established company may be attractive to investors, secured debentures of a new company do not normally evoke same interest in the investing public.

Debentures can be straight debentures or convertible debentures. A convertible debenture is the type which can be converted, either fully or partly, into shares after a specified period of time. Debentures can be divided into the following three categories:

(i) *Non convertible debentures* - These types of debentures do not have any feature of conversion and are repayable on maturity.

(ii) *Fully convertible debentures* - Such debentures are converted into equity shares as per the terms of issue in relation to price and the time of conversion. Interest rates on such debentures are generally less than the non convertible debentures because of their carrying the attractive feature of getting themselves converted into shares.

(iii) *Partly convertible debentures* - Those debentures which carry features of a convertible and a non convertible debenture belong to this category. The investor has the advantage of having both the features in one debenture.

Advantages of raising finance by issue of debentures are:

(i) The cost of debentures is much lower than the cost of preference or equity capital as the interest is tax-deductible. Also, investors consider debenture investment safer than equity or preferred investment and, hence, may require a lower return on debenture investment.

(ii) Debenture financing does not result in dilution of control.

(iii) In a period of rising prices, debenture issue is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.

The disadvantages of debenture financing are:

(i) Debenture interest and capital repayment are obligatory payments.

(ii) The protective covenants associated with a debenture issue may be restrictive.

(iii) Debenture financing enhances the financial risk associated with the firm.

(iv) Since debentures need to be paid during maturity, a large amount of cash outflow is needed at that time.

These days many companies are issuing convertible debentures or bonds with a number of schemes/incentives like warrants/options etc. These bonds or debentures are exchangeable at the option of the holder for ordinary shares under specified terms and conditions. Thus for the first few years these securities remain as debentures and later they can be converted into equity shares at a

pre-determined conversion price. The issue of convertible debentures has distinct advantages from the point of view of the issuing company. Firstly, such an-issue enables the management to raise equity capital indirectly without-diluting the equity holding, until the capital raised has started earning an added return to support the additional shares. Secondly, such securities can be issued even when the equity market is not very good. Thirdly, convertible bonds are normally unsecured and, therefore, their issuance may ordinarily not impair the borrowing capacity. These debentures/bonds are issued subject to the SEBI guidelines notified from time to time.

Public issue of debentures and private placement to mutual funds now require that the issue be rated by a credit rating agency like CRISIL (Credit Rating and information Services of India Ltd.). The credit rating is given after evaluating factors like track record of the company, profitability, debt servicing capacity, credit worthiness and the perceived risk of lending.

13.3.4 Retained Earnings

Long-term funds may also be provided by accumulating the profits of the company and by ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company. A public limited company, must plough back a reasonable amount of profit every year keeping in view the legal requirements in this regard and its own expansion plans. Such funds also entail almost no risk. Further, control of present owners is also not diluted by retaining profits.

13.3.5 Loans from Commercial Banks

The primary role of the commercial banks is to cater to the short term requirements of industry. Of late, however, banks have started taking an interest in term financing of industries in several ways, though the formal term lending is, so far, small and is confined to major banks only.

Term lending by banks has become a controversial issue these days. It has been argued that term loans do not satisfy the canon of liquidity which is a major consideration in all bank operations. According to the traditional values, banks should provide loans only for short periods and for operations which result in the automatic liquidation of such credits over short periods. On the other hand, it is contended that the traditional concept of liquidity requires to be modified. The proceeds of the term loan are generally used for what are broadly known as fixed assets or for expansion in plant capacity. Their repayment is usually scheduled over a long period of time. The liquidity of such loans is said to depend on the anticipated income of the borrowers.

As a matter of fact, a working capital loan is more permanent and long term than a term loan. The reason for making this statement is that a term loan is always repayable on a fixed date and ultimately, a day will come when the account will be totally adjusted. However, in the case of working capital finance, though it is payable on demand, yet in actual practice it is noticed that the account is never adjusted as such; and, if at all the payment is asked back, it is with a clear purpose and intention of refinance being provided at the beginning of the next year or half year.

This technique of providing long term finance can be technically called as “rolled over for periods exceeding more than one year”. Therefore, instead of indulging in term financing by the rolled over method, banks can and should extend credit term after a proper appraisal of applications for terms loans. In fact, as stated above, the degree of liquidity in the provision for regular amortization of term loans is more, than in some of these so called demand loans which are renewed from year to year. Actually, term financing disciplines both the banker and the borrower as long term planning is required to ensure that cash inflows would be adequate to meet the instruments of repayments and allow an active turnover of bank loans. The adoption of the formal term loan lending by commercial banks will not in any way hamper the criteria of liquidity and as a matter of fact, it will introduce flexibility in the operations of tile banking system.

The real limitation to the scope of bank activities in this field is that all banks are not well equipped to make appraisal of such loan proposals. Term loan proposals involve an element of risk because of changes in the conditions affecting the borrower. The bank making such a loan, therefore, has to assess the situation to make a proper appraisal. The decision in such cases would depend on various-factors affecting the conditions of the industry concerned and the earning potential of the borrower.

Bridge Finance: Bridge finance refers to loans taken by a company normally from commercial banks for a short period, pending disbursement of loans sanctioned by financial institutions. Normally, it takes time for financial institutions to disburse loans to companies. However, once the loans are approved by the term lending institutions, companies, in order not to lose further time in starting their projects, arrange short term loans from commercial banks. Bridge loans are also provided by financial institutions pending the signing of regular term loan agreement, which may be delayed due to non-compliance of conditions stipulated by the institutions while sanctioning the loan. The bridge loans are repaid/ adjusted out of the term loans as and when disbursed by the concerned institutions. Bridge loans are normally secured by hypothecating movable assets, personal guarantees and demand promissory notes. Generally, the rate of interest on bridge finance is higher as com- pared with that on term loans.

13.3.6 Loans from Financial Institutions

In India specialized institutions provide long-term financial assistance to industry. Thus, the industrial Finance Corporation of India, the State Financial Corporations, the Life Insurance Corporation of India, the National Small Industries Corporation Limited, the Industrial Credit and Investment Corporation, the Industrial Development Bank of India, and the Industrial Reconstruction Corporation of India provide term loans to companies. Before a term loan is sanctioned, a company has to satisfy the concerned financial institution regarding the technical, commercial, economic, financial and managerial viability of the

project for which the loan is required. Such loans are available at different rates of interest under different schemes of financial institutions and are to be repaid according to a stipulated repayment schedule. The loans in many cases stipulate a number of conditions regarding the management and certain other financial policies of the company.

Term loans represent secured borrowings and at present it is the most important source of finance for new projects. They generally carry a rate of interest inclusive of interest tax, depending on the credit rating of the borrower, the perceived risk of lending and the cost of funds. These loans are generally repayable over a period of 6 to 10 years in annual, semiannual or quarterly installments.

Term loans are also provided by banks, State financial/development institutions and all- India term lending financial institutions. Banks and State Financial Corporations normally provide term loans to projects in the small scale sector while for the medium and large industries term loans are provided by State developmental institutions alone or in consortium with banks and State financial corporations. For large scale projects All India financial institutions provide the bulk of term finance either singly or in consortium with other A1I India financial institutions, State level institutions and/or banks.

After Independence, the institutional set up in India for the provision of medium and long term credit for industry has been broadened. The assistance sanctioned and disbursed by these specialized institutions has increased impressively during the years. A number of such specialized institutions have been established all over the-country.

13.4 SHORT TERM SOURCES OF FINANCE

There are various sources available to meet short term needs of finance. The different sources are discussed below:

13.4.1 Commercial Paper

A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate-borrowers to diversify their sources of short term borrowings and to provide an additional instrument to investors. Subsequently, in addition to the Corporate, Primary Dealers and All India Financial Institutions have also been allowed to issue Commercial Papers. Commercial Papers can be issued for maturities between 15 days and a maximum up to one year from the date of issue. These can be issued in denominations of Rs 5 lakhs or multiples thereof. All eligible issuers are required to get the credit rating from Credit Rating Information Services of India Ltd, (CRISIL), or the Investment Information and Credit Rating Agency of India Ltd (ICRA) or the Credit Analysis and Research Ltd (CARE) or the FITCH Ratings India Pvt Ltd or any such other credit rating agency as is specified by the Reserve Bank of India. Individuals, banking companies, corporate bodies incorporated in India, Non Resident Indians, and Foreign Institutional Investors etc. are allowed to invest in Commercial Paper, the minimum amount of such investment being Rs 5 lakhs.

13.4.2 Trade Credit

It represents credit granted by suppliers of goods, etc., as an incident of sale. The usual duration of such credit is 15 to 90 days. It generates automatically in the course of business and is common to almost all business operations. It can be in the form of an 'open account' or 'bills payable'. Trade credit is preferred as a source of finance because it is without any explicit cost and till a business is a going concern it keeps on rotating. Another very important characteristic of trade credit is that it enhances automatically with the increase in the volume of business.

13.4.3 Advances from Customers

Manufacturers and contractors engaged in producing or constructing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. This is a cost free source of finance and really useful.

13.4.4 Accrued Expenses and Deferred Income

Accrued expenses represent liabilities which a company has to pay for the services which it has already received. Such expenses arise out of the day to day activities of the company and hence represent a spontaneous source of finance.

Deferred income, on the other hand, reflects the amount of funds received by a company in lieu of goods and services to be provided in the future. Since these receipts increase a company's liquidity, they are also considered to be an important source of spontaneous finance.

13.4.5 Bank Advances

Banks receive deposits from public for different periods at varying rates of interest. These funds are invested and lent in such a manner that when required, they may be called back. Lending results in gross revenues out of which costs, such as interest on deposits, administrative costs, etc., are met and a reasonable profit is made. A bank's lending policy is not merely profit motivated but has to also keep in mind the socio- economic development of the country.

Bank advances are in the form of loan, overdraft, cash credit and bills purchased/discounted etc. Banks do not sanction advances on a long term basis beyond a small proportion of their demand and time liabilities. Advances are granted against tangible securities such as goods, shares, government promissory notes, Bills etc. In very rare cases, clean advances may also be allowed.

(i) Loans: In a loan account, the entire advance is disbursed at one time either in cash or by transfer to the current account of the borrower. It is a single advance. Except by way of interest and other charges no further adjustments are made in this account. Loan accounts are not running accounts like overdraft and cash credit accounts, repayment under the loan account may be the full amounts or by way of schedule of repayments agreed upon as in case of term loans. The securities may be shares, government securities, life insurance policies and fixed deposit receipts, etc.

(ii) Overdraft: Under this facility, customers are allowed to withdraw in excess of credit balance standing in their Current Deposit Account. A fixed limit is therefore granted to the borrower within which the borrower is allowed to overdraw his account. Opening -of an overdraft account requires that a current account will have to be formally opened. Though overdrafts are repayable on demand, they generally continue for long periods by annual renewals of the limits. This is a convenient arrangement for the borrower as he is in a position to avail of the limit sanctioned, according to his requirements. Interest is charged on-daily balances. Since these accounts are operative like cash credit and current accounts, cheque books are provided. As in the case of a loan account the security in an overdraft account may be shares, debentures and Government securities. In special cases, life insurance policies and fixed deposit receipts are also accepted.

(iii) Clean Overdrafts: Request for clean advances are entertained only from parties which are financially sound and reputed for their integrity. The bank has to rely upon the personal security of the borrowers. Therefore, while entertaining proposals for clean advances; banks exercise a good deal of restraint since they have no backing of any tangible security. If the parties are already enjoying secured advance facilities, this may be a point in favour and may be taken into account while screening such proposals. The turnover in the account, satisfactory dealings for considerable period and reputation in the market are some of the factors which the bank will normally see. As a safeguard, banks take guarantees from other persons who are credit worthy before granting this facility.

A clean advance is generally granted for a short period and must not be continued for long.

(iv) Cash Credits: Cash Credit is an arrangement under which a customer is allowed an advance up to certain limit against credit granted by bank. Under this arrangement, a customer need not borrow the entire amount of advance at one time; he can only draw to the extent of his requirements and deposit his surplus funds in his account. Interest is not charged on the full amount of the advance but on the amount actually availed of by him. Generally cash credit limits are sanctioned against the security of goods by way of pledge or hypothecation. The borrower can also provide alternative security of goods by way -of pledge or hypothecation. Though these accounts are repayable on demand, banks usually do not recall such advances, unless they are compelled to do so by adverse factors. Hypothecation is an equitable charge on movable goods for an amount of debt where neither possession nor ownership is passed on to the creditor. In case of pledge, the borrower delivers the goods to the creditor as security for repayment of debt. Since the banker, as creditor, is in possession of the goods, he is fully secured and in case of emergency he can fall back on the goods for realisation of his advance under proper notice to the borrower.

