LESSON-1

ESSENTIALS OF A VALID CONTRACT

STRUCTURE

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1.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define the contract and explain the various types of contract

(b) Describe the essentials of a valid contract

1.1 INTRODUCTION

We enter into contracts day after day. Taking a seat in a bus amounts to entering into a contract. When you put a coin in the slot of a weighing machine, you have entered into a contract. You go to a restaurant and take meals, you have entered into a contract. In such cases, we do not even realize that we are making a contract. In the case of people
engaged in trade, commerce and industry, they carry on business by entering into contracts. The law relating to contracts is to be found in the Indian Contract Act, 1872.

The law of contracts differs from other branches of law in a very important respect. It does not lay down so many precise rights and duties which the law will protect and enforce; it contains rather a number of limiting principles, subject to which the parties may create rights and duties for themselves, and the law will uphold those rights and duties. Thus, we can say that the parties to a contract, in a sense make the law for themselves. So long as they do not transgress some legal prohibition, they can frame any rule they like in regard to the subject matter of their contract and the law will give effect to their contract.

1.2 OBJECT OF THE ACT

The main objective of the Contract Act is to ensure that the rights and obligations arising out of a contract are honoured and that legal remedies are made available to an aggrieved party against the party failing to honour his part of agreement. The Act is of great importance to businessmen as it enables them to plan ahead with the knowledge that what has been promised to them will be performed by the promisors failing which they will be liable for the loss suffered.

1.3 DEFINITION OF CONTRACT

A contract is a legally binding agreement, that is, an agreement which will be enforced by the courts. Salmond defines contract as, “an agreement creating and defining obligation between the parties.” Halsbury defines a contract to be, “an agreement between two or more persons which is intended to be enforceable at law and is constituted by the acceptance by one party of an offer made to him by the other party to do or abstain from doing some act.”

The definition of the term ‘contract’ given in the Act is based on the definition given by Halsbury. Section 2(h) of the Indian Contract Act defines a contract as, “An
agreement which is enforceable by law.” This definition has two important components which constitute the basis for a contract. They are:

1. **Agreement**: An agreement gives birth to a contract. An agreement is defined as, “every promise and every set of promises forming consideration for each other.” (Section 2(e)). A proposal when accepted becomes a promise. Thus an agreement is an accepted proposal. An agreement comes into existence only when one party makes a proposal or offer to the other party and the other party signifies his assent thereto. In short, an agreement is the sum total of offer and acceptance. The following are the characteristics of the definition of agreement as given above:

   (a) **Plurality of persons**: There must be two or more persons to make an agreement because one person cannot enter into an agreement with himself.

   (b) **Consensus ad idem**: An agreement is necessarily the outcome of consenting minds or *consensus ad idem*, i.e., the two contracting parties must agree as regards the subject-matter of the contract at the same time and in the same sense.

2. **Legal Obligation**: Although every contract is an agreement, there are many kinds of agreements which are not contracts. An agreement to become a contract must give rise to a legal obligation. Obligation is an undertaking to do or to abstain from doing some definite act. The obligation must be such as is enforceable by law. In other words, it must be a legal obligation and not merely moral, social or religious. To take an example, “Please, come to my house”, says P to D, “and we shall go out for a walk together”. D came to the house of P but P could not leave the house because of some important engagement. D cannot sue P in damages for his not fulfilling the promise, the reason being that there had been no intention between D and P to create any legal obligation by the engagement as made between them. In the circumstances, there was, in the eye of law no contract between P and D. Contracts must not be the sports of an idle hour, or mere matters of pleasantry, never intended by the parties to have any serious effect whatever.
Another kind of obligation which does not constitute a contract is the arrangement made between husband and wife. Such agreements are purely domestic and are not intended to create legal relationship.

The Leading case on this point is Balfour V. Balfour. The points decided were:

(a) Agreements which do not create legal relations are not contracts.
(b) Agreement between husband and wife in domestic affairs is not a contract.

Facts of the case are:

Mr. Balfour was employed in Ceylon. Mrs. Balfour owing to ill health, had to stay in England and could not accompany him to Ceylon. On the occasion of leaving her in England for medical treatment Mr. Balfour promised to send her £30 per month while he was abroad. But Mr. Balfour failed to pay that amount. So Mrs. Balfour filed a suit against her husband for recovering the said amount. The court held that it was a mere domestic agreement and that the promise made by the husband in this case was not intended to be a legal obligation. Hence the suit filed by Mrs. Balfour was dismissed since there was no contract enforceable in a court of law.

In Balfour v. Balfour, the intention not to create a legal obligation was clear from the conduct of the parties. On the other hand the parties may make this intention clear by an express statement in the contract.

The main distinction between a legal obligation and a social or religious obligation is that the former involves money value but the latter does not. In order to constitute a contract an agreement must create legal obligation. It is this theme which has given rise to the popular saying: “All contracts are agreements but all agreements need not be contracts.”

It may be noted that the law of contract deals only with such obligations which spring from agreements. Obligations which are not contractual in nature are outside the scope of the law of contract. For example, obligation to maintain wife and children,
obligation to comply with the orders of a court and obligation arising from a trust do not fall within the scope of the Contract Act.

1.4 CLASSIFICATION OF CONTRACT

Before dealing with the various essentials of a valid contract one by one in detail, it is desirable to discuss the “various types of contract,” because we shall be using terms like ‘voidable contract’, ‘void contract’, ‘void agreement’, ‘unenforceable contract’, etc., very often in the course of our discussion. The classification of contracts from the various points of view may be discussed as follows:

(a) From the point of view of enforceability

Contracts may be classified according to their enforceability as (i) valid (ii) void contracts or agreements (iii) voidable (iv) illegal and (v) unenforceable.

Valid Contract: A valid contract is one which satisfies all the requirements prescribed by law for the validity of a contract, i.e. the essential elements laid down in Sec.10. A valid contract creates in favour of one party a legal obligation binding upon the other.

Void Contract: A contract which was legal and enforceable when it was entered into may subsequently become void due to impossibility of performance, change of law or other reasons. When it becomes void the contract ceases to have legal effect. In other words, a void contract is not valid from its inception but subsequent to its formation, it becomes invalid and destitute of legal effect because of certain reasons. [Sec. 2(j)]

Void Agreement: “An agreement not enforceable by law is said to be void.”—Sec. 2(g). A void agreement has no legal effect. It confers no rights on any person and creates no obligations.

An agreement made by a minor; agreements made without consideration (except the cases coming under Sec.25); certain agreements against public policy; agreements in restraint of trade or in restraint of marriage or in restraint of legal proceedings, etc. are examples of void agreements.
Voidable Contract [Section 2(i)] : A voidable contract is a contract which can be avoided or set aside at the option of one of the parties to the contract. It can be set aside at the option of the party defrauded. Until it is avoided or rescinded by the party entitled to do so by exercising his option in that behalf, it remains valid. But the aggrieved party must exercise his option of rejecting the contract (i) within a reasonable time and (ii) before the rights of third parties intervene, otherwise the contract cannot be repudiated.

Examples

1. X threatens to kill Y if he does not sell his new Ambassador car to X for Rs.12,000. Y agrees. The contract has been brought about by coercion and is voidable at the option of Y, i.e. the aggrieved party.

2. A, with the intention to deceive B, falsely represents that fifty lakh bulbs are made annually at A’s factory, and thereby induces B to buy the factory. The contract has been caused by fraud and as such is voidable at the option of B.

The Indian Contract Act has laid down certain other situations also under which a contract becomes voidable. They are:

1. When a contract contains reciprocal promises, and one party to the contract prevents the other from performing his promise, then the contract becomes voidable at the option of the party so prevented (Sec.53).

   Example : A, contracts with B that A shall repair B’s house for Rs.1000. A is ready and willing to execute the work accordingly, but B does not supply him material and thus prevents him from doing so. The contract is voidable at the option of A.

2. When a party to the contract promises to do a certain thing within a specified time, but fails to do it, then the contract becomes voidable at the option of the promises, provided at the time of entering into contract, the intention of the parties was that the time would be the essence of the contract (Sec.55).
Example: A contracts with B that A shall whitewash B’s house for Rs.1000 within fifteen day. But A does not turn up within the specified time. The contract is voidable at the option of B.

Consequences of Recession of Voidable Contract: Section 64 lays down the rights and obligations of the parties to a voidable contract after it has been rescinded. The section states that when a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is a promisor. If the party rescinding a voidable contract has received any benefit under the contract, he must restore such benefit to the person from whom it was received. For example, when a contract for the sale of a car is avoided on the ground of coercion, any advance received on account of the price must be refunded. The object of this refund of money is to ensure that the parties are placed on the same footing in which they would have been without the contract. However, it must be remembered that the benefit which is to be restored must have been received under the contract. If a certain amount has been received as a security or as an earnest money for the due performance of the contract, such deposit is not to be returned if the promisor fails to fulfill the promise because it is not a benefit received under the contract.

Illegal or Unlawful Contract: The word illegal means ‘contrary to law’ and the term contract refers to an agreement enforceable by law. Therefore to speak of an ‘illegal contract’ involves a contradiction in terms as it amounts to saying that an agreement contrary to law is enforceable by law. Thus it will be appropriate to use the term illegal agreement in place of illegal contract. An illegal agreement is one which is against the law enforceable in India. The term ‘illegal agreement’ has a wider conception than ‘void agreement.’ All illegal agreements are void but all void agreements are not necessarily illegal, e.g., an agreement with a minors is void but not illegal.

Unenforceable Contract: A contract may be valid, but it may not, at the same time, be given effect to in a court of law. The statement is paradoxical; but it is nonetheless true. The contract is valid, because judged by the canons of law which are applied to test the
validity of a contract, the contract is flawless; but it cannot be enforced because of certain technical defects such as absence of writing, registration, requisite stamp, etc., or time barred by the law of limitation. Suppose A gives a loan of Rs.1000 to B. The contract of loan, let us assume, is valid in this case; but if A does not sue on the contract within the period prescribed by law and allows his claim to be barred by time, he cannot afterwards recover it from B. He cannot recover it, not because the contract was invalid, but because the Statute of Limitation bars the suit. Similarly, an oral arbitration agreement is unenforceable, because the law requires an arbitration agreement to be in writing. It is important to remember here that some of the contracts can be enforced if the technical defect is removed. For example, if a document embodying a contract is under stamped, the contract is unenforceable, but if the requisite stamp is affixed (if allowed), the contract becomes enforceable.

**Difference between void and voidable contracts:** A void contract is one which is unenforceable by law. It has no legal existence and, therefore, is destitute of legal effect, whereas a voidable contract is that agreement which is enforceable by law at the option of aggrieved party thereto, but not at the option of the other or others. It is valid so long as it is not rescinded or impeached by the party entitled to do so, i.e. the aggrieved party. If the party fails to use his right of avoidance within a reasonable time, the agreement would be binding.

**Difference between void and illegal contracts:** In all contracts there must be legality, otherwise they are void and hence destitute of legal effect. Some contracts are illegal in themselves, e.g., contracts of immoral nature, contracts against public policy, contracts in restraint of trade. All illegal contracts are void but all void contracts are not illegal. An illegal contract or agreement is destitute of legal effect ab-initio. The difference between void and illegal contracts is significant in cases of collateral transactions, e.g. A, a person, who lent money to another to pay bets already made or lost is not precluded from recovering it; but money advanced for illegal transactions cannot be recovered. Thus the
term ‘illegal’ is narrower in meaning than ‘void’ or ‘voidable’. All illegal contracts are void, but all contracts which are void are not necessarily illegal.

(b) **From the point of view of creation**: From the point of view of creation, contracts may be two types: (i) express contracts, and (ii) implied contracts.

**Express Contract**: Contracts entered into between the parties by words spoken or written, are termed as express contracts. For example, if X tells Y on telephone that he offers to sell his house for Rs.20,000 and Y in reply informs X that he accepts the offer, there is an express contract.

**Implied Contract**: Where the offer or acceptance is made not by words, written or spoken, but by acts and conduct of parties, it is termed as an implied contract. Thus, where X, a coolie, in uniform takes up the luggage of Y to be carried out of a railway station without being asked by Y, and Y allows the coolie to do so, the law implied here that Y agreed to pay for the services of X, and there is an implied contract between X and Y. Similarly, when A takes a seat in a bus, an implied contract comes into being—a contract according to which A will pay the prescribed fare to the conductor (i.e., the agent of the bus company) for taking him to his destination.

(c) **From the point of view of extent of execution or classification according to performance**: On the basis of extent to which the contracts have been performed, we may classify them as (i) executed contract, and (ii) executory contracts.

**Executed Contract**: An executed contract refers to that contract in which both the parties have fulfilled their respective obligations. In other words, an executed contract is one where nothing remains to be done by either party.

**Example**: X agrees to paint a picture for Y for Rs.20. When X paints the picture and Y pays the price, it becomes an executed contract.

Sometimes though the contract may appear to be completed at once yet the effects of it may continue, e.g., when a person buys a bun for a penny and subsequently breaks his tooth due to a stone in it, he has a right to recover damages from the seller.
**Executory Contract**: An executory contract refers to that contract in which both the parties to the contract have yet to perform their respective obligations. In the example referred to above, the contract is executory, if X has not yet painted the picture and Y has not paid the price. Similarly, if A agrees to engage M as his servant from the next month, the contract is executory.

A contract may sometimes be partly executed and partly executory. Thus if Y has paid the price to X and X has not yet painted the picture, the contract is executed as to Y and executory as to X.

On the basis of execution, the contracts may also be classified as (i) unilateral contracts, and (ii) bilateral contracts.

**Unilateral Contract**: A contract is said to be unilateral where one party to a contract has performed his share of obligation either before or at the time when the contract comes into existence. It is only the obligation of the other party which remains outstanding at the time of formation of the contract. Such contracts are also termed as contract with executed consideration. Thus, a contract of loan, where money has been advanced by the creditor is an example of unilateral contract, because the creditor has done what he was to do under the contract, it remains for the debtor to repay the debt.

**Bilateral Contract**: In a bilateral contract obligations of both the parties are outstanding at the time of the formation of the contract. They are, executory contracts or contracts with executory consideration. In other words, in a bilateral contract, there is only a promise for a promise. For example, where X promises to sell his car to Y after 15 days and Y promises to pay the price on the delivery of the car, the contract is bilateral as obligations of both the parties are outstanding at the time of formation on the contract.

It is to be remembered that a contract comes into being on the date on which it is entered into between the parties. The date of its execution is immaterial for determining the validity of the contract. In other words, a contract is a contract from the time it is made and not from the time its performance is due.
(d) **From the point of view of form or mode of the contract:** There are four kinds of contracts: formal contracts, contracts under seal or specialty contracts, simple contracts and quasi-contracts.

**Formal Contracts:** These are in vogue in England. These have not received recognition by the Indian Contract Act. Their validity depends upon their form alone. Consideration is not essential in such contracts. They are required to satisfy certain legal formalities.

**Contract under seal or speciality contracts:** These contracts are those contracts, the terms of which have been written down on a paper and are signed, sealed and delivered. The following contracts must be made under seal, otherwise they will not be valid:

1. Contracts made without consideration.
2. Contracts of lease relating to land for more than three years.
3. Contracts entered into by corporations or companies.
4. Contracts relating to transfer of a British ship or any share therein.

**Simple Contracts:** Contracts which are not formal are known as simple contracts. They are also known as ‘parole contracts’. They are made by words, spoken or written. They are to be valid only when they are supported by consideration.

**Quasi-Contracts:** Contractual obligations are generally created voluntarily; but there are some obligations which are not contractual, but which are treated as such by law, that is to say, there is no contract in fact, but there is one in the contemplation of law. Such contracts are called quasi-contracts. Thus, if X pays a sum of money to Y believing him to be his creditor, while as a matter of fact he was not, he is bound to return the money to X on the assumption that the above sum was given to him by way of loan. The Contract Act has rightly named such contracts as “certain relations resembling those created by contract.”
1.5 ESSENTIAL ELEMENTS OF A VALID CONTRACT

We know that there are two elements of a contract: (1) an agreement; (2) legal obligation. Section 10 of the Act provides for some more elements which are essential in order to constitute a valid contract. It reads as follows:

“All agreements are contracts if they are made by free consent of parties, competent to contract, for a lawful consideration and with a lawful object and are not hereby expressly declared to be void.” Thus the essential elements of a valid contract can be explained as follows:

1. Agreement: As already mentioned, to constitute a contract there must be an agreement. An agreement is composed of two elements – offer and acceptance. The party making the offer is known as the offeror, the party to whom the offer is made is known as the offeree. Thus, there are essentially to be two parties to an agreement. They both must be thinking of the same thing in the same sense. In other words, there must be consensus-ad-idem.

An offer to be valid must fulfill certain conditions, such as it must intend to create legal relations, its terms must be certain and unambiguous, it must be communicated to the person to whom it made, etc. An acceptance to be valid must fulfill certain conditions, such as it must be absolute and unqualified, it must be made in the prescribed manner, it must be communicated by an authorised person before the offer lapses.

Thus, where ‘A’ who owns 2 cars ‘X’ and ‘Y’ wishes to sell car ‘X’ for Rs.30,000. ‘B’, an acquaintance of ‘A’ does not know that ‘A’ owns car ‘X’ also. He thinks that ‘A’ owns only car ‘Y’ and is offering to sell the same for the stated price. He gives his acceptance to buy the same. There is no contract because the contracting parties have not agreed on the same thing at the same time, ‘A’ offering to sell his car ‘X’ and ‘B’ agreeing to buy car ‘Y’. There is no consensus-ad-idem.
2. **Intention to create legal relationship**: As already mentioned there should be an intention on the part of the parties to the agreement to create a legal relationship. An agreement of a purely social or domestic nature is not a contract.

   However, even in the case of agreements of purely social or domestic nature, there may be intention of the parties to create legal obligations. In that case, the social agreement is intended to have legal consequences and, therefore, becomes a contract. Whether or not such an agreement is intended to have legal consequences will be determined with reference to the facts of the case. In commercial and business agreements the law will presume that the parties entering into agreement intend those agreements to have legal consequences. However, this presumption may be negatived by express terms to the contrary. Similarly, in the case of agreements of purely domestic and social nature, the presumption is that they do not give rise to legal consequences. However, this presumption is rebuttable by giving evidence to the contrary, i.e., by showing that the intention of the parties was to create legal obligations.

**Example:** There was an agreement between Rose Company and Crompton Company, whereof the former were appointed selling agents in North America for the latter. One of the clauses included in the agreement was: ‘This arrangement is not... a formal or legal agreement and shall not be subject to legal jurisdiction in the law courts.”

Held that: This agreement was not a legally binding contract as the parties intended not to have legal consequences (Rose and Frank Co. v. J.R. Crompton and Bros. Ltd. (1925) A.C. 445).

3. **Competency of parties**: The parties to the agreement must be competent to contract. If either of the parties to the contract is not competent to contract, the contract is not valid. According to Section 11 following are the persons who are competent to contract –

   (a) who are of the age of majority according to the law to which they are subject;

   (b) who are of sound mind;
(c) who are not disqualified from contracting by any law to which they are subject.

Examples

1. A patient in a lunatic asylum who is at intervals of sound mind may make a contract during those intervals.

2. A sane man, who is delirious from fever or who is so drunk that he cannot understand the terms of a contract, or form a rational judgment as to its effect on his interests, cannot contract whilst such delirium or drunkenness lasts.

4. Free Consent: An agreement must have been made by free consent of the parties. A consent may not be free either on account of mistake in the minds of the parties or on account of the consent being obtained by some unfair means like coercion, fraud, misrepresentation or undue influence. In case of mutual mistakes, the contract would be void, while in case the consent is obtained by unfair means, the contract would be voidable.

Examples

1. X has two scooters, one is blue and the other green. He wants to sell his blue scooter. Y who knows of only X’s green scooter offers to purchase X’s scooter for Rs. 5,000. X accepts the offer thinking it to be an offer for his blue scooter. Held, consent is not free since both the parties are not understanding the same thing in the same sense.

2. An old man executed a sale deed thinking it to be a power of attorney and the deed before execution was not ready over to him. Held, there was no free consent of the man and the contract is not binding on him.

5. Lawful consideration: All contracts must by supported by consideration. Gratuitous promises are not enforceable at law. An agreement made for an unlawful consideration is void. Lawful consideration requires both the presence of consideration and the lawfulness of consideration.
Example: A promises to obtain for B an employment in public service and B promises to pay Rs. 1,000 to A. The agreement is void as the consideration for it is unlawful.

6. Lawful object: The object of an agreement must be lawful. Object has nothing to do with consideration. It means the purpose or design of the contract. Thus, when one hires a house for use as a gambling house, the object of the contract is to run a gambling house. According to Section 23, the object is said to be unlawful if—

   (a) it is forbidden by law;
   (b) it is of such nature that if permitted it would defeat the provisions of any law;
   (c) it is fraudulent;
   (d) it involves an injury to the person or property of any other;
   (e) the court regards it is immoral or opposed to public policy.

Examples

1. A, B and C enter into an agreement for a division among them of gains acquired, or to be acquired, by them by fraud. The agreement is void, as its object is unlawful (Illustration (e) to Sec. 23).

2. A promises to obtain for B an employment in the public service, and B promises to pay Rs. 1,000 to A. The agreement is void as the consideration for it is unlawful (Illustration (f) to Sec. 23).

3. A promises B to drop a prosecution which he has instituted against B for robbery, and B promises to restore the value of the things taken. The agreement is void, as its object is unlawful (Illustration (h) to Sec. 23).

7. Agreements not expressly declared void: The agreement must not have been declared to be expressly void. Agreements mentioned in sections 24 to 30 have been expressly declared to be void.
Under these provisions, agreement in restraint of marriage, agreement in restraint of legal proceedings, agreement in restraint of trade and agreement by way of wager have been expressly declared void.

Examples

1. A makes a contract with B that he will marry nobody except B, and if he marries somebody else, he will pay a certain sum of money to B, the contract is void; because there is no promise of marriage on either side and the agreement is purely restrictive (Lowe v. Peers).

2. An agreement made by a married man that after the death of his wife, he will marry the plaintiff is void; because it interferes with the security of marriage.

3. Where X and Y enter into an agreement which provides that if England’s cricket team wins the test match, X will pay Y Rs.200, and if it loses, Y will pay Rs.200 to X. Nothing can be recovered by the winning party under the agreement as it is by the winning party under the agreement as it is a wagering contract.

4. Where A and B enter into a wagering agreement and each deposits Rs.200 with C instructing him to pay or give the total sum to the winner, no suit can be brought by the winner for recovering the bet amount from C, the stake-holder. Further, if C had paid the sum to the winner, the loser can not bring a suit, for recovering his Rs.200, either against the winner or against C, the stake-holder, even if C had paid after the loser’s definite instructions not to pay.

8. Certainty and possibility of performance: The terms of the contract must be precise and certain. It cannot be left vague. A contract may be void on the ground of uncertainty. Thus a purported acceptance of an offer to buy a lorry ‘on-hire-purchase terms’ does not constitute a contract if the hire-purchase terms are never agreed. (Scammell (G) and Nephew Ltd. v. Ouston (1941) A.C. 251). Similarly an agreement ‘subject to war clause’ is too vague to be enforceable. (Bishop and Barber Ltd. v. Anglo-Eastern Trading and Industrial Co. Ltd. (1944) K.B. 12). The terms of the agreement
must also be capable of performance. An agreement to do an impossible act cannot be enforced.

9. **Legal formalities**: An oral contract is a perfectly valid contract, except in those cases where writing, registration etc. is required by some statute. In India writing is required in cases of sale, mortgage, lease and gift of immovable property, negotiable instrument; memorandum and articles of association of a company, etc. Registration is required in cases of documents coming within the scope of Section 17 of the Registration Act.

All the elements mentioned above must be present in order to make a valid contract. If any one of them is absent the agreement does not become a contract.

1.6 **SUMMARY**

The Indian Contract Act is the most important part of business legislation. A contract is an understanding, promise or agreement made between two or more parties, whereby legal rights and obligation are created which the law shall enforce. Section 2(h) of the Indian Contract Act provides that “an agreement enforceable by law is a contract”. Thus a contract results from a combination of two ideas: agreement and enforceability or obligation. The classification of contracts from the various points of view is (a) from the point of view of enforceability – valid contract, void contract, voidable contract, illegal or unlawful contract and unenforceable contract (b) from the point of view of creation – express contracts and implied contracts (c) from the point of view of extent of execution or classification according to performance – executed contract and executing contract and (d) from the point of view of form or mode of the contract – formal contracts, contracts under seal or specialty contracts, simple contracts and quasi-contracts. The essential elements that characterize a valid contract are agreement, intention to create legal relationship, competency of parties, free consent, lawful consideration, lawful object, agreements not expressly declared void, certainty and possibility of performance, and legal formalities.
1.7  KEYWORDS

**Contract:** A contract is an agreement creating and defining obligations between the parties.

**Agreement:** An agreement is the sum total of offer and acceptance.

**Valid Contract:** A valid contract is one, which satisfied all the requirements prescribed by the law for the validity of a contract.

**Void Contract:** It is one which was legal and enforceable which it was entered into but has subsequently become void because of certain reasons.

**Voidable Contract:** A voidable contract is a contract which can be avoided or set aside at the option of one of the parties to the contract.

1.8  SELF ASSESSMENT QUESTIONS

1. “All contracts are agreements but all agreements are not contracts”. Discuss.

2. Define the term ‘contract’. What are the essentials of a valid contract.

3. Distinguish between :
   (a) Void and illegal contracts
   (b) Executed and executory contracts

4. “As regards the legal effects, there is no difference between a contract in writing and a contract made by word of mouth”. Discuss.
1.9 SUGGESTED READINGS


LESSON-2

VOID AGREEMENTS

STRUCTURE

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2.0 OBJECTIVE

The objective of this lesson is to explain the agreements which have been expressly declared as void agreements by Indian Contract Act.
2.1 INTRODUCTION

All agreements may not be enforceable at law. Only those agreements which fulfil the essentials laid down in Section 10 can be enforced. The Indian Contract Act specifically declares certain agreements to be void. According to Section 2(g), an agreement not enforceable by law is void. Such an agreement does not give rise to any legal consequences and is void ab initio.

It will be useful to distinguish between illegal and void agreement. An unlawful or illegal agreement is one which is actually forbidden by law. A void agreement, on the other hand, is not forbidden by law as in the case of a contract with a minor. But both illegal and void agreements are not enforceable. Thus, an illegal agreement is both unenforceable and forbidden but a void agreement is only unenforceable but not illegal.

Another material difference between an illegal and void agreement relates to their effect upon the collateral transactions. A collateral transaction means a transaction subsidiary to the main transaction. Thus, where money is lent to a loser to enable him to pay a wagering debt, the wager is the main transaction and the loan is subsidiary to it. If the main transaction is forbidden by law, for example, smuggling, a collateral transaction like money given to enable a person to smuggle, will also be tainted with the same illegality and the money will be irrecoverable. But if the main transaction is void only (as in the case of wagering), its collateral transaction will remain enforceable.

The following agreements have been expressly declared as void by the Indian Contract Act.

1. Agreement made by incompetent parties (Sec. 10&11).
2. Agreement made under a mutual mistake of fact (Sec. 20).
3. Agreement, the consideration or object of which is unlawful (Sec. 23).
4. Agreements, the consideration or object of which is unlawful in part (Sec. 24).
5. Agreements made without consideration (Sec. 25).
6. Agreements in restraint of marriage (Sec. 26).
7. Agreements in restraint of trade (Sec. 27).
8. Agreements in restraint of legal proceedings (Sec. 28).
9. Agreements the meaning of which is uncertain (Sec. 29).
10. Agreements by way of wager (Sec. 30).
11. Agreements contingent on impossible events (Sec. 36).
12. Agreements to do impossible acts (Sec. 56).

2.2 AGREEMENT MADE BY INCOMPETENT PARTIES

2.2.1 Minor

An infant or a minor is a person who is not a major. According to the Indian Majority Act, 1875, a minor is one who has not completed his or her 18th year of age. A person attains majority on completing his 18th year in India. In the following two cases, a person continues to be a minor until he completes the age of 21 years.

(a) Where a guardian of minor’s person or property has been appointed under the Guardians and Wards Act, 1890; or

(b) Where the superintendence of a minor’s property is assumed by a Court of Wards.

Why should minors be protected? A minor has an immature mind and cannot think what is good or bad for him. Minors are often exploited and their properties stolen. As such he must be protected by law from any exploitation or ill design. But at the same time, law should not cause unnecessary hardship to persons who deal with minors.

Effects of minor’s agreement

A minor’s agreement being void is wholly devoid of all effects. When there is no contract there should be no contractual obligation either side. The various rules regarding minor’s agreement are discussed below:
1. **An agreement with or by a minor is void**

   Section 10 of the Contract Act requires that the parties to a contract must be competent and Section 11 says that a minor is not competent. But neither Section makes it clear whether the contract entered into by a minor is void or voidable. Till 1903, courts in India were not unanimous on this point. The Privy Council made it perfectly clear that a minor is not competent to contract and that a contract by a minor is void ab initio.

2. **No ratification**

   An agreement with minor is completely void. A minor cannot ratify the agreement even on attaining majority, because a void agreement cannot be ratified. A person who is not competent to authorise an act cannot give it validity by ratifying it. Thus, where a minor borrowed a sum of money by executing a simple pronote for it and after attaining majority executed a second pronote in respect of the original loan plus interest thereon, a suit upon the second pronote was not maintainable.

   If on coming of age, a minor makes a new promise and not merely an affirmation of the old promise, for a fresh consideration, the new promise will be binding.

3. **Minor can be a promisee or beneficiary**

   If a contract is beneficial to a minor it can be enforced by him. There is no restriction on a minor from being a beneficiary, for example, being a payee or a promisee in a contract. Thus a minor is capable of purchasing immovable property and he may sue to recover the possession of the property upon tender of the purchase money. Similarly a minor in whose favour a promissory note has been executed can enforce it.

   **Example:** X, a minor, insured his goods with an insurance company. The goods were damaged. X filed a suit for claim. The insurance company took the plea that the person on whose behalf the goods were insured was a minor. The court rejected the plea and allowed the minor to recover the insurance money. (The General American Insurance Company Ltd. v. Madan Lal Sonu Lal (1935) 59 Bom. 656).
The infancy of one party to a contract does not affect the other party’s liability, the plea of infancy being a privilege personal to the infant, so that although an infant may avoid a contract, he can, nevertheless, hold liable and, if necessary, sue the other party to the contract.

**Contracts of apprenticeship:** Contracts of apprenticeship are also for the benefit of minors. Such contracts, according to the Apprenticeship Act, are binding on minors. But the Act requires that the contracts be made by guardians on behalf of minors. In English Law, contracts of service and apprenticeship are treated as similar to contracts for necessaries.

**4. No estoppel against a minor**

Where a minor by misrepresenting his age has induced the other party to enter into a contract with him, he cannot be made liable on the contract. There can be estoppel against a minor. In other words, a minor is not estopped from pleading his infancy in order to avoid a contract. It has been held by a Full Bench of the Bombay High Court in the case of Gadigeppa v. Balangowala that where an infant represents fraudulently that he is of age and thereby induces another to enter into a contract with him, then in an action founded on the contract, the infant is not estopped from setting up infancy. The court may, however, require the minor to compensate the other party on the ground of equity. This is based on the rule that a minor can have no privilege to cheat men.

Fraudulent misrepresentation as to age by an infant will operate against him in certain cases. If a minor obtains property or goods by misrepresenting his age, he can be compelled to restore it but only so long as the same is traceable in his possession.

If by misrepresenting himself to be of full age, a minor has obtained money from a trustee and given release, the release is good and he cannot compel the trustee to make payment a second time.
5. **No Specific performance**

A minor’s contract being absolutely void, there can be no question of the specific performance of such a contract. A guardian of a minor cannot bind the minor by an agreement for the purchase of immovable property; so the minor cannot ask for the specific performance of the contract which the guardian had no power to enter into.

6. **Liability for torts**

A minor is liable in tort. Thus, where a minor borrowed a horse for riding only he was held liable when he lent the horse to one of his friends who jumped and killed the horse. Similarly, minor was held liable for his failure to return certain instruments which he had hired and then passed on to a friend. But a minor cannot be made liable for a breach of contract by framing the action on tort. You cannot convert a contract into a tort to enable you to sue an infant.

7. **No insolvency**

A minor cannot be declared insolvent even though there are dues payable from the properties of the minor.

8. **Partnership**

A minor being incompetent to contract cannot be a partner in a partnership firm, but under Section 30 of the Indian Partnership Act, he can be admitted to the benefits of partnership.

9. **Minor can be an agent**

A minor can act as an agent. But he will not be liable to his principal for his acts. A minor can draw, deliver and endorse negotiable instruments without himself being liable.
10. **Minor cannot bind parent or guardian**

In the absence of authority, express or implied, an infant is not capable of binding his parent or guardian, even for necessaries.

11. **Joint contract by minor and adult**

In such a case, the adult will be liable on the contract but not the minor.

12. **Liability for necessaries**

The case of necessaries supplied to a minor or to any person whom such minor is legally bound to support is governed by Section 68 of the Indian Contract Act. A claim for necessaries supplied to a minor is enforceable at law. But a minor is not liable for any price that he may promise and never for more than the value of the necessaries. There is no personal liability of the minor, but only his property is liable. A minor is also liable for the value of necessaries supplied to his wife.

Necessaries mean those things that are essentially needed by a minor. They cannot include luxuries or costly or unnecessary articles. Necessaries extend to all such things as reasonable persons would supply to an infant in that class of society to which the infant belongs. Expenses on minor's education, on funeral ceremonies of the wife, husband or children of the minor come within the scope of the word 'necessaries'.

Not only must the goods supplied by such as are suitable to the minor's status, they must also be actually necessary. Ten suits of clothes are necessaries for a minor whereas even three suits may not be deemed necessary for another. The whole question turns upon the minor's status in life. Utility rather than ornament is the criterion.

**Example:** Inman an infant undergraduate in Cambridge bought eleven fancy waistcoats from Nash. He was at that time adequately provided with clothing. Held the waistcoats were not necessary and the price could not be recovered. (Nash v. Inman. (1908) 2. K.B.I.).
Certain services rendered to a minor have been held to be 'necessaries'. These include education, medical advice, a house given to a minor on rent for the purpose of living and continuing his studies, etc.

Goods necessary when ordered might have ceased to be necessary by the time they are delivered. e.g., where a minor orders a suit from a tailor but buys other suits before that ordered is actually delivered. Here the minor could not be made to pay the tailor. The following have been held to be necessaries:

(i) Livery for an officer's servant.
(ii) Horse, when doctor ordered riding exercise.
(iii) Goods supplied to a minor's wife for her support.
(iv) Rings purchased as gifts to the minor's fiancee.
(v) A racing bicycle.

On the other hand, following have been held not to be necessaries:

(i) Goods supplied for the purpose of trading.
(ii) A silver-gift goblet.
(iii) Cigars and tobacco.
(iv) Refreshment to an undergraduate for entertaining.

2.2.2 Persons of unsound mind

Section 11 disqualifies a person who is not of sound mind from entering into a contract. Contracts made by persons of unsound mind like a minor's contract are void. The reason is that a contract requires assent of two minds but a person of unsound mind has nothing which the law recognizes as a mind.

Section 12 deals with the question as to what is a sound mind for the purpose of entering into a contract. It lays down that, "A person is said to be of sound mind for the purpose of making a contract if, at the time when he makes it he is capable of understanding it and of forming a rational judgement as to its effect upon his interests."
A person who is usually of unsound mind but occasionally of sound mind may make a contract when he is of sound mind. Thus a patient in a lunatic asylum, who is at intervals of sound mind may make a contract during those intervals. A person who is usually of sound mind but occasionally of unsound mind is not considered competent to make a contract when he is of unsound mind. Thus a sane man who is so drunk that he cannot understand the terms of a contract or form a rational judgement as to its effect on his interests is incompetent to make a contract, whilst such drunkenness lasts.

Unsoundness of mind does not mean weakness of mind or loss of memory. It means not only lack of capacity to understand the terms of the contract but also lack of understanding to realize the effect of the terms of the contract. There is always a presumption in favour of sanity. The person who relies on the unsoundness of mind must prove it. Persons who are idiots, drunk or lunatic cannot enter into contracts. All these persons stand on the same footing as minors and their contracts are void. A person of unsound mind to whom necessaries are supplied is liable to pay a reasonable price.

Example: A property worth about Rs.25,000 was agreed to be sold by a person for Rs.7,000 only. His mother proved that he was a congenital idiot, incapable of understanding the transaction. The sale was held to be void. (Inder Singh v. Parmeshwardhari Singh AIR 1957 Pat. 491).

2.3 AGREEMENT MADE UNDER A MUTUAL MISTAKE OF FACT

A mistake of fact in the minds of both parties negatives consent and the contract becomes void. Section 20 provides that, "Where both the parties to an agreement are under a mistake as to a matter of fact, essential to the agreement, the agreement is void." Four conditions must be fulfilled before a contract can be avoided on the ground of mistake which are as follows:

(a) There must be mistake as to the formation of contract;
(b) The mistake must be of both the parties i.e., bilateral and not unilateral;
(c) It must be mistake of fact and not of law;
(d) It must be about a fact essential to the agreement.

**Example:** A man and a woman made a separation deed under which the man agreed to pay a weekly allowance to the woman under a mistaken assumption that they were lawfully married. It was held that the agreement was void as there was common mistake on a point of fact which was material to the existence of the agreement. (Galloway v. Galloway (1914) 30 T.L.R. 531)

However, an erroneous opinion as to the value of the thing which forms the subject matter of the agreement is not deemed to be a mistake as to a matter of fact.

**Example:** X buys a painting believing it to be worth Rs.2,000 while actually it is worth Rs.200 only. The agreement cannot be avoided on the ground of mistake.

The cases falling under bilateral mistakes are as follows:

1. **Mistake as to the subject matter**

Mistake as to subject matter falls into six heads, namely

(a) existence, (b) identity, (c) title, (d) price, (e) quantity, (f) quality.

(a) **Mistake as to the existence of the subject matter.** The parties may be mistaken as to the existence of the subject matter of the contract, at the date of the contract. The contract is void if without the knowledge of the parties, the subject matter does not exist at the date of the contract.

**Examples:** There is an agreement between A and B for the purchase of a certain horse. But the horse is dead at the time of the contract. The agreement is void.

(b) **Mistake as to the identity of the subject matter.** A mistake of both parties in relation to the identity of the subject matter (as where one party had one subject in mind and the other party another) prevents a consensus ad idem and invalidates the agreement.

**Example:** A agreed to buy from B 125 bales of cotton "to arrive ex pearless from Bombay". There were two ships of that name sailing from Bombay, one of which
was in the mind of A and the other in the mind of B. It was held that there was a bilateral mistake and there was no contract.

The result would be the same even if the mistake is caused by the negligence of a third party.

(c) **Mistake as to the title of the subject matter.** Where unknown to the parties the buyer is already the owner of the flat which the seller wants to sell him, the contract is void.

Example: There was a contract for lease between X and Y. The rent was inadvertently mentioned as Rs.10 though the agreement was to pay rent of Rs. 230. The contract was held to be void. (Garrad v. Frankel. (1862) 54 ER. 961).

(d) **Mistake as to the quantity of the subject matter.** There is no contract between the parties if there is a difference between the quantity sold and purchased. Thus, where a broker gave two invoices under a contract to a seller and buyer, and if the two invoices differed as to quantity sold and purchased, there was no enforceable contract.

(e) **Mistake as to the quality of the subject matter.** Mistake as to the quality of the thing does not affect consent unless it is the mistake of both parties and it is as to the existence of some quality which makes the thing without the quality essentially different from the thing as it was believed to be. But if the mistake is fundamental it is void. A contract for the sale of a horse believed to be a race horse would be void if it turned out to be a cart horse.

2. **Mistake as to the possibility of performing the contract**

(a) **Physical impossibility.** A contract for the hiring of a room for witnessing the coronation procession was held to be void because unknown to the parties the procession had already cancelled. (Griffith v. Brymer (1903) 19 TLR 534).
(b) **Legal impossibility.** A agreement is void if it provides that something should be done which cannot legally be done. Thus a person cannot take lease of his own land.

2.4 **AGREEMENT, THE CONSIDERATION OR OBJECT OF WHICH IS UNLAWFUL**

According to Section 23 of the Indian Contract Act, an agreement of which the object or consideration is unlawful is void. The word ‘object’ in Section 23 is not used in the same sense as consideration. Object means purpose or design of the contract. It implies the manifestation of intention. Thus, if a person while in insolvent circumstances transfers to another for consideration some property with the object of defrauding his creditors, the consideration of the contract is lawful but the object is unlawful. Both the object and the consideration of agreement must be lawful, otherwise the agreement would be void. The word ‘lawful means ‘permitted by law’. Section 23 of the Contract Act speaks of three thing :

(i) consideration for the agreement;
(ii) object for the agreement; and
(iii) agreement

The consideration or the object of an agreement is unlawful in the following cases:

1. **If it is forbidden by law**

If the consideration or object for a promise is such as is forbidden by law, the agreement is void. The agreement is forbidden by law, if the legislature penalizes it or prohibits it. It is illegal and cannot become valid even if the parties act according to such agreement. Sections 26, 27, 28 and 30 of the Contract Act deal with cases where the consideration or object of an agreement is considered unlawful. Thus, where the lawful wife was alive, any agreement by the husband to marry another is unenforceable as being forbidden by law. Similarly, an agreement to sublet a telephone, in contravention of
conditions is void because it is forbidden by law. Such agreements are illegal not because their consideration or objects is unlawful but because they are forbidden by law.

**Example:** A promises to obtain for B an employment in the public service and B promises to pay Rs. 1000 to A. The agreement is void as the consideration for it is unlawful.

2. **If it is of such a nature that if permitted it would defeat the provisions of any law**

   If the object or consideration of an agreement is of such a nature that if permitted it would defeat the provisions of any law, the agreement is void. A contract which seeks to exclude the application of a statutory provision to the parties is not valid. An agreement to give an annual allowance to the parents of an adopted Hindu boy in order to induce them to consent to the adoption is void.

3. **If it is fraudulent**

   Agreements which are entered into to promote fraud are void. Thus, an agreement for the sale of goods for the purpose of smugling them out of the country is void and the price of the goods so sold, cannot be recovered.

4. **If it involves or implies injury to the person or property of another**

   The object or consideration of an agreement will be unlawful if it tends to injure the person or property of another. Thus, an agreement to pull down another’s house is unlawful. The word ‘injury’ means criminal or wrongful harm. Loss which ensues to a trader as a result of competition by a rival trader is not injury within the meaning of this clause.

5. **If the court regards it as immoral**

   Where the consideration or object of an agreement is such that the court regards it as immoral, the consideration is void. The word immoral means inconsistent with what is
right. Rent due in respect of a flat let to a prostitute for the purpose of her trade cannot be recovered. Similarly money lent for the purpose of assisting the borrower to visit brothels and bring in prostitutes cannot be recorded in a court of law.

6. **If the court regards it as being opposed to public policy**

An agreement is unlawful if the court regards it as opposed to public policy. A contract which is opposed to public policy cannot be enforced by either of the parties to it. Any agreement which tends to promote corruption or injustice or is against the interests of the public is considered to be opposed to public policy. Public policy is that principle of law which holds that no citizen can lawfully do that which has a tendency to be injurious to the public. A contract having tendency to injure public interest or public welfare is opposed to public policy. Public policy is not capable of exact definition and, therefore, courts do not generally go beyond the decided cases on the subject. The courts do not invent a new head of public policy. The courts in India have declared certain agreements as opposed to public policy and hence unenforceable or void.

2.5 **AGREEMENTS FOR WHICH OBJECT OR CONSIDERATION IS UNLAWFUL IN PARTS (SECTION 24).**

Where consideration and object of an agreement is unlawful in part, the whole agreement is void. A promises to work on behalf of B, a legal manufacturer of indigo and an illegal traffic in other articles. B promises to pay to A a salary of Rs. 10,000 a year. The agreement is void. This rule is applicable where legal and illegal transactions cannot be separated and the whole transaction is void. But if a contract consists of a number of distinct promises, a few of which are legal and others illegal, the legal ones can be enforced.