(v) Advances against goods : Advances against goods occupy an important place in total bank credit. Goods are security have certain distinct advantages. They provide a reliable source of repayment. Advances against them are safe and liquid. Also, there is a quick turnover in goods, as they are in constant demand. So a banker accepts them as security. Generally goods are charged to the bank either by way of pledge or by way of hypothecation. The term ‘goods’ includes all forms of movables which are offered to the bank as security. They may be agricultural commodities or industrial raw materials or partly finished goods.

For the purpose of calculation of the drawing limits, valuation of the goods is made from time to time. In case of hypothecation advance, an undertaking is obtained from the borrower that the goods are not charged to some other bank.

The bank also takes periodical statements of stocks regarding quantity valuation etc.

The Reserve Bank of India issues directives from time to time, imposing restrictions on advances against certain commodities. It is obligatory on banks to follow these directives in letter and spirit. The directives also sometimes stipulate changes in the margin.

(vi) Bills Purchased/Discounted : These advances are allowed against the security of bills which may be clean or documentary. Bills are sometimes purchased from approved customers in whose favour limits are sanctioned. Before granting a limit the banker satisfies himself as to the credit worthiness of the drawer. Although the term 'bills purchased' gives the impression that the bank becomes the owner or purchaser of such -bills, in actual practice the bank holds the bills only as security for the advance. The bank, in addition to the rights against the parties liable on the bills, can also exercise a pledge's rights over the goods covered by the documents.

Issuance bills maturing at a future date or sight are discounted by the banks for approved parties. When a bill is discounted, the borrower is paid the present worth. The bankers, however, collect the full amounts on maturity. The difference between these two amounts represents earnings of the bankers for the period. This item of income is called ‘discount’.

Sometimes, overdraft or cash credit limits are allowed against the security of bills. A suitable margin is usually maintained. Here the bill is not a primary security but only a collateral security. The banker in the case, does not become a party to the bill, but merely collects it as an agent for its customer.

When a banker purchases or discounts a bill, he advances against the bill; he has therefore to be very cautious and grant such facilities only to those customers who are creditworthy and have established a steady relationship with the bank. Credit reports are also compiled on the drawees.

(vii) Advance against documents of title to goods: A document becomes a document of title to goods when its possession is recognised by law or business custom as possession of the goods. These documents include a bill of Jading, dock warehouse keeper's certificate, railway receipt, etc. A person in possession of a document to goods can by endorsement or delivery (or both) of document, enable another person to take -delivery of the goods in his right. An advance against the pledge of such documents is equivalent to an advance against the pledge of goods themselves.

(viii) Advance against supply of bills: Advances against bills for supply of goods to government or semi-government departments against firm orders after acceptance of tender fall under this category. The other type of bills which also come under this category are bills from contractors for work executed either wholly or partially under firm contracts entered into, with the above mentioned Government agencies.

These bills are clean bills without being accompanied by any document of title of goods. But they evidence supply of goods directly to Governmental agencies. Sometimes these bills may be accompanied by inspection notes from representatives of government agencies for having inspected the goods before they are dispatched. If bills are without the inspection report, banks like to examine them with the accepted tender or contract for verifying that the goods supplied under the bills strictly conform to the terms and conditions in the acceptance tender.

These supply bills represent debt in favour of suppliers/contractors, for the goods supplied to the government bodies or work executed under contract from the Government bodies. \i is this debt that is assigned to the bank by endorsement of supply bills and executing irrevocable power of attorney in favour of the banks for receiving the amount of supply bills from the Government departments. The power of attorney has got to be registered with the Government department concerned. The banks also take separate letter from the suppliers / contractors instructing the Government body to pay the amount of bills direct to the bank.

Supply bills do not enjoy the legal status of negotiable instruments because they are not bills of exchange. The security available to a banker is by way of assignment of debts represented by the supply bills.

(ix) Term Loans by banks: Term loans are an installment credit repayable over a period of time in monthly/quarterly/half-yearly or yearly installment. Banks grant term loans for small projects falling under priority sector, small scale sector and big units. Banks have now been permitted to sanction term loan for projects as well without association of financial institutions. The banks grant loans for periods which normally range from 3 to 7 years and some- times even more. These loans are granted on the security of fixed assets.

13.4.6 Inter Corporate Loans

The companies can borrow funds for a short period say 6 months from other companies which have surplus liquidity. The rate of interest on inter corporate deposits varies depending upon the amount involved and time period.

13.4.7 Public Deposits

Public deposits are very important source of short-term and medium term finances particularly due to credit squeeze by the Reserve Bank of India. A company can accept public deposits subject to the stipulations of Reserve Bank of India from time to time maximum up to 35 per cent of its paid up capital and reserves, from the public and shareholders. These deposits may be accepted for a period of six months to three years. Public deposits are unsecured loans; they should not be used for acquiring fixed assets since they are to be repaid within a period of 3 years. These are mainly used to finance working capital requirements.

13.4.8 Certificate of Deposit

The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds.

The main advantage of certificate of deposit is that banker is not required to encash the deposit before maturity period and the investor is assured of liquidity because he can sell the certificate of deposit in secondary market.

13.5 DEBT SECURITISATION

Securitization is a financial transaction in which assets are pooled and securities representing interests in the pool are issued. The following example illustrates the process in a conceptual manner:

A finance company has issued a large number of car loans. It desires to raise further cash so as to be in a position to issue more loans. One way to achieve this goal is by selling all the existing loans, however, in the absence of a liquid secondary market for individual car loans, this may not be feasible. Instead, the company pools a large number of these loans and sells interest in the pool to investors. This process helps the company to raise finances and get the loans off its Balance Sheet. These finances shall help the company disburse further loans. Similarly, the process is beneficial to the investors as it creates a liquid investment in a diversified pool of auto loans, which may *be* an attractive option to other fixed income instruments. The whole process is carried out in such a way, that the ultimate debtors- the car owners - may not be aware of the transaction. They shall continue making payments the way they were doing before, however, these payments shall reach the new investors instead of the company they (the car owners) had financed their car from.

The example provided above illustrates the general concept of securitisation as understood in common spoken English. Securitisation can take the form of *'debt* securitization' in which the underlying pool of assets (debt) is sold to a company or a trust for an immediate cash payment. The company which buys these pool of assets issues securities and utilizes the regular cash flows arising out of the underlying pool of -assets for servicing such issued securities. Thus securitization follows a two way process, (1) the sale of an asset or a pool of assets to a company for immediate cash payment and (2) the repackaging and

selling the security interests representing claims on incoming cash flows from the asset or pool of assets to third party investors by issuance of tradable securities.

The company to which the underlying pool of assets or asset is sold is known, as a 'Special Purpose Vehicle' (SPV) and the company which sells the underlying pool of assets or asset is known as the originator.

The process of securitisation is generally without recourse i.e. the investor bears the credit risk or risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by him from the collateral. The issuer however, has a right to legal recourse in the event of default. The risk run by the investor can be further reduced through credit enhancement facilities like insurance, letters of credit and guarantees.

In a simple pass through structure, the investor owns a proportionate share of the asset pool and cash flows when generated are passed on directly to the investor. This is done by issuing pass through certificates. In mortgage or asset backed bonds, the investor has a lien on the underlying asset pool. The SPV accumulates payments from the original borrowers from time to time and makes payments to investors at regular predetermined intervals. The SPV can invest the funds received in short term instruments and improve yield when there is time lag between receipt and payment.

In India, the Reserve Bank of India had issued draft guidelines on securitisation of standard assets in April'2005. These guidelines were applicable to banks, financial institutions and non banking financial companies. The guidelines were suitably modified and brought into effect from February 2006.

Benefits to the Originator

(i) The assets are shifted off the balance sheet, thus giving the originator recourse to off balance sheet funding.

(ii) It converts illiquid assets to liquid portfolio.

(iii) It facilitates better balance sheet management as assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.

(iv) The originator's credit rating enhances.

For the investor securitisation opens up new investment avenues. Though the investor bears the credit risk, the securities are tied up to definite assets.

As compared to factoring or bill discounting which largely solve the problems of short term trade financing, securitisation helps to convert a stream of cash receivables into a source of long term finance.

13.6 VENTURE CAPITAL FINANCING

The venture capital financing refers to financing of new high risky venture promoted -by qualifiedentrepreneurs who lack experience and funds to give shape to their ideas. In broad sense, under venture capital financing venture capitalist make investment to -purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with a potential of success.

Methods

of Venture Capital Financing: In India, Venture Capital financing was first the responsibility of developmental financial institutions such as the Industrial Development Bank of India (IDBI), the Technical Development and Information Corporation of India (now known as ICICI) and the State Finance Corporations (SFCs). In the year 1988, the Government of India took a policy initiative and announced guidelines for Venture Capital Funds (VCFs). In the same year, a Technology Development Fund (TDF) financed by the levy on all payments for technology imports was established. This fund was meant to facilitate the financing of innovative and high risk technology **programmes through the IDBI.**

The guidelines mentioned above restricted the setting up of Venture Capital Funds by banks and financial institutions only. Subsequently guidelines were

issued in the month of September 1995, for overseas investment in Venture Capital in India.

A major development in venture capital financing in India was in the year 1996 when the Securities and Exchange Board of India (SEBI) issued guidelines for venture capital funds to follow. These guidelines described a venture capital fund as a fund established in the form of a company or trust, which raises money through loans, donations, issue of securities or units and makes or proposes to make investments in accordance with the regulations. This move was instrumental in the entry of various foreign venture capital funds to enter India.. The guidelines were further amended in April 2000 with the objective of fuelling the growth of Venture Capital activities in India. A few venture capital companies operate as both investment and fund management companies; others set up funds and function as asset management companies.

It is hoped that the changes in the guidelines for the implementation of venture capital schemes in the country would encourage more funds to be set up to give the required momentum for venture capital investment in India.

Some common methods of venture capital financing are as follows:

(i) Equity financing : The venture capital undertakings generally requires funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of equity share capital. The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur.

(ii) Conditional ban: A conditional loan is repayable in the form of a royalty .after the venture is able to generate sales. No interest is paid on such loans. In India venture capital financiers charge royalty ranging between 2 and 15 per cent; actual rate depends on other factors of the venture such as gestation period, cash flow patterns, risk and other factors of the

enterprise. Some Venture capital financiers give a choice to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially sounds.

(iii) Income note: It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates. IDBPs VCF provides funding equal to 80 - 87.50% of the projects cost for commercial application of indigenous technology.

(iv) Participating debenture: Such security carries charges in three phases - in the start up phase no interest is charged, next stage a low rate of interest is charged up to a particular level of operation, after that, a high rate of interest is required to be paid.

Factors that a venture capitalist should consider before financing any risky project are as follows:

(i) Level of expertise of company's management: Most of venture capitalist believes that the success of a new project is highly dependent on the quality of its management team. They expect that entrepreneur should have a skilled team of managers. Managements -also be required to show a high level of commitments to the project.

(ii) Level of expertise in production: Venture capital should ensure that entrepreneur and his team should have necessary technical ability to be able to develop and produce new product/service.

(iii) Nature of new product / service: The venture capitalist should consider whether the development and production of new product / service should be technically feasible. They should employ experts in their respective fields to examine idea proposed by the entrepreneur.

(iv) Future Prospects: Since the degree of risk involved in investing in the company is quite fairly high, venture capitalists should seek to ensure that the prospects for future profits compensate for the risk. Therefore, they

should see a detailed business plan setting out the future business strategy.

(v) Competition: The venture capitalist should seek assurance that there is actually a market for a new product. Further venture capitalists should see the research carried on by the entrepreneur.

(vi) Risk borne by entrepreneur: The venture capitalist is expected to see that the entrepreneur bears a high degree of risk. This will assure them that the entrepreneur have the sufficient level of the commitments to project as they themselves will have a lot of loss, should the project fail.

(vii) Exit Route: The venture capitalist should try to establish a number of exist routes. These may include a sale of shares to the public, sale of shares to another business, or sale of shares to original owners.

(viii) Board membership: In case of companies, to ensure proper protection of their investment venture capitalist should require a place on the Board of Directors. This will enable them to have their say on all significant matters affecting the business.

13.7 LEASE FINANCING

Leasing is a general contract between the owner and user of the asset over a specified period of time. The asset is purchased initially by the lesser (leasing company) and thereafter leased to the user (lessee company) which pays a specified rent at periodical intervals. Thus, leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover, lease finance can be arranged much faster as compared to term loans from financial institutions.

Types of lease contracts

Broadly lease contracts can be divided into following two categories:

(a) Operating Lease **(b) Finance Lease.**

(a) Operating Lease: A lease is classified as an operating lease if it does not secure for the lesser the recovery of capital outlay plus a return on the funds invested during the lease term. Normally these are callable lease and are cancelable with proper notice.

The term of this type of lease is shorter than the asset's economic life. The lessee is obliged to make payment until the lease expiration, which approaches useful life of the asset.

An operating lease is particularly attractive to companies that continually update or replace equipment and want to use equipment without ownership, but also want to return equipment at lease end and avoid technological obsolescence.

(b) Finance Lease: In contrast to an operating lease, a financial lease is longer term in nature and non-cancelable. In general term, a finance lease can be regarded as any leasing arrangement that is to finance the use of equipment for the major parts of its useful life. The lessee has the right to use the equipment while the lesser retains legal title. It is also called capital lease, as it is nothing but a loan in disguise.

Thus it can be said, a contract involving payments over an obligatory period of specified sums sufficient in total to amortize the capital outlay of the lesser and give some profit.

Other types of Leases

(1) Sales and Lease Back

Under this type of lease, the owner of an asset sells the asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of a lease rentals. Under this arrangement, the assets are not physically exchanged but it happens in records only. The main advantage of this method is that the lessee can satisfy himself completely regarding the quality of an asset and after possession of the asset convert the sale into a lease agreement.

Under this transaction, the seller assumes the role of lessee and the buyer assumes the role of a lesser. The seller gets the agreed selling price and the buyer-gets the lease rentals.

(2) Leveraged Lease

Under this lease, a third party is involved beside lesser and lessee. The lesser borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., lender and asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lesser. The lesser is entitled to claim depreciation allowance.

(3) **Sales-aid Lease**

Under this lease contract, the lesser enters into a tie up with a manufacturer for marketing the latter's product through his leasing operations, it is called a sales-aid-lease. In consideration of the aid in sales, the manufacturers may-grant either credit, or a commission to the lesser. Thus, the lesser earns from both sources i.e. from lessee as well as the manufacturer.

(4) Close-ended and open-ended Leases

In the close-ended lease, the assets get transferred to the lesser at the end of lease, the risk of obsolescence, residual value-etc., remain with the lesser-being the legal owner of the asset. In the open-ended lease, the lessee has the option of purchasing the asset at the end of the lease period.

In recent years, leasing has become a popular source of financing in India. From the lessee's point of view, leasing has the attraction of eliminating immediate cash outflow, and the lease rentals can be deducted for computing the total income under the Income tax Act. As against this, buying has the advantages of depreciation allowance (including additional depreciation) and interest on borrowed capital being tax-deductible. Thus, an evaluation of the two alternatives is to be made in order to take a decision.

13.8 NEW INSTRUMENTS

The new instruments that have been introduced since early 90's as a source of -finance is staggering in their nature and diversity. Few of these new instruments are:

13.8.1 Deep Discount Bonds

Deep Discount Bonds is a form of zero-interest bonds. These bonds are sold at a discounted value and on maturity face value are paid to the investors, in such bonds; there is no interest payout during lock in period.

IDBI was the first to issue a deep discount bond in India in January, 1992.

13.8.2 Secured Premium Notes

Secured Premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say 4 to 7 years. The conversion of detachable warrant into equity shares will have to be done within time period notified by the company.

13.8.3 Zero interest fully convertible debentures

These are fully convertible debentures which do not carry any interest. The debentures are compulsorily and automatically converted after a specified period of time and holders thereof are entitled to new equity shares of the company at predetermined price. From the point of view of company this kind of instrument is beneficial in the sense that no interest is to be paid on it, if the share price of the company in the market is very high than the investors tends to get equity shares of the company at the lower rate.

13.8.4 Zero Coupon Bonds

A Zero Coupon Bonds does not carry any interest but it is sold by the issuing company at a discount. The difference between the discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

13.8.5 Double Option Bonds

These have also been recently issued by the IDBI. The face value of each bond is Rs. 5,000. The bond carries interest at 15% per annum compounded half yearly from the date of allotment. The bond has maturity period of 10 years. Each bond has two parts in the form of two separate certificates, one for principal of Rs. 5,000 and other for interest (including redemption premium) of Rs. 13,500. Both these certificates are listed on all major stock exchanges. The investor has the facility of selling either one or both parts anytime he likes.

13.8.6 Inflation Bonds

Inflation Bonds are the bonds in which interest rate is adjusted for inflation. Thus, the investor gets interest which is free from the effects of inflation. For example, if the interest rate is 11 per cent and the inflation is 5 per cent, the investor will earn 13 per cent meaning thereby that the investor is protected against inflation.

13.8.7 Floating Rate Bonds

This as the name suggests is bond where the interest rate is not fixed and is allowed to float depending upon the market conditions. This is an ideal instrument which can be resorted to by the issuer to hedge themselves against the volatility in the interest rates. This has become more popular as a money market instrument and has been successfully issued by financial institutions like IDBI, ICICI etc.

13.9 INTERNATIONAL FINANCING

The essence of financial management is to raise and utilise the funds raised effectively. There are various avenues for organisations to raise funds either through internal or external sources. The sources of external sources include:

13.9.1 Commercial Banks

Like domestic loans, commercial banks all over the world extend Foreign Currency (FC) loans also for international operations. These banks also provide to overdraw over and above the loan amount.

13.9.2 Development Banks

Development banks offer long & medium term loans including FC loans. Many agencies at the national level offer a number of concessions to foreign companies to invest within their country and to finance exports from their countries. e.g. EXIM Bank of USA.

13.9.3 Discounting of Trade Bills

This is used as a short term financing method. It is used widely in Europe and Asian countries to finance both domestic arid international businesses.

13.9.4 International Agencies

A number of international agencies have emerged over the years to finance international trade & business. The more notable among them include The International Finance Corporation (IFC), The International Bank for Reconstruction and Development (IBRD), The Asian Development Bank (ADB), The International Monetary Fund (IMF), etc.

13.9.5 International Capital Markets

Today, modern organisations including MNC's depend upon sizeable borrowings in Rupees as well as Foreign Currency. In order to cater to the needs of such

organisations, international capital markets have sprung all over the globe such as in London.

In international capital market, the availability of FC is assured under the four main systems viz:

- Euro-currency market
- Export credit facilities
- Bonds issues
- Financial Institutions.

The origin of the Euro-currency market was with the dollar denominated bank deposits & loans in Europe particularly in London. Euro-dollar deposits are dollar denominated time deposits available at foreign branches of US banks & at some foreign banks. Banks based in Europe accept dollar denominated deposits & make dollar denominated deposits to the clients. This forms the backbone of the Euro-currency market all over the globe, in this market, funds are made available as loans through syndicated Euro-credit of instruments such as FRN's. FR certificates of deposits.

13.9.6 Financial Instruments

Some of the various financial instruments dealt with in the international market are briefly described below:

(a) External Commercial Borrowings(ECB): ECBs refer to commercial loans (in the form of bank loans , buyers credit, suppliers credit, securitised instruments (e.g. floating rate notes and fixed rate bonds) availed from non-resident lenders with minimum average maturity of 3 years. Borrowers can raise ECBs through internationally recognised sources like (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions such as the IFC, ADB etc, (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders.

External Commercial Borrowings can be accessed under two routes viz (i) Automatic route and (ii) Approval route. Under the Automatic route there is no need to take the RBI/Government approval whereas such approval is necessary under the Approval route. Company's registered under the Companies Act and NGOs engaged in micro finance activities are eligible for the Automatic Route where as Financial Institutions and Banks dealing exclusively in infrastructure or export finance and the ones which had participated in the textile and steel sector restructuring packages as approved by the government are required to take the Approval Route.

(b) Euro Bonds:

Euro bonds are debt instruments which are not denominated in the currency of the country in which they are issued. e.g. a Yen note floated in Germany. Such bonds are generally issued in a bearer form rather than as registered bonds and in such cases they do not contain the investor's names or the country of their origin. These bonds are an attractive proposition to investors seeking privacy.

(c) Foreign Bonds:

These are debt instruments issued by foreign corporations or foreign governments. Such bonds are exposed to default risk, especially the corporate bonds. These bonds are denominated in the currency of the country where they are issued, however, in case these bonds are issued in a currency other than the investors home currency, they are exposed to exchange rate risks. An example of a foreign bond 'A British firm placing Dollar denominated bonds in USA'.

(d) Fully Hedged Bonds:

As mentioned above, in foreign bonds, the risk of currency fluctuations exists. Fully hedged bonds eliminate the risk by selling in forward markets the entire stream of principal and interest payments.

(e) Medium Term Notes:

Certain issuers need frequent financing through the Bond route including that of the Euro bond. However it may be costly and ineffective to go in for frequent

issues. Instead, investors can follow the MTN programme. Under this programme, several lots of bonds can be issued, all having different features e.g. different coupon rates, different currencies etc. The timing of each lot can be decided keeping in mind the future market opportunities. The entire documentation and various regulatory approvals can be taken at one point of time

(f) Floating Rate Notes:

These are issued up to seven years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans.

(g) Euro Commercial Papers (ECP):

ECPs are short term money market instruments. They are for maturities less than one year. They are usually designated in US Dollars.

(h) Foreign Currency Option:

A FC Option is the right to buy or sell, spot, future or forward, a specified foreign currency. It provides a hedge against financial and economic risks.

(i) Foreign Currency Futures:

FC Futures are obligations to buy or sell a specified currency in the present for settlement at a future date.

13.9.7 Euro Issues by Indian Companies

Indian companies are permitted to raise foreign currency resources through issue of ordinary equity shares through Global Depository Receipts (GDRs)/ American Depository Receipts (ADRs) and / or issue of Foreign Currency Convertible Bonds (FCCB) to foreign investors i.e. institutional investors or individuals (including NRIs) residing abroad . Such investment is treated as Foreign Direct Investment. The government guidelines on these issues are covered under the Foreign Currency Convertible Bonds and Ordinary Shares (Through depositary receipt mechanism) Scheme, 1993 and notifications issued after the implementation of the said scheme.

(a) American Depository Deposits (ADR) : These are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange. ADRs are issued by an approved New York bank or trust company against the deposit of the original shares. These are deposited in a custodial account in the US. Such receipts have to be issued in accordance with the provisions stipulated by the SEC. USA which are very stringent.

ADRs can be traded either by trading existing ADRs or purchasing the shares in the issuer's home market and having new ADRs created, based upon availability and market conditions. When trading in existing ADRs, the trade is executed on the secondary market on the New York Stock Exchange (NYSE) through Depository Trust Company (DTC) without involvement from foreign brokers or custodians. The process of buying new, issued ADRs goes through US brokers, Helsinki Exchanges and DTC as well as Deutsche Bank. When transactions are made, the ADRs change hands, not the certificates. This eliminates the actual transfer of stock certificates between the US and foreign countries.

In a bid to bypass the stringent disclosure norms mandated by the SEC for equity shares, the Indian companies have however, chosen the indirect route to tap the vast American financial market through private debt placement of GDRs listed in London and Luxemburg Stock Exchanges.

The Indian companies have preferred the GDRs to ADRs because the US market exposes them to a higher level or responsibility than a European listing in the areas of disclosure, costs, liabilities and timing. The SECs regulations set up to protect the retail investor base are somewhat more stringent and onerous, even for companies already listed and held by retail investors, in their home country. The most onerous aspect of a US listing for the companies is to provide full, half yearly and quarterly accounts in accordance with, or at least reconciled with US GAAPs.

(b) Global Depository Receipt (GDRs): These are negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country. These financial instruments are used by companies to raise capital in either dollars or Euros. These are mainly traded in European countries and particularly in London.

ADRs/GDRs and the Indian Scenario: Indian companies are shedding their reluctance to tap the US markets. Infosys Technologies was the first Indian company to be listed on Nasdaq in 1999. However, the first Indian firm to issue sponsored GDR or ADR was Reliance industries Limited. Beside, these two companies there are several other Indian firms are also listed in the overseas bourses. These are Satyam Computer, Wipro, MTNL, VSNL, State Bank of India, Tata Motors, Dr Reddy's Lab, Ranbaxy, Larsen & Toubro, ITC, ICICI Bank, Hindalco, HDFC Bank and Bajaj Auto.

(c) Indian Depository Receipts (IDRs): The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian Capital Market through the issue of Indian Depository Receipts (IDRs). IDRs are similar to ADRs/GDRs in the sense that foreign companies can issue IDRs to raise funds from the Indian Capital Market in the same lines as an Indian company uses ADRs/GDRs to raise foreign capital. The IDRs are listed and traded in India in the same way as other Indian securities are traded.

13.9.8 Other Types of International Issues

(a) Foreign Euro Bonds: In-domestic capital markets of various countries the Bonds issues referred to above are known by different names such as Yankee Bonds in the US, Swiss Frances in Switzerland, Samurai Bonds in Tokyo and Bulldogs in UK.

(b) Euro Convertible Bonds: A convertible bond is a debt instrument which gives the holders of the bond an option to convert the bonds into a pre-determined number of equity shares of the company. Usually the price of the

equity shares at the time of conversion will have a premium element. These bonds carry a fixed rate of interest and if the issuer company so desires may also include a Call Option (where the issuer company has the option of calling/ buying the bonds for redemption prior to the maturity date) or a Put Option (which gives the holder the option to put/sell his bonds to the issuer company at a pre-determined date and price).