2.6 **AGREEMENTS MADE WITHOUT CONSIDERATION**

Every agreement to be enforceable at law must be supported by valid consideration. An agreement made without consideration is void and unenforceable
except in certain cases. Section 25 specifies the cases where an agreement though made without consideration will be valid. These are as follows:

1. **Natural love and affection (Sec. 25(1))**

An agreement though made without consideration will be valid if it is in writing and registered and is made on account of natural love and affection between parties standing in a near relation to each other. An agreement without consideration will be valid provided:

   (i) it is expressed in writing;
   (ii) it is registered under the law for the time being a force;
   (iii) it is made on account of natural love and affection; and
   (iv) it is between parties standing in a near relation to each other.

All these essentials must be present to enforce an agreement made without consideration. The presence of only one or some of them will not suffice. Thus, the mere registration of document in the absence of nearness of relationship or natural love and affection will not suffice.

**Example**: A for natural love and affection, promises to give his son B, Rs. 1,000. A puts his promise to B into writing and registers it. This is a contract.

2. **Compensation for services rendered (Sec. 25(2))**

An agreement made without consideration may be valid if it is a promise to compensate wholly or in part a person who has already voluntarily done something for the promisor or something which the promisor was legally compellable to do. To apply this rule the following essentials must exist:

   (a) the act must have been done voluntarily;
   (b) the promisor must be in existence at the time when the act was done;
   (c) the promisor must agree now to compensate the promisee.
**Example**: A finds B’s purse and gives it to him. B promises to give A Rs. 50. This is a contract.

3. **Time-barred debt (Sec. 25(3))**

A promise to pay a time-barred debt is also enforceable. But the promise must be in writing and be signed by the promisor or his agent authorized in that behalf. The promise may be to pay the whole or part of the debt. An oral promise to pay a time-barred debt is unenforceable.

The clause does not apply to promises to pay time-barred debts of third persons. It is restricted to the promisor who is himself liable for the debt. So, where a Hindu son agrees to pay his deceased father’s time-barred debt, there is no personal liability for the son, for it is only the joint-family property in his hands that will answerable for the debt.

The debt must be such which the creditor might have enforced in law for recovery of the payment. A person under no obligation cannot, therefore, promise to pay. An insolvent finally discharged is under no obligation to pay any debt. So any promise to pay by him is not a debt as there is no consideration for such a promise.

**Example**: D owes P Rs.1,000 but the debt is barred by the Limitation Act. D signs a written promise to pay Rs.500 on account of the debt. This is a contract.

The promise to pay referred to in Section 25(3) must be an express one. Thus, a debtor’s letter to his creditor ‘to come and receive’ what was due to him, was held to disclose no express promise. But where a tenant in a letter to the landlord referred to the arrears of time-barred rent and said, “I shall send by the end of December”, it was held that the document contained an express promise as required by Section 25(3).

4. **Completed gifts**

Explanation 1 to Section 25 provides that the rule ‘no consideration, no contract’ shall not affect validity of any gifts actually made between the donor and the donee. Thus if a person gives certain properties to another according to the provisions of the Transfer
of Property Act, he cannot subsequently demand the property back on the ground that there was no consideration.

5. Agency

There is one more exception to the general rule. It is given in Section 185 which says that no consideration is needed to create an agency.

2.7 AGREEMENT IN RESTRAINT OF MARRIAGE

Every individual enjoys the freedom to marry and so according to Section 26 of the Contract Act “every agreement in restraint of the marriage of any person, other than a minor, is void.” The restraint may be general or partial but the agreement is void, and therefore, an agreement agreeing not to marry at all, or a certain person, or a class of persons, or for a fixed period, is void. However, an agreement restraining the marriage of a minor is valid under the Section.

It is interesting to note that a promise to marry a particular person does not imply any restraint of marriage, and is, therefore, a valid contract.

Illustration: A agrees with B for good consideration that she will not marry C. It is a void agreement.

It may be noted that an agreement which provides for a penalty upon remarriage may not be considered as a restraint of marriage.

2.8 AGREEMENTS IN RESTRAINT OF TRADE

The Constitution of India guarantees the freedom of trade and commerce to every citizen and therefore Section 27 declares “every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void.” Thus no person is at liberty to deprive himself of the fruit of his labour, skill or talent, by any contracts that he enters into.
It is to be noted that whether restraint is reasonable or not, if it is in the nature of restraint of trade, the agreement is void always, subject to certain exceptions provided for statutorily.

**Example:** An agreement whereby one of the parties agrees to close his business in consideration of the promise by the other party to pay a certain sum of money, is void, being an agreement is restraint of trade, and the amount is not recoverable, if the other party fails to pay the promised sum of money (Madhub Chander vs. Raj Kumar).

But agreements merely restraining freedom of action necessary for the carrying on of business are not void, for the law does not intend to take away the right of a trader to regulate his business according to his own discretion and choice.

**Exception.** An agreement is restraint of trade is valid in the following cases:

1. **Sale of goodwill.** The seller of the ‘goodwill’ of a business can be restrained from carrying on a similar business, within specified local limits, so long as the buyer, or any person deriving title to the goodwill from him, carries on a like business therein, provided the restraint is reasonable in point of time and space (Exception to Sec. 27).

   **Example:** A, after selling the goodwill of his business to B promises not to carry on similar business “anywhere in the world.” As the restraint is unreasonable the agreement is void.

2. **Partners’ agreement.** An agreement in restraint of trade amount the partners or between any partner and the buyer of firm’s goodwill is valid if the restraint comes within any of the following cases:

   (a) An agreement among the partners that a partner shall not carry on any business other than that of the firm while he is a partner (Section 11(2) of the Partnership Act).

   (b) An agreement by a partner with his other partners that on retiring from the partnership he will not carry on any business similar to that of the firm within
a specified period or within specified local limits provided the restrictions imposed are reasonable (Section 36(2) of the Partnership Act).

(c) An agreement among the partners, upon or in anticipation of the dissolution of the firm, that some or all of them will not carry on a business similar to that of the firm within a specified period or within specified local limits, provided the restrictions imposed are reasonable (Section 54 of the Partnership Act).

(d) An agreement between any partner and the buyer of the firm’s goodwill that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits, provided the restrictions imposed are reasonable (Section 55(3) of the Partnership Act).

3. Trade combinations. As pointed out, an agreement, the primary object of which is to regulate business and not to restrain it, is valid. Thus, an agreement in the nature of a business combination between traders or manufacturers e.g. not to sell their goods below a certain price, to pool profits or output and to divide the same in an agreed proportion, does not amount to a restraint of trade and is perfectly valid (Fraser & Co. vs. Bombay Ice Company). Similarly an agreement amongst the traders of a particular locality with the object of keeping the trade in their own hands is not void merely because it hurts a rival in trade (Bhola Nath vs. Lachmi Narain). But if an agreement attempts to create a monopoly, it would be void (Kameshwar Singh vs. Yasin Khan).

4. Negative stipulations in service agreements. An agreement of service by which a person binds himself during the term of the agreement, not to take service with anyone else, is not in restraint of lawful profession and is valid. Thus a chartered accountant employed in a company may be debarred from private practice or from serving elsewhere during the continuance of service (Maganlal vs. Ambica Mills Ltd.). But an agreement of service which seeks to restrict the freedom of occupation for some period, after the termination of service, is void. Thus, where S, who was an employee of Brahmaputra Tea Co. Assam, agreed not to employ himself or to engage himself in any similar business
within 40 miles from Assam, for a period of five years from the date of the termination of his service, it was held that the agreement is in restraint of lawful profession and hence void (Brahmaputra Tea Co. vs. Scarth).

2.9 AGREEMENT IN RESTRAINT OF LEGAL PRECEDING (SECTION 28)

Agreements entered into by private persons with the purpose of purporting to oust the jurisdiction of the court so as to enable them to alter their personal law or the statute law are void. Section 28 provides that every agreement by which any party thereto is restricted absolutely from enforcing his legal rights under or in respect of any contract, by the usual legal proceedings in the ordinary tribunals or which limits the time within which he may thus enforce his rights, is void to that extent. Thus where a servant agrees not to sue for wrongful dismissal is void under this section. The exceptions to this rule are:

(a) This Section shall not render illegal a contract, by which two or more persons agree that any dispute which may arise between them in respect of any subject or class of subjects shall be referred to arbitration, and that only the amount awarded in such arbitration shall be recoverable in respect of the dispute so referred. In other words, an agreement to refer all future disputes in connection with a contract to arbitration shall be valid.

(b) This Section shall not render illegal any contract in writing, by which two or more persons agree to refer to arbitration any question between them which has already arisen, or affect any provision of any law in force for the time being as to references to arbitration.

2.10 UNCERTAIN AGREEMENTS

Section 29 provides that an agreement the meaning of which is not certain or capable of being made certain is void. If there is ambiguity in the wording of the contract, it is not possible to read the exact intention of the parties to the contract. Where the term
in an agreement is vague in the extreme and might be interpreted in as many ways as there are interpretations thereof, the agreement is certainly one which is void because of uncertainty. Thus an agreement to sell at a concessional rate is void for uncertainty. Similarly an agreement to pay rent in cash without the rate being definitely fixed is void for uncertainty.

Example: A agrees to sell to B “a hundred tons of oil”. There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty.

Agreements in which price is to be based on luck or an certain event are void for uncertainty. Similarly an agreement to agree in future is also void for there is no certainty whether the parties will be able to agree.

2.11 WAGERING AGREEMENTS

An agreement by way of wager is void. No suit will lie for recovering anything alleged to be won on any wager or entrusted to any person to abide by the results of any game or other uncertain even on which any wager is made. (Section 30).

Wager means a bet. A wager may be defined as an agreement to pay money or money’s worth on the happening of a specified uncertain event. It is a game of chance in which the change of either winning or losing is wholly dependent on an certain event. The parties to a wagering contract must agree that upon the determination of the said uncertain even, one should win from the other. Each party stands equally to win or lose the bet. The chance of gain or the risk of loss is not one sided. If either of the parties may win but not lose, or may lose but cannot win, it is not a wagering contract. The essence of a wagering contract is that neither of the parties should have any interest in the contract other than the sum which he will win or lose.

Essentials

The following are the essentials of wagering agreement:

1. There must be a promise to pay money or money’s worth.
2. Promise must be conditional on an event happening or not happening.

3. There must be uncertainty of even. The certain event may be past, present or future.

5. There must be two parties. Each party must stand to win or lose. In other words loss of one must be the gain of other.

5. There must be a common intention to bet at the time of making such agreement.

6. Neither party should have control over the happening of the event. If one of the parties has the event in his own hands, the transaction lacks an essential ingredient of a wager.

7. Parties should have no interest in the event except for stake. If either of the parties has any proprietary interest in the subject matter of the agreement, the same ceases to be a wagering agreement. It is on this basis that a wagering agreement is distinguished from a contract of insurance.

Effect of Wagering Transactions

Agreement by way of wager are void. Hence, such agreements cannot be enforced in any court of law. Any amount won on a wager cannot be recovered. For example, two persons entered into wagering transactions in shares and one became indebted to another. A promissory note was executed for the payment of debt. The note was held to be unenforceable.

Effect of transactions collateral to wager

All agreements by way of wager are void. A wagering contract being only void and not illegal, a collateral contract can well be enforced at law. Thus, it P lends money to D, to pay off a gambling debt, P can recover the money from D.

Example : A lost Rs.8,500 to B on horse races. Subsequently A executed a hundi for same amount in favour of A to prevent B being declared as a defaulter in his club. B filed
a suit on the Hundi. A pleaded that it was a wagering transaction and the consideration was unlawful. It was held that a wagering agreement is void but does not affect the collateral transactions. (Leicester & Co. v. S.P. Mullick (1923) Cal.445).

**Exceptions**

The following agreements are not held to be wagers:

(i) **Horse race**: Section 30 makes an exception in favour of certain prizes for horses races. It provides that an agreement to subscribe or contribute for or towards a plate, prize or a sum of money of the value of Rs.500 or above to be awarded to the winner of a horse race is valid.

(ii) **Commercial Transactions**: An agreement for actual purchase and sale of any commodity is not a wagering agreement. But sometimes it becomes difficult to determine whether a particular transaction was in fact a contract of purchase and sale or a wagering contract for the payment of differences. Thus, for example, if two traders A and B, contract for the sale and purchase of one hundred bags of sugar to be delivered three months after at rupees four hundred per bag, it may be difficult to say whether it is a perfectly good commercial contract entered into with the intention of delivering the goods or whether the two traders are really speculating and wagering upon the prices of sugar. To bring a case within the provisions of Section 30, a common intention to wager, e.g. to pay and receive differences in necessary. The intention to wager must be on the part of both the contracting parties. If only one of the parties to the agreement had the intention that the agreement should be for the mere payment of differences and the other party was not aware of the fact, the agreement is enforceable.

(iii) **Crossword Puzzles**: The literary competitions involving applications of skill are not wagers as here an effort is made to find out the best and skillful competitor.

(iv) **Chit funds**: A chit fund is not a wager. No doubt, some gain does come to some members, but none of them stands to lose his money.
Wager and insurance contracts

A contract of insurance, be it life, accident, fire, marine, etc. is not a wager though it is performable upon an uncertain event. It is so because therein the parties have an interest in the contract. A person has an insurable interest in his own life and he can make a valid contract to insure for the benefit of a third person. But an insurance on the life of a person in which the insurer has no interest whatever is void as being a wager. Thus, a person effecting insurance on his younger brother’s life has no insurable interest and the contract is void.

2.12 AGREEMENTS CONTINGENT ON IMPOSSIBLE EVENTS

“Contingent agreements to do or not do to anything, if an impossible event happens, are void, whether the impossibility of the event is known or not to the parties to the agreement at the time when it is made.” (Sec. 36)

Illustrations (to Sec. 36) : A agrees to pay B Rs.1,000 (as a loan) if two straight lines should enclose a space. The agreement is void.

2.13 AGREEMENTS TO DO IMPOSSIBLE ACTS

“An agreement to do an act impossible in itself is void.” (Sec. 56 Para 1).

Illustrations : (a) A agrees with B to discover treasure by magic. The agreement is void.
(b) A agrees with B to run with a speed of 100 Kilometres per hour. The agreement is void.

2.14 SUMMARY

An agreement not enforceable by law is said to be void. It includes : (a) Agreement made by Incompetent Parties (b) Agreement made under a Mutual Mistake of Fact (c) Agreement, the Consideration or Object of which is Unlawful (d)
Agreements for which Object or Consideration is Unlawful in Parts (Section 24) (e)
Agreements made without Consideration  (f)  Agreement in Restraint of Marriage (g)
Agreements in Restraint of Trade (h)  Agreement in Restraint of Legal Preceding
(Section 28) (i)  Uncertain Agreements  (j)  Wagering Agreements (k)  Agreements
Contingent on Impossible Events, and (l)  Agreements to do Impossible Acts

2.15 KEYWORDS

Void Agreement: An agreement not enforceable by law is said to be void.

Minor: A minor is a person who has not completed eighteen years of age.

Uncertain Agreement: Agreements, the meaning of which is not certain or capable of
being made certain are void.

2.16 SELF ASSESSMENT QUESTIONS

1. In what cases the consideration and object of an agreement are said to be unlawful? Illustrate.

2. What is an agreement by way of wager? In such an agreement void or illegal?
   Is a contract of insurance a wagering contract?

3. Discuss the contractual liability of a minor under the Indian Contract Act.

4. In what cases the consideration and object of an agreement are said to be unlawful? Illustrate with examples.

2.17 SUGGESTED READINGS


K.R. Balchandari, Business Law for Management, Himalaya Publication House,
New Delhi.

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers,
New Delhi.

LESSON-3
PERFORMANCE OF CONTRACTS

STRUCTURE

3.0 Objectives
3.1 Introduction
3.2 Offer of Performance or Tender
3.3 Essentials of a Valid Tender
3.4 Contracts which Need not be Performed
3.5 By Whom Contracts Must Be Performed
3.6 Who can Demand Performance?
3.7 Time and Place of Performance
3.8 Time as The Essence of The Contract
3.9 Devolution of Joint Rights and Liabilities
3.10 Order of Performance of Reciprocal Promises
3.11 Appropriation of Payments
3.12 Summary
3.13 Keywords
3.14 Self Assessment Questions
3.15 Suggested Readings

3.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define offer of performance or tender and explain its essentials.
(b) Discuss the rules regarding time and place of performance
(c) Explain about the devolution of Joint Rights and Joint Liabilities
3.1 INTRODUCTION

A contract creates an obligation which continues till the contract has been discharged by actual performance or attempted performance. Performance of a contract consists in doing or causing to be done what the promisor has promised to do. Section 37 of the Indian Contract Act provides that the parties to a contract must either (i) perform their respective promises or (ii) offer to perform the same, unless (iii) such performance is dispensed with or (iv) excused under the provisions of this act or any other law.

Performance may be actual or attempted. When a party has done what he undertook to do there is nothing left for him to do. Then he is said to have performed his obligation. The performance of the contract in order to be complete must, however, be made in accordance with the terms of the contract. Performance of a contract has two effects:

(i) A party who wishes to enforce the other party's promise may have to show that he has performed or is willing to perform his own promise.

(ii) A party who performs, or tenders performance is thereby discharged from his obligations under the contract.

The contract is completely terminated when both parties completely and precisely perform the exact thing which, each has agreed to do. If one party only performs his promise, he alone, is discharged and he acquires a right of action against the other party.

3.2 OFFER OF PERFORMANCE OR TENDER OR ATTEMPTED PERFORMANCE (SEC. 38)

Where the promisor has made an offer of performance and the offer has been refused, the promisor is not responsible for non-performance. Offer of performance is also known as tender. A party who has entered into a contract to deliver good or to pay money to another will be deemed to have performed it if he has offer the goods or money to the party to whom the delivery or payment was to be made. A valid offer of performance is thus considered to be performance itself. If the offeror produces goods of
the correct quality and quantity, the rejection of his offer discharges him from further liability. If a debtor tenders money due under a debt, the effect of such a tender is to stop the running of interest on the amount payable but the debt is not discharged.

**Kinds of Tender**

Tender or attempted performance is of two types. They are stated below:

**Tender of Goods**

A contract to deliver goods is completely discharged by tendering the goods for acceptance according to the contract. If the goods are refused, they need not be offered again, and the seller is discharged. He can bring an action for non-acceptance, or defend an action for non-delivery.

**Tender of Money**

But where a sum of money is due, tender by the debtor, if refused, does not operate as a discharge. The debtor must remain ready and willing to pay and, if sued, must pay the money to the court, and plead the tender which is then a good defense. But it should be remembered that the interest on the loan ceases to run from the date of valid tender. A tender, in order to be valid, must be unconditional and of the whole amount. The creditor is not bound to accept part-payment of a debt or conditional payment of a debt.

### 3.3 ESSENTIALS OF A VALID TENDER

In order that a tender should be valid and adequate, it must fulfil the following conditions which are laid down in Section 38:

1. **It must be unconditional.** Where a tender or offer of performance is conditional, the other party is under no obligation to accept it. A person is not bound to accept a tender of railway receipt that is made subject to demurrage. But a tender with a request for a receipt is valid.
Example: P sent a single cheque for two items, only one of which was due at
the time, while the other was payable after sometime. The cheque being one and
indivisible could be accepted as whole or not at all. It was held that the promise
was within his right in rejecting cheque. [ Hiralal vs. Khizar Hayat Khan. AIR,
1936 Lah 168].

(ii) **It must be made at a proper time and place.** When the contract provides that
tender should be made at a particular place and time, it should be so done. If the
place is not mentioned the rule is that the debtor must find the creditor. Where no
time is fixed then it is valid to make the lender at any reasonable time. What is
proper time and place is a question of fact depending on the circumstances of each
case. However, a tender before due date is not valid.

Example: A owes B Rs 1000 payable on 1st June with interest. B offers to pay
on 1st May the amount with interest upto 1st May. It is not a valid tender as it is
not made at the appointed time.

(iii) **A person to whom the tender is made must be given a reasonable opportunity
of inspection of goods or articles.** The inspection is to satisfy oneself as to
whether the thing offered is what was promised. There is no valid tender where
goods are locked in a box and the other party is not allowed to open it. The usual
place of inspection is the place of delivery. A tender made at such a late hour of
the due date that the buyer had hardly the time to inspect it, is not good in law.

Example: A contracts to deliver to B at his warehouse on the 1st March 1996,
100 bales of cotton of a particular quality. In order to make a valid offer of
performance, A must bring the cotton to B’s warehouse on the appointed day
under such circumstances that B may have a reasonable opportunity of satisfying
himself that the thing offered is cotton of the quality contracted for and that there
are 100 bales.
(iv) **The tender must be whole and not of the part.** Tender in part is not tender. A creditor need not accept a smaller sum than that what he is entitled to. A tender by installments is invalid unless the contract so provides. A tender of a lesser amount does not stop the running of interest on the entire amount.

(v) **The tender must be in the proper form.** Tender of money should be in the current coins. A person is not bound to accept a cheque. A tender by cheque is valid when the person to whom it is tendered is willing to accept such payment.

(vi) **It must be made to a proper person.** It must be made to the proper promisee. Tender made to stranger would be invalid.

(vii) **The party making the tender must always be ready and willing to fulfil the obligation whenever called upon.** If the tender is of cash payment, actual cash must be available in readiness for payment. But a man cannot be said to be able and willing if he has neither possession of nor control over the goods he had promised to deliver. A mere offer by post to pay the amount is not a valid tender. There is no readiness and willingness in this case to pay the money then and there.

(viii) **A tender made to one of the several joint promisees has the same legal consequences as a tender to all of them.** In other words payment or tender can be legally made to even one of the joint promisees. But the joint promisees must be all joint in status. Thus a payment to a partner is deemed to be a payment to the partnership firm.

**Effect of refusal to accept offer of performance (Sec. 38)**

Where a promisor has made an offer of performance to the promisee and the offer has not been accepted:

(a) the promisor is not responsible for the non-performance; nor.

(b) does he thereby loose his rights under the contract.

**3.4 CONTRACTS WHICH NEED NOT BE PERFORMED**
Sections 62 to 67 of the Contract Act deals with contracts which need not be performed. The relevant provisions are as under:

1. If the parties to a contract agree to novation, rescission or alternation, the original contract need not be performed (Section 62).

2. The promisee may dispense with or remit performance by the promisor in whole or in part or may extend the time for the performance or may accept any satisfaction in lieu thereof (Section 63).

3. When a voidable contract is rescinded, the other party need not perform his promise (Section 64).

4. Where the failure of performance has been caused by the promisee’s neglect or refusal, the promisor will be excused. (Section 67)

3.5 BY WHOM CONTRACTS MUST BE PERFORMED

1. **By the promisor.** As a general rule, a contract may be performed by the promisor, either personally or through any other competent person. But where personal consideration are the foundation of the contract, it has to be performed by the promisor himself and in case of his death or disablement a contract will be discharged and the other party would be freed from liability.

   **Example:** A promises to paint a picture for B, the promise must be performed by A himself.

2. **By the agent.** Where personal skill is not necessary and the work could be done by any one, the promisor or his representative may employ a competent person to perform it. Thus a contract to sell goods can be assigned by the seller to his agent.

3. **By the legal representative.** In the event of the death of the promisor before performance, their representatives are bound by the promises, unless personal considerations are the foundation of the contract. The legal representatives of the deceased promisor cannot be required to perform contract involving personal skill. 
and action. On the death of a person, the benefits and burdens of his contracts pass to the legal representatives as part of his estate.

Example: A promises to deliver goods to B on a certain day on payment of Rs.1000. A dies before that day. A’s representatives are bound to deliver the goods to B, and B is bound to pay Rs. 1000 to A’s representatives.

4. **By third person.** If the promisee accepts performance of the promise from a third party, there is a discharge of the contract. Once the third party performs the contract, and that is accepted by the promisee there is an end of the matter and the promisor is thereby discharged. (Section 41). Thus, where a person has accepted apart payment from a third person in full satisfaction of his claim, he Cannot later on sue the debtor for the balance.

### 3.6 WHO CAN DEMAND PERFORMANCE?

It is only the promisee or his agent who can demand performance of the promise under a contract. It is immaterial whether the promisee is for the benefit of the promisee or for the benefit of some other person. In the case death of the promisee, his legal representatives can demand performance. In certain cases a third person who is not a party to the contract can also demand performance.

Example: A promisee B to sell his house to C for Rs. 20000. A does not perform the contract. C cannot sue A. It is only B who can enforce the promise against A.

### 3.7 TIME AND PLACE OF PERFORMANCE

It is for the parties to contract to decide the time and place for the performance of the contract. Sections 46 to 50 of the Indian Contract Act lay down certain rules in this regard which are as follows:

1. Where a contract does not specify any time for performance, the promisor must perform it within a reasonable time.
What is a reasonable time is a question of the fact. (Section 46). Failure to perform the contract within a reasonable time entitles the other party to put an end to the contract. Thus, where ornaments were borrowed for a wedding ceremony, detaining them after the wedding did not amount to performance within a reasonable time.

2. When a contract is to be performed on a particular day, without any application of the promisee being required, the promisor may perform contract on that particular day during the usual hours of the business on such day and at the place at which promise ought to be performed. (Section 47).

Example: A promises to deliver goods at B's warehouse on the First January. On that day A brings the goods to B's warehouse, but after the usual hour for closing it, and they are not received. A has not performed his promise.

3. In the above two cases, the promisor undertakes to perform the promise without application by the promisee. But where the promise has to be performed on a certain day but the promisor had not undertaken to perform it without application by the promisee, the promisee is bound to apply for performance at a proper place and within the usual hours of business. What is a proper time and place is a question of fact. (Section 48). For example, in case of a deposit it is the duty of the depositor to go to the banker and make a demand for money. It is not the duty of the banker to seek out his creditor.

4. When a promise is to be performed without application by the promisee, and no place is fixed for the performance of it, it is duty of the promisor to apply to the promisee to appoint a reasonable place for the performance of the promise, and perform it at such place (Section 49).

Example: A undertakes to deliver a thousand maunds of jute to B on a fixed day. A must apply to B to appoint a reasonable place for the purpose of receiving it and must deliver to him at such place.

This section incorporates the rule that the debtor must find the creditor but where the creditor has left the country the debtor need not follow him.
5. A contract should be performed in the manner and at the time prescribed in the contract. (Section 50). A promisor is discharged from liability if he performs the promise in a manner or at a time prescribed or sanctioned by the promisee.

**Example:** A desires B who owes him Rs. 100 to send him a note for Rs. 100 by post. The debt is discharged as soon as B puts into the post a letter containing the note duly addressed to A.

### 3.8 TIME AS THE ESSENCE OF THE CONTRACT

A party may promise to perform his obligation by a specified time. This gives the other party a right to expect that it shall be performed by that time. But if the promisor fails to do so, can the promisee rescind the contract? This question can be answered by deciding whether in such case time was or was not the essence of the contract.

The expression ‘time is of the essence of the contract’ means that one who does not perform in full own promised performance within the time specified in the contract cannot maintain any action for the enforcement of a return of promise. It means that the time agreed for the performance of a contract must be strictly observed. Section 55 of the Indian Contract Act deals with this subject and may for the sake of the convenience be studied under the following three heads:

1. **When time is of the essence of the contract**

   Where time is of the essence of a contract and a party who is bound to perform within the time fixed fails to do so, the contract becomes voidable at the option of the other party. An intention to make time as the essence of the contract must be expressed in a very clear language. The law is well settled that merely because of the specification of time on or before which a contract is to be performed, would not make time the essence of the contract. Time is an essence of the contract if the parties intend it to be so.

   **Example:** D agreed to sell and deliver 6 bales of cotton to P on 12th July 1974. But he failed to deliver the cotton by that time. The contract was voidable at the option of P.
Time is always considered to be the essence of the contract in the following cases:

(a) Where the parties have so expressly provided.

(b) Where delay operates as an injury.

(c) Where the nature and necessity of contract requires it to be so constructed, as for example, where a party asks for extension of time for performance.

Example: P stipulated with D to engage his elephant for the purpose of kheda operations (to capture wild elephants). The contract provided that the elephant would be provided on the 1st October; but D obtained an extension of time till the 6th of October and yet did not deliver the elephant till the 11th. P refused to accept the elephant and used for damages for the breach. It was held that P was entitled to recover as the parties intended that time should be of essence of the contract. (Bhudra Chand v. Betts (1915) 22 cat. LJ 566]

2. When time is not of the essence of the contract

Where time is not of the essence of the contract and the promisor fails to perform it within the specified time, the promisee is not entitled to avoid the contract. But he would be entitled to compensation from the promisor for any loss occasioned to him by such failure.

In a contract for the sale of land or immovable property it would normally be presumed that time is not of the essence of the contract. But the renewal of a lease is something different from the sale of immovable property.

Example: The lessee of a petrol pump had to apply for the renewal of the lease within a time fixed by the contract. The lessee was late by 10 days in his application for renewal. The landlord refused to renew. It was held that the time so fixed was of the essence of the bargain. [Caltex (India) Ltd. vs. Bhagwan Devi Marodia AIR 1969 SC 409]

3. Acceptance of performance out of time
Where the promisee accepts performance of a promise at any time other than that agreed, the promisee cannot claim compensation for any loss occasioned by the non-performance of the promise unless at the time of such acceptance he gives notice to the promisor of his intention so to do.

Whether time is or is not of the essence of the contract, depends upon the intention of the parties which can be gathered from the circumstances of each case. In a contract for the sale of immovable property time is not generally of the essence of the contract unless there is a contract to the contrary.

### 3.9 DEVOLUTION OF JOINT RIGHTS AND JOINT LIABILITIES

Devolution means passing over from one person to another. Two or more persons may enter into a joint agreement with one or more persons. For example P and Q jointly promise to pay Rs. 500 to X and Y. In such cases, the question arises also who is liable to perform and who can demand performance? The rights and liabilities of joint promisors and joint promisees are discussed in Sections 42 and 45 of the Indian Contract Act and are as under:

**Meaning of devolution of joint liabilities:** When two or more persons have made a joint promise, all of them must jointly fulfill the promise. If any of the joint promisors die, his legal representatives will be jointly liable for the performance along with the surviving promisor or promisors. If all the original promisors die, then legal representative of all such promisors will be jointly responsible for the performance of the promise. The rule is of course subject to a contract to the contrary. (Section 42).

**Rules regarding performance of joint liabilities:** When two or more persons make a joint promise, the promisee is entitled, in the absence of an express agreement to the contrary, to compel any one or more of such joint promisors to perform the whole of such promise. In other words the liability of joint promisors is joint and several. (Section 43). Thus, in a suit against the firm the plaintiff entitled to proceed against the firm itself or against all the partners or against such partners as he wishes to sue. If one promisor
makes payment in full or otherwise satisfies the entire obligation, the promisee's right against all others who are bound for the same performance is extinguished.

Where one of several joint promisors has performed the promise, he is entitled in the absence of a contract to the contrary to claim equal contribution from the other joint promisors. A person who discharges a joint liability can seek contribution from the persons who are co-promisors.

If a joint promisor makes default in such contribution the remaining joint promisors must share the loss equally.

**Example:** A, B and C jointly promise to pay D Rs. 3000. D may compel either A, or B or C to pay him Rs. 3000.

Explanation to Section 43 provides that as soon as a surety makes any payment to the creditor, he can recover it from the principal debtor. The right of contribution exists between co-sureties as well.

**Example:** A, B and C, are under a joint promise to pay D Rs. 3000. A and B being only sureties for C. C fails to pay. A and B are compelled to pay the whole sum. They are entitled to recover it from C.

A release of one of joint promisors by the promisee does not discharge the other joint promisors. This release does not discharge such joint promisor from responsibility to the other joint promisors. Section 44 is a departure from the rule of English law. Under the English law a release of one of the joint promisor operates as a release of all other promisors.

**Example:** A, B and C are under a joint promise to pay X Rs. 3000 X may release C from liability; A and B remain liable to pay to X. C is not released from the responsibility to A and B. If X recovers the amount from A and B, they have a right of ratable contribution from C.
**Meaning of devolution of joint rights**: Section 45 deals with the devolution of joint rights. Where there are joint promisees the benefit of the promise devolves on the representatives of the deceased promisee. In other words in case of a promise to two or more persons jointly, such persons jointly and on the death of any one or all of them, the survivors or the representatives of deceased promisees jointly are the only persons who are entitled to claim performance of the promise. All the joint promisees must join together to claim performance of the promise. If some only join their suit is liable to be dismissed under Section 45.

**Example**: A in consideration of 5000 rupees lent to him by B and C, promises B and C jointly to repay them that sum with interest on a day specified. B dies. The right to claim performance rests with B’s representative jointly with C during C’s life and after the death of C with representatives of B and C jointly.

### 3.10 ORDER OF PERFORMANCE OF RECIPROCAL PROMISES

Promises which form the consideration for each other are called “reciprocal promises” or “mutual promises”. It is common knowledge that “bilateral contracts” where both contracting parties have to perform their promises, involve “mutual promises” against the parties. In such contracts each party gives a promise in return for a promise. e.g. A promises to sell certain goods to B and B in return promises to pay the price thereof to A, and there is an obligation on each party to perform his own promise and to accept performance of other’s promise.

Reciprocal promise may be classified into three categories: (1) Mutual and Independent (2) Mutual and Dependent and (3) Mutual and Concurrent. Sections 51 to 54 of the Contract Act lay down the rules regarding the order of performance of reciprocal promises, which are stated below:

1. **Mutual and Independent**: Where each party must perform his promise independently without waiting for the performance or the willingness to perform of the other, the promises are ‘mutual and independent’. According to Section 52, such
promises must be performed in the order expressly fixed by the contract, and where the order is not expressly fixed, they must be performed in that order which the nature of the transaction requires.

**Example:** A promise to deliver certain goods to B on 10\textsuperscript{th} April and B promises to pay the price in advance on 1\textsuperscript{st} April and on default to pay interest @ 15 per cent per annum from 1\textsuperscript{st} April till the date of payment. In this case A’s promise to deliver goods is independent of B’s promise to pay the price. Even if B does not pay the price on 1\textsuperscript{st} April, A must deliver the goods on 10\textsuperscript{th} April. A can of course sue B for the payment of price and damages.

Whether the promises are such as are to be independently performed is often a question of construction depending on the intention of the parties collected from the agreement as a whole of from what ‘the nature of transaction requires’.

2. **Mutual and Dependent:** Where the performance of the promise by one party depends on the prior performance of the promise by the other party, the promises are ‘mutual and dependent’. Section 54 provides for such promises and lays down that if the promisor who is required to perform his promise in the first place fails to perform it, such promisor cannot claim the performance of the reciprocal promise, and must make compensation to the other party to the contract for any loss which such other party may sustain by the non-performance of the contract.

**Example:** A contracts with B to execute certain builder’s work for a fixed price. B supplying the scaffolding and timber necessary for the work, B refuses to furnish any scaffolding or timber, and the work cannot be executed. A need not execute the work, and B is bound to make compensation to A for any loss caused to him by the non-performance of the contract [illustration (b) to Section 54].

3. **Mutual and Concurrent:** Where the two promises are to performed simultaneously, they are said to be ‘mutual and concurrent’. According to Section 51 in the case of such promises the promisor need not perform his promise unless the promisee is ready and willing to perform his reciprocal promise.
Example: A and B contract that A shall deliver goods to B to be paid for by B on delivery. Here the promises are ‘mutual and concurrent’ and therefore A need not deliver the goods, unless B is ready and willing to pay for the goods on delivery; and B need not pay for the goods, unless A is ready and willing to deliver them on payment.

4. Consequences where a party prevents performance: When a contract contains reciprocal promises and one party to the contract prevents the other from performing his promise, the contract becomes voidable at the option of the party so prevented; and he is entitled to compensation from the other party for any loss which he may sustain in consequence of the non-performance of the contract. (Sec.53).

Example: A and B contract that B shall execute certain work for A for Rs. 1000. B is ready and willing to do the work accordingly, but A prevents him from doing so. The contract becomes voidable at the option of B, and if he elects to rescind it, he is entitled to recover from A compensation for any loss which he has incurred by its non-performance.

5. Effects of non performance in case of mutual and dependent reciprocal promises (Sec. 54)

“When a contract consists of reciprocal promises, such that one of them cannot be performed, or that its performance cannot be performed, or that its performance cannot be claimed till the other has been performed, and the promisor cannot claim the performance of the reciprocal promise, and must make compensation to the other party to the contract for any loss which such other party may sustain by the non performance of the contract.”- Sec. 54.

Examples

1. A hires B’s ship to take in and convey, from Calcutta to Mauritius, a cargo to be provided by A, B receiving a certain freight for its conveyance. A does not provide any cargo for the ship. A cannot claim the performance of B’s promise and must
make compensation to B for the loss which B sustains by the non performance of the contract.

2. A contracts with B to execute certain builder’s work for a fixed price, B supplying the scaffolding and timber necessary for the work. B refuses to furnish any scaffolding or timber, and the work cannot be executed. A need not execute the work, and B is bound to make compensation to A for any loss caused to him by the non performance of the contract.

6. **Effects of promise to do legal and illegal things (Sec. 57)**

   “When persons reciprocally promise, firstly, to do certain things which are legal and secondly, under specified circumstance, to do certain other things which are illegal, the first set of promises is a contract, but the second is a void agreement.” – Sec. 57.

3.11 **APPROPRIATION OF PAYMENTS**

When a debtor, who owes several debts to the same creditors, makes a payment which is insufficient to satisfy the whole indebtedness, the question arises, “as to which of the debts the payment is to be applied?” Sections 59 to 61 of the Contract Act answer this question and lay down the following rules:

1. **Debtor’s express instruction must be followed**: Appropriation is a right given to the debtor for his benefit. Thus if the debtor expressly states that the payment made by him is to be applied to the discharge of some particular debt, the creditors must act accordingly otherwise he should not accept the payment.

2. **Debtor’s implied intention must be followed**: If there are not express instruction, then debtor’s implied intention should be gathered from the circumstances attending the payment and appropriation must be done accordingly.

**Example**: A owes B, among other debts Rs. 1000 upon a promissory note which falls due on the 1st June. He owes B no other debt of that amount. On the 1st June A pays to B Rs. 1000. The payment is to be applied to the discharge of the promissory note.
3. **Appropriation by creditors**: If there is no express or implied direction by the debtor regarding appropriation, then the creditors has got the option to apply the payment to any debt lawfully due from the debtor, including a debt which is barred by the Limitation Act.

4. **Appropriation by Law**: Where neither the debtor nor the creditor has made any appropriation, then according to law, the payment is to be applied in discharge of the debts in order to time, whether or not they are time barred. If the debts are of equal standing the payment shall be applied in discharge of each proportionately.

5. **When principal and interest both due**: If a payment has been made without expressly stating whether it is towards interest or principal payment is to be applied towards interest first, and then the balance to principal (Srinivasulu vs. Kondappa).

   It may be emphasised that if the creditors accepts the payment, he must follow the above rules of appropriation otherwise he must refuse to accept the payment.

3.12 **SUMMARY**

A contract creates a legal obligation which continues till the contract has been performed or otherwise discharged. Performance of a contract is, however, the most natural and usual mode of extinction of an obligation. Performance may be actual performance or attempted performance. When a party has done what has agreed to, a party to contract is said to have actually performed his promise. Tender or attempted performance is of two types namely tender of goods and tender of money. The tender of performance, in order to have its effect must fulfill contain conditions. Promisor, or his agent, or his legal representative, or third person should perform a contract. It is for the parties to contract to decide the time and place for the performance of the contract. Sometimes, the parties to a contract specify the time for its performance; and in that case
either party is expected to perform his obligation at the stipulated time. Accordingly, where a party to a contract promises to do a thing within a specified time but fails to do so it, then the contract becomes voidable at the option of the other party provided the intention of the parties was that the time should be the essence of the contract.

### 3.13 KEYWORDS

**Tender:** Where the promisor has made an offer of performance and the offer has been refused, the promisor is not responsible for non-performance. Offer of performance is also known as tender.

**Devolution of Joint Liabilities:** When two or more persons have made a joint promise then, unless a contrary intention appears by the contract, all such persons must jointly fulfil the promise.

**Reciprocal Promises:** Promises which form the consideration for each other are called reciprocal promises.

### 3.14 SELF ASSESSMENT QUESTIONS

1. What do you mean by performance of a contract. Under what circumstances a contract need not be performed?
2. Define the term ‘tender’. What are the essentials of a valid tender?
3. Discuss the rules laid down in the act as the devolution of joint rights and liabilities.

### 3.15 SUGGESTED READINGS


LESSON-4
BREACH OF CONTRACT AND ITS REMEDIES

STRUCTURE

4.0 Objective

4.1 Breach of Contract

4.2 Remedies for Breach of Contract
   4.2.1 Rescission of the Contract
   4.2.2 Restitution
   4.2.3 Specific Performance
   4.2.4 Injuction
   4.2.5 Suit for Damages
   4.2.6 Suit upon Quantum Meruit

4.3 Summary

4.4 Keywords

4.5 Self Assessment Questions

4.6 Suggested Readings

4.0 OBJECTIVE

The objective of the present lesson is to discuss

(a) the ways of breach of contract and
(b) remedies to an injured party in case of breach of contract.
4.1 BREACH OF CONTRACT

A breach of contract occurs if any party refuses or fails to perform his part of the contract or by his act makes it impossible to perform his obligation under the contract. In case of breach, the aggrieved party (i.e., the party not at fault) is relieved from performing his obligation and gets a right to proceed against the party at fault.

A contract terminates by breach of contract. Breach of contract may arise in two ways (a) Anticipatory Breach, and (b) Actual Breach.

Anticipatory Breach of Contract (Sec. 39)

Anticipatory breach of contract occurs, when a party repudiates it before the time fixed for performance has arrived or when a party by his own act disables himself from performing the contract.

Examples

(1) A contracts to marry B. Before the agreed date of marriage he married C. B is entitled to sue A for breach of promise.

(2) A promised to marry B as soon as his (A’s) father would die. During the father’s life time. A absolutely refused to marry B. Although the time for performance had not arrived, B was held entitled to sue for breach of promise.

(3) A contract to supply B with certain articles on 1st of August. On 20th July, he informs B that he will not be able to supply the goods. B is entitled to sue A for breach of promise.

Consequences of Anticipatory Breach

Where a party to a contract refuses to perform his part of the contract before the actual time arrives the promisee may either: (a) rescind the contract and treat the contract as at an end, and at once sue for damages, or (b) he may elect not to rescind but to treat the contract operative and wait for the time of performance and then hold the other party liable for the consequences of non-performance. In the latter case, the party who has
repudiated may still perform if he can.

Thus, from the above discussion it follows that 'anticipatory breach' of contract does not by itself discharge the contract. The contract is discharged only when the aggrieved party accepts the repudiation of the contract, i.e., elects to rescind the contract. Notice that if the repudiation is not accepted and subsequently an event happens, discharging the contract legally, the aggrieved party shall lose his right to sue for damages.

**Example**: A agreed to load a cargo of wheal on B’s ship at Odessa by a particular date but when the ship arrived A refused to load the cargo. B did not accept the refusal and continued to demand the cargo. Before the last date of loading had expired the Crimean War broke out, rendering the performance of the contract illegal. Held, the contract was discharged and B could not sue for damages [Avery v. Bowen (1856) 6 E. & B. 965].

Section 39 of the Contract Act deals with anticipatory breach of contract and provides as “when a party to contract has refused to perform, or disabled himself from performing his promise in its entirety, the promisee may put an end to the contract, unless he has signified, by works or conduct, his acquiescence in its continuance”.

**Actual Breach of Contract**

The actual breach may take place (a) at the time when performance is due, or (b) during the performance of the contract.

**Actual breach of Contract, at the time when performance is due.** If a person does not perform his part of the contract at the stipulated time, he will be liable for its breach.

**Example** : A seller offers to execute a deed of sale only on payment by the buyer of a sum higher than is payable under the contract for sale, the vendor shall be liable for the breach. [Jaggo Bai v. Hari Har Prasad Singh, A.I.R. 1947, P.C 173]

**Time as Essence of Contract**

But if the promisor offers to perform his promise subsequently, the question arises
whether it should be accepted, or whether the promisee can refuse such acceptance and hold the promisor liable for the breach. The answer depends upon whether time was considered by the parties to be of the essence of the contract or not. Section 55, in this respect, lays down as follows:

"When a party to a contract promises to do a certain thing at or before a specified time, or certain things at or before specified times and fails to do any such thing at or before the specified time, the contract, or so much of it as has not been performed becomes voidable at the option of the promisee, if the intention of the parties was that time should be of the essence of the contract”.

If it was not the intention of the parties that time should be of the essence of the contract, the contract does not become voidable by the failure to do such thing at or before the specified time but the promisee is entitled to compensation from the promisor for any loss occasioned to him by such failure. If in case of a contract voidable on account of the promisor's failure to perform his promise at the time agreed, the promisee accepts performance of such promise at any time other than agreed, the promisee cannot claim compensation for any loss occasioned by the non-performance of the promise at the time agreed unless, at the time of such acceptance he gives notice to the promisor of his intention to do so.

According to the above provisions, if performance beyond the stipulated time is accepted, the promisee must give notice of his intention to claim compensation. If he fails to give such notice, he will be deemed to have waived that right. In England, however, no such notice is necessary, and the promisee, can even after accepting the belated performance, claim compensation.

**Breach during the Performance of the Contract.** Actual breach of contract also occurs when during the performance of the contract one party fails or refuses to perform his obligation under the contract.
Example: A contracted with a Railway Company to supply it certain quantity of railway chairs at a certain price. The delivery was to be made in installments. After a few installments had been supplied, the Railway Company asked A to deliver no more. Held, A could sue for breach of contract. [Cort v. Ambergate, etc Rly. Co. (1851) 17 Q.B. 1271.]

4.2 REMEDIES FOR BREACH OF CONTRACT

A remedy is the course of action available to an aggrieved party (i.e. the party not at default) for the enforcement of a right under a contract. Whenever there is breach of a contract, the injured party becomes entitled to any one or more of the following remedies against the guilty party:

1. Rescission of the contract
2. Restitution
4. Suit for an injunction
5. Suit for damages.
6. Suit upon quantum meruit

As regard the last two remedies stated above, the law is regulated by the Specific Relief Act.

4.2.1 Rescission of the Contract

When there is a breach of contract by one party, the other party may rescind the contract and need not perform his party of obligations under the contract and may sit quietly at home if he decides not to take any legal action against the guilty party. But in case the aggrieved party intends to sue the guilty party for damages for breach of contract, he has to file a suit for rescission of the contract. When the court grants rescission, the aggrieved party is freed from all his obligations under the contract; and
becomes entitled to compensation for any damage which he has sustained through the nonfulfilment of the contract (Sec. 75).

**Example**: A contacts to supply 100 kg of tea leaves for Rs. 8000 to B on 15 April. If A does not supply the tea leaves on the appointed day, B need not pay the price, B may treat the contract as rescind and may sit quietly at home. B may also file a suit for ‘rescission’ and claim damages.

**When is rescission granted?**

Under Section 39 of Indian Contract Act, the court may grant rescission in the following two cases:

1. Where the contract is voidable at the option of the plaintiff, the court grants rescission to the plaintiff.
2. Where the contract is unlawful for causes not apparent on its face and defendant is more to blame than the plaintiff, the court may grant rescission.

**When may rescission be refused?**

That court may, however, refuse to rescind the contract

(a) Where the plaintiff has expressly or impliedly ratified the contract; or
(b) Where owing to the change of circumstances, the parties cannot be restored to their original positions; or
(c) Where third parties have, during the subsistence of the contract acquired rights in good faith and for value; or
(d) Where only a part of the contract is sought to be rescinded and such part is not servable from the rest of the contract.

### 4.2.2 Restitution

It means return of the benefit received by one party to the contract from the other under a void contract. When a contract becomes void it need not be performed by either
party. Section 65 provides that when an agreement is discovered to be void or when a contract becomes void any person who has received any advantage under such agreement or contract is bound to restore it or to make compensation for it to the person from whom he received it.

This section applies to contracts ‘discovered to be void’ and contracts which become void. It does not apply to contracts which are known to be void. Thus, if A pays Rs 200 to B to beat C, the money is not recoverable.

**Example:** A pays B Rs. 1000 in consideration of B’s promising to marry C, A’s daughter. C is dead at the time of promise. The agreement is void but B must repay A Rs. 1000.

### 4.2.3 Specific Performance

Under certain circumstances a person aggrieved by the breach of the contract can file a suit for specific performance i.e. for an order by the court upon the party guilty of breach of contract directing him to perform what he promised to do. Specific performance is a discretionary remedy which is allowed only in a limited number of cases. Rules regarding the granting of this relief are contained in the Specific Relief Act.

**Example:** A agrees to sell two rare China vases to B. B may compel A to perform the contract specifically, because there is no standard for ascertaining the actual damage which would be caused by the non-performance of the promise.

A is looking for a house. For his residence he finds one. He make a contract with the owner of that house ’B’ to buy the house. Later, ‘B’ refuses to sell the house to ‘A’. In this case, damages from ‘B’ for such breach of contract are not adequate remedy for ‘A’ because he does not get that type of house which he want in the locality. In this situation, A can appeal to the court for the specific performance of the contract.

Some of the case in which specific performance of the contract may be enforced are as follows:
(a) Where monetary consideration is not an adequate remedy for the breach of a contract.

(b) When there exist no standard for ascertaining the actual damage caused by the non-performance of the act.

(c) When it is probable that compensation in money on non-performance of the contract cannot be obtained.

In the following cases however specific performance shall not be granted:-

1. Where the contract is of a personal nature.

2. Where damages are an adequate remedy.

3. Where the court cannot supervise the execution of the contract.

4. Where the contract is made by the trustee in breach of their trust.

5. Where the contract is inequitable to either party.

It is discretionary remedy which is allowed only in a limited number of cases.

4.2.4 Injunction

An aggrieved party can sue for an injunction i.e. an order, of the court restraining the wrong does from doing or continuing the wrongful act complained of. Injunctions are usually granted to enforce negative stipulations in cases where damages are not adequate relief. Injunctions is a preventive relief. It is particularly appropriate in cases of anticipatory breach of contract.

**Example:** G agreed to buy the whole of the electric energy required for his house from a certain company. This was interpreted as a promise not to buy electricity from any other company. He was therefore restrained by an injunction from any other company.[Metropolitan Electric’s Supply Company v. Ginder (1901) 2 Ch.799]

4.2.5 Suit for Damages

Damages are a monetary compensation allowed to the injured party for the loss or injury suffered by him as a result of the breach of contract. The fundamental principle
underlying damages is not punishment but compensation. By awarding damages the court aims to put the injured party into the position in which he would have been, had there been performance and not breach, and not to punish the defaulter party. As a general rule, “compensation must be commensurate with the injury or loss sustained, arising naturally from the breach.” “If actual loss is not proved, no damages will be awarded.”

**Assessment of damages.** We will now consider the extent to which a plaintiff is entitled to demand damages for breach of contract. The rules in this regard have been laid down by Section 73 and 74 of Indian Contract Act, 1872. Accordingly, an injured party is entitled to receive from the defaulter party:

(a) Such damages which naturally arose in the usual course of things from such breach. No compensation is to be given generally for any remote or indirect loss sustained by reason of the breach (Ordinary Damages).

(b) Such damages which the parties knew, when the entered into the contract, as likely to result from the breach (Special Damages).

(c) In estimating the loss or damage caused to a party by breach, the means which existed of remedying the inconvenience caused by the breach must also be taken into account (Explanation Sec. 73). (Duty to mitigate damage suffered).

(d) If the terms of contract defines the amount of damages to be paid in case of breach of contract the aggrieved party is entitled only to a reasonable amount of damages which does not exceeds the amount mentioned in the contract. The amount of reasonable damages is decided by the court.

**Different kinds of damages.** Damages may be of four kinds:

1. Ordinary or General or Compensatory damages (i.e. damages arising naturally from the breach).
2. Special damages (i.e., damages in contemplation of the parties at the time of contract).

3. Exemplary, Punitive or Vindictive damages.

4. Nominal damages.

1. Ordinary Damages

When a contract has been broken, the injured party can, as a rule always recover from the guilty party ordinary or general damages. These are such damages as may fairly and reasonably be considered as arising naturally and directly in the usual course of things from the breach of contract itself. In other words, ordinary damages are restricted to the "direct or proximate consequences" of the breach of contract and remote of indirect losses, which are not the natural and probable consequence of the breach of contract, are generally not regarded.

Example: The leading case of (Hodley vs Baxendale) which is said to be the foundation of modern law of damages in England and India (as Sec. 73 is almost based on the rules laid down ill this case); is an authority on the point In that case:

H's mill was stopped by a breakage of the crankshaft. H delivered the shaft to B, a common carrier, to take it to the manufacturers at Greenwich as a pattern for a new one. The only information given to B was that the article to be carried was the broken shaft of the mill. It was not made known to B that delay would result in loss of profits. By some neglect on the part of B the delivery of the shaft was delayed beyond a reasonable time. In consequence the mill remained idle for a longer period than should have been necessary. H brought an action against B claiming damages for loss of profits which would have been made during the period of delay. Held that B was not liable for loss of profits caused by the delay because it was a remote consequence, and only nominal damages were awarded. The Court pointed out that B, the defendant, was never told that the delay in the delivery of the shaft would entail loss of profits of the mill; the plaintiffs might have had another shaft, or there might have been some other defect in the
machinery to cause the stoppage, or for any other reason there might have been loss actually. Accordingly it was not a direct consequence of the breach and hence not recoverable.

In the case of a contract for ‘sale and purchase’ the general rule as regards measure of damages is that the damages would be assessed on the difference between the contract price and the market price at the date of breach and any subsequent increase or decrease in the market price would not be taken note of. If there is no market price for the subject matter of the contract, the rule is to take the market price of the nearest substitute. If there is no nearest substitute, the market price is to be ascertained by adding to the price at the place of purchase, the conveyance charge to the place of delivery plus the usual profit of the importer (Hajee Ismail & Sons vs Wilson & Co.). If the delivery is to be made in instalments, then the due date of each instalment is taken as the date of breach and the measure of damages is the sum of the difference of the market value at the several dates of delivery.

**Example**: A agrees to sell to B 5 bags of rice at Rs. 500 per bag, delivery to be given after two months. On the date of delivery the price of rice goes up and the rate is Rs. 550 per bag. A refuses to deliver the bags to B. B can claim from A Rs. 250, as ordinary damages arising directly from the breach, being the difference between the contract price (i.e. Rs. 500 per bag) and the market price (i.e. Rs. 550 per bag) on the date of delivery of 5 bags. Notice that if Rs. 250 are paid to B by way of damages, then he will be in the same position as if the contract has been performed.

Under a contract of ‘sale of goods’ if there is as breach of ‘warranty’ the seller is liable to pay all damages which the purchaser has to pay to the person to whom the goods are sold by him, whether the seller is aware of such a sale or not. In order that the purchaser should be able to claim such damages and costs it is an overriding requirement that the sub-contracts should have been made on the same terms and conditions as the first contract.
Example: A sells certain merchandise to B, warranting it to be of a particular quality, and B, in reliance upon this warranty, sells it to C with a similar warranty. The goods prove to be not according to the warranty and B becomes liable to pay C a sum of money by way of compensation. B is entitled to be reimbursed this sum by A.

2. Special Damages

Special damages are those which arise on account of the special or unusual circumstances affecting the plaintiff. In other words, they are such remote losses which are not the natural and probable consequence of the breach of contract. Unlike ordinary damages, special damages cannot be claimed as a matter of right. These can be claimed only if the special circumstances which would result in a special loss in case of breach of contract are brought to the notice of the other party. It is important that such damages must be in contemplation of the parties at the time when the contract is entered into. Subsequent knowledge of the special circumstances will not create any special liability on the guilty party.

Example: A, having contracted with B to supply 1,000 tons of iron at Rs.100 a ton, to be delivered at a stated time, B contracts with C for the purchase of 1,000 tons of iron at Rs.80 a ton, telling C that he does so for the purpose of performing his contract with B. C fails to perform his contract with A, and A could not procure other iron, and B, in consequence rescinds the contract. C must pay to A Rs.20,000 being the profit which A would have made by the performance of his contract with B. (Illustration (i) to Section 73). (If C was not told of B’s contract then only the difference in contract price and market price, if any, could be claimed).

3. Exemplary or Vindictive or Punitive Damages

These are such damages which are awarded with a view to punishing the guilty party for the breach and not by way of compensation for the loss suffered by the aggrieved party. The cardinal principle of law of damages for a breach of contract is to compensate the injured party for the loss suffered and not to punish the guilty party.
Hence, obviously, exemplary damages have not place in the law of contract and are not recoverable for a breach of contract. There are, however, two exceptions to this rule:

(a) **Breach of a contract to marry.** In this case the amount of the damages will depend upon the extent of injury to the party’s feelings. One may be ruined, other may not mind so much.

(b) **Dishonour of a cheque by a banker when there are sufficient funds to the credit of the customer.** In this case the rule of ascertaining damages is, “the smaller the cheque, the greater the damages.” Of course, the actual amount of damages will differ according to the status of the party.

4. **Nominal Damages**

Nominal damages are those which are awarded only for the name sake. These are neither awarded by way of compensation to the aggrieved party nor by way of punishment to the guilty party. These are awarded to establish the right to decree for breach of contract when the injured party has not actually suffered any real damage and consist of a very small sum of money, say, a rupee or two. For example, where in a contract of sale of goods, if the contract price and the market price is almost the same at the date of breach of the contract, then the aggrieved party is entitled only to nominal damages.

**Duty to Mitigate Damage Suffered**

It is the duty of the injured party to mitigate damage suffered as a result of the breach of contract by the other party. He must use all reasonable means of mitigating the damage, just as a prudent man would, under similar circumstances in his own case. He cannot recover any part of the damage, traceable to his own neglect to mitigate. The onus of proof, however, is on the defendant to show that the plaintiff has failed in his duty of mitigation and the plaintiff is free from the burden of proving that he tried his best to mitigate the loss (Pauzu Ltd. vs Saunders).
The rule in regard to mitigation must be applied with discretion and a man who has already put himself in the wrong by breaking his contract has no right to impose new and extraordinary duties on the aggrieved party. Courts should take care to see that they have put the plaintiff in the same position as if the contract had been performed, and have not been overgenerous to the contract-breaker by too severe an application of the rule that the plaintiff must take reasonable steps to mitigate damages.

Example: Where a servant is dismissed, even though wrongfully, it is his duty to mitigate the damages by seeking other employment. He can recover only nominal damages if he refuses a reasonable offer of fresh employment. But if it cannot be proved that he has failed in his duty of mitigation, he will be entitled to the full salary for the whole of the unexpired period of service, if the contract of employment was for a fixed period. If the contract of employment was not for a fixed term, then the principle of awarding damages for a reasonable period of notice comes into play (S.S. Shetty vs. Bharat Nidhi Ltd.).

Liquidated Damages and Penalty

‘Liquidated damages’ means a sum fixed up in advance, which is a fair and genuine pre-estimate of the probable loss that is likely to result from the breach. ‘Penalty’ means a sum fixed up in advance, which is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach. Thus the essence of a penalty is a payment of money stipulated as in terrorem of the offending party.

Sometimes the parties fix up at the time of the contract the sum payable as damages in case of breach. In such a case, a distinction is made in English Law as to whether the provision amounts to ‘liquidated damages’ or a ‘penalty’. Courts in England usually allow ‘liquidated damages’ as stipulated in the contract, without any regard to the actual loss sustained. ‘Penalty’ clauses, however, are treated as invalid and the courts in
that case calculate damages according to the ordinary principles and allow only reasonable compensation.

Under the Indian Law Section 74 does away with the distinction between ‘liquidated damages’ and ‘penalty’. This Section lays down that the Courts are not bound to treat the sum mentioned in the contract, either by way of liquidated damages or penalty, as the sum payable as damages for the breach. Instead the courts are required to allow reasonable compensation so as to cover the actual loss sustained, not exceeding the amount so named in the contract. Thus, according to the Section, the named sum, regardless whether it is a penalty or not, determines only the maximum limit of liability in case of breach of contract. The Section does not confer a special benefit upon any party; it merely declares the law that notwithstanding any term in the contract pre-determining damages or providing for forfeiture of any property by way of penalty, the Court will award to the party aggrieved only reasonable compensation not exceeding the amount named or penalty stipulated.

Exception: There is, however, one exception provided for by Section 74 to the above rule. When any person enters into any bailbond, recognizance or other instrument of the same nature, or under the provisions of any law or under the orders of the Government, gives any bond for the performance of any public duty or act in which the public are interested, he shall be liable to pay the whole sum mentioned therein upon breach of the condition of any such instrument.

Examples: (a) A contracts with B to pay Rs.1,000 if he fails to pay B Rs.500 on a given day. A fails to pay B Rs.500 on that day. B is entitled to recover from A such compensation, not exceeding Rs.1,000 as the court considers reasonable. (Illustration (a) to Section 74).

(b) A undertakes to repay B a loan of Rs.1,000 by five equal monthly instalments with a stipulation that, in default of payment of any instalment, the whole shall become due. This stipulation is not by way of penalty and the contract may be enforced according to its terms. (Illustration (f) to Section 74).
(c) A borrows Rs.100 from B, and gives him a bond for Rs.200 payable by five yearly instalments of Rs.40, with a stipulation that, in default of payment of any instalment, the whole shall become due. This is a stipulation by way of penalty. (Illustration (g) to Section 74).

**Stipulation regarding payment of interest.** The explanation added to Section 74 states, “a stipulation for increased interest from the date of default may be a stipulation by way of penalty.” It implies that such a stipulation may be considered a penalty clause and disallowed by the courts, if the enhanced rate is exorbitant.

**Example:** A gives B a bond for the repayment of Rs.1,000 with interest at 12 per cent per annum at the end of six months, with a stipulation that in case of default interest shall be payable at the rate of 75 per cent p.a. from the date of default. This is a stipulation by way of penalty and B is only entitled to recover from A such compensation as the court considers reasonable.

The following rules must also be noted in connection with payment of interest:

(a) Unless the parties have made a stipulation for the payment of interest, or there is a usage to that effect, interest cannot be recovered legally as damages, generally speaking (Mahabir Prasad vs. Durga Datta).

(b) Where a contract provides that the amount should be paid without interest by a particular date and on default it will be payable with interest, such a stipulation may be allowed if the interest is reasonable. If the interest is exorbitant, the courts will give relief.

(c) Payment of compound interest on default, is allowed, only if it is not at an enhanced rate (Bhushan Rao vs. Subayya).

**Earnest Money:** Money deposited as security for the due performance of a contract is known as earnest money. Forfeiture of earnest money is allowed if the amount is reasonable. But where it is in the nature of penalty, the court has jurisdiction to award such sum only as it considers reasonable but not exceeding the amount so agreed (Fateh
Chand vs Balkishen Dass). The proportion the amount bears to the total sale price, the nature of the contract and other circumstances have to be taken into account in ascertaining the reasonableness of the amount.

**Cost of Suit**

The aggrieved party is entitled, in addition to the damages, to get the costs of getting the decree for damages from the defaulter party. The cost of suit for damages is in the discretion of the court.

**Summary of the Rules Regarding the Measure of Damages**

The principles governing the measure may be summarized as under:

1. The damages are awarded by way of compensation for the loss suffered by the aggrieved party and not for the purpose of punishing the guilty party for the breach.
2. The injured party is to be placed in the same position, so far as money can do, as if the contract had been performed.
3. The aggrieved party can recover by way of compensation only the actual loss suffered by him, arising naturally in the usual course of things from the breach itself.
4. Special or remote damages, i.e. damages which are not the natural and probable consequence of the breach are usually not allowed until they are in the knowledge of both the parties at the time of entering into the contract.
5. The fact that damages are difficult to assess does not prevent the injured party from recovering them.
6. When no real loss arises from the breach of contract, only nominal damages are awarded.
If the parties fix up in advance the sum payable as damages in case of breach of contract, the court will allow only reasonable compensation so as to cover the actual loss sustained, not exceeding the amount so named in the contract.

Exemplary damages cannot be awarded for breach of contract except in case of breach of contract of marriage or wrongful refusal by the bank to honour the customer’s cheque.

It is the duty of the injured party to minimize the damage suffered.

The injured party is entitled to get the costs of getting the decree for damages from the defaulter party.

4.2.6 **Suit upon Quantum Meruit (Sections 65 and 70)**

Another remedy for a breach of contract available to an injured party against the guilty party is to file a suit upon quantum meruit. The phrase quantum meruit literally means “as much as is earned” or “in proportion to the work done.” A right to sue upon quantum meruit arises where a contract, partly performed by one party, has been discharged by breach of contract by the other party or, is discovered void or becomes void. This remedy may be availed of either without claiming damages (i.e., claiming reasonable compensation only for the work done) or in addition to claiming damages for breach (i.e., claiming reasonable compensation for part performance and damages for the remaining unperformed part).

The aggrieved party may file a suit upon quantum meruit and may claim payment in proportion to work done or goods supplied in the following cases:

1. Where work has been done in pursuance of a contract, which has been discharged by the default of the defendant.

**Example:** P agreed to write a volume on ancient armour to be published in a magazine owned by C. For this he was to receive $100 on completion. When he had completed part, but not the whole, of his volume, C abandoned the magazine. P was held entitled to...
get damages for breach of contract and payment quantum meruit for the part already completed (Planche vs. Calburn).

Notice that in the above case the contract was wrongfully terminated by the defendant, and both damages as well as payment quantum meruit have been allowed. It is important that in the case of a wrongful breach of contract the injured party can always claim payment quantum meruit, whether the contract is divisible or indivisible.

2. Where work has been done in pursuance of a contract which is discovered void’ or becomes void,’ provided the contract is divisible.

**Example**: C was appointed as managing director of a company by the board of directors under a written contract which provided for his remuneration. The contract was found void because the directors who constituted the ‘Board’ were not qualified to make the appointment. C nevertheless, purporting to act under the agreement, rendered services to the company and sued for the sums specified in the agreement, or alternatively, for a reasonable remuneration on a quantum meruit. Held, C could recover on a quantum meruit. (Craven-Ellis vs. Canons Ltd).

3. When a person enjoys benefit of non-gratuitous act although there exists no express agreement between the parties. One of such cases is provided in Section 70. Section 70 lays down that when services are rendered or goods are supplied by a person, (i) without any intention of doing so gratuitously, and (ii) the benefit of the same is enjoyed by the other party, the latter must compensate the former or restore the thing so delivered.

**Example**: A, a trader, leaves certain goods at B’s house by mistake. B treats the goods as his own. He is bound to pay A for them. (Illustration (a) to Section 70).

4. A party who is guilty of breach of contract may also sue on a quantum meruit provided both the following conditions are fulfilled

(a) the contract must be divisible, and
(b) the other party must have enjoyed the benefit of the part which has been performed, although he had an option of declining it.

**Example**: Where a common carrier fails to take a complete consignment to the agreed destination, he may recover pro-rata freight. (He will, of course, be liable for breach of the contract).

### 4.3 SUMMARY

A breach of contract occurs if any party refuses or fails to perform his part of contract or by his act makes it impossible to perform his obligation under the contract. Breach of contract arise in two ways: (a) anticipatory breach and (b) actual breach. Anticipatory breach of contract takes place when a party to the contract repudiates his liability under the contract even before the time for performance is due or when a party by his own act disables himself from performing the contract. Actual breach of contract takes place when during the performance of contract or at the time when the performance of the contract is due, one party either fails or refuses to perform his obligations under the contract. When a contract is broken, the aggrieved party has one of the following remedies against the guilty party: (a) rescission of the contract (b) suit for damages (c) restitution (d) suit for specified performance of the contract (e) suit for injunction and (f) suit upon quantum meruit.

### 4.4 KEYWORDS

**Breach of Contract**: A breach of contract occurs if any party refuses or fails to perform his part of the contract or by his act makes it impossible to perform his obligation under the contract.

**Restitution**: It is return of the benefit received by one party to the contract from the other under a void contract.

**Injunction**: Injunction is generally granted to prevent the breach of an obligation arising out of a contract.
4.5 SELF ASSESSMENT QUESTIONS

1. What are the various remedies available to a party in case of breach of contract.

2. “If a contract is broken, the law will endeavour so far as money can do it, to place the injured party in the same position as if the contract has been performed”. Discuss.

3. “Damages for breach of contract are granted by way of compensation and not by way of punishment”. Comment.

4. Is a clause in a deed for payment of interest at an enhanced rate one of penalty? Explain.

4.6 SUGGESTED READINGS


LESSON-5
QUASI-CONTRACTS

STRUCTURE
5.0 Objective
5.1 Introduction
5.2 Meaning of Quasi-Contract
5.3 Cases deemed as Quasi-Contracts
5.4 Quantum Meruit
5.5 Specific Performance
5.6 Summary
5.7 Keywords
5.8 Self Assessment Questions
5.9 Suggested Readings

5.0 OBJECTIVE
After reading this lesson, you should be able to:
(a) Define quasi-contract and explain the causes deemed as quasi-contracts
(b) Explain about the quantum merit.

5.1 INTRODUCTION
A contract is the result of an agreement enforceable by law. It comes into existence from the action of the parties. The parties make actual promises knowing fully well that legal relationship will come into existence. But sometimes there is no intention on the part of the parties to enter into a contract but obligations resembling those created by a contract are imposed by law. Such obligations imposed by law constitute what is
known as quasi-contracts under the English law, and certain relations resembling those created by contracts under the Indian law. A quasi-contract is not in fact a contract at all, but merely resembles one and produces similar effect.

**Example**: If A pays sum of money to B believing him to be his creditor, when as a matter of fact he was not, B is bound to return the money to A on the assumption that the above sum given to him was by way of loan.

### 5.2 MEANING OF QUASI-CONTRACT

A quasi-contract is a kind of contract by which one party is bound to pay money in consideration of something done or suffered by the other party. Though no contractual relation exists between the parties, law makes out a contract for them and such a contract is called a quasi-contract. The basis of quasi-contract is to prevent unjust enrichment or unjust benefit, i.e., no one should grow rich out of another person’s loss.

### 5.3 CASES DEEMED AS QUASI-CONTRACTS

The Indian Contract Act recognises such types of contracts and section 68-72 deal with such contracts. They are as follows:

1. **Claims for necessaries supplied (Section 68)**

   If a person incapable of entering into a contract or any one whom he is legally bound to support, is supplied by another person with necessaries suited to his condition in life, the supplier is entitled to recover the price from the property of the incapable person.

   **Example**: A supplies to B, a lunatic, with necessaries suitable to his condition in life. A is entitled to be reimbursed from B’s property.

   A contract by a minor is wholly void and unenforceable. He cannot even ratify it on attaining majority. But section 68 of the Act provides an exception to this rule and makes the estate of the minor liable for necessaries supplied to him. In order to make an infant liable for necessaries supplied, the plaintiff must prove, (1) that the goods supplied
were reasonable necessary for supporting a person in his position, and (2) that the infant had not already a sufficient supply of these necessaries.

The things supplied must come within the category of necessaries. Facts of individual cases will help in deciding as to what are necessaries. Necessaries are those things without which an individual cannot reasonably exist. The same thing may be necessary to one person under certain circumstances and unnecessary to another person under other circumstances. The standard varies according to the class of society to which the infant belongs. The term necessaries is not confined to goods. It can include other things such as good teaching and instruction. House given to a minor for the purpose of living and continuing his studies is a necessity and the person so giving is entitled to recover the price.

It may, however, be noted that the remedy is not personal but against the estate only. The minor cannot even be made personally liable where necessaries supplied exceed the value of the estate itself. The obligation under section 68 is to pay a reasonable and not the agreed price for the goods. The creditor is entitled to the value of the necessaries but not the interest thereon.

2. **Payment by an interested person (Section 69)**

This section provides that a person who is interested in the payment of money which another is bound by law to pay and who, therefore, pays it, is entitled to be reimbursed by the other.

**Example:** B holds land in Bengal on a lease granted by A, the Zamindar. The revenue payable by A to the Government being in arrear, his land is advertised for sale by the Government. Under the revenue law, the consequence of such sale will be the annulment of B’s lease. B to prevent the sale and the consequent annulment of his own lease pays to the Government the sum due from A. A is bound to make good to B the amount so paid.

In order that section 69 may apply, the following conditions must be satisfied.

1. A person must by law be bound to pay some money.
2. Another person must be interested in the payment of that money.

3. The other person must have paid the money because of such interest.

A person who is interested in the payment of money which another is bound by law to pay, pays it, he is entitled to be reimbursed by the other. If he has no interest in paying, he cannot claim protection. An action is not maintainable under this section, unless the person from whom it is sought to be recovered was bound by law to pay it. Thus, where a seller had to pay all encumbrances, on the property and the purchaser pays such encumbrances, the purchaser is entitled to be reimbursed by the seller.

**Examples:**
(a) A’s goods were wrongfully attached to realise the arrears of Government revenue due by B. A pays the dues to save his property. He is entitled to recover the amount from B. (Tulsa Kunwar v. Jageshar Prasad (1906) 28 All. 5631).
(b) The consignee suffered loss due to fire in the wagon during transit. The insurer made good the loss. The insurer claimed the money from the railway. The claim was allowed under section 69. (Union of India v. Kalinga Textile AIR, 1969 Bom. 401).
(c) In a case E left his carriage at P’s house. P’s landlord seized the carriage as distress for rent. E paid the rent to obtain the release of his carriage. It was held that E could recover the amount from P (Exall v. Partidge (1799) 8. T.R. 308).

3. **Obligation of a person enjoying benefit of non-gratuitous act (Section 70)**

Where a person lawfully does anything for another person or delivers, anything to him, not intending to do so gratuitously, and such other person enjoys the benefit thereof the latter is bound to make compensation to the former in respect of, or to restore the thing so done or delivered.

**Examples:**
(a) A, a tradesman leaves goods at B’s house by mistake. B treats the goods as his own. He is bound to pay A for them.
(b) A saves B’s property from fire. A is not entitled to compensation from B, if the circumstances show that he intended to act gratuitously.
Where irrespective of any agreement or contract, a person lawfully does something for another person which was never intended to be gratuitous, and the other person enjoys the benefit of the thing done the latter is bound to pay compensation to the former in respect of the thing done. For the application of this section, the following conditions must be fulfilled.

(1) The thing must have been done lawfully.

(2) It must have been done by a person not intending to act gratuitously.

(3) The person for whom the act is done must have enjoyed the benefit of it.

If these conditions are satisfied the person enjoying the benefit of the act is put under an obligation to make compensation to the person doing the act or to restore the thing so done or delivered.

The leading case on the point is Damadar Mudaliar V. Secretary for State for India.

The facts of the case are:

The Government carried out repairs to an irrigation tank, owned by the Government jointly with a zamindar and sued the zamindar for contribution in respect of expenses incurred for the repairs, it was held that Government in carrying out the repairs had acted lawfully and had not intended to carry them out gratuitously and that the zamindar who enjoyed the benefit of the repairs was liable to pay compensation.

Examples: (a) The provincial Government in the wrongful exercise of their authority asked the railway company to widen the culvert for the benefit of private owner of property in the neighbourhood. The railway company agreed to widen the culvert of its own cost. On completion of the work a suit was filed by the railway company against the municipality. It was held that although the railway company did not intend to do the work gratuitously, the municipality did not benefit from it and therefore section 70 could not be applied. (Governor General in Council v. Madura Municipality AIR, 1949 PC. 39).
(b) A contractor on the request of an officer of the state of West Bengal constructed a katcha road, office, kitchen, storage sheds for the use of the civil supplies department of the Government. The State accepted the works but tried to evade liability because no contract had been concluded according to the formalities of the Government of India Act. Since the State had enjoyed the benefit of the works, the Supreme Court held the State Government liable. (State of West Bengal v. Mondal & Sons, AIR 1962 Sc. 779).

Section 70 is not based on contract but embodies the equitable principles of restitution and prevention of unjust enrichment. It has no application to persons incompetent to contract (such as minor) and as such they are under no obligation to compensate the other person for any benefit received by them. But the position of the State cannot be compared with that of a minor. Section 70 applies as much to Corporations and Government as to individuals.

Example: X supplied spare motor parts to the Poona Municipal Corporation. The Corporation tried to escape liability on the ground that the contract was not made in accordance with the Bombay Municipal Corporation Act. It was held that the Corporation was liable under Section 70. (Pillo Dhunfishaw v. Municipal Corporation of the city of Poona AIR 1970 SC. 1201).

4. Responsibility of finder of goods (Section 71)

A person who finds goods belonging to another and takes them into his custody, is subject to the same responsibility as a bailee.

A finder of goods is bound to take as much care of the goods found as a man of ordinary prudence would take of his own goods under similar circumstances. He cannot appropriate the goods without taking proper steps to find out the owner and should keep them for a reasonable time so that the owner may turn up and take them. The finder of the goods is entitled to retain the goods against the owner until he receives compensation from him. He is also entitled to the possession of the goods as against the whole world except the true owner.
The finder, however, can retain the goods in the following cases:

(i) Where the thing found is in danger;

(ii) Where the owner cannot with reasonable diligence be found out;

(iii) Where the owner is found out, but refuses to pay lawful charges of the finder;

(iv) Where the lawful charges of the finder, in respect of the thing found, amount to two-thirds of the value of the thing found.

**Example:** H picked up a diamond from the floor of F’s shop and handed it over to F to keep it till the owner is found. Despite best efforts the true owner could not be reached. After some time H tendered to F the lawful expenses incurred by him for finding the true owner and asked him (F) to hand over the diamond to him (H). F refused. It was held that F must return the diamond to H as H was entitled to retain it against the whole world except the true owner. (Hollins v. Fowler L.R. 7 HL. 757).

5. **Money paid by mistake or under coercion (Section 72)**

A person to whom money has been paid or anything delivered by mistake or under coercion, must repay or return it.

**Examples:** (a) A and B jointly owe 100 rupees to C. A alone pays the amount to C and B not knowing of this fact, pay 100 rupees over again to C. C is bound to repay the amount to B.

(b) A railway company refuses to deliver certain goods to the consignee, except upon the payment of illegal charge for carriage. The consignee pays the sum charged in order to obtain the goods. He is entitled to recover so much of the charges as was illegally excessive.

Payment by mistake under this section must refer to a payment which was not legally due. The mistake is thinking that the money paid was due when in fact it was not due. Thus, if money is sent to a wrong person by money order due to bonafide mistake of
fact, the sender can recover it. Similarly a debtor can recover the amount of over payment to a creditor paid under a mistake.

**Examples:** (a) A lessee in a mining lease paid higher rates though he was bound to pay royalties at a lower rate. The money was paid under the belief that it was legally due. The Privy Council held that money paid under mistake of law can be recovered under Section 72. (Sir Shiba Prasad v. Maharajah Srish Chandra. AIR 1949 PC. 297).

(b) A person purchased a car at a price which it was represented by the seller to be controlled price, but afterwards the vendee came to know that he paid more than the controlled price, upon the false representation of the seller. It was held that the excess payment was a payment made by mistake and the vendee could recover it. (Lakshman Prasad & Sons v. S.V. Kamalba AIR 1960 Mad. 335).

Mistake must as to the existence of the obligation and not merely as to some collateral matter which may form a motive for the payment. Mistake may be either of a fact or law. But it must be of fundamental importance.

In the case of Sales Tax Officer, Banares v. Kanhaiya Lal Mukand Lal Saraf, the point decided is :

If a person pays money to another by mistake, then money must be repaid to him.

**Facts of the case are**

A certain amount of sales tax was paid by a firm under the U.P. Sales Tax Law on its forward transactions. Subsequently the court ruled the levy of sales tax on such transactions to be ultra vires. The firm was allowed to recover back the tax.

Payment made under coercion can be recovered like payment made under a mistake. Thus, money paid as income tax under threat of attachment can be recovered. Similarly where a consumer of electricity pays money to the electric company under protest on being threatened with disconnection in case of default, the case is one of coercion under Section 72.
Example: A had obtained a decree against B but obtained an attachment against C’s property and took possession of it to obtain satisfaction for the amount of the decree. C on being ousted from the property paid the sum under protest – C then sued for refund of the money. It was held that C having paid the money under coercion within the meaning of Section 72 was entitled to recover the sum (Seth Kanhaya Lal v. National Bank of India Ltd. AIR 1923 PC. 114).

Compensation for failure to discharge obligation created by quasi-contracts (Sec. 73)

When an obligation created by a quasi-contract is not discharged the injured party is entitled to receive the same compensation from the party in default as if such person had contracted to discharge it and had broken his contract.

5.4 QUANTUM MERUIT

In addition to the above types of quasi-contracts a claim can also be made on the basis of Quantum Meruit. Where one person has rendered service to another in circumstances which indicate an understanding between them that it is to be paid for although no particular remuneration has been fixed the law will infer a promise to pay Quantum Meruit i.e., as much as the party doing the service has deserved. It covers a case where the party injured by the breach had at time of breach done part but not all of the work which he is bound to do under the contract and seeks to be compensated for the value of the work done. For the application of this doctrine two conditions must be fulfilled:

(1) It is only available if the original contract has been discharged.

(2) The claim must be brought by a party not in default.

The object of allowing a claim on quantum meruit is to recompensate the party or person for value of work which he has done. Damages are compensatory in nature while quantum meruit is restitutory. It is but reasonable compensation awarded on implication of a contract to remunerate. Where a person orders from a wine merchant 12 bottles of
whisky and he sends 10 bottles of whiskey and 2 of brandy, and the purchaser accepts them, the purchaser must pay a reasonable price for the brandy.

The claim for quantum meruit arises in the following cases:

1. Where work has been done in pursuance of a contract, which has been discharged by the default of the defendant.

Examples

(a) P agreed to write a volume on ancient armour to be published in a magazine owned by C. For this he was to receive $100 on completion. When he had completed part, but not the whole, of his volume, C abandoned the magazine. P was held entitled to get damages for breach of contract and payment quantum meruit for the part already completed (Planche vs. Colburn).

(b) A, engages B, a contractor, to build a three storied house. After a part is constructed A prevents B from working any more. B, the contractor, is entitled to get reasonable compensation for work done under the doctrine of quantum meruit in addition to the damages for breach of contract.

Notice that in both the above cases the contract was wrongfully terminated by the defendant, and both damages as well as payment quantum meruit have been allowed. It is important that in the case of a wrongful breach of contract the injured party can always claim payment quantum meruit, whether the contract is divisible or indivisible.

2. Where work has been done in pursuance of a contract which is ‘discovered void’ or ‘becomes void’, provided the contract is divisible.

Examples

(a) C was appointed as managing director of a company by the board of directors under a written contract which provided for his remuneration. The contract was found void because the directors who constituted the Board were not qualified to make the appointment. C nevertheless, purporting to act under the agreement, rendered services to the company and sued for the sums specified in the
agreement, or, alternatively, for a reasonable remuneration on a quantum meruit. Held, C could recover on a quantum meruit. (Craven-Ellis vs. Canons Ltd.)

(b) A contracts with B to repair his house at a piece rate. After a part of the repairs were carried out, the house is destroyed by lightning. Although the contract becomes void and stands discharged because of destruction of the house, A can claim payment for the work done on quantum meruit. Note that if under the contract a lump sum is to be paid for the repair job as a whole, then A cannot claim quantum meruit because no money due till the whole job is done.

3. When a person enjoys benefit of non gratuitous act although there exists no express agreement between the parties. One of such cases is provided in Section 70. Section 70 lays down that when service are rendered or goods are supplied by a person, (i) without any intention of doing so gratuitously, and (ii) the benefit of the same is enjoyed by the other party, the latter must compensate the former or restore the thing so delivered.

Examples

(a) A, a trader, leaves certain goods at B’s house by mistake. B treats the goods as his own. He is bound to pay A for them. (illustration (a) to Section 70)

(b) Where A ploughed the field of B with a tractor to the satisfaction of B in B’s presence, it was held that A was entitled to payment as the work was not intended to be gratuitous and the other party has enjoyed the benefit of the same. (Ram Krishna vs Rangoobet).

4. A party who is guilty of breach of contract may also sue on a quantum meruit provided both the following conditions are fulfilled:

   (a) the contract must be divisible, and

   (b) the other party must have enjoyed the benefit of the part which has been performed, although he had an option of declining it.
Examples

(a) Where a common carrier fails to take a complete consignment to the agreed destination, he may recover pro-rata freight. (He will, of course, be liable for breach of the contract).

(b) S had agreed to erect upon H’s land two houses and stables for $ 565. S did part of the work and then abandoned the contract. H himself completed the buildings using some materials left on his land by S. In an action by S for the value of work done and of the materials used by H, it was held that S could recover the value of the materials (for H had the option to accept or to reject these) but he could not recover the value of the work done (for H had no option with regard to the partly erected building, but to accept that). The court observed, “The mere fact that a defendant is in possession of what he cannot held keeping or even has done work upon it, affords no ground for such an inference. He is not bound to keep unfinished a building which in an incomplete state would be a nuisance on his land.” (Sumpter vs. Hedges).

5. When an indivisible contract for a lump sum is completely performed but badly, the person who has performed the contract can claim the lump sum; but the other party can make a deduction for bad work.

DIFFERENCE BETWEEN QUANTUM MERUIT AND DAMAGES

The points of distinction between quantum meruit and damages are as under:

1. **Original Contract**

   The claim for quantum meruit is not a claim upon the original contract, while the claim for damages rests on the original contract. The claim for quantum meruit is based upon a new implied contract created by the offer of what the plaintiff has done and its acceptance by the defendant, while the remedy for claiming damages is to sue on the original contract.

2. **Purpose**
The purpose of damages is to place the injured party in a position where he would have been, if the other party had not broken the original contract, whereas the purpose of quantum meruit is to restore him to the position he would have been, if this new implied contract had not been made.

3. **Principle of Assessment**

The law in quantum meruit is proceeding on a principle of assessment which differs from that which is applied in assessing damages for breach of contract.

5.5 **SPECIFIC PERFORMANCE**

When damage is not an adequate remedy, the court may at its discretion grant the specific performance of the contract i.e. compel a party to do what he promised to do. In other words, it is an order by the court upon the party guilty of breach of contract directing him to perform what he promised to do. But unlike damages, specific performance cannot be claimed as a matter of right.

It is a discretionary remedy which is allowed in a limited number of cases.

Generally speaking, specific performance is directed only in those cases where there exists no standard for ascertaining the actual damage caused by the non-performance of the act agreed to have been done. In other words, specific performance is granted in cases where monetary compensation is found to be an inadequate remedy. For example A agrees to sell two rare China vases to B. B may compel A to perform the contract specifically, because there is no standard for ascertaining the actual damage which would be caused by the non-performance of the promise. But the following contracts cannot be specifically enforced:

(a) A contract for the non-performance of which money is an adequate relief. The courts refuse specific performance of a contract to lend or to borrow money or where the contract is for the sale of goods easily procurable elsewhere.
(b) Where the execution of the contract requires supervision, e.g. a building construction contract, order for specific performance is not issued.

(c) Where the contract is for personal services, e.g., a contract to sing or to paint a picture. In such contracts injunction (i.e. an order which forbids the defendant to perform a like personal service for other persons) is granted in place of specific performance.

5.6 SUMMARY

A quasi contract rests upon the equitable “doctrine of unjust enrichment” which declares that a person shall not be allowed to enrich himself unjustly at the expense of another. Duty, and not a promise or agreement, is the basis of such contracts. Contract Act describes cases which are to be deemed quasi-contracts under the Indian law which are (a) when necessaries are supplied to a person incompetent to contract or anyone to whom he is legally bound to support (b) when a person who is interested in the payment of money which another is bound by law to pay (c) where a person lawfully does anything to him, not intending to do so gratuitously, and such other person enjoys the benefit thereof (d) when a person who finds goods belonging to another and takes them into his custody and (e) a person to whom money has been paid, or anything delivered by mistake or under coercion.