(c) Euro Bonds: Plain Euro Bonds are nothing but debt Instruments. These are not very at-attractive for an investor who desires to have valuable additions to his investments.

(d) Euro Convertible Zero Bonds: These bonds are structured as a convertible bond. No interest is payable on the bonds. But conversion of bonds takes place on maturity at a predetermined price. Usually there is a five years maturity period and they are treated as a deferred equity issue.

(e) Euro Bonds with Equity Warrants: These bonds carry a coupon rate determined by market rates. The warrants are detachable. Pure bonds are traded at a discount. Fixed Income Funds Management may like to invest for the purposes of regular income.

13.10 Summary

To meet the different requirements of business organizations they need funds. Depending upon whether the need is for long term, medium term or short term, different sources of finance are tapped to meet the requirement. Apart from the traditional sources of finance such as owners' capital, equity capital, debenture or bonds etc. certain new instruments are devised which are tailor made to meet the requirements of the organization as well as the investors like debt securitization, commercial papers, lease financing, deep discount bonds, secured premium notes, zero coupon bonds, venture capital financing etc. For tapping the international market to raise funds the various instruments in vogue are euro

bonds, foreign bonds, fully hedged bonds, American depository receipts, Global depository receipts, Indian depository receipts etc.

13.11 Check Your Progress

1. What are the long term and short term sources of finance of a business enterprise?
2. What do you understand by debt securitization?
3. Discuss inter-corporate loans as a source of finance?
4. Discuss the provisions relating to issuance of American Depository Receipts, Global Depository Receipts, and Indian Depository Receipts.
5. What is Venture Capital Financing?

LL.M. Part-1

PAPER CORPORATE LAW

Block III– Protection of Investors & Creditors & Corporate responsibility

Unit 14- Protection of Creditor

STRUCTUR

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14.1 Introduction

The capital markets in India have evoled over more than a century. The seeds of investor protection were soon way back in 1956 at the time of enactment of the Securities Contracts Regulation Act, 1956 wherein several investor protection measurese found their place. Since then, investor protection has been evolving. Over the period, investor protection has been receiving increased attention and focus from the market regulator, the Securities Exchange Board of India (SEBI) as well as stock exchanges.

In the last decade, India has witnessed a transition of focus from investor protection to investor empowerment. Investgor protection int eh tradititional from has certainly played an important role in helping an investor in the eventuality of his xxx into a problem. However, through experience it has been discovered that empowering the investor with valuable information both at the micro and macro levels is the key for creating a safer investment environment, and efforts in this direction would help to perevent problems. Tjhus, both the regulator and stock exchanges have focused on creating freer flow of information between members and investors, and on transparent dissemination of all market related information, including price, disclosures by companies, etc. All actions of the exchange have embedded investor empowerment as the nucleus.

14-2Objective

Investors are the backbone of the securities market. They not only determine the level of activity in the securities market but also the level of activity in the economy. The growth in the numbers of investors in India is encouraging. The trends reveal that in addition to Fils and Institutional Investors, small investors were also gradually beginning to regain the confidence in the capital markets that had been shaken consequent to the stock market scams during the past decade. It is imperative for the healthy growth of the corporate sector that this confidence is maintained.

However, many investors may not possess adequate expertise/knowledge to take informed investment decisions. Some of them may not be aware of the complete risk-return profile of the different investment options. Some investors may not be fully aware of the precautions they should take while dealing with market intermediaries and dealing in different securities. They may not be familiar with the market mechanism and the practices as well as their rights and obligations.

14.3.1. Investor Protection

The corporate systems and processes need to be credible and transparent, so that the interests of the investors may be safeguarded in a manner that enables them to exercise their choice in an informed manner while making investment decisions, and also providing them with a fair exit option. The Securities and Exchange Board of India (SEBI) has been mandated to protect the interests of investors in securities and to promote the development and regulate the securities market so as to establish a dynamicand efficient Securities Market contributing to Indian Economy.

The concept of investor protection has to be looked at from different angles taking into account the requirements of various kinds of investors i.e. (i) investors in equity (ii) large institutional investors (iii) Foreign Investors (iv) investors in debentures and (v) small investors/ deposit holders ete.

SEBI does not give a guarantee for payment of money rather it helps you in recovering the amount back from the concerned entity (broker).

14.3.2.Investor Education and Protection fund

The Government has established an Investor Education and Protection Fund (IEPF) under See. 205 C of the Companies Act, 1956 under which unclaimed funds on account of dividends, matured deposits, matured debentures, share application money ete. are transferred through the IEPF to the Government by the company on completion of seven years. The Government is required to utilize this amount through an Investor Education and Protection Fund. For this purpose, the proceeds from the companies are credited to the Consolidated Fund of India through this fund. The Fund may then be entrusted with full fledged responsibility to carry out activities for education of investors and protection of their rights.

14.3.3.Compensation to the Investors

Capital market includes investment into risk bearing instruments. in such cases, the investor is required to make his own assessment of risk and reward. No compensation could be visualized for such investors whose investments were in risk bearing instruments. Similarly, investment in a fixed return instrument necessitated a careful review of the borrowing entity. Such actions would also be subjected to known or declared risks. Besides, the capital market *also* provides an opportunity for an investor to exit. The need therefore, is to ensure proper and healthy market operation

so that investors could exercise their exit options in a reasonable and equitable environment. However, there may be situations where such a frame work is distorted through frauds. There may be provisions for compensation In the event of fraud by companies being established in securing funds from investors. For this purpose lifting of corporate veil may be enabled by the law.

14.3.4Investor Rights and obligations

Investor Rights	**Investor Obligations**
The right to get	The obligation to
• The best price • Proof of price/ brokerage charged • Your money/ shares on timer • Shares through auction where delivery is not received • Square up amount where delivery not received in auction • Statement of Accounts from trading	• Sign a proper Member- Consti Agreement possess a valid cor or purchase/ sate note • Deliver securities with documents and proper signature
The right of redressal against	**The obligation to ensure**
• Fraudulent price • Unfair brokerage • Delays in receipt of money of shares • Investor unfriendly companies	• To make payment on time • To deliver shares on time • To sent securities for transfer t company on time • Forwarding all the papers rece from the company under objec to the broker on time.

14.3.5.Disclosures and Investor Protection

Proper and timely disclosures are central to safeguarding investor interests. The law should ensure a disclosure regime that compels companies to disclose material information on a continuous, timely and equitable basis. Information should be disclosed when it is still relevant to the market. The companies should, therefore, be made to disclose routine information on a periodic basis and price sensitive information on a continuous basis. Capital market regulator and stock exchanges have a significant role to play in ensuring that such information is accessible by all market participants rather than a few select market players.

Use of modern technology, internet, computers, should be enabled to enhance the efficiency of the disclosure process. It should be possible to submit and disseminate financial and non-financial information by electronic means.

14.3.6 Market structure, product design and operational framework

One of the unique features of Indian markets is that retail investors participate directly in the markets through registered intermediaries, who are popularly known as stock brokers. Given the vast geographical spread of the country and the large number of retail investors, investor empowerment and protection is a core function of both SEBI and the exchanges. NSE India has around 150,000 trading terminals spread across more than 1500 towns and cities, with around 2 to 3 million investors participating in the market on a daily basis.

The structure of the Indian market is designed to protect the interest of investors. Only intermediaries who have obtained a license from SEBI are permitted to deal on behalf of investors. At the time of granting a license and on a continuous basis, an intermediary's financial soundness, track record, fit and proper criteria fulfillment are ensured, thereby making sure that they are adequately geared up to service the investors.

With a view to enhance the transparency of dealings, intermediaries are mandated to route all orders of investors to the trading system of a recognized stock exchange; intermediaries are not allowed to match transactions at their level The order matching at exchanges takes place on the basis of price-time priority, and hence, a small investor gets same priority as a big investor. There is no discrimination based on size of the order, volume, geographical location, etc.

Ensuring the safety of the market, protecting its integrity and the interest of investors is the top most priority of exchanges and SEBI. In order to achieve this, NSE India has designed a robust risk management framework which includes upfront margin collection based on real-time margin computation all at client levels. The exchange has also eliminated counterparty risk by introducing a settlement guarantee mechanism whereby the Clearing Corporation guarantees the settlement. Surveillance activities are carried out both at the member and client levels. Further, the clear flow of information is also considered a very important part of market integrity, and hence a framework for disclosures by listed entities and the member entities is in place The exchange disseminates price sensitive information to investors at large.

In order to provide for genuinely robust investor empowerment, the manner in which critical documents have to flow between members and investors at the beginning of a relationship, and also when transactions take place, is mandated by the exchange. Members are required to segregate their own funds and securities from those of clients, and maintain separate accounts for own funds/securities and clients' funds/securities. Members are required to issue contract notes to investors within 24 hours of a trade execution, and also issue a tatement of funds and securities to investors on a quarterly basis. Members receive funds and securities from the investor for whom transaction is executed, and no third-party funds and securities can be accepted.

Assurance of members' meeting the compliance norms is obtained through periodic third-party audits of systems and operations. Besides, the exchange also undertakes examination of the books and records of members to identify potential areas of risks in their operations that may have an impact on investors.

14.3.7 Investor Education Drive

Though large numbers of investors participate in the market, the percentage ofthe Indian population is very low due to lack of awareness about markets, products, how this all operates. Conscious efforts are being made by multiple agencies, like the Ministry of Finances, SEBI and exchanges to include more and more people by creating targeted awareness initiatives.

Awareness Programs

On a continuous basis, NSE India conducts investor awareness programmes across the country, putting more emphasis on small towns and cities. Programmes are conducted in vernacular languages, so as to eliminate language barriers reducing the reach of the market. During these awareness programs, apart from covering product features and uses, operational aspects like investors' rights and obligations, "dos" and "don'ts" while investing, and diligence that an investor needs to take are also covered. Educational and informative booklets relating to operational and functional aspects ofthe market in English and regional languages are distributed.

Campaigns for financial literacy

Sensing the need to introduce students to the importance of financial planning, NSE India has introduced a financial literacy campaign. The exchange, in collaboration with higher secondary schools and colleges,

conducts programmes covering numerous aspects of investment, including need for saving, avenues to pursue, risks in investment, analysis of company financials, etc.

14.3.8Use of media to reach out to investors

The exchange makes use of multiple channels to spread investor awareness. The exchange issues regular alerts on topics which need investor attention through the print media, both like national and regional newspapers. The exchange also makes use of TV as a medium, and conducts educational programs for the benefit of a wide range of investors.

Direct trade information

In addition to the trade information which members give to investors on a regular basis, the exchange randomly sends out trade information directly to some 250 investors daily. This acts as an additional source of information to investors, and enables them to compare the details received from exchange with those received from the member; they can check if any variations exist. Apart from its usefulness to investors, this also keeps a check on members to ensure that on a continuous basis corrett investor information is maintained, and also that the regular information sent to investors is correct.

Certification program

For investors who are interested in acquiring a structured understanding of the markets, the exchange offers certification on topics such as derivatives, capital markets, depository operations, mutual fund operations, commodities markets, etc. These courses have evoked good responses from investing community.

14.3.9 Investor Services

Investor services cell

National Stock Exchange of India has established a dedicated investor services cell at its head office and its branches, where a dedicated team of officials attend to various service requests. Basic queries of investors are resolved by telephone and personal meetings.

Investors having any dispute or difference against a member or a listed corporate entity can lodge their complaints with the Investor Services Cell of the exchange. The exchange takes up the issue with the concerned member or listed entity, calls for explanations, arranges for a meeting

between the parties where required to resolve the disputes through its intervention. Whernno resolution is reached, or one of the parties is not satisfied with the compromise, the parties can opt for referring the matter to arbitration.

14.3.10Steps taken by SEBI to make investors protection

SEBI launched a comprehensive education campaign aimed at creating awareness among investors about securities market, which has been christened "Securities Market Awareness Campaign" (SMAC). The'motto of the campaign is 'An Educated Investor is a Protected Investor,'

The campaign was launched at the natlOnal level by the then Prime Minister, Shri Atal Bihari Vajpayee, on January 17, 2003.. The national launch was closely followed by launches in 12 states,

The structural foundation of the campaign is based on workshops that are being conducted all across the country with the continued and active participation of market participants, market intermediaries, Investors Associations etc., to spread SEBI's message of "Invest with Knowledge".

Workshops- At workshops, the aim is to acclimatize the investors with the functioning of the securities market, the basic fundamentals of investment and risk management and their rights and responsibilities.

Till date, more than 2188 workshops have been conducted in around the country.. Advertisement- SEBI has prepared simple "dos and don'ts" for investors relating to various aspects of the securities market. Till date, over 700 advertisements relating to various aspects of Securities Market have appeared in 48 different newspapers/magazines, covering approximately 111 cities and 9 regional languages, apart from English and Hindi.