5.7 KEYWORDS

**Quasi Contract:** A quasi contract is a kind of contract by which one party is bound to pay money in consideration of something done or suffered by the other party.

**Quantum Meruit:** Where one person has rendered service to another in circumstances which indicate an understanding between them that it is to be paid for although no particular remuneration has been fixed the law will infer a promise to pay Quantum Meruit.

**Specific Performance:** It is an order by the court upon the party guilty of breach of contract directing him to perform what be promised to do.
5.8 SELF ASSESSMENT QUESTIONS

1. “Under the Indian Contract Act, there are certain relations resembling those created by a contract.” Explain.

2. What are quasi-contracts? Explain briefly the quasi-contracts provided for by the Indian Contract Act.

3. Explain the term ‘Quasi Contracts’ and state their characteristics. Illustrate your answers by giving examples.

4. “A quasi-contracts is not a contract at all. It is an obligation which the law creates.” Amplify and state the quasi-contracts recognised under the Indian Contract Act.

5.9 SUGGESTED READINGS


LESSON-6

CONTRACT OF SALE OF GOODS

STRUCTURE
6.0 Objective
6.1 Introduction
6.2 Contract of sale
6.3 Essentials of a contract of sale
6.4 Distinction between Sale and Agreement to Sell
6.5 Sale Distinguished from Other Transactions
6.6 Goods
6.7 Summary
6.8 Keywords
6.9 Self Assessment Questions
6.10 Suggested Readings

6.0 OBJECTIVE : The objective of this lesson is to:
(a) Define contract of sale and explain its essentials.
(b) Distinguish between sale and agreement to sell.
(c) Explain the different types of goods.

6.1 INTRODUCTION
The law relating to the sale of goods or movables in India is contained in the Sale of Goods Act, 1930. Before the passing of the present act, the law relating to the sale of goods was contained in Chapter VII of the Indian Contract Act, 1872. The provisions of Chapter VII were found to be unsatisfactory and the present Act was passed with the
main object of making the provisions more clear. The act came into force on 1st July, 1930. It contains 66 Sections and extends to the whole of India except the State of Jammu and Kashmir.

The Sale of Goods Act, 1930, is based mainly on the English Act and incorporates many of its provisions excepting those which were not suited to the needs of this country. Though the law relating to the sale of goods is contained in this separate enactment many of the general principles embodied in the Indian Contract Act still continue to be applicable to contracts of sale of goods.

Like any other contract, the contract of sale is the result of offer and acceptance by two different parties. The parties to the contract enjoy unfettered discretion to agree to any terms they like relating to delivery and payment of price. The Sale of Goods Act does not restrict or limit this discretion of the parties to the contract. It lays down certain positive rules and principles which may be applied in those cases where the parties have failed to contemplate expressly for a contingency which may interrupt the performance of the contract of sale such as insolvency of the buyer or the destruction of the subject matter of the contract of sale.

6.2 CONTRACT OF SALE

According to Section 4(1), a contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. A contract of sale may be absolute or conditional. In an absolute sale, the property in the goods passes from the seller to the buyer immediately and nothing remains to be done by the seller. Sale on a counter in a shop is an absolute sale. In a conditional contract of sale, the property in the goods does not pass to the buyer absolutely until a certain condition is fulfilled. The term ‘contract of sale’ is a general term and comprises of:

(1) Sale; and

(2) Agreement to sell
Where the seller transfers the property in the goods immediately to the buyer there is a sale. But where the transfer of the property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, the contract is called an agreement to sell.

**When agreement to sell becomes sale?**

An agreement to sell becomes a sale when the time elapses or the conditions are fulfilled subject to which the property in the goods is to be transferred. Every sale originates in an agreement to sell. It is an agreement of sale which gives birth to a sale. On a sale, the agreement of sale is completely exhausted and ceases to exist.

### 6.3 ESSENTIALS OF A CONTRACT OF SALE

To constitute a valid contract of sale, the following essentials must be present. A brief explanation of the various essentials is as follows:

1. **Contract**

   The word contract means an agreement enforceable by law. It resumes free consent on the part of the parties who should be competent to contract. Thus, a compulsory transfer of goods under a Nationalisation Act is not a sale. The agreement must be made for a lawful consideration and with a lawful object. In other words all the essential elements of a valid contract must also be present in a contract of sale.

2. **Two parties**

   To constitute a contract of sale, there must be a transfer or agreement to transfer the property in goods by the seller to the buyer. It means that there must be two persons, one the seller and the other the buyer. The seller and the buyer must be two different persons, for a man cannot purchase his own goods. The parties must be competent to contract.
Examples: (a) A partnership firm was dissolved and the surplus assets including some goods were divided among the partners in specie. Tax officer wanted to tax this as a sale. The Court held that it was not a sale as the partners were themselves joint owners of the goods and they could not be both sellers and buyers. Moreover no money consideration was passed. (State of Gujarat v. Raman Lal & Co. AIR 1965 Guj 60).

(b) A club supplies food and drinks to its members at fixed price. This was held not to be a sale as a member of the club pays to the members jointly (i.e. the club) Members of a club are undivided joint owners and not part owners (Graft vs. Evans. (1882). 8. QBD 373).

There are certain exceptions to the rule that the same person cannot be both a purchaser and a seller. These are –

(a) Where a person’s goods are sold in execution of a decree, he may himself buy them.

(b) A part owner can sell his share to the other part-owner so as to make the other part-owner the sole owner of the goods.

(c) Where a pawnee sells the goods pledged with him on non-payment of bill money, the pawnor may himself buy such goods.

(d) A partner may also buy the goods from the firm in which he is a partner and vice versa.

(e) In case there is sale by auction the seller may reserve right of making a bid at the auction and may thus purchase his own goods.

3. Transfer the property

In a contract of sale, there should be a transfer or agreement to transfer the absolute or general property in the goods sold or agreed to be sold. It contemplates the transfer of the ownership in the goods. Though passing of the title in the goods is an essential ingredient of sale, physical delivery of goods is not essential. The Sale of Goods Act contemplates the transfer of general property in goods from the seller to the buyer.
4. **Goods**

The subject-matter of the contract of sale must be the goods, the property in which is to be transferred from the seller to the buyer. Goods of any kind except immovable goods may be transferred. It does not include money and other actionable claims. The seller must be the owner of the goods the ownership of which is sought to be transferred. A debt is not goods because it can only be assigned as per Transfer of Property Act but cannot be sold.

**Example:** According to a contract between the hotel and resident customers the hotel made a consolidated charge for residents, services and supply of food. No rebate was allowed if food was not taken. On a question being raised whether the supply of food amounted to sale it was held that it was simply a provision of service as the transaction was an indivisible contract of multiple services and did not involve any sale of food. (Associated Hotels of India V. Excise and Taxation Officer AIR 1966. Punjab, 249).

5. **Price**

To constitute a valid contract of sale, consideration for transfer must be money paid or promised. Where there is no money consideration the transaction is not a contract of sale, as for instance goods given in exchange for goods or as remuneration for work or labour. However, an existing debt due from the seller to the buyer is sufficient. Further, there is nothing to prevent the consideration from being partly in money and partly in goods or some other articles of value. For example, when an old car is returned to the dealer for a new one and the difference is paid in cash, that would also be a sale.

It may be noted that no particular form is necessary to constitute a contract of sale. A contract of sale may be made in writing or by word of mouth or may be implied from the conduct of the parties.
6.4 DISTINCTION BETWEEN SALE AND AGREEMENT TO SELL

The distinction between sale and an agreement to sell is very necessary to determine the rights and the liabilities of the contract. The main points of distinction are:

1) **Nature of contract**

An agreement to sell is an executory contract, is a contract pure and simple and no property passes; whereas a sale is an executed contract plus a conveyance.

2) **Transfer of property**

In a sale the property in the goods passes from the seller to the buyer at the time the contract is made. But in an agreement to sell, the transfer of property takes place at some future time or until some condition is fulfilled.

   In other words in a sale the buyer becomes the owner of the goods immediately at the time of making the contract. In an agreement to sell the seller continues to be the owner until the agreement to sell becomes a sale.

3) **Risk of loss**

In a sale, the buyer immediately becomes the owner of the goods and the risk as a rule passes to the buyer; under an agreement to sell, the seller remains the owner and the risk is with him. Thus under a sale, if the goods are destroyed the loss falls on the buyer, even though the goods are in the possession of the seller. But, under an agreement to sell, the loss will fall on the seller in the case of destruction of goods even though they are in the possession of the buyer.

4) **Consequences of the breach**

On breach of an agreement to sell by the seller, the buyer has only a personal remedy against the seller. But if after a sale the seller breaks the contract (e.g., resell the goods) the buyer may sue for delivery of the goods or for damages.
In an agreement to sell, if the buyer fails to accept the goods the seller may sue for damages only and not for the price. On a sale, if the buyer does not pay the price, the seller may sue him for the price.

(5) **Insolvency of the buyer**

In a sale, if the buyer is adjudged an insolvent, the seller in the absence of a lien over the goods is bound to deliver the goods to the Official Receiver of assignee. The seller will, however, be entitled to a rateable dividend for the price of the goods. In an agreement to sell, when the buyer becomes insolvent before he pays for the goods, the seller may not part with the goods.

(6) **Insolvency of the seller**

In a sale, if the seller becomes insolvent, the buyer is entitled to recover the goods from the Official Receiver or assignee as the property of the goods is with the buyer. In an agreement to sell, if the buyer has already paid the price and the seller becomes insolvent, the buyer can claim only a rateable dividend and not the goods.

(7) **General and particular property**

An agreement to sell creates a right in personam while a sale creates a right in rem. In case of an agreement to sell the buyer and seller get remedy against each other in case of breach of an agreement. The agreement of sale creates a right with which only the contracting parties are concerned and not the whole world, whereas in case of sale, the buyer gets an absolute right of ownership and this right of the buyer is recognized by the whole world.

(8) **Right of re-sale**

In an agreement to sell, the property in the goods remains with the seller and he can dispose of the goods as he likes, although he may thereby commit a breach of his contract. In a sale, the property is with the buyer and as such the seller cannot
resell the goods. If he does so, the buyer can recover the goods sometimes even from third party.

6.5 SALE DISTINGUISHED FROM OTHER TRANSACTIONS

(1) Sale and bailment

Bailment is the delivery of goods by one person to another for some purpose upon a condition that they shall, when the purpose is accomplished, be returned to the person delivering them where of the essence of sale is that the property in goods is transferred from the seller to the buyer for a price. The following are the main points of difference between the two:

<table>
<thead>
<tr>
<th>Sale</th>
<th>Bailment</th>
</tr>
</thead>
<tbody>
<tr>
<td>In a sale, the property in the goods is transferred from the seller to the buyer and the buyer can therefore deal with the goods in any way he likes.</td>
<td>In a bailment, there is only transfer of possession of goods from the bailor to the bailee for any of the reasons like safe custody, carriage, use etc. and the bailee can only deal with the goods according to the directions of the bailor.</td>
</tr>
<tr>
<td>Goods once sold normally cannot be returned unless there is a breach of some condition.</td>
<td>In bailment the bailee must return the goods to the bailor on the accomplishment of the purpose for which the bailment was made.</td>
</tr>
<tr>
<td>In a sale the consideration is the price in terms of money.</td>
<td>In a bailment the consideration is an undertaking to return the goods after the accomplishment of purpose.</td>
</tr>
</tbody>
</table>
(2) **Sale and gift**

Where goods are transferred by one person to another person without any price or consideration, the transaction is called a gift and not a sale. Sale is always for a consideration.

(3) **Sale and barter or exchange**

Where the consideration for transfer of property in goods from one person to another consists of delivery of other goods, the contract is not a contract of sale but is a contract of exchange or barter. The exchange of one form of money into another, as of currency notes into rupees is not a sale. But where property in the goods is transferred from the seller to the buyer against a price it is called a sale. Where, however, the consideration for a transfer consists partly of the delivery of the goods and partly of the payment of money, the contract may be held to be one of sale.

(4) **Sale distinguished from Hire Purchase**

Contracts of sale resemble contracts of hire purchase very closely, and indeed the real object of a contract of hire purchase is the sale of the goods ultimately. Nonetheless a sale has to be distinguished from a hire purchase as their legal incidents are quite different. Under hire purchase agreement the goods are delivered to the hire purchaser for his use at the time of the agreement but the owner of the goods agrees to transfer the property in the goods to the hire purchaser only when a certain fixed number of instalments of price are paid by the hirer. Till that time, the hirer remains the bailee and the instalments paid by him are regarded as the hire-charges for the use of the goods. If there is a default by the hire purchaser in paying an instalment, the owner has a right to resume the possession of the goods immediately without refunding the amount received till then, because the ownership still rests with him. Thus, the essence of hire-purchase agreement is that there is no agreement to buy, but there is only a bailment of the goods coupled with an option to purchase them which may or may not be exercised.
It may be noted that mere payment of price by instalments under an agreement does not necessarily make it a hire-purchase, but it may be a sale. For example, in the case of “Instalment Purchase Method,” there is a ‘sale,’ because in this case the buyer is bound to buy with no option to return and the property in goods passes to the buyer at once. The main points of distinction between the ‘sale’ and ‘hire-purchase’ are as follows:

1. In a sale, property in the goods is transferred to the buyer immediately at the time of contract, whereas in hire-purchase the property in the goods passes to the hirer upon payment of the last instalment.

2. In a sale the position of the buyer is that of the owner of the goods but in hire purchase the position of the hirer is that of a bailee till he pays the last instalment.

3. In the case of a sale, the buyer cannot terminate the contract and is bound to pay the price of the goods. On the other hand, in the case of hire-purchase the hirer may, if he so likes, terminate the contract by returning the goods to its owner without any liability to pay the remaining instalments.

4. In the case of a sale, the seller takes the risk of any loss resulting from the insolvency of the buyer. In the case of hire-purchase, the owner takes no such risk, for if the hirer fails to pay an instalment the owner has the right to take back the goods.

5. In the case of a sale, the buyer can pass a good title to a bonafide purchaser from him but in a hire-purchase, the hirer cannot pass any title even to a bonafide purchaser.

6. In a sale, sales tax is levied at the time of the contract whereas in a hire-purchase sales tax is not leviable until it eventually ripens into a sale.
(5) **Hire-purchase and an agreement to sell**

A contract of hire purchase may also be distinguished from “an agreement to sell” (or “an agreement to buy” from buyer’s point of view). As already observed, a hire-purchase agreement initially is merely an irrevocable offer for sale, that is, under it the owner is bound to sell the goods later if the hirer pays all the instalments as agreed, but on the part of the hire purchaser there is an option to buy or to return the goods and hirer cannot be compelled to buy. ‘An agreement to buy’, on the other hand, imports a legal obligation to buy and therefore there is no option available to the buyer to buy or to terminate the contract in this case. Again, in a hire-purchase agreement, delivery of goods to the hire-purchaser is necessary whereas it is not so in an ‘agreement to sell.’

(6) **Sale distinguished from contract for work and labour**

A distinction has to be make between a contract of sale and a contract for work and labour mainly because of taxation purpose. Sales tax is levied only in the case of a contract of sale. When property in the goods is intended to be transferred and goods are ultimately to be delivered to the buyer, it is a contract of sale even though some labour on the part of the seller of the goods may be necessary. Where, however, the essence of the contract is rendering of service and exercise of skill and no goods are delivered as such, it is a contract of work and labour and not of sale. In fact, the difference between the two is very minute.

**Examples**

(a) A dentist agreed to make a set of false teeth for a lady and fit it into her mouth. Held it is a contract for the sale of goods (Lee Vs. Griffin).

(b) An order for making and fixing curtains in a house is a contract of sale of goods, though it involves some work and labour in fixing the same (Love Vs. Norman Wright (Builders) Ltd.).

(c) G engaged an artist to paint a portrait and supplied the necessary canvas and paint. Held, it is a contract for work and labour as the substance of the
contract is the application of the skill and labour in the production of the portrait (Robinson Vs. Graves). If the canvas and paint are also to be supplied by the painter, it will become a contract of sale of goods.

(d) A contract to take and supply photographs has been held to be a contract of sale of goods (Newman Vs. Lipman).

7. **Sale and mortgage**

A mortgage differs from a contract of sale in the following respects:

(a) In a sale, there is a transfer of the whole interest of the seller in the goods, but in the case of a mortgage there is a transfer of a limited interest.

(b) In a sale the buyer becomes the absolute owner of the goods sold, but in a mortgage the ownership of the goods remains vested in the mortgagor.

(c) The consideration in the case of sale is the price while the consideration in a mortgage is the advance of the loan and the securing of the debt.

6.6 **GOODS**

The subject matter of the contract of sale must be ‘goods’. According to Section 2(7), “goods means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be served before sale or under the contract of sale.”

Thus every kind of movable property except actionable claim and money is regarded as ‘goods’. Goodwill, trade marks, copyrights, patents right, water, gas, electricity, decree of a court of law, are all regarded as goods. Shares and stock are also included in goods. With regard to growing crops, grass and things attached to or forming part of the land, such things are regarded as goods as soon as they are agreed to be separated from the land. Thus where trees were sold so that they could be cut out and separated from the land and then taken away by the buyer, it was held that there was a
contract for sale of movable property or goods (Kursell vs. Timber Operators & Contractors Ltd.). But contracts for sale of things ‘forming part of the land itself’ are not contracts for sale of goods. For example, a contract for the sale of coal mine or building – stone quarry is not a contract of sale goods.

‘Actionable claims’ means claims which can be enforced by a legal action or a suit, e.g., a book debt (i.e., a debt evidenced by an entry by the creditor in his Account Book or Bahi). A book debt is to goods because it can only be assigned as per the Transfer of Property Act but cannot be sold. Similarly, a bill of exchange or a promissory note represents a debt, i.e., an actionable claim and implies the right of the creditor to recover its amount from the debtor. But since these can be transferred under Negotiable Instruments Act by mere delivery or indorsement and delivery, such instruments cannot be sold.

‘Money’ means current money. It is not regarded goods because it is the medium of exchange through which goods can be bought. Old and rare coins, however, may be treated as goods and sold as such.

It may be mentioned that sale of immovable property is governed by the Transfer of Property Act, 1882.

Kinds of Goods

‘Goods’ form the subject matter of a contract of sale. We have already seen the meaning of the term ‘goods’ as per Section 2(7). Goods may be classified into the following types:

1. Existing goods;
2. Future goods; and
3. Contingent goods.

1. Existing goods
Goods which are physically in existence and which are in seller’s ownership and/or possession, at the time of entering the contract of sale are called ‘existing goods’. Where seller is the owner, he has the general property in them. Where seller is in possession, say, as an agent or a pledgee, he has a right to sell them.

Existing goods may again be either ‘specific’ or ‘unascertained.’

(a) **Specific goods**: Goods identified and agreed upon at the time of the making of the contract of sale are called ‘specific goods’ [Sec. 2(14)]. It may be noted that in actual practice the term ‘ascertained goods’ is used in the same sense as ‘specific goods.’ For example, where A agrees to sell to B a particular radio bearing a distinctive number, there is a contract of sale of specific or ascertained goods.

(b) **Unascertained goods**: The goods which are not separately identified or ascertained at the time of the making of the contract are known as ‘unascertained goods.’ They are indicated or defined only by description. For example, if A agrees to sell to B one bag of sugar out of the lot of one hundred bags lying in his godown, it is a sale of unascertained goods because it is not known which bag is to be delivered. As soon as a particular bag is separated from the lot for delivery, it becomes ascertained or specific goods.

The distinction between ‘specific’ or ‘ascertained’ and ‘unascertained’ goods is important in connection with the rules regarding ‘transfer of property’ from the seller to the buyer.

2. **Future goods**: Goods to be manufactured, produced or acquired by the seller after the making of the contract of sale are called ‘future goods’ [Sec. 2(6)]. These goods may be either not yet in existence or be in existence but not yet acquired by the seller. It is worth noting that there can be no present sale of future goods because property cannot pass in what is not owned by the seller at the time of the contract. So even if the parties purport to effect a present sale of future goods, in law it operates only as an ‘agreement to sell’ [Sec. 6(3)].
Examples: (a) A agrees to sell to B all the milk that his cow may yield during the coming year. This is a contract for the sale of future goods.

(b) X agrees to sell to Y all the mangoes which will be produced in his garden next year. It is contract of sale of future goods, amounting to ‘an agreement to sell.’

3. Contingent goods: Goods, the acquisition of which by the seller depends upon an uncertain contingency are called ‘contingent goods’ [Sec. 6(2)]. Obviously they are a type of future goods and therefore a contract for the sale of contingent goods also operates as ‘an agreement to sell’ and not a ‘sale’ so far as the question of passing of property to the buyer is concerned. In other words, like the future goods, in the case of contingent goods also the property does not pass to the buyer at the time of making the contract. It is important to note that a contract of sale of contingent goods is enforceable only if the event on the happening of which the performance of the contract is dependent happens, otherwise the contract becomes void.

Examples: (a) A agrees to sell to B a specific rare painting provided he is able to purchase it from its present owner. This is a contract for the sale of contingent goods.

(b) X agrees to sell to Y 25 bales of Egyptian cotton, provided the ship which is bringing them reaches the port safely. It is a contract for the sale of contingent goods. If the ship is sunk, the contract becomes void and the seller is not liable.

Effect of Perishing of Goods

Section 7 and 8 deal with the effect of perishing of goods on the rights and obligations of the parties to a contract of sale. Under these Sections the word ‘perishing’ means not only physical destruction of the goods but it also covers:

(a) damage to goods so that the goods have ceased to exist in the commercial sense, i.e., their merchantable character as such has been lost (although they are not physically destroyed), e.g., where cement is spoiled by water and becomes almost stone or where sugar becomes sharbat and thus are unsaleable as cement or sugar;
(b) loss of goods by theft (Barrow Ltd. vs. Phillips Ltd.);

(c) where the goods have been lawfully requisitioned by the government (Re Shipton, Anderson & Co.)

It may also be mentioned that it is only the perishing of specific and ascertained goods that affects a contract of sale. Where, therefore, unascertained goods form the subject-matter of a contract of sale, their perishing does not affect the contract and the seller is bound to supply the goods from wherever he likes, otherwise be liable for breach of contract. Thus where A agrees to sell to B ten bales of Egyptian cotton out of 100 bales lying in his godown and the bales in the godown are completely destroyed by fire, the contract does not become void. A must supply ten bales of cotton after purchasing them from the market or pay damages for the breach.

The effect of perishing of goods maybe discussed under the following heads:

1. **Perishing of goods at or before making of the contract (Sec. 7).** This may again be divided into the following sub-heads:

   (i) **In case of perishing of the ‘whole’ of the goods.** Where specific goods from the subject-matter of a contract of sale (both actual sale and agreement to sell), and they, without the knowledge of the seller, perish, at or before the time of the contract, the contract is void. This provision is based either on the ground of mutual mistake as to a matter of fact essential to the agreement, or on the ground of impossibility of performance, both of which render an agreement void ab-initio.

   **Examples:**

   (a) A sold to B a specific cargo of goods supposed to on its way from England to Bombay. It turned out, however, that before the day of the bargain, the ship conveying the cargo had been cast away and the goods were lost. Neither party was aware of the fact. The agreement was held to be void (Hastie vs. Conturier).

   (b) A agrees to sell to B a certain horse. It turns out that the horse was dead at the time of bargain, though neither party was aware of the fact. The agreement is void.
(ii) **In case of perishing of only ‘a part’ of the goods.** Where in a contract for the sale of specific goods, only part of the goods are destroyed or damaged, the effect of perishing will depend upon whether the contract is entire or divisible. If it is entire (i.e., indivisible) and part only of the goods has perished, the contract is void. If the contract is divisible, it will not be void and the part available in good condition must be accepted by the buyer.

**Example:** There was a contract for the sale of a parcel containing 700 bags of Chinese groundnuts of different qualities. Unknown to the seller 109 bags had been stolen at the time of the contract. The seller delivered the remaining 591 bags and, on the buyer’s refusal to take them, brought an action for the price. It was held that the contract, being indivisible, had become void by reason of the loss of the goods and the buyer was not bound to take delivery of 591 bags or pay for the goods (Barrow Ltd. vs. Philips Ltd.). (Note that had there been all bags of the same weight and quality for certain price per bag, the contract would have been divisible and the buyer could only have avoided the contract as to those goods which had actually perished).

2. **Perishing of goods before sale but after agreement to sell (Sec. 8):** Where there is an agreement to sell specific goods, and subsequently the goods, without any fault on the part of the seller or buyer, perish before the risk passes to the buyer, the agreement is thereby avoided, i.e., the contract of sale becomes void and both parties are excused from performance of the contract. This provision is based on the ground of supervening impossibility of performance which makes a contract void. Notice that under Section 7 the agreement is void ab-initio while under this Section the contract becomes void later.

   If only part of the goods agreed to be sold perish, the contract becomes void if it is indivisible. But if it is divisible then the parties are absolved from their obligations only to the extent of the perishing of the goods (i.e., the contract remains valid as regards the part available in good condition).
It must further be noted that if fault of either party causes the destruction of the good, then the party in default is liable for non-delivery or to pay for the goods, as the case may be (Sec. 26). Again, if the risk has passed to the buyer, he must pay for the goods though undelivered (unless otherwise agreed… risk prima facie passes with the property (Sec. 26).

**Examples**: (a) A buyer took a horse on a trial for 8 days on condition that if found suitable for his purpose the bargain would become absolute. The horse died on the 3rd day without any fault of either party. Held, the contract, which was in the form of an agreement to sell, becomes void and the seller should bear the loss (Elphick vs. Barnes).

(b) A, had contracted to erect machinery on M’s premises, the price was to be paid on completion. During the course of the work, there was a fire which completely destroyed the premises and the machinery. It was held that both parties were excused from further performance and A was not entitled to any payment as the price was payable on the completion of entire work (Appleby vs. Myers).

*Effect of perishing of future goods.* As observed earlier, a present sale of future goods always operates as an agreement to sell [Sec. 6(3)]. As such there arises a question as to whether Section 8 applies to a contract of sale of future goods (amounting to an agreement to sell) as well? The answer is found in the leading case of Howell vs. Coupland, where it has been held that future goods, if sufficiently identified, are to be treated as specific goods, the destruction of which makes the contract void. The facts of the cases are as follows:

*Example*: C agreed to sell to H 200 tons of potatoes to be grown on C’s land. C sowed sufficient land to grow the required quantity of potatoes, but without any fault on his part, a disease attacked the crop and he could deliver only about ten tons. The contract was held to have become void.
The Price

The money consideration for a sale of goods is known as ‘price’ [Sec. 2(10)]. We have already seen that the price is an essential element in every contract of sale of goods, that is, no valid sale can take place without a price. The price should be paid or promised to be paid in legal tender money, unless otherwise agreed. It may be paid in the form of a cheque, hundi, bank deposit etc. For, it is not the mode of payment of a price but the agreement to pay a price in money that is requisite to constitute a valid contract of sale.

Modes of fixing the price: According to Section 9 the price may be fixed by one or the other of the following modes:

1. **It may be expressly fixed by the contract itself.** This is the most usual mode of fixing the price. The parties are free to fix any price they like and the court will not question as to the adequacy of price. But the sum should be definite. Where an alternative price is fixed, the agreement is void ab-initio as it involves an element of wager (Bourke vs. Short).

2. **It may be fixed in accordance with an agreed manner provided by the contract.** For example, it may be agreed that the buyer would pay the market price prevailing on a particular date, or that the price is to be fixed by a third party (i.e., valuer) appointed by the consent of the parties. But in the following cases where the agreement of the parties as to price is uncertain, price is deemed as ‘not capable of being fixed’ and hence the agreement is void ab-initio for uncertainty:

   (a) if the price is agreed to be whatever sum the seller be offered by any third party or

   (b) if the price is left to be fixed by one of the contracting parties, expressly.

Remember that if no price is fixed then the contract is not void for uncertainty because in that case law usually allows market price prevailing on the date of supply of goods as the price bargained for.
3. **It may be determined by the course of dealings between the parties.** For example, if the buyer has been previously paying to a particular seller the price prevailing on the date of placing the order, the course of dealings suggest that in subsequent transactions also the price as on the date of order will be paid.

4. **If the price is not capable of being determined in accordance with any of the above modes, the buyer is bound to pay to the seller a ‘reasonable price.’** What is a reasonable price is a question of fact dependent on the circumstances of each particular case. Ordinarily, the market price of the goods prevailing on the date of supply is taken as reasonable price.

**Agreement to sell at valuation (Sec. 10).** Where there is an agreement to sell goods on the terms that the price is to be fixed by the valuation of a third party and such third party fails to fix the price (either because he cannot value or because he does not want to value), the contract becomes void, except as to part of goods delivered and accepted, if any, under the contract, as regards which the buyer is bound to pay a reasonable price. If, however, any one of the two parties, namely, the seller or the buyer, prevents the third party from making the valuation, the innocent party may maintain a suit for damages against the party in fault. Notice that although in this case also the contract becomes void, yet the party at fault is bound to compensate the other party for the actual loss suffered by him because of the act of prevention.

It is to be remembered that unless otherwise agreed, payment of the price and delivery of the goods are concurrent conditions (Sec.32). Again, Section 64-A, which provides for “Escalation Clause,” is important. As per Section 64-A, unless otherwise agreed, where, after making of the contract and fixing the price but before the delivery of the goods a new or increased custom or excise duty or sale or purchase tax is imposed and the seller has to pay it, the seller is entitled to add the same to the price. Conversely, if the rate of duty or tax is lowered, the buyer would be entitled to a reduction in price.
Earnest or Deposit

Money deposited with seller by the buyer as security for due fulfillment of the contract is called ‘earnest’ or ‘deposit’. Where the contract is carried through, earnest money counts as part payment and only the balance of the price is required to be paid. But if the contract goes off because of the fault of the buyer, the seller is entitled to forfeit it and where it falls through because of the default of the seller, the buyer is entitled to recover the earnest money in addition to damages for breach. If on the breach of the agreement by the buyer, the seller sues him for the breach, the earnest, although forfeited, is to be taken into account as diminishing the amount of damages (Jaganadhayya vs. Ramanatha).

Stipulations as to Time

Stipulations as to time in a contract of sale fall under the following two heads :

1. Stipulation relating to time of delivery of goods.
2. Stipulation relating to time of payment of the price.

As regards the time fixed for the delivery of goods, time is usually held ‘to be of the essence of the contract.’ Thus if time is fixed for the delivery of goods and the seller makes a delay, the contract is voidable at the option of the buyer. In case of late delivery, therefore, the buyer may refuse to accept the delivery and may put an end to the contract.

As regards the time fixed for the payment of the price, the general rule is that ‘time is not deemed to be of the essence of the contract,’ unless a different intention appears from the terms of the contract (Sec. 11). Thus even if the price is not paid as agreed, the seller cannot avoid the contract on that account. He has to deliver the good if the buyer tenders the price within reasonable time before resale of the goods. The seller may, however, claim compensation for the loss occasioned to him by the buyer’s failure to pay on the appointed day.
Document of Title to Goods

Any document which is used in the ordinary course of business as proof of the possession or control of goods, or authorizing or purporting to authorize, either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented is a document of title to goods [Sec.2(4)]. Thus a document of title is a proof of the ownership of the goods. It authorizes its holder to receive goods mentioned therein or to further transfer such right to another person by proper endorsement or delivery.

A document of title to goods contains an undertaking on the part of the issuing authority to deliver the goods to the holder thereof unconditionally. Although such a document can be transferred by mere delivery o by endorsement, yet it is regarded as ‘quasi negotiable instrument’ because the title of the transferee (even if bonafide) will not be superior to that of the transferor in the case of transfer of such document.

Bill of lading, dock-warrant, warehouse keeper’s certificate, wharfinger’s certificate, railway receipt, delivery order, etc. are popular examples of the documents of title to goods.

6.7 SUMMARY

A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price. A contract of sale may be absolute or conditional. The essential elements of the contract are (a) contract (b) two parties (c) transfer of property (d) goods and (e) price. Goods are the subject-matter of a contract of sale. Goods are of three types namely existing goods, future goods and contingent goods.

6.8 KEYWORDS

Contract of Sale: A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price.
**Goods:** Goods means every kind of movable property other than actionable claims and money and includes stock and shares growing crops, grass and things attached to or forming part of the land which he agreed to be severed before the sale or under the contract of sale.

**Sale:** Where under a contract of sale the property in the goods is transferred from the seller to the buyer, the contract is called a sale.

**Agreement to Sell:** Where the transfer of the property in the goods is to take a place at a future time or subject to some condition thereafter to be fulfilled the contract is called an agreement to sell.

### 6.9 SELF ASSESSMENT QUESTIONS

1. What is a contract of sale of goods? Discuss the essential features of a contract of sale goods?

2. Define the term ‘sale’ and ‘agreement to sell’ and distinguish between the two. Give examples.

3. How would you distinguish between:
   (a) A sale and hire purchase.
   (b) A sale and a contract for work and labour.

4. Define the term ‘goods’. What are the different types of goods?

5. What is the effect of perishing of goods on a contract of sale?

6. Explain the various modes of fixing the price in a contract of sale.
6.10 SUGGESTED READINGS

LESSON-7
REMEDIAL MEASURES

STRUCTURE
7.0 Objective
7.1 Introduction
7.2 Rights of an Unpaid Seller
7.3 Buyer’s Rights against Seller
7.4 Auction Sale
7.5 Summary
7.6 Keywords
7.7 Self Assessment Questions
7.8 Suggested Readings

7.0 OBJECTIVE
After reading this lesson, you should be able to:

(a) Define unpaid seller and explain his rights.
(b) Discuss the rights of buyer against the seller.
(c) State the rules regarding sale by auction.

7.1 INTRODUCTION
Section 45 lays down that a seller is unpaid

(1) When the whole of the price has not been paid or tendered.
When a negotiable instrument or a bill of exchange has been received as conditional payment and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise.

The seller remains an unpaid seller so long as any portion of the price however small, remains unpaid. Where the whole of price has been tendered, and the seller refused to accept such a tender, seller ceases to be an unpaid seller. In such a case the seller loses all his rights against the goods. If there is period of credit then the seller is not unpaid until the price becomes due. Again if there is a condition attached to payment it must be fulfilled.

The term ‘seller’ here includes any person who is in the position of a seller, as, for instance, an agent of the seller to whom the bill of lading has been endorsed, or a consignor or agent who has himself paid, or is directly responsible for, the price (Sec. 45).

An analysis of the definition of ‘unpaid seller’ reveals the following characteristics:

(a) He must sell goods against cash only and not on credit, and he must be unpaid.

(b) He must be unpaid either wholly or partly.

(c) He must not refuse payment when tendered, otherwise he will cease to be an unpaid seller.

The unpaid seller’s right can be exercised by an agent of the seller to whom the bill of lading has been endorsed, or a consignor or an agent who has himself paid, or is directly responsible for the price.

7.2 RIGHTS OF AN UNPAID SELLER

The Sale of Goods Act has expressly given two kinds of rights to an unpaid seller of goods, namely.
(1) **Against the goods**

   (a) When the property in the goods has passed

      (i) right of lien

      (ii) Right of stoppage of goods in transit

      (iii) Right of re-sale.

   These rights of an unpaid seller do not depend upon any agreement, express or implied between the parties. They arise by the implication of law.

   (b) When property in the goods has not passed.

      (i) Right of withholding delivery.

   Where the property in goods has not passed to the buyer, the unpaid seller has an addition to other remedies a right of withholding delivery, similar to and co-extensive with his right of lien and stoppage in transit, where the property has passed to the buyer.

2. **Against the buyer personally**

   (i) Right to sue for price

   (ii) Right to sue for damages

   (iii) Right to sue for interest

7.2.1 **Rights of unpaid seller against the goods**

   (i) **Right of lien (Section 47-49)**

   ‘Lien’ is the right to retain possession of goods until payment in respect of them is paid. Section 47(1) describes the circumstances in which an unpaid seller may exercise his right of lien. The unpaid seller of goods, who is in possession of them, can retain possession until payment or tender of the price in the following case:

   (a) Where the goods have been sold without any stipulation as to credit;

   (b) Where the goods have been sold on credit, but the term of credit has expired.

   (c) where the buyer becomes insolvent.
The right of lien is linked with possession and not with title. It is essentially a right over the property of another person. The unpaid seller’s lien can be exercised only so long as the goods are in the actual possession of the seller or his agent. Once the possession is lost, the lien is also lost. The right of lien cannot be exercised during the currency of credit term. When the term expires, the unpaid seller may exercise the right of lien. The lien of the unpaid seller the is for the price only; so when the price has been paid or tendered, he cannot retain possession of the goods any longer. Again the right of lien does not extend to other charges which the seller may have to incur for storing the goods during the exercise of the lien.

**Conditions for the Exercise of Right of Lien:** The following are conditions precedent to the exercise of the right of lien:

(a) the ownership must have passed to the buyer.

(b) The goods must be in possession of the seller or under his control as bailee, etc.

(c) The possession of the goods by the seller must not expressly exclude the right of lien.

(d) The whole or part of the price must remain unpaid. It may be noted that the lien can be exercised only for price. Thus the seller cannot claim lien for godown charges, for storing of goods in exercise of his lien for price.

The lien of an unpaid seller is a particular one. It is the personal right which can be exercised only by him and not by his assignee or his creditors.

**Part Delivery:** Where an unpaid seller has made party-delivery of the goods, he may exercise his right of lien on the remainder, unless such part-delivery has been made under such circumstances as to show an agreement to waive the lien.

Thus in case of part-delivery of the goods, the unpaid seller may exercise his right of lien on the remainder, but where part delivery has been made under circumstances as to show an agreement to waive the lien, the seller cannot exercise his lien.
Example: A sold certain shares to B. The relative share certificates and transfer forms duly signed were handed over by the seller to the buyer against payment of price by cheque. The buyer became insolvent. It was held by the Privy Council that the seller had no lien on shares because his lien ceased when he parted with the possession. (Bharucha V. Wadihah, 28 Bom. L.R. 777 (P.C.))

The right of lien is indivisible in nature, and so the buyer is not entitled to claim delivery of a portion of the goods on payment of a proportionate price. Further this right is available even after part delivery of the goods has been made, unless such part delivery is made under such circumstances as to show an agreement to waive the lien. (Section 48).

Example: A sells to B a certain quantity of sugar. It is agreed that three months credit shall be given. B allows the sugar to remain in A’s warehouse till the expiry of the three months, and then does not pay for them. A may retain the goods for price.

Termination of lien

Section 49 provides that an unpaid seller loses his lien on the goods in the following cases:

(a) When he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal.

Where the seller regains possession of the goods from the carrier by exercising his right of stoppage in transit, his lien revives. But if he takes back the goods from the carrier for any other purpose, the lien does not revive.

Example: The goods sold were delivered to the buyer’s shipping agents, who had put them on board a ship. But the goods were returned to the seller for repacking. While they were still with the seller on this mission, the buyer became insolvent, and the seller being unpaid, claimed to retain the goods in the exercise of his lien. It was held that, having lost his lien by delivery to the shipping agents, his refusal to deliver was wrongful. (Valpy V. Gibson (1847) 4 (B) 837).
(b) When the buyer or his agent lawfully obtains possession of the goods. For example in a case in which the goods were delivered to a forwarding agent who was to receive instructions from the buyer as to the ultimate destination of the goods. In the meantime the buyer became insolvent it was held that the right of lien was lost with the delivery of goods to such a forwarding agent.

(c) By waiver thereof

When the unpaid seller waives his right of lien expressly or impliedly. Express waiver is there when the contract of sale provides that the seller shall not retain possession of goods even if the price remains unpaid. On the contrary, implied waiver means that the seller by his conduct waives the right of lien. It may be done in the manner as stated below:

(i) When the goods are sold on credit or the seller, on the expiry of the original term of credit, grants a fresh term of credit, the lien in these cases revives on the expiry of the term of credit.

(ii) When seller takes a bill for the price to be paid at a future date, lien revives on the dishonour of the bill.

(iii) When the seller agrees to a sub-sale, the lien is waived.

(vi) An unpaid seller’s lien is also lost by payment or tender of price.

Further, it may be noted that the right of the lien of an unpaid seller is not lost because he has obtained a decree for the price of the goods against the buyer.

(ii) Right of stoppage in transit (Sections 50-52)

The second important right which is available to an unpaid seller is the right of stoppage in transit. The right to stoppage means the right to stop further transit of the goods, to resume possession thereof and to retain the same till the price is paid. The right can be exercised under the following circumstances:

(i) The seller must be unpaid.
(ii) The seller must have parted with the possession of the goods and the buyer must not have acquired it.

(iii) The buyer must be insolvent.

(iv) The property must have passed from the seller to the buyer.

**Example**

When the goods reach their destination and after taking delivery the buyer puts them on his cart, though the cart has not left the station, the railway company cannot stop the goods at this stage if the seller asks. The transit has already ended (GIP Railway Co. V. Hanuman das).

The right of stoppage in transit arises only after the seller has parted with possession of the goods and the buyer has become insolvent. This right is only available when the goods are neither in the possession of the seller nor that of the buyer, but are in the possession of a middleman for the purpose of transmission to the buyer.

**Example:** B, who had bought goods from M/s Clark & Co. of Glasgow, instructed the sellers to send the goods by a certain named ship to Melbourne. Goods were first railed to London and then shipped to Melbourne, a mate’s receipt being sent to buyers. On B becoming insolvent, the sellers gave notice to the Rail Co. to stop delivery to buyers, but it was too late. They then gave fresh notice to the shipowners claiming back the goods before the ship arrived at Melbourne. On arrival there, the receiver in bankruptcy of B demanded the bills of lading from the master. Held, the goods having been effectively stopped in transit, the trustee could not claim them. (Bathell v. Clark 19 Q.B.D. 553).

**Duration of transit**

Since the right of stoppage in transit can be validly exercised only during transit, the question of duration of transit is of great importance. Goods are deemed to be in transit from the time they are delivered to a carrier or other bailee for the purpose of transmission to the buyer until the buyer or his agent takes delivery thereof. Much
depends upon the capacity in which the carrier holds the goods. The carrier may hold the goods:

1. as seller’s agent. In this case, there is no transit because the goods are under the seller’s lien.

2. as buyer’s agent. In this case the seller cannot exercise his right of stoppage in transit because the buyer has acquired possession.

3. as an independent contractor. In this case the seller has and can exercise the right of stoppage in transit. It is not necessary that the goods should be actually moving.

The transit comes to an end in the following cases:

1. If the buyer or his agent obtains delivery of the goods before their arrival at the appointed destination.

2. If after the arrival of the goods at the appointed destination, the carrier or other bailee acknowledges to the buyer or his agent that he holds them on his behalf.

3. In case the carrier or other bailee wrongfully refuses to deliver the goods to the buyer or his agent.

Example

In a case the buyer was insolvent when the goods (timber) arrived at the destination. However, his agent went on board the ship and demanded possession of the goods. The captain refused to deliver the goods until freight was paid. In the mean time, the seller exercised his right of stoppage in transit by giving a notice to the captain who delivered the goods to the agent of the seller. It was held that the carrier was supposed to return the goods to the seller as the transit had not ended (White Head V. Anderson).

When the buyer rejects the Goods

The buyer may reject the goods wholly or partly:
(i) **When He Rejects Wholly**: When the buyer rejects the goods and the carrier or any other bailee continues to possess them, the transit is not said to have ended. This will be so even if the seller refuses to take back the goods.

**Example**

The buyer accepted a part of the goods and rejected the rest. The seller refused to take back the goods and ordered them back to the buyer who again refused to take their delivery. In the mean-time the buyer was declared insolvent and the seller exercised his right of stoppage in transit. It was held that the transit continued (Bolten v. L and Y Co.).

(ii) **Part Delivery** Where the goods have been delivered in part, the seller may stop the remainder of goods, unless the part delivery shows an intention to give up the possession of the whole.