500 cities/towns across

Educative Materials-SEBI has prepared a standardized reading material and presentation material for the workshops

All India Radio- With regard to educating investors through the medium of radio, SEBI Officials regularly participate in programmes aired by All India Radio.

Website dedicated to Investor Education: http: / /investor. sebi .gov. in

Cautionary Message on television- With a view to use the electronic media to reach out to a larger number of investors, a short cautionary message, in the form of a 40 seconds filmlet, has been prepared and the same is being aired on television

Internet based response system: A simple and effective internet based response to investor complaints has been set up. On filing of your complaint electronically, an acknowledgement mail would be sent to your specified email address and you will be issued a complaint registration number instantaneously.

14.3.11INVESTORS' RIGHTS, RESPONSIBILITIES AND REDRESSAL OF GRIEVANCES

14.3.12Risks in investing in Securities.

Investment in equity shares can not be guaranteed with any income and/or growth.

Equity holders are the real owner of the company and with the growth of the company equity

holders also get capital appreciation. Vice versa is also true.

Investment in other securities say debenture, preference shares may yield as specified return to the investors.

14.3.13Rights of a shareholder

To receive the share certificates, on allotment or transfer (if opted for transaction in physical mode) as the case may be, in due time.

To receive copies of the Annual Report containing the Balance Sheet, the Profit & Loss account and the Auditor's Report.

To participate and vote in general meetings either personally or through proxy. To receive dividends in due time once approved in general meetings.

To receive corporate benefits like rights, bonus, etc. once approved.

To apply to Company Law Board (CLB) to call or direct the Annual General Meeting. To inspect the minute books of the general meetings and to receive copies thereof.

To proceed against the company by way of civil or criminal proceedings. To apply for the winding up of the company.

To receive the residual proceeds.

To receive offer to subscribe to rights shares in case of further issues of shares.

To receive offer under takeover or buyback offer under SEBI Regulations.

Besides the above rights, which you enjoy as an individual shareholder, you also enjoy the following rights as a group:

To requisite an Extra-ordinary General meeting. To demand a poll on any resolution.

To apply to CLB to investigate the affairs of the company.

14.3.14Rights of a debenture holder

To receive interest/redemption in due time. To receive a copy of the trust deed on request.

To apply before the CLB in case of default in redemption of debentures on the date of maturity.

To apply for winding up of the company if the company fails to pay its debt. To approach the Debenture Trustee with your grievance.

You may note that the above mentioned rights may not necessarily be absolute. **Responsibilities of a security holder**

These are general and not statutory liabilities:

To be specific.

To remain informed.

To be vigilant.

To participate and vote in general meetings.

To exercise your rights on your own or as a group.

14.3.15Advantages of dealing through a Stock Exchange

If you choose to deal (buy or sell) directly with another person, you are exposed to counter party risk, i.e. the risk of nonperformance by that party. However, if you deal through a Stock Exchange, this counter party risk is reduced due to trade/settlement guarantee offered by the Stock Exchange mechanism. Further, you also have certain protections against defaults by your broker.

When you operate through an exchange, you have the right to receive the best price prevailing at that time for the trade.

Right to receive the money or securities on time. You also have the right to receive a contract note from the broker confirming the trade and indicating the time of execution of the order and other necessary details of the trade. If you have opted for transaction in physical mode, you also have the right to receive good delivery and the right to insist on rectification of bad delivery. If you have a dispute with your broker, you can resolve it through arbitration under the ~egis of the exchange, instead of filing a civil suit.

Larger number of buyers and sellers are available at Stock Exchange and this way it ensure liquidity to the investors.

14.3.16Important Don’ts of Investor

Deal with any un-registered intermediary / unauthorized person / third party. Forget to get one copy of the Member-Client-Agreement, for your record.

Forget to get one copy of the clauses / agreement (if they are separate documents), for your record.

Deposit monies and / or securities with the trading member unless deposited specifically as margin / security deposit or in relation to any trades executed on the trading system of the

Exchange.

Accept unsigned and / or duplicate contract notes / bills.

Forget to demand contract notes / bills / statement of account, if anyone is not received, within stipulated period.

Make payment in the personal / beneficiary account of the authorized persons, sub-brokers, employees or directors of the trading member.

Give delivery of shares in to beneficiary account of the authorized persons, sub-brokers, employees or directors of the trading member.

Delay payment of funds and / or deliveries of securities to the trading member towards margin and / or settlement liability.

Make payment in cash and / or delivery of shares from any account other than your own beneficiary account.

Sign blank delivery instruction slip towards security pay-in obligations. Get carried away to luring advertisement, if any.

Be led by market rumors and / or get into / participate in shady transactions (not apparently looking to be normal transactions).

Delay to demand pay-out of money and / or securities if not received within one working day.

Delay to lodge your complaint with the Exchange if you have a grievance against any sub-broker or trading member beyond 30 calendar days from the date of transaction / latest date by which the member ought to have forwarded the document as above / the member ought to have settled the claim made by you.

Accept cheques / securities from the personal bank / beneficiary accounts of Authorized Person, Sub broker, employees, directors in the settlement of any trade executed by you

Transfer balances between several accounts of relatives.

Subscribe to trading in complex leverage products offered by the trading members without completely understanding the implications of all the features offered in such products

Blindly follow rumors / market call on securities given by any entity.

14.4Question

1. What do you mean by investor protection?
2. What are right and obligation of investors?
3. What are the rights of share holders?
4. What re important don’ts which investor have to follow whete investing.

14.5Suggested Readings

1. Securities Contracts Regulations Act 1956
2. Companies Act 1956
3. SEBI guidelines for investors
4. Company law by Avtar Singh

LL.M. Part-1

PAPER CORPORATE LAW

Block III– Protection of Investors & Creditors & Corporate responsibility

Unit 15- Protection of Creditor

STRUCTUR

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15.4 Question for self assessment.
15.5 Suggested Readings

15.1 Introduction

The average shareholder, who is typically not involved in the day-to-day operations of the company, relies on several parties to protect and further his or her interests. These parties include the company's employees, its executives and its board of directors. However, each one of these parties has its own interests, which may conflict with those of the shareholder.
The board of directors is elected by the shareholders of a corporation to oversee and govern management and to make corporate decisions on their behalf. As a result, the board is directly responsible for protecting and managing shareholders' interests in the company.
For a board of directors to be truly effective, it needs to be objective and proactive in its policies and dealings with management. This helps to ensure that management is generating shareholder value. A more objective board of directors, or one that is separate from a company's management, is more likely to promote or protect the interests of the company's shareholders. For example, a board of directors made up entirely or primarily of management would clearly be hampered by conflicts of interest, and the preservation of shareholder value might not be a priority.
Another factor that has an impact on the effectiveness of a board of directors is compensation. Adequately compensating board members for their work is one way to ensure that they will make every effort to promote and protect investor interests. The members of a board of directors are paid in cash and/or stock. Likewise, management and employees also need to be aligned with investors and this can be achieved through the compensation that both groups receive. This may include making both parties owners (investors) in the company. When management and employees are also shareholders, they will be motivated to protect shareholder interests as their own. This helps to protect a company from mismanagement and weak employee productivity. Also, a bonus targeting system can be used in which employees and managers receive bonuses when certain goals are met. Such strategies help to align the interests of employees and management with those of investors.

15.2 Objective

Objective of this unit is to make the readers aware of their rights as in investors to know the role of SEBI, Reserve Bank of India, and other orginisation values are directly related to the investment policy and monetary policy and to know the corporate governance Standard
If these groups are not aligned with the interests of investors, major problems can arise and destroy shareholder value. Although the average shareholder does not have control over the board of directors or the day-to-day operations of the company, the ultimate responsibility for the protection of shareholder value lies with each individual investor. The investor is ultimately responsible for reviewing corporate policy and governance as well as for the compensation of managers. Investors who feel that a company does not show an adequate level of commitment to shareholders can always sell their investment.
India's financial sector watchdogs have demonstrated their independence time and again. For example, the country's central bank, the Reserve Bank of India, was one of the few central banks that chose to break from prevailing global loose monetary policies. India's other regulator, the Securities and Exchange Board of India (SEBI), which is equivalent to the Securities and Exchange Commission (SEC) in United States, has also come a long way in asserting itself. Established in 1992, SEBI has been making systemic reforms aimed at better corporate governance, deeper capital markets and more satisfied investors.
SEBI's primary goal has always been investor protection. Its recent efforts to abolish entry and exit loads—sales charges paid by mutual fund investors—has significantly brought down investing costs. SEBI's recent listing regulations have balanced the interests of minority shareholders with those of promoters intending to delist companies. It has also offered guidelines for enhanced disclosures and mandatory grading of Initial Public Offerings (IPOs). Real estate IPOs, for example, are required to reveal complete ownership details of land banks and report market-determined asset values.
The regulator has also been gradually raising India's corporate governance standards. A decade ago, SEBI managed to implement the disclosure of quarterly financial results amid huge resistance. Recently, it required the semiannual disclosure of balance sheets, in efforts to limit the scope of any "creative accounting." SEBI has also asked companies to increase the weight of independent directors on their boards as part of its

efforts to create checks and balances. These checks are meant to improve auditor oversight following an accounting scandal that surfaced at a leading technology company early last year.

Developing capital markets has been a high priority for SEBI. About a decade ago, SEBI streamlined security transactions by eliminating the need for investors to hold shares in paper form. This was followed by their push to have exchanges implement online trading capabilities. To improve liquidity and price discovery, it recently introduced short selling and is now enhancing securities lending mechanisms that enable this. SEBI has also proactively introduced new asset classes and exchanges to enable broader capital market participation.

Despite its accomplishments, SEBI still has a lot of unfinished work. For example, the liquidity in India's capital markets is significantly lower than expected. In addition, SEBI—which currently spurs product innovation—could arguably be better served to leave that function in the hands of the exchanges themselves, and focus on the task of regulating its markets.

15.3.1 Function of SEBI

The Primary function of Securities and Exchange Board of India under the SEBI Act, 1992 is the protection of the investors' interest and the healthy development of Indian financial markets. No doubt, it is very difficult and herculean task for the regulators to prevent the scams in the markets considering the great difficulty in regulating and monitoring each and every segment of the financial markets and the same is true for the Indian regulator also. But what are the responsibilities of the regulators to set the system right once the scam has taken place, especially the responsibility of redressing the grievances of the investors so that their confidence is restored? The redressal of investors' grievances, after the scam, is the most challenging task before the regulators all over the world and the Indian regulator is not an exception. One of the weapons in the hand of the regulators is the collection and distribution of disgorged money to the aggrieved investors. SEBI had issued guidelines for the protection of the investors through the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000. These Guidelines have been issued by the Securities and Exchange Board of India under Section 11 of the Securities and Exchange Board of India Act, 1992.

Before proceeding further we need to be well informed about few important definitions as stated under the guidelines, to start with is; Issuer Company- means a company which has filed offer documents with the Board for making issue of securities in terms of these guidelines , Listed Company- means a company which has any of its securities offered through an offer document listed on a recognised stock exchange and also includes Public Sector Undertakings whose securities are listed on a recognised stock exchange , Merchant Banker- means an entity registered under Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992 , Offer Document- means Prospectus in case of a public issue or offer for sale and Letter of Offer in case of a rights issue , Offer for Sale- means offer of securities by existing shareholder(s) of a company to the public for subscription, through an offer document.

15.3.2 The Zeal For Investor's Protection

Now let's traverse through some important guidelines that are offered by the SEBI dedicated to the cause of investor's protection.

15.3.3 Eligibility Norms For Companies Issuing Securities:-

Provisions regarding this are enshrined in Chapter-II of the said guidelines. No company shall make any issue of a public issue of securities, unless a draft prospectus has been filed with the Board, through an eligible Merchant Banker, at least 21 days prior to the filing of Prospectus with the Registrar of Companies (ROCs). Provided that if, within 21 days from the date of submission of draft Prospectus, the Board specifies changes, if any, in the draft Prospectus (without being under any obligation to do so), the issuer or the Lead Merchant banker shall carry out such changes in the draft prospectus before filing the prospectus with ROCs.

No listed company shall make any issue of security through a rights issue where the aggregate value of securities, including premium, if any, exceeds Rs.50 lacs, unless the letter of offer is filed with the Board, through an eligible Merchant Banker, at least 21 days prior to the filing of the Letter of Offer with RSE. Provided that if, within 21 days from the date

of filing of draft letter of offer, the Board specifies changes, if any, in the draft letter of offer, (without being under any obligation to do so), the issuer or the Lead Merchant banker shall carry out such changes before filing the draft letter of offer. No company shall make an issue of securities if the company has been prohibited from accessing the capital market under any order or direction passed by the Board.