**Example**

A sells to B 100 bales of cotton; 60 bales having come into B’s possession and 40 being still in transit, B becomes insolvent; and A, being still unpaid, stops the 40 bales in transit. A is entitled to hold the 40 bales until the price of the 100 bales is paid.

When Delivery is made to a Ship Chartered by the Buyer (Sec.51(5)) : If the goods are delivered to a ship chartered by the buyer and the goods are held by him as an agent of the buyer, the transit comes to an end. Where goods are delivered to a ship chartered by the seller, it is a question depending on the circumstances of the particular case, whether they are in the possession of the master as a carrier or as agent of the buyer.

When the carrier of Bailee Wrongfully Refuses to Deliver the Goods to the Buyer: Where the carrier or other bailee wrongfully refuses to deliver the goods to the buyer or his agent in that behalf, the transit will not come to an end.
It is obvious that the goods should have arrived at their destination because otherwise the carrier cannot refuse to deliver the goods.

**How right of stoppage in transit is exercised**

The unpaid seller may exercise the right of stoppage in transit:

1. by actually taking possession of the goods, or
2. by giving notice of his claim to the carrier or other bailee in whose possession the goods are.

Such notice may be given either to the person in actual possession of the goods or to his principal. In the latter case, notice must be given in sufficient time to enable the principal to communicate the same to his agent, so as to prevent delivery to the buyer.

When notice of stoppage in transit is given by the seller to carrier or other bailee in possession of the goods, he shall re-deliver the goods to or according to the directions of the seller. The expenses of such re-delivery shall be borne by the seller.

**Wrongful Refusal by the Carrier**

If, even after a proper notice by the seller to the carrier for stopping the goods in transit, the carrier delivers them to the buyer, he shall be liable to the seller for conversion, i.e., wrongful appropriation of the goods to another. If after the transit has ended and the carrier wrongfully returns the goods to the seller, he is liable to the buyer for conversion.

**Distinction between right of lien and right of stoppage in transit**

Both the rights are designed for the protection of the unpaid seller. The effect of their exercise is also the same, because when the seller stops the goods in transit he resumes possession and the goods once again fall into the spell of his lien until the price is paid. Yet it is important to know their distinction.

The main points of distinction between the two are as follows:
(1) Right of stoppage in transit arises when the buyer is insolvent and is unable to pay. But the right of lien can be exercised even when the buyer is able to pay but does not pay.

(2) The right of stoppage in transit comes into operation only after the seller has parted with the possession of the goods but the seller’s lien comes into existence and continues so long as the seller has got possession of the goods.

(3) The right of stoppage in transit commences when the goods have left the possession of the seller and continues until the buyer has acquired possession thereof. But the right of lien comes to an end as soon as the goods go out of the possession of the seller.

(4) The right of lien is right to retain possession of the goods. The right of stoppage on the other hand is the right to regain possession of the goods.

(5) Possession is the test of a right of lien. The test for stoppage in transit is the non-delivery of the goods to the buyer.

**Effect of Sub-Sale or Pledge by Buyer (Sec. 53)**

The general rule is that the unpaid seller’s right of lien or stoppage in transit is not affected by any sale or other disposition of the goods which the buyer may have made. However, there are two exceptions to this general rule. They are stated below:

1. When the seller has assented to the sale or other disposition which the buyer may have made.

**Example**

A sold to B 80 maunds of grain out of a granary. B then sold (out of these 80 maunds) 60 maunds to C. C after receiving from B the delivery order presented it to A. A told C that the grains would be delivered in due course, B then became insolvent. A’s right against the 60 maunds is not lost since A recognized the title of C the sub-buyer (Knights vs.Wiffen).
2. When a document of title to goods (e.g., a bill of lading or railway receipt) has been issued or transferred to a buyer, and the buyer transfers the document to a person who takes the document in good faith and for consideration, then

(a) If such last mentioned transfer was by way of sale, the unpaid seller’s right of lien or stoppage in transit is defeated, and

(b) If such last mentioned transfer was by way of pledgee, the unpaid seller’s right of lien or stoppage in transit can only be exercised, subject to the rights of the pledgee. But in this case the unpaid seller may require the pledgee to satisfy his claim against the buyer first out of any other goods or securities of the buyer in the hands of the pledgee.

(iii) Right of re-sale (Section 54)

In addition to the rights of lien and stoppage in transit, the unpaid seller has got the valuable right of re-sale of the goods, which are the subject-matter of the contract. This limited right of resale is conferred by the section 54 which also enumerates the circumstances under which the right of re-sale may be exercised. The right may be exercised in the following cases:

(a) Where the goods are of a perishable nature. In this case the unpaid seller need not give a notice to the buyer of his intention to resell the goods.

(b) Where the unpaid seller has exercised his right of lien or stoppage in transit, he can give notice to the buyer of his intention to resell the goods. If after such notice the buyer does not within a reasonable time pay or tender the price, the seller can resell the goods within a reasonable time. He can recover from the original buyer any loss occasioned by the breach of the contract. The seller shall be entitled to the profits, if any on the resale. If the unpaid seller fails to give such notice he cannot recover damages from the buyer and is under an obligation to pay over the profits, if any, arising from the resale.
Where the seller has expressly reserved a right of resale, in case the buyer makes default. In such a case, on re-sale though the original contract of sale is thereby rescinded, the unpaid seller does not lose his right to claim damages for breach of the contract.

Where an unpaid seller who has exercised his right of lien or stoppage in transit, resells the goods, the buyer acquires a good title thereto as against the original buyer.

**Right of withholding delivery**

Where the property in the goods has not passed to the buyer, the unpaid seller has in addition to other remedies against the buyer personally, a right of withholding delivery of goods which are the subject-matter of the contract. This right is similar to and co-extensive with his right of lien and stoppage in transit. This right can be exercised even if the sale was on credit or that the goods were specific or unascertained.

**7.2.2 Rights of Unpaid Seller against the Buyer Personally**

The unpaid seller, in addition to his rights against the goods as discussed above, has the following three rights of action against the buyer personally:

1. **Suit for price (Sec. 55).** Where property in goods has passed to the buyer; or where the sale price is payable ‘on a day certain’, although the property in goods has not passed; and the buyer wrongfully neglects or refuses to pay the price according to the terms of the contract, the seller is entitled to sue the buyer for price, irrespective of the delivery of goods.

2. **Suit for damages for non-acceptance (Sec.56).** Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages for non-acceptance. The seller’s remedy in this cases is a suit for damages rather than an action for the full price of the goods.

The damages are calculated in accordance with the rules contained in Section 73 of the Indian Contract Act, that is, the measure of damages is the estimated loss arising
directly and naturally from the buyer’s breach of contract. Where the goods have a ready market the principle applicable is that the seller may recover from the buyer damages equal to the difference between the contract price and the market price on the date of the breach of the contract. Thus, if the difference between the contract price and market price is nil, the seller can get only nominal damages (Charter Vs. Sullivan). But where the goods do not have any ready market, the measure of damages will depend upon the facts of each case. For example, in Thompson Ltd. Vs. Robinson the damages were assessed on the basis of profits lost. In that case, T Ltd. who were car dealers, contracted to supply a motorcar to R. R refused to accept delivery. It was found as a fact that the supply of cars exceeded the demand at the time of breach and hence in a sense there was no market price on the date of breach. Held, T Ltd., were entitled to damages for the loss of their bargain viz., the profit they would have made, as they had sold one car less than they otherwise would have sold. To take another illustration, if the goods have been manufactured to some special order and they are unsaleable and have no value at all for other buyers, then the seller may even be allowed the full price of the goods as damages.

3. **Suit for special damages and interest (Sec. 61).** This Section entitles the seller to sue the buyer for ‘special damages’ also for such loss “which the parties knew, when they made the contract, to be likely to result from the breach of it.” In fact the Section is only declaratory of the principle regarding ‘special damages’ laid down in Section 73 of the Indian Contract Act. The Section also recognises unpaid seller’s right to get interest at a reasonable rate on the total unpaid price of the goods sold, from the time it was due until it is actually paid.

7.3 **BUYER’S RIGHTS AGAINST SELLER**

   The buyer has the following rights against the seller for breach of contract:

1. **Suit for damages for non-delivery (Sec. 57).** Where the seller wrongfully neglects or refuses to deliver the goods to the buyer, the buyer may sue the seller for damages for non-delivery.
The damages are assessed in accordance with the rules contained in Section 73 of the Indian Contract Act, that is, the measure of damages shall be the estimated loss directly and naturally resulting, in the ordinary course of events, from the seller’s breach of contract. If the goods in question have a ready market the measure of damages in prima facie to be ascertained by the difference between the contract price and market price on the date of breach. Section 61 entitles the buyer to sue the seller for ‘special damages’ also for such loss which the seller knew when they made the contract to be likely to result from the breach of it.

**Goods Readily Available**

When the goods are readily available in the market, the buyer is entitled to get damages equal to the difference between the contract price and the market price on the day of the breach. The market value of the goods is “value in the market independently of the circumstances peculiar to the buyer.”

Thus where the buyer has agreed to resell the goods at a profit and lost that profit by reason of the seller’s breach is usually ignored in calculating damages. Where, however, the ‘sub-sale’ to be made by the said buyer is actually mentioned in the contract itself so as to make known the fact of sub-sale to the seller, the buyer then can recover.

(i) Damages reflected in the sub-sale, plus  
(ii) damages he had paid to the sub-buyer.

**Goods Readily not Available in the Market**

Where the goods do not have a ready market, the measure of damage shall depend upon the facts of each case.

**Remedy for Breach of Warranty (Sec. 59)**

Where there is a breach of warranty or where the buyer elects or is compelled to treat the breach of condition as a breach of warranty, the buyer cannot reject the goods. He can set up the breach of warranty in extinction or diminution of the price payable by
him and if the loss suffered by him is more than the price, he may sue the seller for
damage. If he has already paid the price, his only remedy is an action for damages.

**Example:** A, having contracted with B to supply B with 1,000 tons of iron at Rs.100 a
ton, to be at a stated time, contracts with C for the purchase of 1,000 tons of iron at Rs.80
a ton, telling C that he does so for the purpose of performing his contract with B. C fails
to perform his contract with A, who cannot procure other iron, and B in consequence
rescinds the contract. C must pay to A Rs. 20,000 being the profit which A would have
made by the performance of his contract with B.

2. **Suit for specific performance (Sec. 58).** Where there is breach of a contract for
the sale of specific or ascertained goods, the buyer may file a suit for the specific
performance of the contract. This remedy is discretionary and will only be granted when
damages would not be an adequate remedy, for instance, the subject-matter of the
contract is rare goods, say, a picture by a dead painter.

This remedy is allowed by the court subject to certain conditions given below:

(i) The contract must be for the sale of specific or ascertained goods.

(ii) The court can order the specific performance when the damages would not be
an adequate remedy.

**Example**

In a sale of timber standing on the seller’s land, the seller was asked not to
obstruct the buyer from removing the timber in terms of the contract as the timber of that
quality may not be available elsewhere (James Jones and Sons Ltd. v. East of Tanker
Villi).

3. **Suit for damages for breach of warranty (Sec. 59).** Where there is a breach of
warranty by the seller, or where the buyer elects or is compelled to treat breach of
condition as breach of warranty, the buyer is entitled to file a suit for damages if the price
has already been paid. But if the buyer has not yet paid the price he may ask the seller for
a reasonable reduction in price.
Here also damages are to be ascertained in accordance with the provisions of Section 73 of the Indian Contract Act. Thus, the loss arising directly and naturally from the breach, i.e., the difference between the value of the goods as delivered, and the value they would have had if the goods had answered to the warranty, can be recovered.

4. **Suit for recession of contract and for damages for breach of ‘condition’**. The breach of ‘condition’ entitles the buyer to treat the contract as repudiated (Sec. 12(2)). Accordingly, where there is a breach of ‘condition’ by the seller, the buyer is entitled to file a suit for recession of the contract. Also, he may claim damages for loss suffered on the footing that the whole contract is broken and the seller is guilty of non-delivery (Millar’s Machinery Co. Ltd. Vs. David Way & Son).

5. **Suit for recovery of the price together with interest (Sec. 61)**. If the buyer has already paid the price of the goods to the seller and the goods are not delivered or they are stolen one, he can sue the seller for the refund of the price and also for the interest at reasonable rate from the date of payment to the date of refund.

**Remedies Available to the Buyer and Seller both**

The following remedies are available to the buyer and seller both:

**Suit in Case of Anticipatory Breach (Sec. 60)**: This section deals with the consequences of repudiation of contract before the due date.

Where either party to a contract of sale repudiates the contract before the date of delivery, the other party may either treat the contract as subsisting and wait till the date of delivery, or he may treat the contract rescinded and sue for damages for the breach.

The analysis of this section reveals that if a party to a contract of sale repudiates the contract before the date of delivery, the other party can choose any of the following path:

(a) to immediately accept the breach and bring an action for damages, or

(b) to wait till the actual date of delivery.

If the party chooses path (a)
(a) the contract is thereby rescinded and damages shall be assessed according to the prices then prevailing. And if the party chooses path (b)

(b) the contract remains open at the risk and for the benefit of both the parties. The result being that not only the party repudiating may subsequently choose to perform but also damages will be assessed according to the prices on the day stipulated for delivery.

**Interest by Way of Damages and Special Damages (Sec. 61)**

(i) According to Sec. 61(1) the seller or the buyer, as the case may be, may recover interest or special damages in any case where by law interest or special damages may be recoverable, or to recover the money paid where the consideration for the payment of it has failed.

(ii) Moreover, according to Sec. 61(2), in the absence of a contract to the contrary, the court may award interest at such rate as it thinks fit on the amount of the price.

(a) to the seller in a suit by him for the amount of the price from the date of the tender of the goods or form the date on which the price was payable.

(b) to the buyer in a suit by him for the refund of the price in a case of breach of the contract on the part of the seller from the date on which the payment was made.

7.4 **AUCTION SALE**

In an auction sale, the auctioneer invites bids from prospective purchasers and sells the goods to the highest bidder. Section 64 lays down the following rules relating to an auction sale:

1. Where goods are put up for sale in lots, each lot is prima facie deemed to be the subject of a separate contract of sale.

2. The sale is complete when the auctioneer announces its completion by the fall of the hammer or in other customary manner, say, by saying word like “one, two, three” or “going, going, gone;” and, until such announcement is made, any bidder
may retract his bid. On the other hand, the auctioneer is also not bound to accept the highest bid if he feels that it is much below his expectation. Of course, his not accepting the highest bid would injure his business reputation because it is the custom of trade that goods must be sold to the highest bidder.

In the language of the Contract Act, a notice or advertisement of an auction sale is simply ‘an invitation to an offer.’ The bid constitutes the ‘offer,’ and the fall of hammer constitutes the ‘acceptance.’ An offer can always be withdrawn before its acceptance, and need not necessarily be accepted. In this connection, it may be of interest to note that the auctioneer has the right to make the auction subject to any conditions he likes (The Coffee Board Vs. Famous Coffee and Tea Works). Thus, if the auctioneer expressly announces that biddings once made cannot be withdrawn, then that will hold good and the normal contractual rule, i.e., an offer may be revoked before its acceptance will not apply.

3. The seller or any one person on his behalf can bid at the auction, provided such a right to bid has been expressly reserved at the time of notifying the auction sale. (The employment of a second puffer is fraudulent even if the right to bid is expressly reserved). If the seller makes use of pretended bidding to raise the price without expressly notifying about the same, the sale may be treated as fraudulent by the buyer and he may avoid the contract on that ground.

4. The sale may be notified to be subject to a reserved or upset price. It is a price below which the auctioneer will not sell, and if he by mistake knocks down the lot for less than the reserved price, no valid contract comes into existence and he can refuse to deliver the goods to the highest bidder (Rainbow Vs. Hawkins). Where the sale is ‘without reserve’ the goods must be sold to the highest bidder, irrespective of the bid amount. But it is only a usage or custom of the trade because otherwise the auctioneer is free to accept or reject any offer or bid made to him.
5. A ‘knock out’ agreement between intending buyers not to bid against each other is not illegal (Lachman Dass & Others Vs. Sita Ram & Others).

6. The auctioneer cannot sell goods on credit or accept payment by means of a bill of exchange. Also, he cannot be compelled to accept a cheque for the purchase price.

7.5 SUMMARY

A seller of goods is deemed to be an unpaid seller within the meaning of the Sale of Goods Act when (a) the whole of the price has not been paid or tendered, or (b) when the bill of exchange or other negotiable instrument has been received as conditional payment, and the condition on which it was received has not been fulfilled by reason of dishonour of the instrument or otherwise. The rights of an unpaid seller may be broadly classified under the two heads namely as regards goods and as against the buyer personally. The rights of unpaid seller against the goods can be studied in two parts (a) In case the property in goods has not passed and (b) In case the property in goods has passed to the buyer. In addition to the remedies of the seller against the goods, the seller also enjoys the remedies against the buyer personally viz suit for price, suit for damages and suit for interest.

7.6 KEYWORDS

Unpaid Seller: A person who has sold goods to another person but has not been paid for the goods, or has been paid partially is called an unpaid seller.

Right of Lien: When the seller of goods has not been paid and the ownership of goods has been transferred to the buyer but the goods are in the possession of the seller, the seller has the right of retain the goods till he receives the price of goods from the buyer.

7.7 SELF ASSESSMENT QUESTIONS

1. Who is an unpaid seller of goods and what are his rights against the goods? Has he any remedy against the buyer personally?
2. What is meant by an unpaid seller? Explain the nature of the right of lien and the right of stoppage of goods in transit of an unpaid seller. How are these rights affected by a sub-sale or pledge by the buyer?

3. What is meant by the unpaid seller’s right of stoppage of goods in transit? Show how it differs from the unpaid seller’s lien.

5. State the rules regarding sale of by auction.

7.8 SUGGESTED READINGS


LESSON-8
NATURE AND TYPES OF NEGOTIABLE INSTRUMENT

STRUCTURE
8.0 Objective
8.1 Introduction
8.2 Meaning of Negotiable Instruments
8.3 Characteristics of a Negotiable Instrument
8.4 Presumptions as to Negotiable Instrument
8.5 Types of Negotiable Instrument
8.6 Parties to Negotiable Instruments
8.7 Summary
8.8 Keywords
8.9 Self Assessment Questions
8.10 Suggested Readings

8.0 OBJECTIVE
After reading this lesson, you should be able to:

(a) Define negotiable instrument and discuss the characteristics of negotiable instruments.

(b) Describe the various types of negotiable instruments.

(c) Discuss the parties to negotiable instruments.
8.1 INTRODUCTION

The law relating to Negotiable Instruments is laid down in Negotiable Instruments Act, 1881, which came into force from March 1, 1882. It extends to the whole of India except the State of Jammu and Kashmir. The Act operates subject to the provisions of Sections 31 and 32 of the Reserve Bank of India Act, 1934.

Section 31 of the Reserve Bank of India Act provides that no person in India other than the Bank or as expressly authorised by this Act, the Central Government shall draw, accept, make or issue any bill of exchange, hundi, promissory note or engagement for the payment of money payable to bearer on demand. This Section further provides that no one except the RBI or the Central Government can make or issue a promissory note expressed to be payable or demand or after a certain time.

Section 32 of the Reserve Bank of India Act makes issue of such bills or notes punishable with fine which may extend to the amount of the instrument. The effect or the consequences of these provisions are:

1. A promissory note cannot be made payable to the bearer, no matter whether it is payable on demand or after a certain time.
2. A bill of exchange cannot be made payable to the bearer on demand though it can be made payable to the bearer after a certain time.
3. But a cheque {though a bill of exchange} payable to bearer or demand can be drawn on a person's account with a banker.

8.2 MEANING OF NEGOTIABLE INSTRUMENTS

According to Section 13 (a) of the Act, "Negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer, whether the word "order" or "bearer" appear on the instrument or not."

In the words of Justice, Willis, "A negotiable instrument is one, the property in which is acquired by anyone who takes it bonafide and for value notwithstanding any
defects of the title in the person from whom he took it".

Thus, the term, negotiable instrument means a written document which creates a right in favour of some person and which is freely transferable. Although the Act mentions only these three instruments (such as a promissory note, a bill of exchange and cheque), it does not exclude the possibility of adding any other instrument which satisfies the following two conditions of negotiability:

(1) the instrument should be freely transferable (by delivery or by endorsement, and delivery) by the custom of the trade; and

(2) the person who obtains it in good faith and for value should get it free from all defects, and be entitled to recover the money of the instrument in his own name.

As such, documents like share warrants payable to bearer, debentures payable to bearer and dividend warrants are negotiable instruments. But the money orders and postal orders, deposit receipts, share certificates, bill of lading, dock warrant, etc. are not negotiable instruments. Although they are transferable by delivery and endorsements, yet they are not able to give better title to the bonafide transferee for value than what the transferor has.

8.3 CHARACTERISTICS OF A NEGOTIABLE INSTRUMENT

A negotiable instrument has the following characteristics:

1. **Property**

The possessor of the negotiable instrument is presumed to be the owner of the property contained therein. A negotiable instrument does not merely give possession of the instrument but right to property also. The property in a negotiable instrument can be transferred without any formality. In the case of bearer instrument, the property passes by mere delivery to the transferee. In the case of an order instrument, endorsement and delivery are required for the transfer
of property.

2. **Title**

The transferee of a negotiable instrument is known as 'holder in due course.' A bona fide transferee for value is not affected by any defect of title on the part of the transferor or of any of the previous holders of the instrument.

3. **Rights**

The transferee of the negotiable instrument can sue in his own name, in case of dishonour.

A negotiable instrument can be transferred any number of times till it is at maturity. The holder of the instrument need not give notice of transfer to the party liable on the instrument to pay.

4. **Presumptions**

Certain presumptions apply to all negotiable instruments e.g., a presumption that consideration has been paid under it. It is not necessary to write in a promissory note the words ‘for value received’ or similar expressions because the payment of consideration is presumed. The words are usually included to create additional evidence of consideration.

5. **Prompt payment**

A negotiable instrument enables the holder to expect prompt payment because a dishonour means the ruin of the credit of all persons who are parties to the instrument.

8.4 **PRESUMPTIONS AS TO NEGOTIABLE INSTRUMENT**

Sections 118 and 119 of the Negotiable Instrument Act lay down certain presumptions which the court presumes in regard to negotiable instruments. In other words these presumptions need not be proved as they are presumed to exist in every
negotiable instrument. Until the contrary is proved the following presumptions shall be made in case of all negotiable instruments:

1. **Consideration**

   It shall be presumed that every negotiable instrument was made drawn, accepted or endorsed for consideration. It is presumed that, consideration is present in every negotiable instrument until the contrary is presumed. The presumption of consideration, however may be rebutted by proof that the instrument had been obtained from, its lawful owner by means of fraud or undue influence.

2. **Date**

   Where a negotiable instrument is dated, the presumption is that it has been made or drawn on such date, unless the contrary is proved.

3. **Time of acceptance**

   Unless the contrary is proved, every accepted bill of exchange is presumed to have been accepted within a reasonable time after its issue and before its maturity. This presumption only applies when the acceptance is not dated; if the acceptance bears a date, it will prima facie be taken as evidence of the date on which it was made.

4. **Time of transfer**

   Unless the contrary is presumed it shall be presumed that every transfer of a negotiable instrument was made before its maturity.

5. **Order of endorsement**

   Until the contrary is proved it shall be presumed that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

6. **Stamp**

   Unless the contrary is proved, it shall be presumed that a lost promissory note, bill
of exchange or cheque was duly stamped.

7. **Holder in due course**

Until the contrary is proved, it shall be presumed that the holder of a negotiable instrument is the holder in due course. Every holder of a negotiable instrument is presumed to have paid consideration for it and to have taken it in good faith. But if the instrument was obtained from its lawful owner by means of an offence or fraud, the holder has to prove that he is a holder in due course.

8. **Proof of protest**

Section 119 lays down that in a suit upon an instrument which has been dishonoured, the court shall on proof of the protest, presume the fact of dishonour, unless and until such fact is disproved.

8.5 **TYPES OF NEGOTIABLE INSTRUMENT**

(a) Negotiable instruments recognised by statute are :

(i) Promissory notes  (ii) Bills of exchange  (iii) Cheques

(b) Negotiable instruments recognised by usage or custom are :


This list of negotiable instrument is not a closed chapter. With the growth of commerce, new kinds of securities may claim recognition as negotiable instruments. The courts in India usually follow the practice of English courts in according the character of negotiability to other instruments.
8.5.1 PROMISSORY NOTES

Section 4 of the Act defines, "A promissory note is an instrument in writing (note being a bank-note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to or to the order of a certain person, or to the bearer of the instruments."

**Essential elements**

An instrument to be a promissory note must possess the following elements:

1. **It must be in writing**: A mere verbal promise to pay is not a promissory note. The method of writing (either in ink or pencil or printing, etc.) is unimportant, but it must be in any form that cannot be altered easily.

2. **It must certainly an express promise or clear understanding to pay**: There must be an express undertaking to pay. A mere acknowledgment is not enough. The following are not promissory notes as there is no promise to pay:

   - (a) "Mr. B, I.O.U. (I owe you) Rs. 500"
   - (b) "I am liable to pay you Rs. 500".
   - (c) "I have taken from you Rs. 100, whenever you ask for it have to pay".

The following will be taken as promissory notes because there is an express promise to pay:

**If A writes**:

   - (a) "I promise to pay B or order Rs. 500"
   - (b) "I acknowledge myself to be indebted to B in Rs. 1000 to be paid on demand, for the value received".
(3) **Promise to pay must be unconditional**: A conditional undertaking destroys the negotiable character of an otherwise negotiable instrument. Therefore, the promise to pay must not depend upon the happening of some outside contingency or event. It must be payable absolutely.

(4) **It should be signed by the maker**: The person who promise to pay must sign the instrument even though it might have been written by the promisor himself. There are no restrictions regarding the form or place of signatures in the instrument. It may be in any part of the instrument. It may be in pencil or ink, a thumb mark or initials. The promissory note can be signed by the authorised agent of the maker, but the agent must expressly state as to on whose behalf he is signing, otherwise he himself may be held liable as a maker. The only legal requirement is that it should indicate with certainty the identity of the person and his intention to be bound by the terms of the agreement.

(5) **The maker must be certain**: The note self must show clearly who is the person agreeing to undertake the liability to pay the amount. In case a person signs in an assumed name, he is liable as a maker because a maker is taken as certain if from his description sufficient indication follows about his identity. In case two or more persons promise to pay, they may bind themselves jointly or jointly and severally, but their liability cannot be in the alternative.

(6) **The payee must be certain**: The instrument must point out with certainty the person to whom the promise has been made. The payee may be ascertained by name or by designation. A note payable to the maker himself is not pronate unless it is indorsed by him. In case, there is a mistake in the name of the payee or his designation; the note is valid, if the payee can be ascertained by evidence. Even where the name of a dead person is entered as payee in ignorance of his death, his legal representative can enforce payment.
(7) **The promise should be to pay money and money only**: Money means legal tender money and not old and rare coins. A promise to deliver paddy either in the alternative or in addition to money does not constitute a promissory note.

(8) **The amount should be certain**: One of the important characteristics of a promissory note is certainty—not only regarding the person to whom or by whom payment is to be made but also regarding the amount.

However, paragraph 3 of Section 5 provides that the sum does not become indefinite merely because

(a) there is a promise to pay amount with interest at a specified rate.
(b) the amount is to be paid at an indicated rate of exchange.
(c) the amount is payable by installments with a condition that the whole balance shall fall due for payment on a default being committed in the payment of anyone installment.

(9) **Other formalities**: The other formalities regarding number, place, date, consideration etc. though usually found given in the promissory notes but are not essential in law. The date of instrument is not material unless the amount is made payable at a certain time after date. Even in such a case, omission of date does not invalidate the instrument and the date of execution can be independently ascertained and proved.
Specimen of Promissory Notes

<table>
<thead>
<tr>
<th>Rs. 1000</th>
<th>Delhi</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 30, 2003</td>
<td></td>
</tr>
</tbody>
</table>

On demand (or six month after date) I promise to pay Peter or order the sum of rupees one thousand with interest at 8 per cent per annum until payment.

Drucker is the maker  
and Peter is the Payee  
Stamp  
Sd. by Drucker

8.5.2 BILL OF EXCHANGE

Section 5 of the Act defines, "A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument".

A bill of exchange, therefore, is a written acknowledgement of the debt, written by the creditor and accepted by the debtor. There are usually three parties to a bill of exchange drawer, acceptor or drawee and payee. Drawer himself may be the payee.

Essential conditions of a bill of exchange

1. It must be in writing.
2. It must be signed by the drawer.
3. The drawer, drawee and payee must be certain.
4. The sum payable must also be certain.
5. It should be properly stamped.
6. It must contain an express order to pay money and money alone.

For example, In the following cases, there is no order to pay, but only a request to pay. Therefore, none can be considered as a bill of exchange:
(a) "I shall be highly obliged if you make it convenient to pay Rs. 1000 to Suresh".

(b) "Mr. Ramesh, please let the bearer have one thousand rupees, and place it to my account and oblige"

However, there is an order to pay, though it is politely made, in the following examples:

(a) "Please pay Rs. 500 to the order of 'A'.

(b) 'Mr. A will oblige Mr. C, by paying to the order of P'.

(7) The order must be unconditional.

**Distinction Between Bill of Exchange and Promissory Note**

(1) **Number of parties**: In a promissory note there are only two parties – the maker (debtor) and the payee (creditor). In a bill of exchange, there are three parties; drawer, drawee and payee; although any two out of the three may be filled by one and the same person,

(2) **Payment to the maker**: A promissory note cannot be made payable the maker himself, while in a bill of exchange to the drawer and payee or drawee and payee may be same person.

(3) **Unconditional promise**: A promissory note contains an unconditional promise by the maker to pay to the payee or his order, whereas in a bill of exchange, there is an unconditional order to the drawee to pay according to the direction of the drawer.

(4) **Prior acceptance**: A note is presented for payment without any prior acceptance by the maker. A bill of exchange is payable after sight must be accepted by the drawee or someone else on his behalf, before it can be presented for payment.

(5) **Primary or absolute liability**: The liability of the maker of a promissory note is primary and absolute, but the liability of the drawer of a bill of exchange is
secondary and conditional.

(6) **Relation:** The maker of the promissory note stands in immediate relation with the payee, while the maker or drawer of an accepted bill stands in immediate relations with the acceptor and not the payee.

(7) **Protest for dishonour:** Foreign bill of exchange must be protested for dishonour when such protest is required to be made by the law of the country where they are drawn, but no such protest is needed in the case of a promissory note.

(8) **Notice of dishonour:** When a bill is dishonoured, due notice of dishonour is to be given by the holder to the drawer and the intermediate indorsers, but no such notice need be given in the case of a note.

**Classification of Bills**

Bills can be classified as:

1. Inland and foreign bills.
2. Time and demand bills.
3. Trade and accommodation bills.

(1) **Inland and Foreign Bills**

**Inland bill:** A bill is, named as an inland bill if:

(a) it is drawn in India on a person residing in India, whether payable in or outside India, or

(b) it is drawn in India on a person residing outside India but payable in India.

**The following are the Inland bills**

(i) A bill is drawn by a merchant in Delhi on a merchant in Madras. It is payable in Bombay. The bill is an inland bill.

(ii) A bill is drawn by a Delhi merchant on a person in London, but is made payable in India. This is an inland bill.

(iii) A bill is drawn by a merchant in Delhi on a merchant in Madras. It is
accepted for payment in Japan. The bill is an inland bill. Specimen of Inland Bill of is:

<table>
<thead>
<tr>
<th>Rs. 1000</th>
<th>Delhi</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stamp</td>
<td>August 30, 2003</td>
</tr>
<tr>
<td>Three months after date pay William or order the sum of one thousand rupees only for value received.</td>
<td></td>
</tr>
<tr>
<td>To.</td>
<td>R.C. Patel</td>
</tr>
<tr>
<td>R.C. Patel</td>
<td></td>
</tr>
<tr>
<td>Park Street</td>
<td></td>
</tr>
<tr>
<td>Bombay</td>
<td>Simon</td>
</tr>
</tbody>
</table>

(Here Simon is the drawer, William is the payee and R.K. Gupta the drawee who, on testifying his willingness to pay by 'accepting" the bill, becomes acceptor.)

**Foreign Bill** : A bill which is not an inland bill is a foreign bill. The following are the foreign bills:

1. A bill drawn outside India and made payable in India.
2. A bill drawn outside India on any person residing outside India.
3. A bill drawn in India on a person residing outside India and made payable outside India.
4. A bill drawn outside India on a person residing in India.
5. A bill drawn outside India and made payable outside India.

**Specimen of foreign bills**

<table>
<thead>
<tr>
<th>London</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stamp</td>
</tr>
<tr>
<td>August 30, 2003</td>
</tr>
<tr>
<td>Sixty days after sight of the first of Exchange (second and third of same tenor and date unpaid) pay to the order of Messers Hindustan Liver Ltd. Mumbai, the sum of Rupees Five thousand only, value received Rs. 5000</td>
</tr>
<tr>
<td>Messers William Jack &amp; Co.</td>
</tr>
<tr>
<td>Lamigton Raod</td>
</tr>
<tr>
<td>Mumbai</td>
</tr>
<tr>
<td>Hindustan Lever Ltd.</td>
</tr>
</tbody>
</table>
Bills in sets (Secs. 132 and 133): The foreign bills are generally drawn in sets of three, and each set is termed as a 'via'.

As soon as anyone of the set is paid, the others becomes inoperative. These bills are drawn in different parts. They are drawn in order to avoid their loss or miscarriage during transit. Each part is despatched separately. To avoid delay, all the parts are sent on the same day; by different mode of conveyance.

Rules: Sections 132 and 133 provide for the following rules:

(i) A bill of exchange may be drawn in parts, each part being numbered and containing a provision that it shall continue payable only so long as the others remain unpaid. All parts make one bill and the entire bill is extinguished, i.e. when payment is made on one part- the other parts will become inoperative (Section 132).

(ii) The drawer should sign and deliver all the parts but the acceptance is to be conveyed only on one of the parts. In case a person accepts or endorses different parts of the bill in favour of different persons, he and the subsequent endorsers of each part are liable on such part as if it were a separate bill (Sec. 132).

(iii) As between holders in due course of the different parts of the same bill, he who first acquired title to anyone part is entitled to the other parts and is also entitled to claim the money represented by bill (Sec. 133).

Specimen of a Bill in Sets (First Copy)
(2) **Time and Demand Bill**

<table>
<thead>
<tr>
<th>Rs. 10000</th>
<th>London</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 30, 2003</td>
<td></td>
</tr>
</tbody>
</table>

Sixty days after sight of the first of Exchange (second and third of same tenor and date unpaid) pay to the order of Ms Whiteway & Co. Mumbai, the sum of Rupees ten thousand only, value received.

To
M/s Henry Flint & Brothers
Church gate
Mumbai

**Time bill**: A bill payable after a fixed time is termed as a time bill. In other words, bill payable "after date" is a time bill.

**Demand bill**: A bill payable at sight or on demand is termed as a demand bill.

(3) **Trade and Accommodation Bill**

**Trade bill**: A bill drawn and accepted for a genuine trade transaction is termed as a "trade bill".

**Accommodation bill**: A bill drawn and accepted not for a genuine trade transaction but only to provide financial help to some party is termed as an "accommodation bill".

**Example**: A, is need of money for three months. He induces his friend B to accept a bill of exchange drawn on him for Rs. 1,000 for three months. The bill is drawn and accepted. The bill is an "accommodation bill". A may get the bill discounted from his bankers immediately, paying a small sum as discount. Thus, he can use the funds for three months and then just before maturity he may remit the money to B, who will meet the bill on maturity.

In the above example A is the “accommodated party” while B is the "accommodating party".
It is to be noted that an recommendation bill may be for accommodation of both the drawer arid acceptor. In such a case, they share the proceeds of the discounted bill.

Rules regarding accommodation bills are:

(i) In case the patty accommodated continues to hold the bill till maturity, the accommodating party shall not be liable to him for payment of, the bill since the contract between them is not based on any consideration (Section 43).

(ii) But the accommodating party shall be liable to any subsequent holder for value who may be knowing the exact position that the bill is an accommodation bill and that the full consideration has not been received by the acceptor. The accommodating party can, in turn, claim compensation from the accommodated party for the amount it has been asked to pay the holder for value.

(iii) An accommodation bill may be negotiated after maturity. The holder or such a bill after maturity is in the same position as a holder before maturity, provided he takes it in good faith and for value (Sec. 59).

In form and all other respects an accommodation bill is quite similar to an ordinary bill of exchange. There is nothing on the face of the accommodation bill to distinguish it from an ordinary trade bill.

### 8.5.3 CHEQUES

Section 6 of the Act defines "A cheque is a bill of exchange drawn on a specified banker, and not expressed to be payable otherwise than on demand".

A cheque is bill of exchange with two more qualifications, namely, (i) it is always drawn on a specified banker, and (ii) it is always payable on demand. Consequently, all cheque are bill of exchange, but all bills are not cheque. A cheque must satisfy all the requirements of a bill of exchange; that is, it must be signed by the drawer, and must
contain an unconditional order on a specified banker to pay a certain sum of money to or to the order of a certain person or to the bearer of the cheque. It does not require acceptance.

**Distinction Between Bills of Exchange and Cheque**

1. A bill of exchange is usually drawn on some person or firm, while a cheque is always drawn on a bank.

2. It is essential that a bill of exchange must be accepted before its payment can be claimed. A cheque does not require any such acceptance.

3. A cheque can only be drawn payable on demand, a bill may be also drawn payable on demand, or on the expiry of a certain period after date or sight.

4. A grace of three days is allowed in the case of time bills while no grace is given in the case of a cheque.

5. The drawer of the bill is discharged from his liability, if it is not presented for payment, but the drawer of a cheque is discharged only if he suffers any damage by delay in presenting the cheque for payment.

6. Notice of dishonour of a bill is necessary, but no such notice is necessary in the case of cheque.

7. A cheque may be crossed, but not needed in the case of bill.

8. A bill of exchange must be properly stamped, while a cheque does not require any stamp.

9. A cheque drawn to bearer payable on demand shall be valid but a bill payable on demand can never be drawn to bearer.

10. Unlike cheques, the payment of a bill cannot be countermanded by the drawer.
8.5.4 HUNDIS

A "Hundi" is a negotiable instrument written in an oriental language. The term hundi includes all indigenous negotiable instrument whether they be in the form of notes or bills.

The word 'hundi' is said to be derived from the Sanskrit word 'hundi', which means "to collect". They are quite popular among the Indian merchants from very old days. They are used to finance trade and commerce and provide a facile and sound medium of currency and credit.

Hundis are governed by the custom and usage of the locality in which they are intended to be used and not by the provision of the Negotiable Instruments Act. In case there is no customary rule known as to a certain point, the court may apply the provisions of the Negotiable Instruments Act. It is also open to the parties to expressly exclude the applicability of any custom relating to hundis by agreement (Indur Chandra vs. Lachhmi Bibi, 7 B.I.R. 682).

Types of Hundi: There are several varieties of hundis currently in the country but only the important among them are given below:

1. **Darshani Hundi**: A darshani hundi is one payable at sight. It should be presented for payment within a reasonable time of its receipt by the holder. It is similar to a demand bill.

2. **Muddati or Miadi Hundi**: A hundi payable after a specified period of time is called a Miadi Hundi. It is similar to a time bill of exchange.

3. **Shahjog Hundi**: A shahjog hundi is one which is payable to or through a Shah. Shah means a respectable and responsible person, a man of worth, and known in the bazar. A shahjog hundi passes from hand to hand by mere delivery till it reaches the hands of Shah who presents it for acceptance or for payment. If after acceptance the Shah indorses it to a person of straw, the drawee can refuse to honour the hundi. The shahjog
hundi is payable on the responsibility of the Shah and in case the hundi turns out to be false or stolen, the money can be recovered by the drawee from the Shah. It is, thus, similar to a crossed cheque.

(4) **Nam Jog Hundi**: A hundi payable to the party named in the hundi or according to his order is, called a Nam Jog Hundi.

(5) **Firman Jog Hundi**: A hundi payable to order is called a Firman Jog Hundi.

(6) **Dhani Jog or Dekhanhar Hundi**: It is payable to bearer.

(7) **Jawabee Hundi**: This type of hundi is used for remittance of money from one place to another. The person receiving the money has to send a "Jawab" (answer) showing that he has received the money, to the remitter.

(8) **Jokhmi Hundi**: A jokhmi hundi is in the nature of a policy of insurance with this difference that money is paid before hand and is to be recovered if the ship arrives safely, (Jadowjee Gopal vs. Jetha Shamji, 4 Bom. 333). The hundi is drawn by the shipper on the consignee and negotiated with the insurer at a price which is less than the amount of the hundi (at the current rate of exchange) by the amount of the premium of insurance. If the goods arrive the issuer may obtain them or the value of them as stated in the hundi. If the goods are lost he cannot claim payment, but he is entitled to be paid in full in the case of a partial loss or damage unless it amounts to general average loss in which case a rebate is made to the extent of the loss.

**Other Terms**

(1) **Zkri Chit**: The zikri chit is a letter addressed to some person residing in the town to which the hundi is addressed or in which the hundi is made payable. The letter asks the addressee to take up the hundi in case it has been dishonoured. This letter is given to the holder by the drawer or any other prior party. When the hundi get
dishonoured, such a person can accept of pay the hundi without prior noting or protest.

(2) **Peth or Perneth** : When a hundi is lost the holder may call upon the drawer to give a duplicate. This duplicate of a huhndi is called ‘Peth’. The duplicate of a duplicate hundi is called 'perpeth.'

(3) **Khokha** : A hundi when paid and cancelled is called a Khokha. (Mathwa vs Girdharilal, 7 B.H.C.R.(O. C. J.)

(4) **Purja** : It is request in writing by the borrower to the lender to pay the amount mentioned therein. It is used for temporary loans.

### 8.6 PARTIES TO NEGOTIABLE INSTRUMENTS

#### Parties to Bill of Exchange

1. **Drawer** : The maker of a bill of exchange is called the 'drawer'.

2. **Drawee** : The person directed to pay the money by the drawer is called the 'drawee',

3. **Acceptor** : After a drawee of a bill has signed his assent upon the bill, or if there are more parts than one, upon one of such pares and delivered the same, or given notice of such signing to the holder or to some person on his behalf, he is called the ' acceptor'.

4. **Payee** : The person named in the instrument, to whom or to whose order the money is directed to be paid by the instrument is called the ‘payee’. He is the real beneficiary under the instrument. Where he signs his name and makes the instrument payable to some other person, that other person does not become the payee.

5. **Indorser** : When the holder transfers or indorses the instrument to anyone else, the holder becomes the ‘indorser’. 
6. **Indorsee:** The person to whom the bill is indorsed is called an 'indorsee'.

7. **Holder:** A person who is legally entitled to the possession of the negotiable instrument in his own name and to receive the amount thereof, is called a 'holder'. He is either the original payee, or the indorsee. In case the bill is payable to the bearer, the person in possession of the negotiable instrument is called the 'holder'.

8. **Drawee in case of need:** When in the bill or in any endorsement, the name of any person is given, in addition to the drawee, to be resorted to in case of need, such a person is called 'drawee in case of need'.

   In such a case it is obligatory on the part of the holder to present the bill to such a drawee in case the original drawee refuses to accept the bill. The bill is taken to be dishonoured by non-acceptance or for nonpayment, only when such a drawee refuses to accept or pay the bill.

9. **Acceptor for honour:** In case the original drawee refuses to accept the bill or to furnish better security when demanded by the notary, any person who is not liable on the bill, may accept it with the consent of the holder, for the honour of any party liable on the bill. Such an acceptor is called ‘acceptor for honour’.

**Parties to a Promissory Note**

1. **Maker.** He is the person who promises to pay the amount stated in the note. He is the debtor.

2. **Payee.** He is the person to whom the amount is payable i.e. the creditor.

3. **Holder.** He is the payee or the person to whom the note might have been indorsed.

4. The indorser and indorsee (the same as in the case of a bill).
Parties to a Cheque

1. **Drawer.** He is the person who draws the cheque, i.e., the depositor of money in the bank.

2. **Drawee.** It is the drawer's banker on whom the cheque has been drawn.

3. **Payee.** He is the person who is entitled to receive the payment of the cheque.

4. The holder, indorser and indorsee (the same as in the case of a bill or note).

8.7 SUMMARY

A negotiable instrument is a piece of paper which entitles a person to a sum of money and which is transferable from one person to another by mere delivery or by indorsement and delivery. The characteristics of a negotiable instrument are easy negotiability, transferee gets good title, transferee gets a right to sue in his own name and certain presumptions which apply to all negotiable instruments. There are two types of negotiable instruments (a) Recognised by statue: Promissory notes, Bill of exchange and cheques and (b) Recognised by usage: Hundis, Bill of lading, Share warrant, Dividend warrant, Railway receipts, Delivery orders etc. The parties to bill of exchange are drawer, drawee, acceptor, payee, indorser, indorsee, holder, drawee in case of need and acceptor for honour. The parties to a promissory note are maker, payee, holder, indorser and indorsee while parties to cheque are drawer, drawee, payee, holder, indorser and indorsee.

8.8 KEYWORDS

**Negotiable Instrument:** A negotiable instrument is a piece of paper which entitles a person to a sum of money and which is transferable from one person to another by mere delivery or by indorsement and delivery.

**Promissory Note:** A promissory note is an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking signed by the maker, to pay
a certain sum of money only to, or the order of a certain person or to the bearer of the instrument.

**Bill of Exchange:** A bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or the bearer of the instrument.

**Cheque:** A cheque is an unconditional order in writing drawn by a customer on his bank, requesting the specifying bank to pay on demand a certain sum of money to a person named in the cheque or to the bearer or to the order of a stated person.

### 8.9 SELF ASSESSMENT QUESTIONS

1. Define the term ‘negotiable instrument’. What are its essential characteristics.

2. Discuss the presumptions in respect of a negotiable instrument.

3. What is a bill of exchange? How does it differ from a promissory note.

4. Who are the parties to a negotiable instrument? Discuss.

5. Define cheque. Distinguish between a cheque and a bill of exchange.

### 8.10 SUGGESTED READINGS


LESSON-9

NEGOTIATION & ASSIGNMENT, HOLDER IN DUE COURSE, DISHONOUR AND DISCHARGE OF A NEGOTIABLE INSTRUMENT

STRUCTURE

9.0 Objective
9.1 Introduction
9.2 Transfer by Negotiation
9.3 Modes of Negotiation
9.4 Transfer by Assignment
9.5 Importance of delivery in Negotiation
9.6 Endorsement
9.7 Instruments Obtained by Unlawful Means or for Unlawful Consideration
9.8 Holder in Due Course
9.9 Dishonour of a Negotiable Instrument
9.10 Noting and Protesting
9.11 Discharge of Parties and Instruments
9.12 Summary
9.13 Keywords
9.14 Self Assessment Questions
9.15 Suggested Readings

9.0 OBJECTIVE: The objective of this lesson is to discuss about:

(a) Modes of transfer of Negotiable Instrument
9.1 INTRODUCTION

One of the essential features of a negotiable instrument is its transferability. A negotiable instrument may be transferred from one person to another in either of the following ways, namely (i) By negotiation and (ii) By assignment. Easy transferability being one of the essential features of negotiable instruments, they are frequently transferred from one person to another for making payment and discharging business obligations. Generally the person who is entitled to receive the payment of a negotiable instrument (i.e., the holder) does not retain it will maturity but transfers it to one of his creditors in payment of his debt, who in turn again transfer it to his creditor and so on the ownership of a negotiable instrument continues to be transferred from one to another. This process of transferring the title or ownership of negotiable instruments is called negotiation.

9.2 TRANSFER BY NEGOTIATION

Negotiation may be defined as the process by which a third party is constituted the holder of the instrument so as to entitle him to the possession of the same and to receive the amount due thereon in his own name. According to section 14 of the Act, ‘when a promissory note, bill of exchange or cheque is transferred to any person so as to constitute that person the holder thereof, the instrument is said to be negotiated.’ The main purpose and essence of negotiation is to make the transferee of a promissory note, a bill of exchange or a cheque the holder there of.
Negotiation thus requires two conditions to be fulfilled, namely:

1. There must be a transfer of the instrument to another person; and
2. The transfer must be made in such a manner as to constitute the transferee the holder of the instrument.

Handing over a negotiable instrument to a servant for safe custody is not negotiation; there must be a transfer with an intention to pass title.

9.3 MODES OF NEGOTIATION

Negotiation may be effected in the following two ways:

1. **Negotiation by delivery (Sec. 47)**: Where a promissory note or a bill of exchange or a cheque is payable to a bearer, it may be negotiated by delivery thereof.

   **Example**: A, the holder of a negotiable instrument payable to bearer, delivers it to B’s agent to keep it for B. The instrument has been negotiated.

2. **Negotiation by endorsement and delivery (Sec. 48)**: A promissory note, a cheque or a bill of exchange payable to order can be negotiated only by endorsement and delivery. Unless the holder signs his endorsement on the instrument and delivers it, the transferee does not become a holder. If there are more payees than one, all must endorse it.

9.4 TRANSFER BY ASSIGNMENT

Bills, notes and cheques represent debts and as such have been held to be assignable without endorsement. Transfer by assignment takes place when the holder of a negotiable instrument sells his right to another person without endorsing it. The assignee is entitled to get possession and can recover the amount due on the instrument from the parties thereto.

Of the two methods of transfer of negotiable instruments discussed, transfer by negotiation is recognised by the Negotiable Instrument Act.
Negotiation and Assignment Distinguished

The various points of distinction between negotiation and assignment are as below:

1. Negotiation requires delivery only to constitute a transfer, whereas assignment requires a written document signed by the transferor.

2. Consideration is always presumed in the case of transfer by negotiation. In the case of assignment consideration must be proved.

3. In case of negotiation, notice of transfer is not necessary, whereas in the case of assignment notice of the transfer must be given by the assignee to the debtor.

4. The assignee takes the instrument subject to all the defects in the title of the transferor. If the title of the assignor was defective the title of the assignee is also defective. However, in case of negotiation the transferee takes the instrument free from all the defects in the title of the transferor. A holder in due course is not affected by any defect in the title of the transferor. He may therefore have a better title than the transferor.

5. In case of negotiation a transferee can sue the third party in his own name. But an assignee cannot do so.

9.5 IMPORTANCE OF DELIVERY IN NEGOTIATION

Delivery is a voluntary transfer of possession from one person to another. Delivery is essential to complete any contract on a negotiable instrument whether it be contract of making endorsement or acceptance. The property in the instrument does not pass unless the delivery is fully completed. Section 46 of the Act provides that a negotiable instrument is not made or accepted or endorsed unless it is delivered to a proper person. For instance, if a person signs a promissory note and keeps it with himself, he cannot be said to have made a promissory note; only when it is delivered to the payee that the promissory note is made.
Delivery may be actual or constructive. Delivery is actual when it is accompanied by actual change of possession of the instrument. Constructive delivery is effected without any change of actual possession.

**Who may negotiate**

Section 51 enumerates the persons who can negotiate a negotiable instrument. They are the maker, the drawer, the payee and the endorse. Where there are more such persons than one, all must join in negotiating an instrument. All the above mentioned persons are capable of negotiating an instrument only, if the negotiability of such instrument has not been restricted.

**Duration of negotiability (Section 60)**

A negotiable instrument is negotiable until it has been paid or satisfied on behalf of the maker, drawee or acceptor, at or after maturity. After payment or satisfaction it cannot be negotiated. If, however, a negotiable instrument is paid before maturity it can still be negotiated. This is so, because such payment is not a payment in due course.

**9.6 ENDORSEMENT**

The word ‘endorsement’ in its literal sense means, writing on the back of an instrument. But under the Negotiable Instruments Act it means, the writing of one’s name on the back of the instrument or any paper attached to it with the intention of transferring the rights therein. Thus, endorsement is signing a negotiable instrument for the purpose of negotiation. The person who effects an endorsement is called an ‘endorser’, and the person to whom negotiable instrument is transferred by endorsement is called the ‘endorsee’.

** Essentials of a valid endorsement**

The following are the essentials of a valid endorsement:

1. **Signature**: The signed name of the person endorsing the instrument.
2. **Transfer of Rights**: The endorsement must be made with the intention of transferring the rights in the instrument.
3. **Position of Signature**: The signature must be placed in a position where it can be easily seen.
4. **Formalities**: The endorsement must be in writing and contain the name of the endorser and the endorsee.
5. **Maturity Date**: If the instrument is a time instrument, the maturity date must be indicated.
6. **Intention of Transfer**: The endorsement must be accompanied by an intention to transfer the rights in the instrument.
7. **Commitment to Pay**: If the instrument is a promissory note, the endorser must commit to pay the instrument if the endorsee is unable to do so.

These essentials are necessary for a valid endorsement.
1. It must be on the instrument. The endorsement may be on the back or face of the instrument and if no space is left on the instrument, it may be made on a separate paper attached to it called allonage. It should usually be in ink.

2. It must be made by the maker or holder of the instrument. A stranger cannot endorse it.

3. It must be signed by the endorser. Full name is not essential. Initials may suffice. Thumb-impression should be attested. Signature may be made on any part of the instrument. A rubber stamp is not accepted but the designation of the holder can be done by a rubber stamp.

4. It may be made either by the endorser merely signing his name on the instrument (it is a blank endorsement) or by any words showing an intention to endorse or transfer the instrument to a specified person (it is an endorsement in full). No specific form of words is prescribed for an endorsement. But intention to transfer must be present. When in a bill or note payable to order the endorsee’s name is wrongly spelt, he should when he endorses it, sign the name as spelt in the instrument and write the correct spelling within brackets after his endorsement.

5. It must be completed by delivery of the instrument. The delivery must be made by the endorser himself or by somebody on his behalf with the intention of passing property therein. Thus, where a person endorses an instrument to another and keeps it in his papers where it is found after his death and then delivered to the endorsee, the latter gets no right on the instrument.

6. It must be an endorsement of the entire bill. A partial endorsement i.e. which purports to transfer to the endorse a part only of the amount payable does not operate as a valid endorsement.

   If delivery is conditional, endorsement is not complete until the condition is fulfilled.
Who may endorse?

The payee of an instrument is the rightful person to make the first endorsement. Thereafter the instrument may be endorsed by any person who has become the holder of the instrument. The maker or the drawer cannot endorse the instrument but if any of them has become the holder thereof he may endorse the instrument. (Sec. 51).

The maker or drawer cannot endorse or negotiate an instrument unless he is in lawful possession of instrument or is the holder thereof. A payee or indorsee cannot endorse or negotiate unless he is the holder thereof.

Classes of endorsement

An endorsement may be:

1. Blank or general.
2. Special or full.
3. Partial.
4. Restrictive.
5. Conditional.

(a) Blank or general endorsement (Sections 16 and 54).

It is an endorsement when the endorser merely signs on the instrument without mentioning the name of the person in whose favour the endorsement is made. Endorsement in blank specifies no endorsee. It simply consists of the signature of the endorser on the endorsement. A negotiable instrument even though payable to order becomes a bearer instrument if endorsed in blank. Then it is transferable by mere delivery. An endorsement in blank may be followed by an endorsement in full.

Example: A bill is payable to X. X endorses the bill by simply affixing his signature. This is an endorsement in blank by X. In this case the bill becomes payable to bearer.
There is no difference between a bill or note indorsed in blank and one payable to bearer. They can both be negotiated by delivery.

(b) Special or full endorsement (Section 16)

When the endorsement contains not only the signature of the endorser but also the name of the person in whose favour the endorsement is made, then it is an endorsement in full. Thus, when endorsement is made by writing the words “Pay to A or A’s order,” followed by the signature of the endorser, it is an endorsement in full. In such an endorsement, it is only the endorsee who can transfer the instrument.

Conversion of endorsement in blank into endorsement in full : When a person receives a negotiable instrument in blank, he may without signing his own name, convert the blank endorsement into an endorsement in full by writing above the endorser’s signature a direction to pay to or to the order of himself or some other person. In such a case the person is not liable as the endorser on the bill. In other words, the person transferring such an instrument does not incur all the liabilities of an endorser. (Section 49).

Example : A is the holder of a bill endorsed by B in blank. A writes over B’s signature the words “Pay to C or order.” A is not liable as endorser but the writing operates as an endorsement in full from B to C.

Where a bill is endorsed in blank, or is payable to bearer and is afterwards endorsed by another in full, the bill remains transferable by delivery with regard to all parties prior to such endorser in full. But such endorser in full cannot be sued by any one except the person in whose favour the endorsement in full is made. (Section 55).

Example : C the payee of a bill endorses it in blank and delivers it to D, who specially endorses it to E or order. E without endorsement transfers the bill to F. F as the bearer is entitled to receive payment or to sue the drawer, the acceptor, or C who endorsed the bill in blank but he cannot sue D or E.
(c) Partial endorsement (Section 56)

A partial endorsement is one which purports to transfer to the endorsee a part only of the amount payable on the instrument. Such an endorsement does not operate as a negotiation of the instrument.

Example: A is the holder of a bill for Rs.1000. He endorses it “pay to B or order Rs.500.” This is a partial endorsement and invalid for the purpose of negotiation.

(d) Restrictive endorsement (Section 50)

The endorsement of an instrument may contain terms making it restrictive. Restrictive endorsement is one which either by express words restricts or prohibits the further negotiation of a bill or which expresses that it is not a complete and unconditional transfer of the instrument but is a mere authority to the endorsee to deal with bill as directed by such endorsement.

“Pay C,” “Pay C for my use,” “Pay C for the account of B” are instances of restrictive endorsement. The endorsee under a restrictive endorsement acquires all the rights of the endorser except the right of negotiation.

Conditional or qualified endorsement

It is open to the endorser to annex some condition to his owner liability on the endorsement. An endorsement where the endorsee limits or negatives his liability by putting some condition in the instrument is called a conditional endorsement. A condition imposed by the endorser may be a condition precedent or a condition subsequent. An endorsement which says that the amount will become payable if the endorsee attains majority embodies a condition precedent. A conditional endorsement unlike the restrictive endorsement does not affect the negotiability of the instrument. It is also some times called qualified endorsement. An endorsement may be made conditional or qualified in any of the following forms:
(i) ‘Sans recourse’ endorsement: An endorser may be express word exclude his own liability thereon to the endorser or any subsequent holder in case of dishonour of the instrument. Such an endorsement is called an endorsement sans recourse (without recourse). Thus ‘Pay to A or order sans recourse, ‘pay to A or order without recourse to me,’ are instances of this type of endorsement. Here if the instrument is dishonoured, the subsequent holder or the indorsee cannot look to the indorser for payment of the same.

An agent signing a negotiable instrument may exclude his personal liability by using words to indicate that he is signing as agent only. The same rule applies to directors of a company signing instruments on behalf of a company. The intention to exclude personal liability must be clear.

Where an endorser so excludes his liability and afterwards becomes the holder of the instrument, all intermediate endorsers are liable to him.

Example: A is the holder of a negotiable instrument. Excluding personal liability by an endorsement without recourse, he transfers the instrument to B, and B endorses it to C, who endorses it to A. A can recover the amount of the bill from B and C.

(ii) Facultative endorsement: An endorsement where the endorser extends his liability or abandons some right under a negotiable instrument, is called a facultative endorsement. “Pay A or order, Notice of dishonour waived” is an example of facultative endorsement.

(iii) ‘Sans frais’ endorsement: Where the endorser does not want the endorsee or any subsequent holder, to incur any expense on his account on the instrument, the endorsement is ‘sans frais’.

(iv) Liability dependent upon a contingency: Where an endorser makes his liability depend upon the happening of a contingent event, or makes the rights of the endorsee to receive the amount depend upon any contingent event, in such a case the liability of the endorser will arise only on the happening of that contingent event. Thus, an endorser may write ‘Pay A or order on his marriage with B’.
such a case, the endorser will not be liable until the marriage takes place and if the marriage becomes impossible, the liability of the endorser comes to an end.

**Effects of endorsement**

The legal effect of negotiation by endorsement and delivery is:

(i) to transfer property in the instrument from the endorser to the endorsee.
(ii) to vest in the latter the right of further negotiation, and
(iii) a right to sue on the instrument in his own name against all the other parties (Section 50).

**Cancellation of endorsement**

When the holder of a negotiable instrument, without the consent of the endorser destroys or impairs the endorser’s remedy against prior party, the endorser is discharged from liability to the holder to the same extent as if the instrument had been paid at maturity (Section 40).

**Negotiation back**

‘Negotiation back’ is a process under which an endorsee comes again into possession of the instrument in his own right. Where a bill is re-endorsed to a previous endorser, he has no remedy against the intermediate parties to whom he was previously liable though he may further negotiate the bill.

**9.7 INSTRUMENTS OBTAINED BY UNLAWFUL MEANS OR FOR UNLAWFUL CONSIDERATION**

A person cannot pass a better title than he himself possesses. A person who is a mere finder of a lost goods or a thief or one who obtains any article by fraud or for an unlawful consideration does not get any title to the thing so acquired. The true owner can recover it not only from him but from any person to whom he may have sold it. But there is a difference between the transfer of ordinary goods and negotiation of negotiable
instruments. The Negotiable Instruments Act provides protection to those persons who acquire the instruments in good faith and for valuable consideration. A holder in due course who has no means to discover the defect of title in an instrument of any previous holder when the instrument may have passed through several hands must be protected if he obtains the instrument for value and in good faith.

Section 58 of the Act provides that no person in possession of an instrument with a defect of title can claim the amount of the instrument unless he is a holder in due course. The moment an instrument comes into the hands of a holder in due course, not only does he get a title which is free from all defects, but having passed through his hands the instrument is cleaned of all defects.

**Lost instruments**

Where the holder of a bill or note loses it, the finder gets no title to it. The finder cannot lawfully transfer it. The man who lost it can recover it from the finder. But if the instrument is transferable by mere delivery and there is nothing on its face to show that it does not belong to the finder, a holder obtaining it from the finder in good faith and for valuable consideration and before maturity is entitled to the instrument and can recover payment from all the parties thereof. If the instrument is transferable by endorsement, the finder cannot negotiate it except by forging the endorsement.

The holder of the instrument when it is lost must give a notice of loss to all the parties liable on it and also a public notice by advertisement. The holder of a lost bill remains owner in law and as such on maturity can demand payment from the acceptor, and if is dishonoured he must give notice of dishonour to prior parties. The owner of the lost bill has a right to obtain the duplicate from the drawer and on refusal he can sue the drawer for the same.

**Stolen instrument**

The position of thief of an instrument is exactly the same as that of a finder of lost instruments. A thief acquires no title to an instrument if he receives payment on it the
owner can sue him for the recovery of the amount. But if an instrument payable to bearer is stolen and if transferred to a holder in due course, the owner must suffer.

**Instruments obtained by fraud**

It is of the essence of all contracts including those on negotiable instruments, that they must have been brought about by free consent of the parties competent to contract. Any contract to which consent has been obtained by fraud is voidable at the option of the person whose consent was so obtained. A person who obtains an instrument by fraud gets a defective title. But if such an instrument passes into the hands of a holder in due course, the plea of fraud will not be available against him. If however, it could be shown that a person without negligence on his part was induced to sign an instrument it being represented to him to be a document of a different kind he would not be liable even to a holder in due course.

**Instrument obtained for an unlawful consideration**

The general rules as to the legality of object or consideration of a contract apply to contracts on negotiable instruments also. An instrument given for an illegal consideration is void and does not convey a valid title to the holder. He cannot enforce payment against any party thereto. Thus, a bill of exchange given in consideration of future illicit cohabitation is void. But if such an instrument passes into the hands of a holder in due course, he obtains a good and complete title to it.

**Forged instrument**

Forgery confers no title and a holder acquires no title to a forged instrument. A forged instrument is treated as annullity. Forgery with the intention of obtaining title to an instrument would include:

1. fraudulently writing the name of an existing person,
2. signing the name of a fictitious person with the intention that it may pass that of a real person, or
(3) signing one’s own name with the intention that the signature may pass as the signature of some other person of the same name.

**Example:** A bill is payable to Ram Sunder or order. At maturity it wrongfully comes into the possession of another Ram Sunder who knows that he has no claim on the bill. He puts his own signature and the acceptor pays him. The bill is not discharged and the acceptor remains liable to Ram Sunder who is the owner of the bill.

A forged instrument has no existence in the eyes of law. A title which never came into existence cannot be improved even if it passes into the hands of a holder in due course. A forges B’s signature on a promissory note and transfers the same to C who takes it in good faith for value. C gets no title of the note even though he is a holder in due course.

**Examples:** (a) On a note for Rs.1000, A forges B’s signature to it as maker. C, a holder who takes it bonafide and for value acquires no title to the note.

(b) On a bill for Rs.1000 A’s acceptance to the bill is forged. The bill comes into hands of B, a bonafide holder for value, B acquires no title to the bill.

**Forged endorsement**

The case of a forged endorsement is slightly different. If an instrument is endorsed in full, it cannot be negotiated except by an endorsement signed by the person to whom or to whose order the instrument is payable, for the endorsee obtains title only through his endorsement. If an endorsement is forged, the endorsee acquires no title to the instrument even if he is a bonafide purchaser. On the other hand, if the instrument is a bearer instrument or has been endorsed in blank, and there is a forged endorsement the holder gets a good title because holder in such a case derives title by delivery and not by endorsement. Bankers are specially protected against forged endorsement under section 85 of the Act.

**Examples:** (a) A bill is endorsed, “Pay X or order.” X must endorse the bill and if his signature is forged, the bill is worthless.
(b) A bill is payable to “X or order.” It is stolen from X and the thief forges X’s endorsement and endorses it to Y who takes it in good faith and for value. Y acquires no title to the bill.

(c) A bill payable to “A or order” is endorsed in blank by A. It comes into the hands of B. B by simple delivery passes it to C. C forges B’s endorsement and transfers it to D. As D does not derive his title through the forged endorsement of B, but through the genuine endorsement of A, he obtains a good title to the instrument in spite of the intervening forged endorsement.

**Instrument without consideration**

Sections 43 to 45 of the Negotiable Instrument Act deal with the consequences of failure or absence of consideration in negotiable instruments. In the case of negotiable instruments consideration is presumed to exist between the parties unless the contrary is proved. As between immediate parties, if an instrument is made, drawn or endorsed without consideration, or for a consideration which subsequently fails, it is void. As between immediate parties, failure of consideration has the same effect as the absence of consideration. For instance if a promissory note is delivered by the maker to the payee as a gift, it cannot be enforced against such maker.

**Examples:**

(a) C the holder of a bill endorses it in blank to D receiving no value. D for value transfers it by delivery to E. E is a holder of value.

(b) A is the holder of a bill for consideration. A endorses it to B, without consideration. The property in the bill passes to B. The bill is dishonoured at maturity. B cannot sue A on the bill.

As between remote parties, the defence of absence or failure of consideration is not available at all. The holder in due course who has paid consideration can recover it from all prior parties immaterial of the fact whether any of them has received consideration or not.
Where there is a partial absence or failure of consideration, as between immediate parties, only that part can be recovered which was actually paid. However, a holder in due course is not affected by this rule. But even between immediate parties, where the part of the consideration which is absent or cannot be ascertained without collateral inquiry, the whole of the amount is recoverable.

**Examples:**
(a) A owes B Rs. 500. B draws a bill on A for Rs. 1000. A to accommodate B and at his request accepts it. If B sues A on the bill he can only recover Rs. 500.

(b) A draws a bill on B for Rs. 500 payable to the order A. B accepts the bill but subsequently dishonours it by non-payment. A sues B on the bill. B proves that it was accepted for value as to Rs. 400 and as an accommodation to A (the plaintiff) for Rs. 100. A can only recover Rs. 400. But if this bill gets into the hands of a holder in due course, he can recover the full amount of Rs. 500.

**9.8 HOLDER IN DUE COURSE**

Section 9 of the Act defines 'holder in due course' as any person who (i) for valuable consideration, (ii) becomes the possessor of a negotiable instrument payable to bearer or the indorsee or payee thereof, (iii) before the amount mentioned in the document becomes payable, and (iv) without having sufficient cause to believe that any defect existed in the title of the person from whom he derives his title. (English law does not regard payee as a holder in due course).

The essential qualification of a holder in due course may, therefore, be summed up as follows:

1. **He must be a holder for valuable consideration.** Consideration must not be void or illegal, e.g. a debt due on a wagering agreement. It may, however, be inadequate. A donee, who acquired title to the instrument by way of gift, is not a holder in due course, since there is no consideration to the contract. He cannot maintain any action against the debtor on the instrument. Similarly, money due on a promissory note executed in consideration of the balance of
the security deposit for the lease of a house taken for immoral purposes cannot be recovered by a suit.

2. He must have become a holder (possessor) before the date of maturity of the negotiable instrument. Therefore, a person who takes a bill or promissory note on the day on which it becomes payable cannot claim rights of a holder in due course because he takes it after it becomes payable, as the bill or note can be discharged at any time on that day.

3. He must have become holder of the negotiable instrument in good faith. Good faith implies that he should not have accepted the negotiable instrument after knowing about any defect in the title to the instrument. But, notice of defect in the title received subsequent to the acquisition of the title will not affect the rights of a holder in due course. Besides good faith, the Indian Law also requires reasonable care on the part of the holder before he acquires title of the negotiable instrument. He should take the instrument without any negligence on his part. Reasonable care and due caution will be the proper test of his bona fides. It will not be enough to show that the holder acquired the instrument honestly, if in fact, he was negligent or careless. Under conditions of sufficient indications showing the existence of a defect in the title of the transferor, the holder will not become a holder in due course even though he might have taken the instrument without any suspicion or knowledge.

**Example**

(i) A bill made out by pasting together pieces of a torn bill taken without enquiry will not make the holder, a holder in due course. It was sufficient to show the intention to cancel the bill. A bill should not be taken without enquiry if suspicion has been aroused.

(ii) A post-dated cheque is not irregular. It will not preclude a bonafide purchase
instrument from claiming the rights of a holder in due course.

It is to be noted that it is the notice of the defect in the title of his immediate transferor which deprives a person from claiming the right of a holder in due course. Notice of defect in the title of any prior party does not affect the title of the holder.

4. A holder in due course must take the negotiable instrument complete and regular on the face of it.

Privileges of a holder in due course

1. Instrument purged of all defects: A holder in due course who gets the instrument in good faith in the course of its currency is not only himself protected against all defects of title of the person from whom he has received it, but also serves, as a channel to protect all subsequent holders. A holder in due course can recover the amount of the instrument from all previous parties although, as a matter of fact, no consideration was paid by some of the previous parties to instrument or there was a defect of title in the party from whom he took it. Once an instrument passes through the hands of a holder in due course, it is purged of all defects. It is like a current coin. Who-so-ever takes it can recover the amount from all parties previous to such holder (Sec. 53).

It is to be noted that a holder in due course can purify a defective title but cannot create any title unless the instrument happens to be a bearer one.

Examples:

(i) A obtains B's acceptance to a bill by fraud. A indorses it to C who takes it as a holder in due course. The instrument is purged of its defects and C gets a good title to it. In case C indorses it to some other person he will also get a good title to it except when he is also a party to the fraud played by A.

(ii) A bill is payable to "A or order". It is stolen from A and the thief forges A’s signatures and indorses it to B who takes it as a holder in due course. B cannot
recover the money. It is not a case of defective title but a case where title is absolutely absent. The thief does not get any title therefore, cannot transfer any title to it.

(iii) A bill of exchange payable to bearer is stolen. The thief delivers it to B, a holder in due course. B can recover the money of the bill.

2. **Rights not affected in case of an inchoate instrument**: Right of a holder in due course to recover money is not at all affected even though the instrument was originally an inchoate stamped instrument and the transferor completed the instrument for a sum greater than what was intended by the maker. (Sec. 20)

3. **All prior parties liable**: All prior parties to the instrument (the maker or drawer, acceptor and intervening indorers) continue to remain liable to the holder in due course until the instrument is duty satisfied. The holder in due course can file a suit against the parties liable to pay, in his own name (Sec. 36)

4. **Can enforce payment of a fictitious bill**: Where both drawer and payee of a bill are fictitious persons, the acceptor is liable on the bill to a holder in due course. If the latter can show that the signature of the supposed drawer and the first indorser are in the same hand, for the bill being payable to the drawer's order the fictitious drawer must indorse the bill before he can negotiate it. (Sec. 42).

5. **No effect of conditional delivery**: Where negotiable instrument is delivered conditionally or for a special purpose and is negotiated to a holder in due course, a valid delivery of it is conclusively presumed and he acquired good title to it. (Sec. 46).

**Example**: A, the holder of a bill indorses it "B or order" for the express purpose that B may get it discounted. B does not do so and negotiates it to C, a holder in due course. D acquires a good title to the bill and can sue all the parties on it.

6. **No effect of absence of consideration or presence of an unlawful consideration**: The plea of absence of or unlawful consideration is not
available against the holder in due course. The party responsible will have to make payment (Sec. 58).

7. **Estoppel against denying original validity of instrument:** The plea of original invalidity of the instrument cannot be put forth, against the holder in due course by the drawer of a bill of exchange or cheque or by an acceptor for the honour of the drawer. But where the instrument is void on the face of it e.g. promissory note made payable to "bearer", even the holder in due course cannot recover the money. Similarly, a minor cannot be prevented from taking the defence of minority. Also, there is no liability if the signatures are forged. (Sec. 120).

8. **Estoppel against denying capacity of the payee to indorse:** No maker of promissory note and no acceptor of a bill of exchange payable to order shall, in a suit therein by a holder in due course, be permitted to resist the claim of the holder in due course on the plea that the payee had not the capacity to indorse the instrument on the date of the note as he was a minor or insane or that he had no legal existence (Sec 121).

9. **Estoppel against indorser to deny capacity of parties:** An indorser of the bill by his endorsement guarantees that all previous endorsements are genuine and that all prior parties had capacity to enter into valid contracts. Therefore, he on a suit thereon by the subsequent holder, cannot deny the signature or capacity to contract of any prior party to the instrument.

**9.9 DISHONOUR OF A NEGOTIABLE INSTRUMENT**

When a negotiable instrument is dishonoured, the holder must give a notice of dishonour to all the previous parties in order to make them liable. A negotiable instrument can be dishonoured either by non-acceptance or by non-payment. A cheque and a promissory note can only be dishonoured by non-payment but a bill of exchange can be dishonoured either by non-acceptance or by non-payment.
Dishonour by non-acceptance (Section 91)

A bill of exchange can be dishonoured by non-acceptance in the following ways:

1. If a bill is presented to the drawee for acceptance and he does not accept it within 48 hours from the time of presentment for acceptance. When there are several drawees even if one of them makes a default in acceptance, the bill is deemed to be dishonoured unless these several drawees are partners. Ordinarily when there are a number of drawees all of them must accept the same, but when the drawees are partners acceptance by one of them means acceptance by all.

2. When the drawee is a fictitious person or if he cannot be traced after reasonable search.

3. When the drawee is incompetent to contract, the bill is treated as dishonoured.

4. When a bill is accepted with a qualified acceptance, the holder may treat the bill of exchange having been dishonoured.

5. When the drawee has either become insolvent or is dead.

6. When presentment for acceptance is excused and the bill is not accepted. Where a drawee in case of need is named in a bill or in any indorsement thereon, the bill is not dishonoured until it has been dishonoured by such drawee.

Dishonour by non-payment (Section 92)

A bill after being accepted has got to be presented for payment on the date of its maturity. If the acceptor fails to make payment when it is due, the bill is dishonoured by non-payment. In the case of a promissory note if the maker fails to make payment on the due date the note is dishonoured by non-payment. A cheque is dishonoured by non-payment as soon as a banker refuses to pay.

An instrument is also dishonoured by non-payment when presentment for payment is excused and the instrument when overdue remains unpaid (Sec 76).
Effect of dishonour: When a negotiable instrument is dishonoured either by non-acceptance or by non-payment, the other parties thereto can be charged with liability. For example if the acceptor of a bill dishonours the bill, the holder may bring an action against the drawer and the indorsers. There is a duty cast upon the holder towards those whom he wants to make liable to give notice of dishonour to them.

Notice of dishonour: Notice of dishonour means the actual notification of the dishonour of the instrument by non-acceptance or by non-payment. When a negotiable instrument is refused acceptance or payment notice of such refusal must immediately be given to parties to whom the holder wishes to make liable. Failure to give notice of the dishonour by the holder would discharge all parties other than the maker or the acceptor (Sec. 93).

Notice by whom: Where a negotiable instrument is dishonoured either by non-acceptance or by non-payment, the holder of the instrument or some party to it who is liable thereon must give a notice of dishonour to all the prior parties whom he wants to make liable on the instrument (Section 93). The agent of any such party may also be given notice of dishonour. A notice given by a stranger is not valid. Each party receiving notice of dishonour must, in order to render any prior party liable give notice of dishonour to such party within a reasonable time after he has received it. (Sec. 95)

When an instrument is deposited with an agent for presentment and is dishonoured, he may either himself give notice to the parties liable on the instrument or he may give notice to his principal. If he gives notice to his principal, he must do so within the same time as if he were the holder. The principal, too, in his turn has the same time for giving notice as if the agent is an independent holder. (Sec. 96)

Notice to whom? : Notice of dishonour must be given to all parties to whom the holder seeks to make liable. No notice need be given to a maker, acceptor or drawee, who are the principal debtors (Section 93).

Notice of dishonour may be given to an endorser. Notice of dishonour may be given to a duly authorised agent of the person to whom it is required to be given. In case
of the death of such a person, it may be given to his legal representative. Where he has been declared insolvent the notice may be given to him or to his official assignee (Section 94). Where a party entitled to a notice of dishonour is dead, and notice is given to him in ignorance of his death, it is sufficient (Section 97).

**Mode of notice:** The notice of dishonour may be oral or written or partly oral and partly written. It may be sent by post. It may be in any form but it must inform the party to whom it is given either in express terms or by reasonable intendment that the instrument has been dishonoured and in what way it has been dishonoured and that the person served with the notice will be held liable thereon.

**What is reasonable time?** It is not possible to lay down any hard and fast rule for determining what is reasonable time. In determining what is reasonable time, regard shall be had to the nature of the instrument, the usual course the dealings with respect to similar instrument, the distance between the parties and the nature of communication between them. In calculating reasonable time, public holidays shall be excluded (Section 105).

Section 106 lays down two different rules for determining reasonable time in connection with the notice of dishonour (a) when the holder and the party to whom notice is due carry on business or live in different places, (b) when the parties live or carry on business in the same place.

In the first case the notice of dishonour must be dispatched by the next post or on the day next after the day of dishonour. In the second case the notice of dishonour should reach its destination on the day next after dishonour.

**Place of notice:** The place of business or (in case such party has no place of business) at the residence of the party for whom it is intended, is the place where the notice is to given. If the person who is to give the notice does not know the address of the person to whom the notice is to be given, he must make reasonable efforts to find the latter's
address. But if the party entitled to the notice cannot after due search be found, notice of dishonour is dispensed with.

**When notice of dishonour is unnecessary:** Notice of dishonour must be given by a holder to the persons whom he seeks to make liable on the instrument. But notice of dishonour is not necessary in the following cases:

1. When it is dispensed with by the party entitled thereto.
2. In order to charge the drawer, when he has countermanded payment.
3. When the party charged could not suffer damage for want of notice.
4. When the party entitled to notice cannot after due search be found or where the party bound to give cannot give notice through no fault of his own.
5. Where the drawer and acceptor are the same person.
6. In the case of a promissory note which is not negotiable.
7. When the party entitled to notice, knowing the facts, unconditionally agrees to pay the amount.
8. When the omission to give notice is caused by unavoidable circumstances i.e., for reasons beyond the control of the holder of the instrument. Illness or death of the holder is reason excusable to give notice.

**Duties of the holder upon dishonour**

1. **Notice of dishonour.** When a promissory note, bill of exchange or cheque is dishonoured by non-acceptance or non-payment the holder must give notice of dishonour to all the parties to the instrument whom he seeks to make liable thereon. (Sec. 93)

2. **Noting and protesting.** When a promissory note or bill of exchange has been dishonoured by non-acceptance or non-payment, the holder may cause such dishonour to be noted by a notary public upon the instrument or upon a paper
attached thereto or partly upon each (Sec. 99). The holder may also within a
reasonable time of the dishonour of the note or bill, get the instrument protested by
notary public (Sec. 100).

(3) **Suit for money.** After the formality of noting and protesting is gone through, the
holder may bring a suit against the parties liable for the recovery of the amount
due on the instrument.

**Instrument acquired after dishonour :** The holder for value of a negotiable instrument
as a rule, is not affected by the defect of title in his transferor. But this rule is subject to
two important exceptions (i) when the holder acquires it after maturity and (ii) when he
acquires it with notice of dishonour.

The holder of a negotiable instrument who acquired it after dishonour, whether by
non-acceptance or non-payment, with notice thereof, or after maturity, has only, as
against the other parties, the rights thereon of his transfer. (Sec. 59).

**9.10 NOTING AND PROTESTING**

When a negotiable instrument is dishonoured the holder may sue his prior parties
i.e the drawer and the indorsers after he has given a notice of dishonour to them. The
holder may need an authentic evidence of the fact that a negotiable instrument has been
dishonoured. When a cheque is dishonoured generally the bank who refuses payment
returns back the cheque giving reasons in writing for the dishonour of the cheque.
Sections 99 and 100 provide convenient methods of authenticating the fact of dishonour
of a bill of exchange and a promissory note by means of ‘noting' and 'protest'.

**Noting**

As soon as a bill of exchange or a promissory note is dishonoured, the holder can
after giving the parties due notice of dishonour, sue the parties liable thereon. Section 99
provides a mode of authenticating the fact of the bill having been dishonoured. Such
mode is by noting the instrument. Noting is a minute recorded by a notary public on the
dishonoured instrument or on a paper attached to such instrument. When a bill is to be noted, the bill is taken to a notary public who represents it for acceptance or payment as the case may be and if the drawee or acceptor still refuses to accept or pay the bill, the bill is noted as stated above.

Noting should specify in the instrument, (a) the fact of dishonour, (b) the date of dishonour, (c) the reason for such dishonour, if any (d) the notary's charges, (e) a reference to the notary's register and (f) the notary's initials.

Noting should be made by the notary within a reasonable time after dishonour. Noting and protesting is not compulsory but foreign bills must be protested for dishonour when such protest is required by the law of the place where they are drawn. Cheques do not require noting and protesting. Noting by itself has no legal effect. Still it has some advantages. If noting is done within a reasonable time protest may be drawn later on. Noting without protest is sufficient to allow a bill to be accepted for honour.

**Protest**

Protest is a formal certificate of the notary public attesting the dishonour of the bill by non-acceptance or by non-payment. After noting, the next step for notary is to draw a certificate of protest, which is a formal declaration on the bill or a copy thereof. The chief advantage of protest is that the court on proof of the protest shall presume the fact of dishonour.

Besides the protest for non-acceptance and for non-payment the holder may protest the bill for better security. When the acceptor of a bill becomes insolvent or suspends payment before the date of maturity, or when he absconds the holder may protest it in order to obtain better security for the amount due. For this purpose the holder may employ a notary public to make the demand on the acceptor and if refused, protest may be made. Notice of protest may be given to prior parties. When promissory notes and bills of exchange are required to be protested, notice of protest must be given instead of notice of dishonour. (Sec. 102)
Inland bills may or may not be protested. But foreign bills must be protested for dishonour when such protest is required by the law of the place where they are drawn (Sec. 104).

Where a bill is required to be protested under the Act within a specified time, it is sufficient if it is 'noted for protest' within such time. The formal protest may be given at anytime after the noting (Sec. 104A)

Contents of protest

Section 101 of the Act lays down the contents of a regular and perfect protest which are as follows:

1. The instrument itself or a literal transcript of the instrument; and of everything written or printed thereupon.

2. The name of the person for whom and against whom the instrument has been protested.

3. The fact of and reasons for dishonour i.e. a statement that payment or acceptance or better security, as the case may be, has been demanded of such person by the notary public from the person concerned and he refused to give it or did not answer or that he could not be found.

4. The time and place of demand and dishonour.

5. The signature of the notary public.

6. In the case of acceptance for honour or payment for honour the person by whom or for whom such acceptance or payment was offered and effected.

Difference between noting and protest

Noting is merely a record of the fact of dishonour. When the notary public issues a certificate stating the particulars regarding the dishonour it is called a protest.
Compensation for dishonour

Section 117 lays down the rules for determining the amount of compensation payable to the holder or any endorsee in case of dishonour of the instrument:

1. The holder is entitled to the amount due upon the instrument together with the expenses properly incurred in presenting, noting and protesting it.

2. An endorser who has paid the amount due on the instrument is entitled to the amount so paid with interest at 18 per cent per annum from the date of payment until realisation thereof along with all expenses caused by dishonour and non-payment. [Rate of interest from 6 to 18 per cent per annum by the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988]

3. Where the person sought to be charged, resides in a country different from the country in which the bill is payable, the holder is entitled, to receive a sum which will be the equivalent of the amount due on the instrument in the country in which the amount is payable.

4. When the person charged and such indorser reside at different places, the indorser is entitled to receive such sum at the current rate of exchange between the two places.

5. A party entitled to compensation may draw a bill payable at sight or on demand for the amount due to him together with all expenses properly incurred by him upon the party to compensate him. Such a bill is called as a 'redraft'. The redraft must be accompanied by the dishonoured instrument and the protest if any. The party who makes payment of a redraft is entitled to draw a similar redraft on the parties prior to him. If the redraft is dishonoured, the party on whom it is drawn shall compensate the drawer as if the redraft were an original bill.

9.11 DISCHARGE OF PARTIES AND INSTRUMENTS

The term 'discharge' in relation to negotiable instruments has two meanings:
(1) the discharge of the instrument, and

(2) discharge of one or more parties from liability on the instrument.

**Discharge of the instrument**

An instrument is said to be discharged when all rights under it are extinguished, or ceases to be negotiable and even a holder in due course does not acquire any rights under it. This happens when the party who is primarily and ultimately liable on the instrument is discharged from liability. A negotiable instrument may be discharged by any of the following ways:

1. **By payment in due course.**
2. Where the principal debtor becomes the holder.
3. Where it discharges as simple contract.
4. By renunciation, and
5. By cancellation.

**1. By payment in due course**

A negotiable instrument is discharged by payment made in due course by or for the primary party or by a person who is accommodated, in case the instrument was made or accepted for accommodation. Payment in due course means that it must be made at or after the 'maturity' of the instrument to the 'holder' in good faith, or his agent. The right of further negotiation is denied (a) when the drawer pays an instrument which is payable to the order of a third person, or (b) when instrument executed or accepted for accommodation is paid by the party for whose accommodation the instrument was executed.

For final discharge of payment, the principal and the interest, if any, both must be paid. The person paying the instrument has the right to demand the surrender of the instrument.
2. **Where the principal debtor becomes the holder**

When the primary party lawfully becomes the holder of the instrument in his own right at or after maturity, the instrument is discharged. In the following cases, the instrument will not be discharged:

(a) If the debtor acquires the instrument before maturity, in this case he may negotiate it further in the same way as any other holder could; or

(b) If the holder did not acquire it lawfully or in his own right, as when he acquired it by fraud or as an agent for another person.

3. **Where it discharges as simple contract**

A negotiable instrument, in certain cases, may be discharged in the same way as a simple contract for the payment of money. Like an ordinary contract, the instrument may be discharged by novating, a covenant not to sue, rescission or substitution of another instrument.

4. **By renunciation**

A negotiable instrument is discharged when the holder renounces or gives up his right against all the parties to the instrument. It must however, be in writing.

5. **By cancellation**

The party who is entitled to enforce the payment of an instrument may surrender it to the party liable thereon with an intention to release him from the obligation. This operates as a discharge of the instrument and is known as cancellation. Cancellation may also take place by physical destruction of the instrument itself made with the intention to terminate liability. It may also be done by crossing out signature on the instrument.