15.3.4 Pricing By Companies Issuing Securities:-

These provisions are being dealt in the Chapter-III of the guidelines. A listed company whose equity shares are listed on a stock exchange, may freely price its equity shares and any security convertible into equity at a later date, offered through a public or rights issue. An unlisted company eligible to make a public issue and desirous of getting its securities listed on a recognised stock exchange pursuant to a public issue, may freely price its equity shares or any securities convertible at a later date into equity shares. An eligible company shall be free to make public or rights issue of equity shares in any denomination determined by it in accordance with Sub-section (4) of Section 13 of the Companies Act, 1956 and in compliance with the following and other norms as may be specified by SEBI from time to time:
In case of initial public offer by an unlisted company, if the issue price is Rs. 500/- or more, the issuer company shall have a discretion to fix the face value below Rs. 10/- per share subject to the condition that the face value shall in no case be less than Rs. 1 per share; and, if issue price is less than Rs. 500 per share, the face value shall be Rs. 10/- per share; The disclosure about the face value of shares (including the statement about the issue price being “X” times of the face value) shall be made in the advertisement, offer documents and in application forms in identical font size as that of issue price or price band.)

15.3.5 Pre- Issue Obligations:-

The pre issue obligations are provided in Chapter-V, they are as follows:-
The lead merchant banker shall exercise due diligence.
The standard of due diligence shall be such that the merchant banker

shall satisfy himself about all the aspects of offering, veracity and adequacy of disclosure in the offer documents.
The liability of the merchant banker shall continue even after the completion of issue process.
No company shall make an issue of security through a public or rights issue unless a Memorandum of Understanding has been entered into between a lead merchant banker and the issuer company specifying their mutual rights, liabilities and obligations relating to the issue.

15.3.6 Contents Of Offer Document:-

In addition to the disclosures specified in Schedule II of the Companies Act, 1956, the prospectus shall also contain all material information which shall be true and adequate so as to enable the investors to make informed decision on the investments in the issue. The prospectus shall also contain the information and statements specified in this chapter and shall as far as possible follow the order in which the requirements are listed in this chapter and summarised in Schedule VIIA.

15.3.7 Consequence Of Non-Observance Of The Guidelines

SEBI in case of non-observance of these guidelines (Section 11B) as it seems to be a bar from doing such things which may prejudice the interest of the investors the board can give the following directions:-
Direct the persons concerned to refund any money collected under an issue to the investors with or without requisite interest, as the case may be, direct the persons concerned not to access the capital market for a particular period, direct the stock exchange concerned not to list or permit trading in the securities, direct the stock exchange concerned to forfeit the security deposit deposited by the issuer company, any other direction which the Board may deem fit and proper in the circumstances of the case.
Provided that before issuing any directions the Board may give a reasonable opportunity to the person concerned. Provided further that if any interim direction is sought to be passed, the Board may give post decisional hearing to such person.

15.3.8 Protection of Investors Rights and Interest.

The Securities and Exchange Board of India (SEBI) has been mandated to protect the interests of investors in securities and to promote the development of and to regulate the securities market so as to establish a dynamic and efficient Securities Market contributing to Indian Economy.
SEBI strongly believes that investors are the backbone of the securities market. They not only determine the level of activity in the secunties market but also the level of activity in the economy.
However, many investors may not possess adequate expertise/knowledge to take informed investment decisions. Some of them may not be 3vvare of the complete risk-return profile of the different investment options. Some investors may not be fully aware of the precautions they should take while dealing with market intermediaries and dealing in different securities. They may not be familiar with the market mechanism and the practices as well as their rights and obligations.

1. What are my rights as a shareholder?

- To receive the share certificates, on allotment or transfer (if opted for transaction in physical mode) as the case may be, in due time.
- To receive copies of the Annual Report containing the Balance Sheet, the Profit & Loss account and the Auditor's Report.
- To participate and vote in general meetings either person<1lly or through proxy.
- To receive dividends in due time once approved in general meetings.
- To receive corporate benefits like rights, bonus, etc. once approved.
- To apply to Company Law Board (CLB) to call or direct the Annual General Meeting.
- To inspect the minute books of the general meetings and to receive copies thereof.
- To proceed against the company by way of civil or criminal proceedings.
- To apply for the winding up of the company
- To receive the residual proceeds.

- To receive offer to subscribe to rights shares in case of further issues of shares.
- To receive offer under takeover or buyback offer under SEBI Regulations.
- Besides the above rights, which you enjoy as an individual shareholder, you also enjoy the following rights as a group: To requisite an Extra-ordinary General meeting.
- To demand a poll on any resolution.
- To apply to CLB to investigate the affairs of the company.
- To apply to CLB for relief in cases of oppression and/or mismanagement.

2- What are my rights as a debenture holder?

- To receive interest/ redemption in due time.
- To receive a copy of the trust deed on request.
- To apply before the CLB in case of defau1t in redemption of debentures on the date of maturity.
- To apply for winding up of the company if the company fails to pay its debt.

- To approach the Debenture Trustee with your grievance.
- You may note that the above mentioned rights may not necessarily be absolute. For example, the right to transfer securities (in physical mode) is subject to the company's right to refuse transfer as per statutory provisions.

What are my responsibilities as a security holder?

- While you may be happy to note that you have so many rigbts as a stakeholder in the company that should not lead you to complacency; because you have also certain responsibilities to discharge.
- To be specific.
- To remain informed.
- To be vigilant.
- To participate and vote in general meetings.
- To exercise your rights on your own or as a group.

15.3.9 What are the advantages I have, of dealing through a Stock Exchange?

- If you choose to deal (buy or sell) directly witb another person, you are exposed to counter party risk, i.e. the risk of nonperformance by that party. However, if you deal through a Stock Exchange, this counter party risk is reduced due to trade/settlement guarantee offered by the Stock Exchange mechanism. Further, you also have certain protections against defaults by your broker.
- When you operate trough an exchange, you have the right to receive the best price prevailing at that time for the trade and the right to receive the money or securities on time. You also have the right to receive a contract note from the broker confirming the trade and indicating the time of execution of the order and other necessary details of the trade. If you have opted for transaction in physical mode, you also have the right to receive good delivery and the right to insist on rectification of bad deliver. If you have a dispute with your broker, you can resolve it through arbitration under the aegis of the exchange, instead of filing a civil suit.

<u>How Can I enter in a deal through a Stock Exchange?</u>

- If you decide to operate through an exchange, you have to avail the
- services of a registered broker/sub-broker. You have to enter into a broker client agreement and file a client registration form. Since the contract note is a legally enforceable document, you should insist on receiving it. You have the obligation to deliver the securities in case of sale or pay the money in case of purchase within the time prescribed. If you have opted for transaction in physical mode, in case of bad delivery of securities by you, you have the responsibility to rectify them or replace them with good ones.

Whether investors/ shareholders can file application before Consumer Forum?

- Whether; Shares of debentures after they have been issued or allotted to investor are regarded as goods. In case of deficiency of service by an intermediary or listed company, an investor qm approach the Consumer Forum.

What steps are taken by SEBI to make investors aware to their rights?

- SEBI launched a comprehensive education campaign aimed at creating awareness among investors about securities market, which has been christened - "Securities Market Awareness Campaign" (SMAC). The motto of the campaign is - I An Educated Investor isa Protected Investor.'
- The campaign was launched at the national level by the then Prime Minister, Shri Atal Bihari Vajpayee, on January 17, 2003.
- The national launch was closely followed by launches in 12 states.
- The structural foundation of the campaign is based on workshops that are being conducted all across the country with the continued And active participa tion of market participantsl market intermediaries, Investors Associations etc., to spread SEBI's message of "Invest With Knowledge".
- Workshops- At workshops, the aim is to acclimatize the investors with the functioning of the securities market, the basic fundamentals of investment and risk management and their rights and responsibilities. Till date, more than 2188 workshops have been conducted in around 500 cities/towns across the country.
- Advertisement- SEBI has prepared simple II dos and don'ts" for investors relating to various aspects of the securities market. Till date, over 700 advertisements relating to various aspects of Securities Market have appeared in 48 different newspapers/ magaines, covenng approximately 111 cities and 9 regional languages, apart from English and Hindi.
- **Educative Materials-SEBI** his prepmed a standardized reading material and presentation material for the workshops
- **All India Radio-** With regard to educating investors through the medium of radio, SEB Officials regularly participate programmes aired by All India Radio.
- **Website dedicated to Investor Education** http://investor.sebi.gov.in)
- **Cautionary Message on television-** With a view to use the electronic media to reach out to a larger number of investors, a short cautionary message, in the form of a 40 seconds filmic, has been prepared and the same is being aired on television
- **Internet based response system:** A simple and effective internet based response to investor complaints has been set up. On filing of

your complaint electronically, an acknowledgement mail would be sent to your specified email address and you will be issued a complaint registration number instantaneously.

15.4 Question

1.What do you mean by Investor?
2. How this protection is given to the investor?
3. What are rights of share holders?
4. What are rights of debentures?

15.5 Suggested Readings

1. Company law by Avtar Singh
2. Company law by N.D. Kapoor
3. Material from Internet, Google search.

LL.M. Part-1

PAPER CORPORATE LAW

Block IV– Protection of Investors & Creditors & Corporate responsibility

Unit 16- Corporate Governance, Corporate Social Responsibility

STRUCTUR

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16.1 Introduction-

‘Corporate Governance implies that the company would manage its affairs with dillgence, tranprency, responsibility and accountability and would maximize sharcholder wealth. Hence it is required to design system, processes, procedures structures and lake decisions to augment its finaincial performance and share holder value in the long run.

16.2Objective:

Business organizations are social groupings established for the achievement of their goals. They operate in a macro environment that consist of both economic and non-economic variables. The key of satisfying organizational goals is customer satisfaction.

Theories of Corporate Govereonance- There are at least four theories of corporate governance these theories are as follows

16.3.1 The agency theory-

The pure finance view of the firm is that managers must maximize the shareholders wealth. The share holder wealth maximization model may not work because of the agency problem. The basic for the agency theory is the separation of ownership and control. The principal (shareholders) own the company but the agents (Managers) control it. The discrectionary powers possessed by the managers motivate them to expropriate the company’s wealth to themselves. Thuys they may not work to maximize the owner’s value. Under the agency theory of corporate governance, the main concern is to develop rules and incentives based on implicit or explicit contracts, to eliminate or at least, minimize the confilit of intersest between owners and managers.

The firm devises rules and incentive at its own, and they may be in additions to legal regulations in a country

16.3.2 The stewardship theory-

This theory views managers as stewards. They are assumed to work efficiently and nonestly in the interest of company and owner. They are self directed and are motivated by high achievements and responsibility in discharging their duties. In this theory managers are goal-oriented and self motivated and feel constrained if they are controlled by outside directors.

16.3.3The Stake holder theory-

They stake holder theory is based on the promise that the fundamental responsibility of managers is to maximize the total wealth of all stakeholders of the firm, rather than only the shareholders' wealth. Hence, the corporate governance efforts are intended to empower those stakeholders who contribute or control critical resources and skills and to ensure that the interests of these stakeholders are aligned with that of shareholders.

16.3.4 The political theory

The political theory states that it is the government that decides the allocation of control, rights, responsibility, profit etc. between owners, managers, employees and other stakeholders. Within the overall macro-structure, each stakeholder may try to enhance its bargaining power to negotiate higher allocation in its favour. The corporate governance efforts will, thus, depend on the allocated powers of the stakeholders.

16.3.5 Corporate Governance Practice

Good corporate governance requires companies to adopt practices and policies which comprise performance accountability, effective management control by the Board of Directors, constitution of the Board Committees as a part of the internal control system, fair representation of professionally qualified, non-executive and independent Directors on the Board, the adequate timely disclosure of information and the prompt discharge of statutory duties. In fact, companies are needed to at least have policies and practices in conformity with the requirements stipulated under Clause 49 of the Listing Agreement.

16.3.6 Board of Directors

The Board of Directors constitute the top and strategic decision making body of a company. The Board of Directors should be composed of Executive and Non-Executive Directors, meeting the requirement of the Code of Corporate Governance. The Board should represent an optimum mix of professionalism, knowledge and expertise. The Board should meet frequently and all pertinent information affecting or relating to the functioning of the company should be placed before the Board. Some of the significant matters generally placed before the Board include:

- Review of annual operating plans of business, capital expenditure budget and updates, if any
- Quarterly results of the company
- Minutes of the meeting of the Audit Committee and other committees
- Information on the recruitment and remuneration of senior officers just below the Board level, including the appointment and removal of the Chief Financial Officer and the Company Secretary .
- Materially important show causes, demands, prosecutions and penalty notices
- Fatal or serious accidents or dangerous occurrences
- Any materially significant effluent or pollution issues
- Any materially relevant default in financial obligations to and by the company or any substantial non-payment for goods sold by the company
- Any issue which involves possible public or product liability claims of a substantial nature
- Details of any joint venture or collaboration agreement
- Transactions that involve substantial payments towards goodwill, brand equity and intellectual property, if any
- Significant labour problems and development in human resources/industrial relations
- Material sale of investments, subsidiaries and assets not in the normal course of business
- Quarterly details of foreign exchange exposure and the steps taken by the management to limit the risk of adverse exchange rate movement
- Non-compliance of any regulatory provision or listing requirements as well as shareholder service such as the non-payment of dividend and delays in share transfer

Working of the subsidiary companies

Almost half the directors on the Board should be independent directors. The independent directors are expected to act independently, without any prejudice to anyone, and should playa significant role in Board meetings. They make critical assessment of all issues discussed in the Board

meetings and make significant contribution drawing from their wide experience and expertise in various fields.