**Discharge of one or more parties from liability on the instrument**

When any particular party or parties are discharged, the instrument continues to be negotiable and the discharged parties remain liable on it. For example, the non-
presentation of a bill on the due date discharges the indorsers from their liability, but the acceptor remains liable on it.

A party or parties may be discharged from liability in the following ways:

1. **By cancellation**: Where the holder of the instrument cancels the name of any party to it, with the intention of discharging him from liability, such party and all others are, discharged from liability. However, a cancellation made by mistake will not discharge any party.

2. **By release**: Where the holder of a negotiable instrument grants a release to the person liable, to pay, by an agreement, discharges the party or parties concerning from the liability.

3. **By discharge of secondary parties (that is, indorsers)**: A person secondarily liable on the instrument is discharged by the discharge of the primary party and by valid tender or payment made by a prior party.

4. **By operation of law**: Discharge of liability takes place by operation of law, such as insolvency of the debtor, expiry of the limitation or by merger, etc.

5. **By allowing drawee more than 48 hours**: If the holder of a bill allows the drawee more than 48 hours, exclusive of public holidays, to consider whether he will accept the same, all previous parties not consenting to such allowance are discharged from liability to the holder (Sec. 83).

6. **By non-presentment of cheque**: Where a cheque is not presented for payment within a reasonable time (six months) of its issue, and the bank fails and the drawer suffers actual damage through the delay, he is discharged from liability to the holder to the extent to which such drawer is a creditor of the banker, but not more than that (Sec. 84).

7. **Cheque payable to order**: Where a cheque payable to order stands to be indorsed by or on behalf of the payee, the banker is discharged by payment
in due course. In case a cheque originally drawn payable to bearer, the banker is discharged by paying in due course to the bearer thereof, even if any indorsement restricts or excludes further negotiation (Sec. 85-A).

8. **Drafts by one branch to another branch:** Where a draft drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand, on behalf of the payee, the bank is discharged by payment in due course (Sec. 85-A).

9. **By taking qualified acceptance:** If the holder of a bill takes a qualified acceptance, all the previous parties whose consent is not obtained to such acceptance are discharged from liability. (Sec. 86).

10. **By material alternation:** Any material alteration of a negotiable instrument renders the same void as against anyone who is a party to alteration. Any alteration made by an indorsee discharges his indorser from all liability to him in respect of the consideration thereof. (Sec. 87).

    Following are some of the alterations which have been held to be material alterations:

    (1) Alteration in the date of the instrument.
    (2) Alteration in the sum payable.
    (3) Alteration in the time of payment.
    (4) Alteration in the place of payment.
    (5) Alteration in the rate of interest.
    (6) Alteration by the addition of a new party.
    (7) Alterations authorised by the Act.
    (8) Filling in of the blanks in an inchoate instrument.
    (9) The conversion of an indorsement in blank into an indorsement in full
(Sec. 49).

(10) The qualifying or limiting of an acceptance (Sec. 86)

(11) The crossing of a cheque after it has been issued. (See. 125)

(12) Discharge of payment of altered instrument: Where an instrument has been materially altered, but does not appear to have been altered, or where a cheque is presented for payment which does not appear to be crossed at the time of presentation, payment of the amount due on the instrument according to the apparent tenor thereof, and in due course discharge the person making the payment. (Sec. 89).

(13) Bill in acceptor's hand: When a bill of exchange is held by the acceptor in his own right at or after maturity, all rights of action thereon are extinguished. (Sec. 90)

9.12 SUMMARY

Negotiation of an instrument is a process by which the ownership of the instrument is transferred by one person to another. There are two methods of negotiation: by mere delivery and by endorsement. In its literal sense, the term ‘indorsement’ means writing on an instrument but in its technical sense, under the Negotiable Instrument Act, it means the writing of a person’s name on the face or back of a negotiable instrument or on a slip of paper annexed thereto, for the purpose of negotiation. A bill may be dishonoured by non-acceptance (since only bills require acceptance) or by non-payment, while a promissory note and cheque may be dishonoured by non-payment only. Noting means recording of the fact of dishonour by a notary public on the bill or paper or both partly. Protest is a formal notarial certificate attesting the dishonour of the bill. The term ‘discharge’ in relation to negotiable instrument is used in two senses, viz., (a) discharge of one or more parties from liability thereon, and (b) discharge of the instrument.
9.13 KEYWORDS

**Negotiation:** Negotiation of an instrument is a process by which the ownership of the instrument is transferred by one person to another.

**Endorsement:** It means the writing of a person name on the face or back of a negotiable instrument or on a slip of paper annexed thereto, for the purpose of negotiation.

**Noting:** Noting is a witness by the notary public that the bill or note has in fact been dishonoured.

**Protest:** It is a formal notarial certificate attesting the dishonour of the bill.

9.14 SELF ASSESSMENT QUESTIONS

1. What is meant by negotiation? How is it effected and how does it differ from an assignment?

2. Define endorsement. What are the various classes of endorsement?

3. Explain the privileges granted to a holder in due course.

4. In what different ways may a negotiable instrument be dishonoured? What are the duties of a holder of a dishonoured bill?

5. How and when should a notice be served on a bill being dishonoured by either non-acceptance or non-payment? Under what circumstances is notice of dishonour unnecessary?

6. What are the various ways in which one or more parties to a negotiable instrument is/are discharged for liability? Discuss.
9.15 SUGGESTED READINGS


LESSON-10
NATURE AND TYPES OF COMPANIES

STRUCTURE
10.0 Objective
10.1 Introduction
10.2 Meaning of a Company
10.3 Characteristics of Company
10.4 Lifting of the Corporate Veil
10.5 Types of Companies
10.6 Difference between Public and Private Company
10.7 Privileges of a Private Company
10.8 Conversion of Private Company into Public Company
10.9 Conversion of Public Company into Private Company
10.10 Summary
10.11 Keywords
10.12 Self Assessment Questions
10.13 Suggested Readings

10.0 OBJECTIVE
After reading this lesson, you should be able to:
(a) Define a company and explain its characteristics.
(b) Discuss the various types of companies.
(c) Enumerate the circumstances for lifting the corporate veil.
(d) Describe the privileges of a private company.
(e) Explain the procedure for conversion of private company into public company and vice-versa.

10.1 INTRODUCTION

The word company is the most widely used word in the whole of commercedom these days. This word has been derived from the combination of two Latin words, namely, ‘com’ and ‘panis’. The word ‘com’ means together and ‘panis’ means bread. Thus initially the word company referred to an association of persons who took their meals together. The people took advantage of these festive gatherings to discuss their business matters. So generally speaking, a company means a voluntary association of individuals formed for some common purpose. It has no strictly technical and legal meaning. It is a legal device for the attainment of common social or economic objectives. It is the outcome of the deficiencies of other forms of organisations like sole trade and partnership and gives a perfect solution to the problems being confronted by these forms of organisation.

10.2 MEANING OF A COMPANY

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concerned, it shall mean by it a company formed and registered under the Companies Act. A company may be formed for trading as well as non-trading purposes. Thus company is the only choice where an enterprise requires a rather greater mobilization of capital which the resources of a few persons cannot provide. The following are some of the definitions of company given by legal luminaries and scholars of law:

“Company means a company formed and registered under this Act or an existing company. Existing company means a company formed and registered under the previous company laws.”

**Companies Act, 1956 Sec. 3 (i & ii)**

“A company is a association of persons united for a common object.”

**Justice James**

“A joint stock company is a voluntary association of individuals for profit, having a capital divided into transferable shares, the ownership of which is the condition of membership.”

**L. H. Haney**

“A joint stock company is an artificial person-invisible, intangible and existing only in the eyes of law.”

**Justice Marshal**

“Company means an association of persons united for a common object.”

**Justice James**

“A joint stock company means a company having 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 a company when registered with limited liability under this Act, shall be deemed to be a company limited by shares.”
Section 566 of the Companies Act, 1956

Thus a company is a means of co-operation in the conduct of an enterprise. It is legally an entity apart from its members, is capable of rights and duties of its own and endowed with the potential of perpetual succession. Finally, it can be said that a company is an incorporated association, which is an artificial legal person having an independent legal entity with a perpetual succession, a common seal, a common capital comprising transferable shares and having limited liability. At present, the companies in India are incorporated under the Companies Act, 1956.

10.3 CHARACTERISTICS OF COMPANY

Company is an artificial person created by law for some common purpose of which the capital is divisible into parts, known as shares and with a limited liability. It enjoys the following special characteristics for advantages in comparison with other forms of organization:

1. Artificial Person

A company is an artificial person existing in the eyes of law only. It is invisible, intangible, immortal and lacks the physical attribute possessed by natural persons which means that a company does not eat food, cannot marry and cannot be sent to prison. The law treats it as a legal person as it can conduct lawful business and enter into contracts with other persons in its own name. It can sell or purchase property. It can sue and be sued in its name. It cannot be regarded as an imaginary person because it has a legal existence. Thus company is an artificial person created by law.

In the case of Bath V. Standard Land Co. 1910, 2 ch. 408, it was held that the boards are the brains and the only brains of the company which is the body and the company can and does act only through them.
2. **Independent Corporate Existence**

A company has a separate independent corporate existence. Its entity is always separate from its members. The property of the company belongs to it and not to the shareholders. It must be utilized for the benefit of the company and not for the personal benefits of the shareholders. The company cannot be held liable for the acts of the members and the members can not be held liable for the acts or wrongs or misdeeds of the company. The members of the company can enter into contracts with the company in the same manner as any other individual. The company’s debts are the debts of the company and the shareholders can not be compelled to pay them. Thus, once a company is incorporated, it must be treated like any other independent person.

The principle of separate legal entity was explained in the famous case of Salomon V. Salomon & Company Ltd. (1897) A.C.22. In this case, a person named Salomon was a shoe manufacturer. He incorporated a company named Salomon & Company Ltd. for the purpose of taking over and carrying on of his business. The company consisted of him, his wife, one daughter and four sons. Salomon and his two sons constituted the board of directors of the company. Salomon sold his boot business to the newly formed company for £ 30,000. His wife, one daughter and four sons took up one share of £ 1 each. Salomon took 20,000 shares of £ 1 each and debentures worth £ 10,000. These debentures certified that the company owed Salomon £ 10,000 and created a charge on the company’s assets. The company went into liquidation within a year because of the general trade depression.

At the time of winding up, its statement of affairs showed total assets of £ 6,000; liabilities included Salomon as secured debenture holder £ 10,000 and unsecured creditors of £ 7,000. The unsecured creditors claimed priority in payment over Salmon’s claim as a debenture holder on the ground that Salomon and his company were one and the same person. The company was merely an agent for Salomon since the business belonged solely to him and was conducted by him and for him. The company was, therefore, a mere sham and fraud.
But the House of Lords held that the company was a real company fulfilling all the requirements. The company in the eyes of the law is a separate person, independent of Salomon. Salomon, though virtually the holder of all the shares in the company, was also a secured creditor and was entitled to repayment in priority to the unsecured creditors.

Lord Macnaghten emphasised in this case that the company is, in law, a different person altogether from the subscribers to the memorandum and though it may be that after incorporation, the business is precisely the same as before and the same persons are the managers, and the same persons receive the profits, the company is not in law, their agent or trustee. There is nothing in law to indicate the extent of interest a person may possess nor does the law require that the subscribers to the memorandum should be independent or unconnected.

3. **Perpetual Succession**

A company is created by law and it can be brought to an end by law. The life of the company does not depend upon the life of its members. Describing the continuity of a steam, the great English poet Lord Tennyson says in his famous poem ‘The Brook’:

“Men may come and men may go

But I go on for ever.”

We may say the same about the continuity of the company. Members may come and members may go but the company goes on for ever until dissolved. Its continuance is not affected by the various incapacities from which its individual members may suffer such as death, illness, mental or physical disability etc. It continues to exist even if all its human members are dead. Prof. Gower, in his Modern Company Law cites an example: “During the war, all the members of a private company were killed by a bomb while they were in a general meeting, but the company survived. Even a hydrogen bomb could not destroy it.” It is created by law and the law alone can dissolve it.

In Gapalpur Tea Co. Ltd. V. Penhok Tea Co. Ltd. (1982), the High Court of Calcutta observed that though the whole undertaking of a company was taken over under
the Act which purported to extinguish all rights of action against the company, neither the company was thereby extinguished nor anybody’s claim against it.

4. **Common Seal**

A company is an artificial person and is competent to enter into contracts. But it does not have any physical existence and it can not sign any documents personally. It has to act through a human agency known as directors. Therefore, every company must have a seal with its name engraved on it. The seal of the company is affixed on the documents which require the approval of the company. The two directors must witness the affixation of the seal. Thus, the common seal is the official signature of the company.

5. **Limited Liability**

The liability of the members of the company is limited up to the unpaid value of their shares. In any case a shareholder can not be called upon to pay more than the amount of his holdings. For example, if a person is having 50 shares of Rs.10/- each and he has already paid Rs.5/- per share at the time of application and allotment, his unpaid liability comes to Rs.250/- which he has to pay at any time the company calls for that payment. He is not required to pay more than Rs.250/- in any case. In case the company is limited by guarantee also, the members undertaking the guarantee have to pay the guarantee money at the time of winding up of the company. Thus, on account of the principle of limited liability, the shareholders do not incur the risk of losing their personal property in the event of the company’s inability to pay its debts.

In London and Globe Finance Corporation (1903) case, Justice Buckley highlighted the importance of limited liability when he said, “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 of the investor as well 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.”
6. **Transferability of Shares**

The shares of a public company are freely transferable. Section 82 of the Companies Act declares that the shares or other interests of any member in a company shall be movable property transferable in the manner provided by the Articles of the company. The right to transfer shares is a statutory right and it can not be taken away by making a provision to the effect in the Articles. Thus a member is free to sell his shares in the open market and to get back his investment without having to withdraw the money from the company. This provides liquidity to the investor and stability to the company. A private company, however, restricts the right to transfer its shares under section 3(1) (iii) of the Companies Act, 1956.

7. **Separate Property**

A company can own, manage, control and dispose of property in its own name. The company becomes the owner of its capital and assets. The shareholders are not the private or joint owners of the company’s property. A shareholder does not even have an insurable interest in the property of the company. In the case of Macaura V. Northern Assurance Co. Ltd. (1925), Macaura was the holder of nearly all the shares (except one) of a timber company. He was also a substantial creditor of the company. He insured the company’s timber in his own name. The timber was destroyed by fire and he claimed the loss from the insurance company. It was held that the insurance company was not liable to him.

In R.T. Perumal V. John Deavin, AIR 1960, 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 observed that no member can claim himself to be the owner of the company’s property during its existence or in its winding up.

Thus the property of the company is not the property of the shareholders; it is the property of the company. The shareholders do not have any legal or equitable interest in the property of the company.
8. **Right to Sue**

A company, being a legal person, can enforce its rights through suits and by the same token, it can be sued for breach of its legal duties e.g. a company was engaged in the manufacturing of television sets. It purchased certain electronic components from another company, named Gupta Company and paid the price for the same. But Gupta Company supplied the components of poor quality. In this case the company which purchased the electronic components may file a suit against Gupta Company for the recovery of the damages. Similarly, if Gupta Company supplies the components of good quality but the purchasing company fails to pay the price, then the Gupta Company can file a suit against it for the recovery of the price of the electronic components.

9. **Professional Management**

Management is divorced from ownership in the case of the company form of organization. Due to this factor, the corporate sector is capable of attracting the growing cadre of professional managers. The managers are experts in the field of management because of their specialised knowledge of the subject and they function independently and without any interference. Such an atmosphere of independence gives them an opportunity to develop extraordinary managerial capacities. Thus, the company form of organization attracts young professional managing personnel to conduct its affairs effectively and efficiently.

10.4 **LIFTING OF THE CORPORATE VEIL**

The concept of separate entity is the chief advantage of the company form of organization. A company becomes a legal person after its incorporation and it has a separate entity from its members. This principle of separate entity is known as the veil of incorporation. Once a company gets incorporated, all the dealings of the company would be in its own name without looking into the identity of the persons behind its formation. This principle was established in the famous case of Salomon Vs Salomon Company Ltd. The effect of this principle is that there is a fictional veil between the company and its
members. Normally, the separate entity of the company is respected. But sometimes, the persons behind the veil start using the company for some fraudulent purposes. In these circumstances, the courts are compelled to disregard this veil and to determine the real beneficiaries hiding behind the veil. This phenomenon is called the lifting of the corporate veil. The corporate veil is said to be lifted when the court ignores the company and concerns itself directly with the members or managers. The cases in which such lifting is done may be discussed under two broad headings namely: under statutory provisions and under judicial provisions.

i) Statutory Exceptions

The Companies Act, 1956 contains certain provisions under which the directors or members of a company may be held personally liable. These statutory provisions are discussed as under:-

1. Reduction of Membership

It is provided in section 45 of the Companies Act that if the number of members of a company is reduced, in the case of a public company below seven or in the case of a private company below two and the company carries on business for more than six months after the membership is so reduced, every person who is a member of the company and who is aware of this fact shall be personally and severally liable for the payment of all the debts contracted during that time. However, the members shall be liable only if they are aware of the fact of the number falling below the statutory minimum.

2. Misstatement in the Prospectus

According to section 62 (1), every director, promoter and every person who has authorized himself to be named in the prospectus as director or every person who has authorized the issue of the prospectus, shall be liable for misstatement in the prospectus to pay compensation to every person who subscribes to any shares or debentures showing
faith in the prospectus for any loss or damage he may have sustained by reason of the untrue statement.

3. **Failure to Refund Application Money**

   Section 69(5) provides that 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 the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of 6% per annum from the expiry of the 130th day.

4. **Mis-description of the Company’s Name**

   Section 147 of the Company Act provides that every company shall indicate its name and address on every document or act or contract of the company. If any officer or agent of the 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. In the case of Hendon Vs Adelman (1973), the directors were held personally liable on a cheque signed by them in the name of the company stating the company’s name as “LR Agencies Ltd.,” the real name being “L&R Agencies Ltd.”

5. **Investigation of Ownership**

   Under section 247(1) where it appears to the Central Government that there is good reason to do so, it may appoint one or more inspectors to investigate and report on the membership of any company or other matters relating to the company for the purpose of determining the true persons who are financially interested in the success or failure of the company and who control and materially influence the policy of the company.

6. **Directors with unlimited liability**

   Section 322 of the Companies Act provides that the liability of the directors or any of the directors if so provided by the memorandum may be made unlimited. However, if there is no such clause originally in the memorandum, it may be added by alteration in
the memorandum by means of a special resolution provided the company is authorized to do so by its Articles. In case of unlimited liability of directors, they shall be personally liable for the debts of the company.

7. **Fraudulent Trading**

Section 542(1) provides for the liability for fraudulent conduct of business. If in the course of the winding up of a company, it appears that any business of the company has been carried on with an intent to defraud the creditors of the company or any other persons or for any fraudulent purpose, the court may, on the application of the official liquidator or any creditor or contributor of the company declare that any persons who were knowingly parties to the carrying on of the business in this way are personally liable without any limitation of liability for all or any of the debts or other liabilities of the company as the court may direct.

II. **Judicial Exceptions**

The courts may lift the corporate veil whenever it is necessary to secure justice or it is in public interest or for the benefit of revenue. The power is however discretionary. The following are the important cases in which the courts disregarded the corporate personality of the company and lifted the corporate veil:

1. **Determination of the Character of the Company**

Sometimes it becomes necessary to determine the character of a company. The court may examine the company to ascertain whether it has assumed enemy character or whether there exists interlocking of directorates. For this purpose, the membership of the company is examined to find out who is really in control of the corporate affairs.

If the persons who are the controlling hands, are the citizens of an enemy country, the company assumes the position of an enemy company. In this case, the court may lift the corporate veil and declare the company as an enemy company.
In Daimler Co. Ltd. V. Continental Tyre & Rubber Co. Ltd. (1916), a company was incorporated in England for the purpose of selling tyres made in Germany by a German Company. The majority of its shareholders and all the directors were German residents in Germany. During the first World War, the company commenced an action to recover a trade debt. Held, that the company had become an enemy company as it was controlled by the residents of an enemy country. The suit was dismissed on the ground that such a permission would be against the public policy.

2. Protection of Revenue

The court may disregard the separate entity if it is used for tax evasion or to prevent tax obligations. Where it is desired to determine for tax purposes the residence of a company, the court will lift the veil and find out where its central management is and that place will determine the residence of the company. The following case make the point very clear:

In the case of Sir Dinshaw Maneckjee Peti Re A.I.R. (1927) Bom. 371, the assessee was a millionaire enjoying a huge dividend and interest income. He floated four private companies and transferred his interest to them in exchange for shares. The income was received by the companies and thereafter handed down to the assessee as a pretended loan. Held, the company is not carrying on any business. It was nothing more than the assessee himself created ostensibly to reduce tax liability.

3. Fraud or Improper Conduct

The corporate entity of a company may be ignored and disregarded if it is found acting with fraudulent ulterior objectives. The courts will refuse to respect the separate existence of the company where it is formed to defeat or prevent law, to defraud creditors or to avoid legal obligations. Professor Grower says 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. The following case illustrates this point:
In Gilford Motor Co. Ltd. v. Horne, Horne was appointed a managing director of the plaintiff company on the condition that “he shall not at any time while he shall hold the office of a managing director or afterwards, solicit or entice away the customers of the company,” His employment was determined under an agreement. Shortly afterwards he opened a business in the name of a company which solicited the plaintiff’s customers. It was held that “the company was a mere cloak or sham for the purpose of enabling the defendant to commit a breach of his covenant (mutual agreement) against solicitation.

4. **Company acting as an agent or trustee of the shareholders**

A company may sometimes act as an agent or trustee for its own shareholders or the shareholders of another company. In such cases, the shareholders would be liable as principal for the acts of the company. The relationship of agency may be inferred from the agreement or from the circumstances of a particular case. The following case is worth nothing in this regard:

In F.G. Films Ltd. (1953) 1 E.R. 615, an American Company financed the production of a film in India in the name of British company. The president of the American company held 90% 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 the British company acted merely as the nominee of the American company.

5. **Protecting Public Policy**

If the company works against the law of the land or the public policy, the courts may lift the corporate veil to protect the public policy and prevent transactions contrary to the public policy.

6. **Avoidance of legal obligations**

Where the company is avoiding legal obligations, the court may disregard the separate entity of the company and proceed on the assumption as if no company exists
e.g. if a partnership firm sells its business to somebody on the undertaking that it will not start a similar business in a certain number of years but converts itself into a private limited company and starts similar business, the court may restrain the company from doing that business.

In Workmen of Associated Rubber Industry Ltd. Vs. The Associated Rubber Industry Ltd., Bhavnagar AIR 1986, a new principal company was created wholly owned by the principal company, with no business or income of its own except receiving dividend from shares transferred to it by the principal company and serving no purpose whatsoever except to reduce the gross profit of the principal company. The Supreme Court found that the creation of new company was intended as a device to reduce the amount of bonus payable to workmen of the principal company and therefore separate existence of the two companies had to be ignored while computing the bonus.

10.5 TYPES OF COMPANIES

Company is a legal device for the achievement of some common social and economic objectives. It can be defined as an association of persons established by law, having a separate entity from its members and aiming at a common objective. It has a perpetual succession and the liability of its members is limited. The company form of organization is the strongest pillar of the grand edifice of modern business and industrial world. It has eliminated the limitations of sole trade and partnership forms of organization. These companies may be classified on different bases which are described below:

(a) According to Incorporation

The act of forming a corporation or company is called incorporation. It is the process of uniting a group of persons into a legal body by following the prescribed procedure. According to the mode of incorporation, companies may be divided into the following three categories:
1. **Chartered Companies**

These companies are incorporated under the Royal or a special charter granted by the British King or Queen. The powers and nature of business of the companies of this type are defined in the charter. The sovereign has the power to put an end to the charter if the company fails to follow its terms. The objective of these companies was generally to rule over certain territories, perpetuate army control or to hold trade. The East India Company, which was incorporated by a charter of Queen Elizabeth on 31\textsuperscript{st} December, 1600 with the objective of holding trade with India and which established the British rule in India, is an example of this type of companies. Bank of England, Standard Chartered Bank, the British Broadcasting Corporation and Dutch East India Company of Holland are other examples of chartered companies.

2. **Statutory Companies**

These companies are incorporated by a special act passed by central or state legislature. The objective or objectives, scope, rights and responsibilities of these companies are clearly mentioned in the Act under which these are incorporated. These companies are formed to undertake business of public welfare and national importance. The Reserve Bank of India, The State Bank of India, The Life Insurance Corporation of India and the Food Corporation of India are governed by their respective acts and need not have either the Memorandum of Association or Articles of Association. They also need not use the word ‘Limited’ with their names. These companies are in many ways like the companies formed and registered under the Companies Act, 1956. The provisions of this act are also applicable to these companies provided they are not inconsistent with the provisions of the special act under which they are formed. It should be kept in mind that though a statutory company is owned by the Government yet it has a separate legal entity and we can not consider it a department of the Government.
3. Registered Companies

Companies formed by registration under the Companies Act 1956 are known as registered companies. Most of the companies in India belong to this type. Any existing company which had been formed and registered under any of the earlier Companies Acts, is also included in this category. It must be noted that such companies come into existence only when they are registered under the Act and a certificate of incorporation is granted to them by the Registrar of Companies. The registered companies are governed by the provisions of the Companies Act, 1956 and by the rules and regulations laid down in ‘memorandum’ and ‘articles’ of association of the companies. The liability of the members of this type of company is limited up to the unpaid value of their shares or the amount of guarantee undertaken by them.

(b) According to Liability

The liability of members of a company is the second basis on which the companies can be divided into different kinds. Liability here means, the unpaid amount of money a member of the company has to pay for the shares held by him and the amount of guarantee undertaken by him which he has to pay at the time of winding up of the company. The members are liable only upto a limit and beyond that limit they can not be asked to contribute anything towards the payment of company’s liabilities. Thus, if in the event of winding up of a company, the assets of the company are not sufficient to pay its liabilities, then the private property of the members cannot be utilized for making payment for the company’s liabilities. It is appropriate to note here that a limited company is required to ‘add’ the word ‘limited’ after its name. On this basis, there are the following three types of companies:

1. Companies limited by shares

When the liability of the members of a company is limited up to the unpaid value of their shares, it is called a limited liability company or a company limited by shares. This liability or unpaid amount may be called up at any time during the life time of the
company or at the time of its winding up. For example, if a person holds 100 shares of the value of Rs.10 each and has paid Rs.5 per share with the application and allotment of shares, his total liability will be Rs.500 only which can be called up at any time. In no case can he be required to pay more than this amount. If the shares are fully paid up, the liability of the person holding such shares is nil. Such a company must have share capital since the extent of liability is determined on the basis of the face value of shares. This company may be a public company or a private company. (Sec.12(2)(a)).

2. **Companies limited by Guarantee**

The liability of a member in these companies is limited to the amount undertaken to be contributed by him at the time of winding up of the company. The amount of guarantee is mentioned in the memorandum of association. As per section 13(3), the memorandum of a company limited by guarantee shall also state that each member undertakes to contribute to the assets of the company in the event of its being wound up while he is a member or within one year after he ceases to be a member, for payment of debts and liabilities of the company or of such debts and liabilities of the company as may have been contracted before he ceases to be a member, as the case may be, and of the costs, charges and expenses of winding up, and for adjustment of the rights of the contributors among themselves, such amount as may be required, not exceeding a specified amount. The articles of such companies must state the number of members with which these are to be registered (Sec.27(2)). Such companies are formed for non trading purposes such as charity, promotion of sports, science, art, culture etc. These companies may or may not have any share capital. If these companies do not have any share capital, the members can be required to pay the amount of guarantee undertaken by them and that too in the event of their liquidation. But if these companies have any share capital, the members are liable to pay the amount which remains unpaid on their shares together with the amount payable under the guarantee. Thus the amount of guarantee is like reserve capital of the company. A company limited by guarantee and having a share capital may be a public company or a private company. (Sec.12(2)(b)).
3. **Unlimited Companies**

An unlimited companies is that company which has no limit on the liability of its members. It means that its members are liable to contribute to the debts of the company in proportion to their respective interests. In case a member is unable to contribute his share, his deficiency is shared by the rest of the members in proportion to their capital in the company. If the assets of such a company are not sufficient to pay off its liabilities, the private assets of the members can be utilized for this purpose. In this respect, a company with unlimited liability resembles partnership. Such as company may or may not have share capital. In case, it has a share capital, it can be either a public company or a private company. It is essential for this type of company to have its articles of association which must state the number of members with which the company is to be registered (Sec.12(2)(c). However under section 32 of the Act, it is provided that an unlimited company can be converted into a limited company by passing a special resolution for this purpose.

The resolution must state the manner in which the liability of members is to be limited. The unlimited companies are rarely found in these days.

(c) **According to number of members**

There are two types of companies according to the number of the persons who form the company: private company and public company.

1. **Private Company**

Private company means a company which by its articles –

a) restricts the right of members to transfer its shares, if any

b) limits the number of its members to 50. This number excludes the past or present employees of the company who are its members.

(c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.
The words ‘if any’ in clause (a) indicate that share capital is not a must for this company.

Regarding clause (b), it is worth remembering that the director or directors of the company will not be considered employees of the company and joint holders shall be treated as single members. The minimum number of members of a private company is two and it must have the words Pvt. Ltd. as the last part of its name.

It may also be mentioned here that the number of debenture holders can exceed fifty because the provisions dealing with private company are silent in this regard. (Sec.3(1)(iii)).

If a private company is not having share capital, the articles need not contain provisions for restricting the right of members to transfer shares. (Sec.27(3)).

2. Public Company

According to the Companies Act, a public company is a company which is not a private company. Thus, it is a company which by its articles does not :-

   a) restricts the right of members to transfer its shares, if any
   b) limits the number of its members to 50.
   c) prohibits any invitation to the public to subscribe for any shares or debentures of the company.

The minimum number of members of a public company is seven but there is no upper limit on its membership. Its shares are freely transferable. The word ‘Ltd.’ may be appended to its name. It can invite the general public to subscribe for its shares. (Sec.3(1)(iv)).

(d) According to control and management

Control and management of a company refers to the composition of its board of directors or holding of majority of shares. On this basis, companies can be divided into two classes - Holding Company and Subsidiary Company.
1. **Holding Company**

The Company Law defines a holding company as a company which controls another company. A company is deemed to be a holding company of another company, if:

a) it controls the composition of the board of directors of another company which means that it has the power to appoint or remove all or majority of its directors.

A company shall be considered to have the power to appoint the directors of another company in the following cases:

i) If a person can not be appointed as a director without the consent of that company.

ii) If his appointment as a director is possible only because he is the director of that other company.

iii) If the person, holding the office of a director, is the person nominated by the other company or by its subsidiary company.

b) it holds more than half the nominal value of the equity share capital of another company.

c) any company becomes a subsidiary of another company which itself is a subsidiary of the controlling company. (Sec.4(4)).

To illustrate this point, if company A is a subsidiary of company B and the company B is subsidiary of another company C, the company A will also become the subsidiary of Company C. So it means that the subsidiary of your subsidiary is also your subsidiary.

2. **Subsidiary Company**

A subsidiary company is a company which is controlled by another company. It is deemed to be controlled by another company, if
a) the composition of its board of directors is controlled by another company which means that another company has the power to appoint or remove all or majority of its directors.

b) another company holds more than half the nominal value of its equity share capital.

c) it becomes a subsidiary company of another company which itself is a subsidiary of the controlling company. (Sec.4(1))

A holding company and its subsidiary companies are separate legal entities and each has a separate corporate veil. The holding and subsidiary companies can not be treated as one company.

It is important to note that under section (3) the following types of controls do not make the company a holding company:

i) Where the shares are held or the power is exercisable by the company in a fiduciary capacity.

ii) Where the shares are held or the power is exercisable by any person by virtue of any debentures or by a trust deed for securing any issue of such debentures.

iii) Where the shares are held or the power is exercisable by a lending company by way of security, and only for the purpose of a transaction entered into in the ordinary course of business.

(e) **According to ownership**

Companies can be distinguished from one another on the basis of their ownership also. The word ownership here implies the proportion of capital held. The following are the two types of companies on this basis:
1. **Government Company**

The Companies Act defines a government company as a company in which not less than 51 per cent of the paid up share capital is held by:

- a) The Central Government or
- b) Any State Government or
- c) Partly by the Central Government and partly by one or more State Governments.

It should be noted carefully that a company which is a subsidiary of a government company shall be considered a government company. (Sec. 617).

2. **Non-Government Companies**

All those companies which are registered and incorporated under the Companies Act but which are not government companies are known as non-government companies. It implies that if 51 per cent or more of the paid up share capital is held by the private sector, it is called a non government or private sector company. Tata Iron and Steel Company Ltd. (TISCO), Reliance Industries Ltd. (RIL) and Hindustan Lever Ltd. (HLL) are a few examples of private sector companies.

(f) **According to Nationality**

The company also has a nationality like a citizen although it can not be called a citizen. The nationality of a company is determined by the place of its incorporation. On this basis, there can be two types of companies – Foreign Companies and Indian Companies.

1. **Foreign Companies**

Foreign companies are those companies which are incorporated outside India but which have a place of business within India. (Sec. 591(1)). Place of business here means
an identifiable place where it carries on business such as office, store house, godown etc. Share transfer or share registration office shall also be considered a place of business.

If 50 per cent or more of the paid up share capital of a foreign company is held by Indian Citizens and or by companies incorporated in India whether singly or jointly, it shall be treated as an Indian Company in respect of its business in India. It means that such a company has to comply with the provisions of the Companies Act as if it were an Indian company. (Sec.591(2))

2. Native or Indian Companies

All the companies which are not foreign companies according to the provisions of the Act as mentioned above are native or Indian Companies.

Some other kinds of companies

1. Licensed companies or association not for profit

The Companies Act permits the registration, under a licence granted by the Central Government, of an association not for profit with limited liability. However, such a company can not use the word “Ltd.” or the words “Pvt. Ltd.” with its name. This type of association or company is formed for the promotion of charity, science, commerce, sports, art or culture etc. Naturally, such associations are not of a commercial nature and do not aim at earning profits. Given below are the conditions for the grant of licence to such companies:

a) The object of the association must be the promotion of charity, science, commerce, sports, art, religion, culture or some other socially useful activity.

b) It must utilize its income or profits, if any, for the promotion of its objects as stated above. It can not distribute its profits as dividend to its members.

On the fulfillment of these conditions, it may be granted a licence by the Central Government. On registration, it enjoys all the privileges, and is subject to all the obligations of a limited company. It is exempted from certain provisions of the Act and is
registered without paying any stamp duty. These exemptions are intended to encourage the incorporation of such associations for the above mentioned objects. It can not alter its object without the prior approval of the Central Government. The Central Government may, however, revoke the licence at any time. But before taking such a step, the Central Government shall give a notice in writing of its intention to do so and shall also give it an opportunity of being heard in opposition to the revocation. (Sec.25)

2. **One man company**

One man company is usually a private company though legally speaking, there can be no one man company. It is a company in which one man holds practically the whole of its share capital. In order to meet the statutory requirement of minimum number of members, some dummy members comprising mostly friends or relatives are included. Such members hold just one or two shares each. The member holding the bulk of the share capital exercises absolute control over the company. It is nothing more than a family company.

A one man company is a legal entity and is perfectly valid, like any other company. The law does not prohibit friends or relatives from being the members of a company. Nor does it bother about the motives of a promoter so long as the objects stated by him in the memorandum are legal. This enables a man to control the company as well as to enjoy its profits and also gives him the advantage of limited liability. In the famous case of Saloman V. Saloman Company Ltd., the company was virtually a one man company in which Saloman was all powerful.

10.6 **DIFFERENCE BETWEEN PUBLIC AND PRIVATE COMPANY**

The companies incorporated in India under the Companies Act are divided into two kinds of the basis of organization and the number of members. The following are the differences between these two types of companies:
<table>
<thead>
<tr>
<th>Public Company</th>
<th>Private Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The minimum number of its members is 7. But there is no upper limit on its membership.</td>
<td>The minimum number of members is 2 and the maximum number is 50. It excludes past and present employees of the company.</td>
</tr>
<tr>
<td>2. It must have at least three directors.</td>
<td>The minimum number of directors is two.</td>
</tr>
<tr>
<td>3. It quorum for meetings is 5 members unless articles provide a larger quorum.</td>
<td>Its quorum for general meetings is 2 members.</td>
</tr>
<tr>
<td>4. It invites general public to subscribe to its shares or debentures.</td>
<td>It can not invite the general public to subscribe to its shares or debentures.</td>
</tr>
<tr>
<td>5. Its shares are fully and freely transferable.</td>
<td>Its shares are not transferable.</td>
</tr>
<tr>
<td>6. It must issue the prospectus or statement in lieu of prospectus.</td>
<td>It can not issue prospectus or statement in lieu of prospectus.</td>
</tr>
<tr>
<td>7. It can issue the share warrant.</td>
<td>It can not issue the share warrant.</td>
</tr>
<tr>
<td>8. It can not commence business before obtaining a certificate to commence business.</td>
<td>It can commerce business immediately after obtaining the certificate of incorporation.</td>
</tr>
<tr>
<td>9. It can not allot its shares unless the minimum subscription is received.</td>
<td>It can allot shares at any time after its registration. The condition of minimum subscription does not apply to it.</td>
</tr>
<tr>
<td>10. The word ‘limited’ is added at the end of its name.</td>
<td>The words ‘private limited’ must be added at the end of its name.</td>
</tr>
<tr>
<td>11. It must not hold a statutory meeting either before one month or after six months of getting the certificate to commence business. It has also to file a statutory report with the Registrar.</td>
<td>It need not hold any statutory meeting nor file any statutory report.</td>
</tr>
</tbody>
</table>
12. The total managerial remuneration in it can not exceed 11 per cent of the net profit in a year.

There is no restriction on the managerial remuneration.

10.7 PRIVILEGES OF A PRIVATE COMPANY

A private company enjoys a number of privileges. There are some privileges which are available to all private companies. But there are some others which are available only to independent private companies. The privileges enjoyed by a private company are as under:

1. The formation of a private company is very easy. It can be started with only two members.
2. It can start its business immediately on incorporation and does not have to wait for the receipt of the certificate of commencement of business. (Sec.149(7)).
3. A private company has no need to issue a prospectus or a statement in lieu of prospectus. (Sec.70(3)).
4. It can allot shares before the minimum subscription is subscribed for or paid.
5. There is no obligation on a private company to offer a new issue of shares to the existing share holders on pro-rata basis as right shares.
6. It need not hold a statutory meeting or file a statutory report with the Registrar. (Sec.165).
7. The minimum number of directors of a private company is only two and they are exempted from filing their consent with the Registrar or from holding qualification shares (Sec.252(2), 264(3), 266(5)).
8. It need not keep an index of members.
9. The quorum for the meetings of the shares holders of a private company is fixed at two members.
10. The rules regarding maximum managerial remuneration are not applicable to a private company. (Sec.198(1)).

All the private companies avail themselves of the privileges mentioned above but the independent private companies by which we mean those companies which are not subsidiaries of any public company enjoy some additional privileges which are detailed below:

1. There is no restriction on the remuneration of directors. So unlike public companies, it can pay more than 11 per cent of its profits in a year to its directors. (Sec.309(9)).

2. There is no need to file a statement with regard to the consent of directors to act as directors and to buy the qualification shares. (Sec.260(5)).

3. A director can participate in the discussion relating to any contract and can exercise his vote if he so desires.

4. A person can become the director of any number of companies at a time. (Sec.275-79).

5. The provisions regarding the appointment, reappointment and retirement of directors are not applicable to independent private companies. (Sec.266).

6. The number of directors can be increased or decreased without taking the consent of the Central Government. Also there is age limit for the appointment of directors. (Sec.259).

7. It may issue deferred shares without any restriction.

8. The restrictions regarding the loans to other companies do not apply to it. (Sec.370(2)).

9. If may purchase or subscribe to the shares or debentures of other companies in the same group.(Sec.372(4)).
10. It can keep its affairs secret and accordingly a non-member has no right to inspect or take copies of the profit or loss amount of the company filed with the Registrar.

Disadvantages of a private company

Despite the various privileges enjoyed by a private company, it also suffers from certain disadvantages some of which are as under:

1) It cannot issue share warrant under its common seal stating that the bearer of share warrant is entitled to the shares therein. (Sec.114)

2) A private company has to file annual list of its members and summary with the Registrar as per section 159.

3) A member of the private company shall not be entitled to appoint more than one proxy to attend on the same occasion and a proxy shall not be entitled to vote except in a poll.

4) A private company has to send a certificate to the Registrar stating that its annual turnover in the preceding three years never reached rupees one crore or more, that it did no hold 25% or more of paid up share capital of one or more public companies; and that since its last general meeting no body corporate has held 25% or more of its paid up share capital.

10.8 CONVERSION OF PRIVATE COMPANY INTO PUBLIC COMPANY

Section 43, 43-A and 44 of the Companies Act deal with the provisions under which a private company can become a public company. These provisions are discussed as under:

1. Conversion by default (Sec.43)

If a private company makes a default in complying with the essential requirements of a private company, it becomes a public company and loses the privileges of a private
company. In this case the provisions of the Companies Act apply to it as if it were a public company. However the relief in the following cases may be grant:

(a) If non-compliance was accidental or unknowing or
(b) If it is just and equitable to grant the relief.

But the grant of the above relief is discretionary and it can be given on an application made by the company or any interested person.

2. **Conversion by operation of law (Sec.43-A)**

Private companies enjoy certain privileges and get certain exemptions under the Act on the basis that they are family concerns in which the public is not directly interested. This section is applicable to those private companies which have employed public funds to a considerable extent and yet escaped the restrictions and limitations applicable to public companies. This section provides that a private company shall be deemed to be a public company:

i) if twenty five per cent or more of its paid up share capital is held by one or more bodies corporate. However, the shares held by a banking company as a trustee, executor or administrator of a deceased person shall not be taken into account. The term body corporate here means a public company or a private company which has becomes a public company by virtue of Sec.43-A.

ii) if it holds twenty five per cent or more of the paid up share capital of a public company having a share capital.

In the above cases the private company shall become a public company on and from the date on which the prescribed percentage is first held.

iii) if the average annual turn over of the private company for three consecutive financial years is rupees ten crore or more. It will become a public company on and from the expiry of three months from the last day of the period during which the prescribed turnover was achieved.
iv) if the private company invites, accepts or renews deposits from the public it shall become a public company on and from the date when such deposits were first accepted or renewed. However acceptance of deposits from the members of the company, directors and their relatives is excluded from the purview of this provision.

A private company which becomes a deemed public company has to observe the following rules:

a) Information to Registrar

Section 43A(2) provides that within three months of becoming a deemed public company, it must inform the Registrar so that he may delete the word ‘private’ before the word ‘limited’ from its name and also make necessary alternations in the certificate of incorporation as well as the Memorandum of Association. If the company makes default in complying with this provision, the company and every officer of the company who is in default is punishable with fine which may extend to Rs.500/- for every day during which the default continues.

b) Filling of certain certificates with the Registrar

The following certificates along with the annual return under section 161 are filed by a private company having share capital:

i) A certificate that since the date of the last annual return, no body corporate has held twenty five per cent or more of its paid up share capital, nor has it attained an average turnover of rupees ten crore during the relevant period and also that it has not accepted or renewed deposits from the public.

ii) A certificate that since the last general meeting, it has not held twenty five per cent or more of the paid share capital of one or more public companies.

Even after becoming a deemed public company, it may retain the features of a private company. It becomes a special type of public company. For example it may retain the three basic restrictions envisaged in the case of a private company.
On having become a deemed public company, it would continue to be so until it has again become a private company with the approval of the Central Government and in accordance with the provisions of the Act.

3. Conversion by choice (Sec.44)

A private company may voluntarily become a public company-

a) by passing a special resolution deleting the three restrictions of section 3(i), (iii) and

b) by filing with the Registrar a copy of the resolution along with a copy of the altered articles and a copy of prospectus or statement in lieu of prospectus and

c) by increasing the number of its members to seven and that of the directors to three.