The meetings of the Board of Directors should be held at regular intervals of not more than four months. The provisions under the Companies Act, 1956 and those under Clause 49 of the Listing Agreement should be strictly followed in this regard. The Board should meet at least once a quarter to review the performance and financial results. The statutory auditors and senior executives of the Company may be invited to the Board meeting for discussion and to provide inputs whenever required.

Audit Committee The appointment of the Audit Committee is mandatory, and it's a very powerful instrument of ensuring good governance in the' financial matters. The Audit Committee should have independent directors as its members. The members should have experience in the areas of finance, accounts, taxation, company law etc. The company could derive significant advantage from the discussions in the Audit Committee meetings.

The Audit Committee carries out the functions in accordance with the terms of reference set out under Clause 49(II) of the Listing Agreement read together with Section 292A of the Companies Act, 1956, and additional responsibilities assigned to the committee by the Board of Directors. The committee also reviews reports of the internal auditors and statutory auditors along with the comments and action taken. Senior executives are invited to the meetings of the Audit Committee as and when considered appropriate. The head of the management audit, the head of the finance function, statutory auditors and cost auditor regularly attend the meetings of the Audit Committee; the company Secretary acts as the secretary of the committee.

'The functions of the Audit Committee *inter alia* include the following:

- Overseeing the Company's financial reporting process and ensuring the correct, adequate and credible disclosure of financial statements;
- Reviewing with management, the annual financial statements before their submission to the Board with a special emphasis on accounting policies and practices, internal control requirements, compliance with the accounting standards and other legal requirements concerning financial statements;
- Reviewing the adequacy of the audit and compliance function, including their policies, procedures, techniques and other regulatory requirements;

- Recommending the appointment of statutory auditors;
- To review the observations of internal and statutory auditors *about* the findings during the audit of the Company.

Shareholders'/Investors' Grievance Committee **As** a part of corporate governance, companies should form a Shareholders' /Investors' Grievance Committee under the Chairmanship of a non-executive independent director. The committee should monitors investors' the grievances. The committee is responsible for attending to the grievances of shareholders and investors relating to transfer of shares and non-receipt of dividend.

Remuneration Committee The company may appoint a Remuneration Committee to decide the remuneration and other perks etc. of the CEO and other senior management officials as per the Companies Act and other relevant provisions.

Management Analysis Management is required to make full'disclosure of all material information to investors. It should give detailed discussion and analysis of the company's .operations and financial information. There should be enough information given *about* the share prices and movement during the period under review.

Communication The quarterly, half-yearly and annual financial results of the Company must be sent to the Stock

Exchanges immediately after they have been taken on record by the Board. Some companies simultaneously post them on their website. Companies may also provide periodic event-based information to investors and the public at large by way of press releases/intimation to the Stock Exchanges where the shares of the companies are listed.13

The company also makes the presentation to the Institutional Investors and the copy of presentation are also filed with the Stock Exchange and also uploaded on the company's website for the information of the investors

16.3.7 Corporate Social Responsibility

16.3.8 Introduction –

For a long time in the past, profit maximisation was viewed as the sole business objective, but this view no more holds good. Even the

memorandum of association of a company does not specify profit maximisation as the company's main obective. If companies wish to survive and maintain their growth rate in the market, if they wish to become market leaders, if they wish to sustain an increasing share of sales and assets, they have to sacrifice a art of their off' in favotere its of groups other than the owners. Not on y t e owners, but the shareholders and salaried employees of the firms also wish their companies to cater to varied interests of society rather than maximising their profits.

This general outlook of business firms recognises the concept of social responsibility.

16.3.9 Meaning of Social responsibility –

The concept of social responsibility entails the business organisation's obligations to look after the interests of society beyond the limits of their economic interests.

Traditionally, providing goods and services to society according to their demands and needs, maximising corporate profits and creating more job opportunities were viewed as social responsibilities of the business but the focus has gradually changed from economic aspects to social aspects of the business decisions. Business organisation is viewed as an institution that helps in solving a broad range of social problems like poverty, crime, pollution, raising the level of education, creating better job opportunities, upliftment of the minority and the weaker sections of society, etc.

Business managers have begun to realise that they owe a responsibility towards society as they owe it to the business enterprises.

The terms 'social responsibility' has been defined by different management thinkers as follows:

"Social responsibility is an organisation's obligation to benefit society in ways that transcend the primary business objective of mrodmising profit."7 -

"Social responsibility refers to the obligation of an organisation to seek actions that protect and improve the welfare of society along with its own interests."s

S.R. is the implied, enforced, or felt obligation of managers, acting in their official capacities to serve or protect the interest of groups other than themselves."

Nature of S.R. - The nature of S.R. can be understood as follows:

(1) ***Focus on business firms***- Though business and non-business organisation must be equally in discharge of responsibilites towards society, the focus is more in business firms to look after the social interests.

(2**) *It deals with the moral issues-*** Companies have specified policies and programmes for lookingg after the interests of their employees and non-employees. These programmes emanate from the need to do What is right and just for the society as a whole.

(3) *It is. commensurate w.ith .the objective of profit maximisation* - Social goals are fulfilled by the organisation when they. are economically sound. A financially unviable enterprises will not look after the mterests of society. In fact, the increased costs that companies have to bear on account of discharge of SR are passed on to consumers in the form of increased prices of goods and services.

(4) *It is a pervasive activity* - SR is not only the obligation of top level managers; managers at all levels must involve themselves in discharge of SR.

(5) *It is a continuing activity-* SR is not catering to the interests of society once or twice. It is important for organisations to continuously engage themselves in social issues if they want to survive and grow in the long run. The economic and the social. issues, in fact, go hand in hand.

16.3.10 Why social responsibility –

In the early 1900s. business firms were governed by economic motives but modern business organisations have experienced a marked shift from economic to economic and non-economic objectives. A question that arises here is-What caused management shift its attitude from purely profit-oriented approach to social causes such as aid to education, urban renewal, opening up of job opportunities for the minorities etc. ? The modern managers 'give due regard to social concerns because of the following reasons:

(1) *Social forces* - Business organisation are powerful institutions that dominate the society. There acceptance by the society of which they are a part will be denied if they ignore social problems. To avoid self destruction in the long-run, business enterprises have to assume social responsibilities.

(2) *Avoid Government interference* - Non-conformance to social norms is likely to attract legislative restrictions. The Government directly int1uenccs the organisations through rules and regulations

that dictate what they should do and what not. Various agencies monitor the business activities. For example c*entral Pollution Control Board* takes care of issues related to environmental pollution, *Securities and Exchange Board of India* takes care of issues related to investor protection em*ployees State Insurance Corporation* takes care of issues related to employees' health etc. Ogranisations that violate these regulations are subject to levy of fines and penalties. To avoid such interventions, business organisations have risen to the cause of social concerns.

3) Strength of the labour force - Labour force today is united into unions which have organised themselves in groups that demand protection of their rights from the business enterprises. To continue to get the support of the workers, it has become necessary for business organisations to discharge responsibility towards their employees.

(4) *Consumer protection* - *Caveat emptor("let* the buyer beware") which was once the dictum of many business firms no more holds true. Consumer today's the kingpin around which all marketing activities resolve. Consumer today will not buy what is offered to him. He buys what he wants. Business Firms that fail to offer goods and services that satisfy the needs of consumers are Likely to be liquidated sooner or later. Besides, there are consumer redressal cells where consumers are given protection against anti-consumer activities that are carried on by the business firms. Consumer sovereignty has, thus, forced business firms. to assume social responsiveness towards them.

(5) *Self enlightenment* - With increase in the level of education and understanding of the business men that they are the creations of society, they are themselves motivated to work for the cause of social good. Managers create public expectations by voluntarily setting and following idealistic standards of moral and social responsibility. They ensure that they are paying their taxes regularly, paying dividends to shareholders regularly, paying fair wages to workers, providing quality goods to consumers and so on. Rather than legislative interference being the cause of social responsibility, business concerns assume social responsibility on their own.

(6) *Professionalisation* - **Management is** moving towards professionalism and this growing professionalisation of business firms is contributing to growing social orientation of business. Increasing professionalism is causing managers to have proper management education and qualifications. He specialises in planning, organising,

leading and controlling the efforts of others through use of his knowledge and subscribes to the code of ethics established by a recognised body. The ethics of profession bind business managers to social values and growing concern for society.

Increasing awareness of social responsibility is, thus, the outcome of a businessman's concern for above factors. To survive and grow in an environment of dynamism and challenge, the business concern does not decide about whether or not to discharge social responsibilities but decides upon the extent of discharge of social responsibility. A good business concern should anticipate developments through forecasts and act in accordance with the currently conceived social responsibilities to achieve the future targets.

16.3.11 Scope of Social responsibility

A hierarchy of the extent to which business units are engaged in discharge of their social responsibilities has been developed by *R. Joseph Monsen.1O* Starting from the lowest level, following are the four levels of hierarchy :

(1) ***Obeyance of the law***- Managers feel that they are discharging social responsibility by merely obeying the law. .

(2) ***Catering to public expectations*** - The concept of social responsibility goes beyond mere obeying the law. In addition to abiding by the legal framework of the country, SR' also aims at catering to what public, expectations are from the business enterprises (for example, providing job opportunities, quality goods, controlling polution.etc.)

(3) ***Anticipation of public expectations* -** At a still higher level, business firms not only fulfill what society expects from them, they of the society and devise programmes to fulfil those needs.

(4) ***Creation of public expectations*** - At the highest level of hierarchy are managers who not only cater to public demands; but also set standards of social responsibilities and want the society to be benefited by those standards.

Business enterprises are moving from lower to the higher levels of this hierarchy.

16.3.12 Historical perspectives of SR –

Expectations of society from the business concerns as regardsd corporate social responsibility has gone through three phases:

(1) **Profit maximisation**- Historically, public viewed business enterprises as institutions which had to mainly look after the interests of their owners. The discharge of SR was to the extent of maximising company's profits within the legal framework of the country.

(2**) *Trusteeship management* -** During .the later years, the concept of SR got widened from: mere satisfaction of owner s mterests to looking after the interests of other sections of society as well, such as, employees, consumers, creditors etc. Providing adequate working conditions, goods of the right quality and quantity, timely repayment of loans to creditors etc. were viewed as essential aspects of SR,

(3) ***Quality of life management* -** A still wider perspective of SR which developed since 1960s viewed business enterprises as institutions which help in removing social ills and promoting upliftment of the society.

Philosophical Perspectives of ***SR*** . Similar to three phases of historical perspectives, are the three phases of the philosophical perspectives of SR, These are:

(1) *Traditional philosophy* - Similar to the profit maximisation phase, the traditional philosophy defines SR as production of goods and services for society at the lowest costl2. Economist, *Milton Friedman'3* is a pronounced advocate of this philosophy, According to him, since business enterprises use shareholders' money, they should optimally utilise it, so as to be able to give them a reasonable return on their capital. Looking after the interests of shareholders is the prime responsibility of business as per the traditional philosophy. Social problems have to dealt with by the Government rather than the business enterprises.

(2) *Stakeholder Philosophy-* It is an extension of the traditional philosophy. According to this philosophy, similar to the trusteeship management, business enterprises must broaden their scope of SR to look after the interests of shareholders along with other sections of society such as, consumers, Government, labour unions, suppliers etc.

This is important for long-run survival of business firms even if it results in business losses in the short-run. .

(3) *Affirmative Philosophy* - Similar to third phase of the historical perspective (quality of life management), the affirmative philosophy aims at the broadest spectrum of social responsibility. It holds that managers have a responsibility to promote mutual interest of the firm and its various stakeholders, including the general public.

Not only should managers cater to present needs of the society, they must also anticipate their future needs and try to integrate and coordinate needs of the society with needs (goals) of the organisation.

16.3.13 Arguments in favour of SR –

Following arguments have been offered in favour of assuming corporate SR :

***(1) Long run surival of the business concerns*-** Firm which are engaged in assuming SR may suffer losses in the short-run but in fulfilling social obligation is certainly beneficial for the long-run survival of the firm. The short term costs are, therefore, seen as investments in long-run profitability.

***(2) Profitable for the business concerns* -** The fact that SR is necessary and helpful for . long-run survival of the firm also substantiates long-run profitability of the business organisations.

3) *Moral and social commitment-* Business organisations operate in a social environment and therefore, should be morally committed to look after interests of the society. A plant, where manufacturing activities result in toxic waste should be morally bound to devise methods for disposal of this waste to avoid environmental pollution. .

4) *Improvement in the public image* - A business firm that looks after interests of the society creates goodwill and public image for itself. Its goods and services are more readily acceptable to society than those of its competitors.

5) *Helps in avoiding Government regulation* - Business organisations which do not assume SR on their own shall be required to do so by the Government. To avoid excessive Government regulation and interference, the enterprises themselves become morally aware of the SRs.

Arguments against S.*R.* - The concept of corporate SR has been criticised on the following grounds:

1) *Business is an economic activity* - It is often argued by opponents of SR that main function of a business enterprise is to look into the economic viability of its operations. It is for the Government to look after interests of the society. The prime responsibility of assuming SR should, therefore, be that of the Government and not of the business enterprises.

2) *Quantification of social benefits* - What exactly measures SR and to what extent should a business enterprise be engaged in it, what amount of resources should be committed to the societal values, whose interest

should hold priority over others (shareholders should be preferred over suppliers or *vice versa)* and numerous other questions are open to subjective considerations which make SR a difficult task to be assumed.

3) *Cost-benefit analysis.* Any social-benefit programme where initial costs exceed its benefits is not likely to be taken up by the business enterprises even in the shortrun.

4) *Lack of skill and competence*- Professionally qualified managers may not have the required aptitude for solving the social problems.

5) *Transfer of social costs* - Costs related to social programmes are adjusted by the business concerns in the following ways is:

(a) Increase in prices - The costs are passed on to consumers in the form of increased prices of goods and services.

(b)Reduction in wages - If managers wish to maintain existing level of prices, the social costs may be reflected in reduction of wages.

(c)Reduction in profits - Wages, if aimed at being stabilised, company's profits would be reduced which will be reflected in lower rate of dividends to the shareholders. Profits; once reduced, will vitiate the .manager's desire to further engage in assuming corporate SR.

6)*Sub-optimal utilisation of resources* - Scarce business resources, if utilised for meeting social goals, would violate the very purpose of existence of an organisation.

Barriers to SR - Social responsiveness of business enterprises is affected by the following barriers:

(1) *Managerial perceptions-* Even if employees of an organisation wish to assume SR. their superiors may not allow them to do so. In such situations employees may be forced to make a. choice between their personal growth and' social growth. The inevitable choice IS personal growth even If it is at the cost of social values.

(2) Co*mparison of divisional performance*- The overall performance of an organisation is Judged by performance of Its various departments. A department which is more actively engaged in discharging SR is likely to show lower profits than its counterparts. This may not be acceptable to top managers unless of course, the social programmes are sanctioned and approved by them.

(3) *Overall organisational barriers* - Reduced level of profits on account of discharge of SR may not be acceptable to owners (shareholders) or employees of the organisation if it is reflected in lower dividends or lower

wages. Catering to the values of one section of society at the cost of another is not justified.

(4) *International barriers* - If a multinational corporation is buying its supplies from the home industry and domestic companies sell the supplies at a higher price (because of increased social costs) *vis-a-vis* other countries, they are likely to lose their standing in the international market. International business may, thus, act as a barrier to social responsiveness of business enterprises.

In view of the above discussion, it is advisable for any business enterprise to take up social programmes only if its benefits outweigh its costs.

Various stakeholders and SR - Socially responsive firms often face a question - To whom are we responsible?

Various groups towards whom business organisations have to discharge SR are:

- Shareholders
- Employees
- Customers
- Community
- Organisations
- Government

16.3.15 SHAREHOLDERS –

Shareholders bring in capital for the business enterprise and facilitate its smooth functioning. The business enterprise, in turn, owes the following responsibilities to shareholders:

(1) *Payment of fair and regular dividends to the shareholders* - Shareholders give money to company in return for a dividend. The companies must, therefore, ensure regular payment of dividends to them.

(2) *Increase in the value of investment* - Shareholders not only want a regular payment of dividend, they also want a regular increase in the rate of dividend. The companies must, therefore, improve upon their financial performance to pay dividends at an increasing rate in each succeeding year. .

(3) *Safety of investment* - Equity shareholders are the last claimants of company's assets in the event of its winding up. Companies must maintain sufficient assets

with them so as to ensure safety of shareholders' investment in the worst circumstances of winding up.

(4) *Disclosure* - Companies must fully disclose their financial position in the annual reports so that shareholders know the progress of the company and the extent to which their interests are secured in it.

16.3.16 EMPLOYEES –

Employees help in smooth administration of a business firm and also help in effective conversion of its inputs into outputs. The business organisations must, therefore, discharge following obligations towards employees:

(1) *Proper working conditions* - Business firms must ensure proper working conditions for their employees. Basic facilities like lighting, ventilation and sanitation should be provided for. Good and healthy working conditions also help in increasing industrial productivity.

(2) *Financial benefits-* Financial benefits like pension, provident fund and perquisites like medical and recreational facilities must be provided for in the organisation. These benefits are necessary for fulfilment of their physiological needs and a secured future.

(3) *Participation in decision-making processes*- Workers should be allowed to participate in managerial decision-making and express their view points on organisational matters. This not only allows for the overall development of the workers' personality but also provides management with useful and constructive suggestions.

(4) *Training and motivation* - Training programmes should be regularly conducted to update their knowledge in the areas of their job and suitable motivators (financial and non-financial) must also be provided to motivate them to increase their individual output.

(5) *Recognition of their rights* - Management must recognise the right of workers to form trade unions and bargain with managers about their wages, working hours and working conditions.

6) *Obeyance of labour laws* - Management must obey labour laws with respect to payment of wages, settlement of industrial disputes, payment of bonus, gratuity, compensation etc. Adherence to legislative measures ensures protection of workers' rights.

(7) ***Job security***- Not only should organisations protect workers' rights, they must also provide them job security. Secured jobs will promote workers' satisfaction and greater output.

16.3.17 CUSTOMERS

Consumer is the king'. This is an accepted fact in the marketing world today. Unless the customer buys company's products, the company's existence carries no meaning. Business firms owe the following responsibilities to customers:

(1) ***Provision of quality goods*** **-** Firms must provide customers with goods of ~he right quality, at the right price, in the right quantity and the right place. Not only will this satisfy customers' needs, it will also provide a regular clientele to the business firms.

(2) ***Complete information.*** Complete information about use and quality of goods should be given in the advertisement. The advertisement must express both, positive and negative attributes of the product.

(3) ***Customer service*** - After sales services like installation, repair, warranty etc. add tothe customer goodwill and also promote company's products in the market.

(4) ***Need based products.*** Companies should produce products that satisfy needs of the customers rather than those that maximise their profits.

(5) ***Regular supply of goods.*** Business firms should avoid indulging in practices like hoardmg and black-marketing and ensure a steady supply of goods in the market. Customers should be able to buy the goods when needed.

(6) ***Safety of products*** **-** The products that business firms are selling must conform to, health and safety standards. Their consumption should be safe and not lead to health hazards.

16.3.18 COMMUNITY.

Various resources, financial and non-financial, are provided by community to the business enterprises and, therefore, their interest must also be looked after by the business organisations :

(1) ***Pollution-free environment*** - The industrial machinery is likely to produce noise and air pollution. This is against the health and safety measures of the community. Business firms must conform to pollution

standards and attempt to provide a clean and healthy environment to the community at large.

(2) ***Promotion of artistic and cultural activities*** - Business firm must donate funds for artistic and cultural development of community.

(3) ***Assistance*** **in** ***urban and rural planning and development*** - Business enterprises must assist the Government in urban and rural planning and developmeDt. This raises the standard of living of community which is ultimately reflected in the development of the nation through development of business enterprises.

(4) ***Support local health-care programmes*** - Business support for health-care programmes will result in a healthy society. Healthy society will provide healthy workers to business enterprises and lead to development of organisations and individuals working therein.

(5) ***Employment opportunity*** **-** Though adoption of capital-intensive technology is good for development of an organisation, it must ensure/at the same time, to offer enough employment opportunities to the people of its community.

(6) ***Optimum utilisation of resources****.* Physical and financial resources are provided to business firms by the community members. It becomes the duty of business enterprises, therefore, to optimally utilise those resources so that they produce maximum output at minimum cost.

(7) Social programmes. Business organisations should conduct social programmes like career counseling and also provide job and career opportunities to graduate and post-graduate students of national universities.

(8) ***Solve social problems.*** Business enterprises can contribute in solving social problems like untouchability, poverty, racism etc. as much as non-business organisations can.

(9) ***Conformance to business ethics*** - Business houses should conform to business ethics and a socially acceptable code of conduct. Indulgence in unfair practiees like hoarding, speculation and adulteration should be avoided.

16.3.19 ORGANISA TIONS –

Business organizations belonging to same trade compete for resources which are in scarce supply. They must show concern and responsibility towards each other in the following areas:

(1) Healthy competition-

Business firms should avoid cut-throat competition. Healthy competition will further mutual interests of organisations belonging to the same industry.

(2) Sharing of resources

The resources being scarce, organisations should share them in a way that each one of them can carry out its productive and administrative processes smoothly.

16.3.20 GOVERNMENT –

Government provides numerous facilities to business enterprises like transportation facilities, electricity, water and sewage facilities, police and fire protection etc. The business organisations must also, in turn, discharge social responsibility towards the Government:

(l) ***Payment of taxes*** - Business firms must submit their yearly returns of income and pay income-tax judiciously. Taxes are a source of revenue for the Government which will be used by it for furtherance of business interests.

(2) ***Obey the law*** - Government has introduced a number of legislative measures to smoothen the business operations. The business firms, in turn, should obey the legislature machinery (Income-tax law, company law, labour laws etc.) and help the Government in providing support to the legal enactment.

(3) ***Contribute to national goals*** - Business objectives should contribute to national goals which will enhance the nation's industrial image in the international market. This will also strengthen the firm's foreign exchange reserves.

Compromise between conflicting groups

The above discussion reveals that different groups want their returns to be maximised from business enterprises. While owners want maximum profits, shareholders want maximum dividends, workers want increased wages, consumers want quality goods at reduced prices, community wants upliftment of the social programmes, the Government wants regular payment of taxes. Which of these interests holds prime importance for the managers is difficult to assert. Balancing the demands of all the stakeholders becomes important for business managers so that multiple demands do not jeopardise the achievement of company's objectives. Managers should avoid conflicting interests over matters such as profits, wages, dividends, taxes etc. and carry on the business activities in a manner that provides support to each of the stakeholders.

16.3.21 Profit maximisation and social responsibility –

Given to understand that social responsibility is essential for long-run survival and growth of business enterprises, does it amount to saying that the firms should limit their profits in their efforts to recognise social responsibility?

Profits are and will continue to be the criterion for testing the economic efficiency of business enterprises. Some managers insist that maximisation of profits is the road to social responsibility. They feel that by maximising profits they can create more jobs, pay more dividends, wages and taxes. As observed by *Goyder"in* the responsible company, profits will continue to be the criterion of financial health". Profits are the life- of the business enterprise but maximising profits should not be the ultimate objective of a company. It is necessary that a company makes profits. Unless it earns sufficient profits it will not be able to discharge its social responsibilities.

Profits help in maintaining the support of shareholders and creditors. Profits improve the firm's public image. All social programmes conducted by firms involve costs that may be borne by organisations by increasing their prices, lowering wages or reducing profits. If companies pass the costs of social responsibilities to consumers in the form of high prices or workers by reducing their wages or shareholders by reducing their dividends, the very purpose of social responsibility gets defeated.

According to *Friedman,* "there is one and only one social responsibility of business, to use its resources and energy in activities designed to increase its profits so long as it stays within the rules of the game...engages in open and free competition, without deception and fraud: Organisations that are doing well financially feel more able to engage in activities related to social responsibility.

This makes clear the fact that that there is nothing against the idea of business making profits. What is important is that profits should be used to achieve the objectives of social responsibility. Profit maximisation without regard to societal interests (shareholders, consumers, employees, etc.), has no meaning.

Social actions of firms are also important because they help in making a prosperous society which will ultimately contribute to the company's potential pool of shoppers and help it in maximising its profits. Profit maximisition and social responsibility, thus, can be said to be complementary to each other.

16.4 Question:

Q.1. What is meant by corporate governance?

Q.2. Briefly explain theories of corporate governance?

Q.3. What is the role of the Board of Directors and Audit Committee?

Q.4. Discuss the concept of social responsibility of business: What are these responsibilities?

Q.5. Social responsibility of the business is an exercise of balancing the objective of society on are hand and the objective of the business on the other named pisuss?

Q.6. Explain the meaning, nature and scope of social responsibility?

Q.7. Explain the arguments for and against social responsibility?

16.5 Suggested Reading

1. Student’s guide to business organization by Dr. Neeru Vasishth
2. Industrial Relations in India by Ratna Sen