If the company makes default in complying with the provisions of this section, the company and every defaulting officer of the company is liable to fine which may extend to Rs.500/- for every day during which the default continues.

10.9 CONVERSION OF PUBLIC COMPANY INTO PRIVATE COMPANY

Just as a private company can be converted into a public company, in the same way a public company can also be converted into a private company. The following procedure prescribed under Section 31 of the Act has to be adopted for this purpose:

i) The articles have to be altered by passing a special resolution to include the statutory restrictions imposed by the Act on private companies. Any provisions in the Articles which are inconsistent with the requirements of a private company like the power to issue share warrant to the bearer shall also be deleted.

ii) The approval of the Central Government shall be obtained for the purpose.
iii) A copy of the approval along with a printed copy of the altered Articles are to be filed with the Registrar within one month of the receipt of the Government approval.

The company becomes a private company on and from the date on which the approval of the Central Government is obtained. The words ‘Private Limited’ are appended to its name and it starts availing itself of all the privileges of a private company.

10.10 SUMMARY

A company, in its ordinary, non-technical sense, means a body of individuals associated together for a common objective, which may be business for profit or for some charitable purposes. From the juristic point of view, a company is a separate legal person distinct from its members. This principle of separate entity is known as the veil of incorporation. The effect of this principle is that there is a fictional veil between the company and its members. Sometimes, it may become necessary to break through the corporate veil and look at the persons behind the company. This is known as lifting of the corporate veil. Companies may be classified into various categories: according to incorporation – chartered companies, statutory companies and registered companies, according to liability – companies limited by shares, guarantee and unlimited companies, according to number of members – private and public company, according to control and management – holding and subsidiary company, according to ownership – government and non-government company and according to nationality – foreign and Indian company.

10.11 KEYWORDS

Company: A company, in its ordinary, non-technical sense, means a body of individuals associated together for a common objective, which may be business for profit or for some charitable purposes.
**Registered Company:** A registered company is one which is formed and registered under the Indian Companies Act, 1956 or under any earlier Companies Act in force in India.

**Public Company:** A public company means a company which is not a private company. Any seven or more persons can join hands to form a public company.

**Holding Company:** A company shall be deemed to be the holding company to another if that other is its subsidiary.

**One Man Company:** A one-man company is one of which almost the whole share capital is held by a single man who takes a few dummy members simply to meet the statute’s requirement regarding the minimum number of members – may be giving only one share to each of the dummy members.

### 10.12 SELF ASSESSMENT QUESTIONS

1. What is a company? Discuss its main characteristics.
2. What is the corporate veil? Under what circumstances can this veil be lifted?
3. Explain the different types of companies which may be incorporated under the Companies Act?
4. Define a private company? What privileges and exemptions are enjoyed by a private company.
5. When does a private company become a public company?

### 10.13 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.
LESSON 11
FORMATION OF A COMPANY

11.0 OBJECTIVE
This lesson discusses the process of formation of a company.

11.1 INTRODUCTION
A company is an association of persons formed for some common purpose. It is a complex, centralized, economic, administrative structure run by professional managers who hire capital from the investors. It is the most dominant form of business organization and it offers the privilege of limited personal liability for business debts. A company has neither a body, nor a soul, nor a conscience, nor is it subject to the limitations of the body; even then, it exists in the eyes of the law. It is a legal person just as much as a human being but with no physical existence. It is the only choice where the enterprise
requires a greater mobilization of capital which the resources of a few persons can not provide. Thus, the modern industrialized society is the outcome of the company form of organization. Companies in India are incorporated under the Companies Act, 1956. The process of formation of a company can be divided and discussed under the following four stages:

i) Promotion
ii) Incorporation
iii) Capital subscription
iv) Commencement of business

11.2 PROMOTION

Promotion is the first stage in formation of a company. This stage covers all the preliminary steps incidental to the formation of the company. It covers the questions like whether it should be a private company or a public company, what business is to be done by the company, when it is to be done, what its capital should be and whether it would be worth while to form a new company or take over the business of an already established concern. Promotion begins with the conception of an idea and it goes on to include preliminary investigations into the feasibility and preparation of necessary documents, making preliminary contracts, arrangement of finance etc. So promotion implies all the initial steps taken in the formation of a company.

“Promotion is the process of creating of specific business enterprise. The aggregate of activities contributed by all those who participate in the building of the business constitute promotion.”

Dr. Henry E. Hoagland

Thus, the promotion stage starts with the conception of an idea and it continues till the company is formally incorporated. All the preliminaries done for the formation of a company are included in the process of promotion. The persons who do the necessary
preliminary work incidental to the formation of a company are termed the promoters of the company. The necessary investigation regarding the business to be started and the assembling of the various factors like the selection of the site of business, deciding about the size of business, decision regarding the purchase of plant and machinery etc. form a part of the promotion stage. The efforts for the arrangement of finance are made and all the preliminary contracts are also entered into in the promoting stage. The promoters also prepare the necessary documents for the formation of the company. These documents generally include the memorandum of association and articles of association. The approval regarding the proposed name of the company is also sought from the Registrar of Companies before the preparation of the above documents.

**Promoters of a company**

The term promoter is not a legal term and neither has it been defined in the Companies Act anywhere. Still it is frequently used in the commerce literature and the Companies Act itself uses the word at some places in the Act for the purpose of imposing liability upon the promoters. However, inspite of its frequent use, there is no statutory definition of the term promoter. Simply stated, a promoter is a person who undertakes to form a company with reference to a given object and brings it into actual existence. Chronologically, the first persons who control the affairs of a company are its promoters. It is the promoters who take the necessary steps to get the company incorporated, provide it with a capital and acquire the business or property which it is to manage. A promoter is a person who brings about the incorporation and organization of a corporation. He brings together the persons who become interested in the enterprise, aids in procuring subscriptions and sets in motion the machinery which leads to the formation itself. The following are some of the interpretations of the term ‘promoter’ derived from the various case decisions:

A promoter is one who “plans to form a company, prepares memorandum of association and articles of association, gets them registered, looks for directors, enters
into preliminary contracts and makes arrangements for advertising and circulating the prospectus and placing the capital.”

**Palmer**

“A promoter is one who undertakes to form a company with reference to a given project and to set it going and who takes the necessary steps to accomplish that purpose.”

**Justice Cockburn**

Thus a promoter is a person who procures or aids in procuring the incorporation of a company. The promoter may be an individual, firm, association of persons or even a company. But everybody connected with the formation of a company is not a promoter. A person who acts in a professional capacity is not a promoter. Thus, solicitor, who prepares on behalf of the promoters the primary documents of the proposed company, is not a promoter. Similarly, an accountant, valuer, a surveyor or an engineer who helps in his professional capacity is not a promoter. Section 62(6) of the Companies Act also excludes such persons to act in a professional capacity for the formation of a company. But if any such person acts beyond the scope of his professional duty and helps in any way in the formation of the company, he will become a promoter. A person may, for example help in acquiring a patent for the company or in getting personnel for the company. Any such role may make him a promoter. Thus, whether a person is or is not a promoter of a company, is a question of fact depending upon the role performed by him in the formation of the company. It is pertinent to note that the functions of promoters come to an end as soon as they hand over the company to a governing body like the Board of Directors.

**Functions of promoters**

Promoters are the persons who undertake, do and go through all the necessary and incidental preliminaries for the formation of a company. They conceive the idea of forming the company with reference to a given object and then get it going. All the
functions before the registration of the company are performed by the promoters. More specifically, the following are included in the purview of their functions:

1. **Planning**
   It is the fundamental function of the promoters to make plans regarding the nature of business to be started. They decide what business should be done, when it should be done, where it should be done and how it should be done. They also decide the amount of capital required and the sources from which the capital will be acquired. In this way, the promoters determine the scope of the company.

2. **Nomenclature**
   The second major function of the promoters is to decide the name of the proposed company. They also decide the location of the registered office of the company and the objective of the company.

3. **Arrangement of necessary infrastructure**
   The promoters arrange the necessary infrastructural facilities like land, building, machinery and other equipments. If a company wants to purchase the business or assets of any person or persons, the promoters do the needful for this purchase.

4. **Preparation of documents**
   There are certain important documents which must be submitted to the Registrar for the registration of the company. Important among these are the memorandum of Association and Articles of Association. The promoters get these documents prepared with the help of legal experts.

5. **Arrangement of capital**
   The promoters have to make necessary arrangements for acquiring the capital. If the company to be incorporated is a public company and invitation is to be given to the public for the purchase of its shares, the promoters also have to prepare the
6. Consent of directors

The promoters decide the first directors of the company and get their consent to act as directors. Sometimes, they themselves may become the directors of the company.

7. Appointments

Promoters appoint the banker, the auditor, the legal adviser and the broker of the company. They also enter into pre-incorporation or preliminary contracts for the incorporation of the company.

8. Miscellaneous

The promoters submit the necessary documents along with the required fees to the Registrar of companies after completing the necessary legal formalities and get the certificate of incorporation. They also arrange licence, if any required for any purpose of the company.

Legal position of promoters

A promoter is a person who brings about the incorporation and organization of a corporation. He occupies an important position and has very wide powers relating to the formation of the company. However, as far as his legal position is concerned he is neither an agent nor a trustee of the proposed company. He is not the agent because there is no principal in existence. And he is not the trustee because there is no trust is existence. But it does not mean that he does not possess any legal relationship with the proposed company. He stands in a fiduciary relationship towards the company which he brings into existence.
Lord Cairns in Erlanges V. New Sombrero Phosphate Co. (1878) expressed his views about the legal position of promoters when he said that promoters stand in my opinion, undoubtedly in a fiduciary position. They have in their hands the creation and moulding of the company. They have the power of defining how and when in what shape and under what supervision the company shall start into existence and begin to act as a trading corporation.

In another case of Lyndey and Wigpool Iron Ore Co. V. Bird, it was observed by L. J. Lindley that a promoter although not an agent of the company nor a trustee for it before its formation, the old principles of the law of agency and of trusteeship have been extended and very properly extended to meet such cases.

The fiduciary position of promoters gives rise to the following legal consequences:

a) A promoter is not allowed to make any secret profits. If it is found that in any particular transactions of the company, the promoter has obtained a secret profit for himself, he will be bound to refund the same to the company.

b) He is not allowed to derive a profit from the sale of his own property unless all the material facts are disclosed. If a promoter contracts to sell the company a property without making a full disclosure, and the property was acquired by him at a time when he stood in a fiduciary position towards the company, the company either rescind the sale or affirm the contract and recover the profit made from it by the promoters.

Sec. 56 of the Companies Act, 1956 also makes it mandatory that the profits earned by promoters should be disclosed in the prospectus itself.

Thus promoter stands in a fiduciary relationship and it imposes an obligation on him to disclose fully all the material facts relating to the formation of the company. His dealings with the proposed company must be open and fair.
Remuneration of Promoters

A promoter has no right to get remuneration from the company for the services rendered to the company unless there is a specific contract to that effect. Since a company is a non entity before its incorporation, it can not make a valid contract with the promoter to pay him for his services. In Clinton’s case, (1908) 2 Ch. 515 a syndicate which promoted a company incurred certain expenses in respect of fees and stamp duty incidental to the formation of the company. The company was later wound up. Held, the syndicate was not entitled to recover the expenses incurred by it.

In the absence of a formal contract made by the company after its incorporation, a promoter has no legal right to sue the company for his remuneration and other preliminary expenses. However, the normal ways of rewarding the promoters for their valuable services are as follows:

i) They may be paid a lump sum either in cash or in the form of shares or debentures of the company.

ii) They may be given commission on the purchase price of the business taken over by the company.

iii) They may be inducted into the board of directors.

iv) They may sell their own property to the company at an inflated price.

v) They may be given an option to buy the shares of the company at par when their market price is higher.

Where the remuneration to the promoters has been paid within the preceding two years from the date of issue of the prospectus, it must be disclosed in the prospectus.

Liabilities of promoters

Although the promoters have a very important role in the formation of a company, their job is full of risks. They have to perform a number of jobs from the conception of the idea of floating a company to the registration of company for which they themselves
are responsible. So they have a very wide area of liabilities and they continue to be liable even after the creation of the company.

The promoters stand in a fiduciary relation i.e. relation requiring confidence or trust to the company which they promote. It is well described by Lord Cairns in Erlanger Vs. New Sombrero Phosphate Co. (1878) in the following words:

They stand, in my opinion, undoubtedly in a fiduciary position. They have in their hands the creation and moulding of the company. They have the power of defining how and when, what shape and under what supervision the company shall start into existence and begin to act as a trading corporation.

Thus the courts have imposed an important responsibility on the promoter to act as a fiduciary agent. The liabilities of the promoters can be summed up as follows:

1. **Liability for secret profit**

   It is the duty of the promoter not to make any profit at the expense of the company which is being promoted. If he makes any secret profit without full disclosure to the company, the company may on discovering it compel him to account for and surrender such profit. Similarly, if the promoter sells to the company his stock or shares at a price more than the market price, he may be liable to damages for the excess price received by him.

2. **Liability for non disclosing his profit and interest**

   It is one of the prime duties of a promotor that if he starts a company for the purpose of buying his property and wants to draw his payment from the money obtained from the shareholders, he must faithfully disclose all facts relating to the character or value of the property, or his personal interest in the proposed sale. The company will be entitled to set aside the transaction or recover compensation for its loss. He is guilty of breech of trust if the sells property to the company without informing the company that the property belongs to him. He may also commit breach of trust by accepting a bonus or
commission from a person who sells property to the company. In short, the chief duty of
the promoter as a fiduciary agent is to disclose to the company his position, his profit and
his interest in the property which is the subject of purchase or sale by the company.

The above liability becomes clear from the well known decision given by the
House of Lords in the case of Gluckstein V. Barnes (1990) in which a syndicate of
persons was formed to raise a fund, buy a property called “Olympia” and resell it to a
company. They first bought up some of the charges upon the property for sums below the
amount which the charges afterwards realized, and thereby made a profit of £ 20,000.
They bought the property for £ 1,40,000, formed a limited company, of which they were
the first directors. They issued a prospectus inviting applications for shares and disclosing
the two prices of £ 1,40,000 and £ 1,80,000 but not the profit of £ 20,000. Shares were
issued but the company afterwards went into liquidation. It was held that the promoters
ought to have disclosed to the company the profit of £ 20,000.

3. Liability of mis-statement in the prospectus

A promoter under section 62(1) is liable to pay compensation to every person who
subscribes to any shares or debentures on the basis of his faith in the prospectus and
incurs loss or damage due to misstatements contained therein.

Under section 63, he is criminally liable for mis-statement in the prospectus. Shareholders may hold him liable for omitting to state certain matters or to give report as
specified in section 56. Further, he may be sued for deceit under the general law in case
of fraudulent mis-statements in the prospectus.

4. Liability for misfeasance or breach of trust

Under section 543 of the Act, it is provided that if in the course of winding up of a
company, it appears that the promoter has misapplied or retained any money or property
of the company or has been guilty of any misfeasance or breach of trust in relation to the
company, the court may on the application of the official liquidator or of any creditor
make him liable and compel him to repay or restore the money or property or to
contribute such sum to the assets of the company by way of compensation in respect of the misapplication, misfeasance or breach of trust as the court thinks just.

5. **Public examination of a promoter**

   When an order has been made for the winding up of a company by the court, and the official liquidator has made a report to the court under this Act stating that, in his opinion, a fraud has been committed by the promoter in the promotion or formation of the company, the court may under section 478, after considering the report, order a public examination of his conduct and dealings.

6. **Liability for preliminary contracts**

   The promoters of a company are liable for the preliminary contracts which they have made before the incorporation of the company. These contracts are considered to be entered into by them in their personal capacity. In case of any failure to execute these contracts, they are themselves liable.

11.3 **INCORPORATION**

   It is the second stage in the formation of a company. The act of forming a corporation or company is called incorporation. It is the process of uniting a group of persons into a legal body by following the prescribed procedure. According to section 12 (21) of the Companies Act, any seven or more persons, or where the company to be formed is 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. Such a company may be either a company limited by shares or a company limited by guarantee or an unlimited company. However, the purpose for which a company is proposed to be established must be lawful. It must not be in contravention of the general laws of the country. Before applying for
registration and submitting the necessary documents, it must be ascertained from the Register of companies whether the proposed name has been approved by the Registrar.

The following documents as per section 33 of the Companies Act shall be presented for registration to the Registrar of the State in which the registered office of the company is to be situated:

1) The memorandum of association duly signed by the subscribers.

2) The articles of association, if any. It is important to note that a public company limited by shares need not prepare and file a copy of the articles if it has adopted table A given in the schedule to the Act.

3) The agreement, if any, which the company proposes to make with an individual for appointment as its managing or whole time director or manager.

4) A statutory declaration that all the legal requirements of the Act precedent to incorporation have been complied with. It must be signed by an advocate of the Supreme Court or High Court or an attorney or pleader entitled to appear before a High Court or a company secretary or a chartered accountant in whole time practice who is engaged in the formation of the company or by a person named in the Articles as a director, manager or secretary of the company.

5) A list of persons who have consented to become the directors of the company and their written consent to act as such and to take up the qualification shares as per section 266.

6) According to section 146(2), within 30 days of the incorporation of the company, a notice situation of the registered office of the company shall be given to the Registrar.

If the Registrar is satisfied that all the aforesaid requirements have been complied with by the company, he will register the company and issue the certificate of
registration. On the registration of the memorandum of a company, the Registrar shall certify under his hand that the company is limited. From the date of incorporation mentioned in the certificate of incorporation, the subscribers to the memorandum and any other persons, who may from time to time become members of the company, shall be a body corporate by the name contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company, and having perpetual succession and a common seal, but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is mentioned in this Act.

**Conclusiveness of the certificate of incorporation**

Section 35 of the Act provides that a certificate of incorporation given by the Registrar in respect of any association shall be a conclusive evidence that all the requirements of this Act have been complied with in respect of registration and matters precedent and incidental thereto, and that the association is a company authorized to be registered and duly registered under this Act.

Once the certificate of incorporation has been granted, no one can question the regularity of the incorporation, in Peel’s case. Lord Cairns remarked that once the certificate of incorporation is given, nothing is to be enquired into as to the regularity of the prior proceedings. Similar observations were made in the following cases:

In the case of Moosa Goolam Ariff V. Ebrahim Goolam Ariff LR(1913) 40 I.P.C. a company was issued the certificate of incorporation by the Registrar on the basis of the memorandum of association which was signed by two adult persons and by a guardian of the other members who were minors at the time. The guardian signed separately for all the 5 minors. The plaintiff contended that the certificate of incorporation should be declared void. Held, the certificate of incorporation was valid.

In the case of Jubliee Cotton Mills Ltd. V. Lewis (1924) A.C. 958, on 6th January, the necessary documents were delivered to the Registrar for registration. Two days after, the Registrar issued the certificate of incorporation but dated it 6th January instead of 8th
i.e. the day on which the documents were submitted. On 6th January, some shares were allotted to Lewis before the certificate of incorporation was issued. The question arose whether the allotment was void. The certificate of incorporation is conclusive evidence of all that it contains. In law, the company was formed on 6th January and therefore, the allotment of shares was held valid.

Thus the validity of the certificate can not be disputed on any ground whatsoever. However, where the company is registered with illegal objects, the certificate would not validate them. Once the company has been created, the only method to extinguish it is to resort to the provisions for winding up.

The following are the consequences of the certificate of incorporation:

1) The company becomes a distinct legal entity. Its life begins from the date mentioned in the certificate of incorporation.
2) It acquires perpetual succession.
3) The memorandum and articles of association become binding on the members as if they had been signed by the company and by each member.
4) The liability of the members of a limited company becomes limited.

14.4 CAPITAL SUBSCRIPTION

A private company or a public company not having share capital can commence business immediately on incorporation. Public companies having share capital have to pass through two more stages before they can commence business or exercise borrowing powers.

According to section 149(1) of the Companies Act, where a company having a share capital has issued a prospectus inviting the public to subscribe to its shares, it is necessary to appoint brokers, underwriters, bankers etc. and to arrange with the stock exchange for the enlistment of the securities, issue the prospectus etc. Thereafter, the following documents must be filed with the Registrar:
(i) A copy of the prospectus.

(ii) A statutory declaration verified by a director or the secretary of the company to the effect that:
   a) The directors have taken up and paid for the qualification shares in cash an amount equal to the amount payable by other subscribers on application and allotment;
   b) The shares allotted are not less than the amount of minimum subscription, and
   c) No money has become liable to refund by reason of the failure to apply for or to obtain permission of the stock exchange for dealing in its shares or debentures.

(iii) Where a company having a share capital has not issued a prospectus inviting the public to subscribe to its shares, the company shall not commence any business or exercise borrowing powers as per section 149(2) of the Act unless-
   a) a statement in lieu of prospectus has been filed with the Registrar,
   b) every director of the company has paid to the company, on each of the shares taken or contracted to be taken by him and for which he is liable to pay in cash, a proportion equal to the proportion payable on application and allotment on the shares payable in cash;
   c) a statutory declaration verified by one of the directors or the secretary of the company that the directors have taken up and paid for their qualification shares in cash an amount equal to that payable by other subscribers on application and allotment.

The company can not allot shares unless the amount of minimum subscription stated in the prospectus has been subscribed. If the company fails to receive the minimum subscription within 120 days of the issue of prospectus, all the money received shall be refunded without interest as per the provisions of section 69(5).
11.5 COMMENCEMENT OF BUSINESS

It is the last stage in the process of formation of a company. A private company can commence business immediately after incorporation. But in the case of a public company, the certificate for the commencement of business has to be obtained as per the provisions of section 149. This becomes necessary where a company has issued a prospectus inviting the public to subscribe to its shares. The certificate to commence business will be granted only after getting the declaration signed by any director of the company or its secretary that the following requirements have been complied with. This declaration should be filed with the Registrar. The conditions to be complied with are as follows:

a) Shares payable in cash must have been allotted up to the amount of the minimum subscription;

b) The directors must have paid in cash the application and allotment money in respect of the shares contracted to be taken by them for cash;

c) No money is liable to become refundable to the applicants by reason of failure to apply for or to obtain permission for shares for debentures to be dealt in on any recognized stock exchange.

If any company commences business or exercises borrowing powers before getting the certificate to commence business, every person who is responsible for the contravention shall, without prejudice to any other liability, be punishable with fine which may extend to five hundred rupees for every day during which the contravention continues.

When the Registrar is satisfied about the requirements, he will issue the certificate to commence business. If the company does not commence business within a year of its incorporation, it may be wound up by the court.

This is how companies are formed and registered under the Companies Act, 1956.
Preliminary contracts

Preliminary contracts or pre-incorporation contracts are those contracts which are made by the promoters on behalf of a company yet to be incorporated. These contracts normally relate to the acquisition of some property or right for the company. These contracts are made by the promoters as agents or trustees of the company. However, the company is not liable for the acts of promoters done before its incorporation because a company is a non-entity before incorporation. The legal position with regard to the pre-incorporation contracts can be summed up as follows:

1. These contracts do not bind the company even if the company has derived benefit out of these contracts. In English and Colonial Produce Co. Ltd. (1962) 2 Ch.435 C.A., on the request of the promoters of a company, a solicitor prepared the memorandum and articles of the company, paid the registration fee and got the company registered. Held, the company was not bound to pay for the services and expenses incurred by the solicitor since it was not in existence at that time.

2. A company can not sue and nor can it be sued for the enforcement of pre-incorporation contracts. In Natal Land and Colonisation Co. Ltd. V. Pauline Colliery Syndicate (19045) A.C. 120, the company promised C, an agent of a syndicate yet to be formed to grant to the syndicate a lease of a coal mine after the syndicate was registered. The lease was refused. Held, the company could not enforce specific performance against the syndicate as it could not make a binding contract before incorporation.

3. The pre-incorporation contracts made on behalf of the company can not be ratified even if these are for its benefit. Ratification is possible only where an agent has contracted on behalf of a principal who is in existence and competent to contract at the time of the making of the contract.

4. The promoters remain personally liable on a contract made on behalf a company not yet in existence, such a contract is deemed to have been entered into
personally by the promoters and they are liable to pay damages for failure to perform the promises made in the company’s name.

11.6 SUMMARY

The formation of a company is a lengthy process indeed. The stages in the formation are (a) promotion (b) incorporation (c) capital subscription and (d) commencement of business. The promotion stage starts with the conception of an idea and it continues till the company is formally incorporated. All the preliminaries done for the formation of a company are included in the process of formation. Incorporation of the company is the second stage of company formation. An application is made to the concerned Registrar for the registration of the company. The application for registration must be accompanied by the required documents along with the necessary filing and registration fee. A private company or a public company not having share capital can commence business immediately on incorporation. Public companies having share capital have to pass through two more stages before they can commence business or exercise borrowing powers namely capital subscription and commencement of business.

11.7 KEYWORDS

Promotion: Promotion means the discovery of business opportunities and the subsequent organisation of funds, property and managerial ability into a business concern for the purpose of making profits therefrom.

Promoter: A promoter is a person who undertakes to form a company with reference to a given object and brings it into actual existence.

Preliminary Contract: Preliminary contract refers to those agreements or contracts entered into between different parties on behalf and for the benefit of the company prior to its incorporation.
Certificate of commencement of business: A public company, having a share capital and issuing a prospectus inviting the public to subscribe for shares, will have to file a few documents with the registrar who shall scrutinise them and if satisfied will issue a certificate to commence business

11.8 SELF ASSESSMENT QUESTIONS

1. Who are the promoters? Discuss their liabilities.

2. “A promoter stands in a fiduciary relation towards the company he promotes”. Explain.

3. Explain the process of the formation of a company.

4. How is a company incorporated? Which documents are filed with the Registrar in that connection?

11.9 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.


LESSON 12

PROSPECTUS

STRUCTURE
12.0 Objective
12.1 Introduction
12.2 Meaning and contents of Prospectus
12.3 Statement in lieu of Prospectus
12.4 Liability for Misstatement in Prospectus
12.5 Minimum Subscription
12.6 Summary
12.7 Keywords
12.8 Self Assessment Questions
12.9 Suggested Readings

12.0 OBJECTIVE

The present lesson discusses about prospectus, statement in lieu of prospectus and liability for misstatement in prospectus.

12.1 INTRODUCTION

A private limited company is prohibited by its Articles from extending any invitation to the public to subscribe to any of its shares or debentures. A public limited company can invite monetary participation from the general public. It is the prospectus through which the company invites deposits or offers for shares or debentures from the public. The prospectus is the document which tells the prospective investors the future prospectus of the company and the purpose for which the capital is required so as to
enable them to make up their mind whether to invest in its shares or debentures or not. It serves the purpose of a window for the prospective investors through which they can gain a useful view of the salient aspects of a company. However, it is not essential for a public company to issue a prospectus. If the promoters are confident of raising the required capital privately from their relatives and friends, they need not issue a prospectus. In such a case, a statement in lieu of the prospectus must be filed with the Registrar of Companies.

12.1 MEANING AND CONTENTS OF PROSPECTUS

A private company is prohibited by its articles from extending any invitation to the public to subscribe to any of its shares or debentures. A public limited company can invite monetary participation from the general public. It is the prospectus through which the company invites deposits or offers for shares or debentures from the public. The prospectus is the document which tells the prospective investors about the future prospectus of the company and the purpose for which the capital is required so as to enable them to make up their mind whether to invest in its shares or debentures or not. It serves the purpose of a window for the prospective investors through which they can gain a useful view of the salient aspects of a company. However, it is not essential for a public company to issue a prospectus. If the promoters are confident of raising the required capital privately from their relatives and friends, they need not issue a prospectus. In such a case, a statement in lieu of the prospectus must be filed with the Registrar of Companies.

Sec.2(36) defines a prospectus as any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for subscription to or purchase of any shares in or debentures of a body corporate. Thus, the prospectus is an invitation for offers by a company i.e. it invites offers from the public to subscribe to the company’s shares or debentures. It is not an offer to the public because if any offer is made and the other party accepts it, it becomes a contract (Agreement which is enforceable by law).
The prospectus only invites offers from the public regarding subscription to the shares or debentures of the company and it is for the company to accept the offers or not.

The prospectus is a written document in the form of a notice, circular, advertisement etc. An oral invitation is not a prospectus. The invitation must be to subscribe to or purchase the shares or debentures of the company. An advertisement was given 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”. It was held to be a prospectus as it invited the public to purchase shares. (Parmatha Nath Sanyal V. Kali Kumar Dutt AIR 1925 Calcutta 714).

**Public Issue**

By the word “Issue” we mean that the prospectus has been issued to the public. But whether the prospectus has been issued to the public or not depends upon the circumstances of each case.

**Case I**: Some copies of the prospectus marked “for private circulation only” were circulated among the shareholders of a gas company in which the promoters were interested. It was not publicly advertised. It contained a statement that its copy had been filed with the Registrar. It was held that the prospectus was an offer of shares to the public. (South of England Natural Gas and Petroleum Company Ltd. (1911) I. Ch.513).

**Case II**: 1000 copies of a prospectus marked “strictly private and confidential” were printed. The directors distributed 200 copies to their own and the promoters’ friends and relatives. It was held that, it was not an invitation to the public. (Sherwell V. Combined Incandescent Mantles Syndicate (1907) W.N.110).

**Case III**: A document in the form of a prospectus was prepared by the directors and marked “strictly private and confidential.” It did not contain all the material facts required to be disclosed by the Companies Act. It was not publicly advertised. One of its copies was sent by its co-director to the solicitor who gave it to a client. The client sent it to his relative. Thus, the document passed through a small circle of the friends of the director. It
was held that the document did not amount to an issue of the prospectus. (Nash V. Lynde, (1929) A.C. 158).

The prospectus need not necessarily be issued by the company. The agents of the company like issuing houses may issue the prospectus on its behalf.

Contents of the prospectus

The prospectus is a document from which a prospective investor can have an idea of the future prospects of the company he is going to invest in. A small untrue statement can tilt the mind of the prospective investor. The Companies Act has provided for a large number of regulations to be observed at the time of issue of the prospectus. This has been done to protect the interests of the investing public from the frauds of the promoters. The Government has given the format of the prospectus in Schedule II of the Companies Act, 1956. Failure to comply with such provisions is an offence and it is punishable with imprisonment or fine or both. So, a great care should be taken while drafting the prospectus.

It is provided in Section 56 of the Act that every prospectus shall contain the matters specified in Schedule II of the Act. This schedule is divided into three parts. Part I contains the matters to be disclosed, Part II required the reports to be set out, while Part III is explanatory of parts I and II. The explanation of these parts is as under :

Part I

The following matters are to be disclosed in a prospectus :

1. a) The main objects of the company including the details about the signatories to the Memorandum. This is, however, not necessary when the prospectus is published as a newspaper advertisement.

b) The number and classes of shares. The interest of the shareholders in the property and profits of the company.
c) The number of redeemable preference shares specifying the date or notice required for redemption

2. Qualification shares of the directors, if any.

3. (a) Names, descriptions and address of the directors, or proposed directors, managing director, or manager.

   b) Contents of the Articles or of any contract relating to their appointment, remuneration and compensation for loss of office.

4. Where shares are offered to the public, the minimum subscription, which means the minimum amount which in the opinion of the promoters must be raised to provide for the purchase price of any property purchased or to be purchased, preliminary expenses, underwriting commission, repayment of money borrowed for these purposes and working capital.

5. The time of the opening of the subscription list.

6. The amount payable on application and allotment. If any prospectus was issued within two years, the details of the shares subscribed for and allotted.

7. The particulars about any option of preferential rights to be given to any person to subscribe for shares or debentures of the company.

8. The number of shares or debentures which within the two preceding years have been issued for a consideration other than cash.

9. Particulars about premium received on shares within the two preceding years or to be received.

10. Where any issue of debentures or shares is underwritten, the names of the underwriters, and the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations.
11. Particulars about vendors from whom any property has been or is to be acquired by the company and the price whereof is to be paid out of the proceeds of the issue.

12. The amount or rate of underwriting commission.

13. Preliminary expenses.

14. The amount paid within the last two years or to be paid to the promoters of the company. The statement must include any other benefit given.

15. The date of and parties to any material contract unless it is made in the ordinary course of business or two years before the date of the prospectus.

16. The names and addresses of the auditors, if any, of the company.

17. Full particulars about the interest, if any, of every director or promoter in the promotion of the company or in any property acquired by the company.

18. Where the shares are of more than one class, the rights of voting and the rights as to capital and dividend attached to the several classes of shares.

19. The restrictions, if any, imposed by the Articles on the right to attend, speak or vote at the meetings of the company, on the right to transfer shares and upon the directors of the company in respect of their powers of management.

20. The length of time for which the company has carried on business. If the company proposes to acquire a business which has been carried on for less than three years, the length of time during which the business has been carried on.

21. If any reserves or profits of the company have been capitalized, particulars of capitalization and particulars of the surplus arising from any revaluation of the assets of the company.

22. A reasonable time and place at which copies of all the accounts on which the report of the auditors is based may be inspected.
Part II

The following reports are required to be set out in a prospectus:

1. A report by the auditors of the company relating to profits and losses and assets and liabilities of the company. The report must refer to the rates of dividends, if any, paid by the company in respect of each class of shares for each of the five financial years before the issue of the prospectus. The report of the auditors must also state separately the profits and losses of the company’s subsidiaries and also the combined profits and losses.

2. If the company proposes to acquire any business, a report should be made by an accountant, whose name should be disclosed, upon the profits and losses of the business for five years before the date of the prospectus and the assets and liabilities of the business.

12.3 STATEMENT IN LIEU OF PROSPECTUS

A company need not approach the public for money. The promoters may tap their private resources or contacts for raising the requisite capital. In such a case no prospectus need be issued to the public, but promoters must prepare a document, akin to the prospectus known as “Statement in lieu of prospectus”. This document must be in the form set out in Schedule III of the Act and must contain practically the same information as is required in the prospectus. When a private company converts itself into a public company it must either issue a prospectus or file a statement in lieu of prospectus.

The document shall be delivered to the Registrar for registration at least three days before the first allotment of shares. This is intended to preserve an authoritative record of the terms and conditions of the capital issue. The statement must be signed by every director or proposed director or his agent. If a company fails to deliver a statement in lieu of prospectus, it cannot allot any shares or debentures. An allotment, if made, is voidable if the allottee notifies the company within 2 months after the statutory meeting or in case where there is no such meeting within two months after allotment.
If a company fails to fulfil the above conditions, the company and every director who has been knowingly a party to this contravention shall be liable for fine upto Rs.1,000. If a statement in lieu of prospectus delivered to the Registrar contains an untrue or a misleading statement, every person who authorized the delivery of the statement shall be liable to imprisonment for two years and fine of Rs.5,000.

The above provisions do not apply to a private company. (Section 70).

12.4 LIABILITY FOR MISSTATEMENTS IN PROSPECTUS

Golden rule as to the framing of prospectus. A prospectus constitutes the basis of the contract between the company and the person who purchases shares or debentures. The persons who are behind the company have all the knowledge or means of knowledge as to the present position and future prospects of the enterprise and the investing public has none. It is but fair that the former should not only disclose all the matters within their knowledge relating to the enterprise, which might affect the investing mind but should state them accurately, correctly and unambiguously. A prospectus must, therefore, tell the truth, the whole truth and nothing but truth. Also it must not conceal any fact which ought to be disclosed. This is known as the ‘golden rule’ as to the framing of the prospectus and was laid down by Kindersley V.C. in New Brunswick etc. Co. V. Muggeridge.

What is an untrue statement?

It is necessary to find out as to what constitutes an untrue statement. Whether a statement is untrue or not is to be judged by the context in which it appears and the totality of impression it would create. According to section 65(1) (a), “a statement included in a prospectus shall be deemed to be untrue, if the statement is misleading in the form and context in which it is included”. A statement, may be false, not only because of what it states but also because of what it conceals or omits. Where certain matter which is material enough has been omitted from the prospectus, the prospectus shall be deemed, in respect of such omission, to be a prospectus in which an untrue statement is
included. If taking the whole prospectus together, there was really a misrepresentation of fact, the contract may be set aside, though each statement by itself is literally true.

A person subscribing for shares as a result of a prospectus is not bound to verify the accuracy of the statements contained in it, and will be entitled to avoid the contract if they turn out to be untrue, even though he had the means of discovering the inaccuracy. In order to call a prospectus a ‘misleading prospectus’ there must be mis-representation of facts and not of law. A statement in the prospectus that property has been acquired but which has not been in fact acquired, will be a ground for an action against directors even if the property is acquired a few days after the allotment of shares. But where a prospectus represents that the company’s fully paid shares will be issued at half their nominal price whereas section 79 prohibits the issue of shares at a discount exceeding 10% it is a misrepresentation of law and a person deceived by it will have no remedy.

Who can be sued?

Where a person has bought shares on the faith of a prospectus which is misleading because of a mis-statement in or an omission from the prospectus, he may have a legal remedy against all or any of the following.

(i) the company;
(ii) every director;
(iii) every person whose name appeared in the prospectus as a proposed director;
(iv) every promoter;
(v) every person who has authorized the issue of the prospectus.

Onus of proof

An allottee must prove that:

(i) the misrepresentation was of fact;
(ii) it was in respect of a material fact;
(iii) he acted on the misrepresentation; and
(iv) he has suffered damages in consequence

Civil liabilities

A person who has subscribed for shares on the faith of the misleading prospectus has remedies against—

(a) the company, and

(b) the directors, promoters, and experts

Remedies against the company

A person who has been induced to subscribe for shares may (1) rescind the contract to take the shares; (2) claim damages.

1. Rescission of the contract

Where a person has purchased the shares of a company on the faith of a prospectus which contained an untrue or misleading, but not necessarily fraudulent statement, he can seek rescission of the contract. This right is based on the general rule that a contract induced by a material misrepresentation is voidable, and may, at the option of the party induced be rescinded and it makes no difference that the misrepresentation was an innocent one.

The right to rescind the contract is available if he proves the following:

(i) **Prospectus was issued by or on behalf of the company.** It must be established that the prospectus was issued by the company or by some one duly authorized by the company. If the prospectus was issued by the promoters and the board of directors have ratified or adopted the issue, the company will be responsible for it.

(ii) **Statement must be untrue.** The prospectus must contain a false statement whether fraudulent or innocent. False representation takes place when there is positive misstatement or a concealment of matters of fact. Section 65 provides that a statement included in a prospectus shall be deemed to be false or untrue if
the statement is misleading in the form and context in which it is included. The section also provides that in case the omission from a prospectus of any matter is calculated to mislead, the prospectus shall be deemed, in respect of such omission, to be a prospectus in which untrue statement is included.

(iii) **Statement must be a material misrepresentation.** The false statement contained in the prospectus must be material to the contract to take shares or debentures. Whether a particular misrepresentation is material or not is a question of fact in each case. A statement will be material misrepresentation if it is likely to influence the decision of the person who is considering whether to purchase shares or not.

(iv) **The misrepresentation must have induced the shareholder to take the shares and he must have relied on the statement in applying for shares.** But it is not necessary that he should have verified it before relying upon it. Misrepresentation must have been at least one of the inducements for the contract to purchase the shares, only then the contract can be rescinded. Where a person ignored the misrepresentation and relied only on an independent report, he cannot complain of misrepresentation. Further only original allotees can repudiate the allotment of shares on the ground of misrepresentation and not subsequent purchasers from them because the effect of a prospectus is exhausted as soon as allotment is made.

(v) **Misrepresentation must be of facts and not of law.** The statement which induced the shareholders to take shares must be one of fact and not merely an expression of opinion or expectation. Thus, the statement in the prospectus, that due to honest and efficient management the company is expected to progress by leaps and bounds, is only a statement of opinion and will give no right of rescission. Moreover, the representation must be of existing fact. Thus a calculation as to future profits cannot be taken as a statement of existing fact.
A misrepresentation of fact entitles the allottee to rescind the contract. But a misrepresentation of law in the prospectus cannot be pleaded as a ground for the rescission of the contract, because ignorance of law is no excuse.

(vi) **That he has taken action promptly to rescind the contract.** The shareholder must start proceedings for rescission within a reasonable time and before the company goes into liquidation.

**Loss of right to rescind the contract**

The subscriber loses his right to rescind the contract in the following cases:

(a) **Unreasonable delay**: The right to rescind is lost if the shareholder fails to take any action within a reasonable time after he has come to know the misrepresentation in the prospectus. Shareholder must make up his mind as to accept or rescind the contract. In one case even a lapse of fifteen days after the shareholder became fully aware of the circumstances entitling him to apply for rescission was held to deprive him of his right to rescind the contract.

(b) **Affirmation**: If the shareholder, with full knowledge of misrepresentation in the prospectus, affirms his contract for purchase of shares he cannot rescind the contract afterwards. However, affirmation may be express or implied.

(c) **Commencement of winding up**: The right of rescission is lost if the shareholder does not exercise the right until after the commencement of winding up. Accordingly, if a shareholder having a right to rescind the contract for shares is on the register of members at the commencement of the winding up he cannot escape liability as a contributory unless he has commenced legal proceedings to enforce rescission before the date of the winding up.

2. **Right of action for damages**

In cases where misstatement in the prospectus amounts to fraud, injured party is also entitled to sue the company for damages provided he has rescinded his contract in
time. This remedy is available even after the company has gone into liquidation. He cannot both retain the shares and get damages against the company. However rescission is not possible as where the company has gone into liquidation, as action for damages is also not maintainable.

In actual practice suits for damages against the company are seldom resorted to. But damages are claimed from the directors, promoters and other officer who had authorized the issue of the prospectus. If the action is against the directors or promoters or other officers of the company, the allottee need no rescind the contract.

**Remedies against the directors, promoters and experts**

Any person who has purchased shares or debentures on the faith of the prospectus containing the untrue statement may sue:

1. every director;
2. every person whose name appeared in the prospectus as a proposed director;
3. every promoter; and
4. every person who authorized the issue of the prospectus.

The aggrieved person may claim:

1. **Compensation under section 62**

Directors, promoters and all others who authorized the issue of the prospectus are liable to compensate person who subscribe for shares on the faith of the prospectus for loss sustained by reason of any untrue statement in it. However, it is immaterial whether the director sees the prospectus or not and it is enough if he authorizes its issue. Moreover, the allottee does not have to prove that the director knew that the statement in the prospectus was true. It is the directors who are supposed to know what is true and is untrue.

The liability consists in paying damages by way of compensation to the aggrieved party. The principle of measuring damages is same as stated in section 73 of the Indian
Contract Act, 1972. The compensation payable will be the difference between the price paid for the shares or debentures and their value at the date they were allotted to the subscriber.

**Defences of directors, promoters, etc. (Section 62(2)).**

The persons sued for damages can escape liability for damages by successfully pleading any of the following defences:

(i) **Withdrawal of consent.** A director may escape liability if he proves that he withdrew his consent to act as a director before the prospectus was issued and it was issued without his authority or consent.

(ii) **Issue without knowledge.** A director will not be liable if the prospectus was issued without his knowledge or consent and that on becoming aware of its issue, he gave reasonable public notice to that effect.

(iii) **Ignorance of untrue statement.** Sometimes a director may be ignorant of the untrue statements contained in the prospectus. Such a director can defend himself by proving that after the issue of prospectus and before allotment, he on becoming aware of the untrue statement in it, withdrew his consent and gave reasonable public notice of the withdrawal and the reasons for it.

(iv) **Reasonable ground for belief.** A director will also be protected if he proves that he had reasonable grounds to believe and did believe until the time of allotment of shares or debentures that the statement was true.

(v) **Statement of expert.** A director will also be not liable if he proves that the statement was a correct copy or a correct and fair extract from the report of an expert who was competent to make it and that person had given the consent to the issue of the prospectus and had not withdrawn the consent.

(vi) **Correct copy of an extract.** A director will also be protected if he proves that the statement was a correct and true copy of an official document.
Defences of an expert (Section 62(3)).

An expert will not be liable if he can prove—

(ii) that he withdrew in writing his consent to the issue of the prospectus before it was delivered to the Registrar for registration;

(ii) that after delivery but before allotment of shares he became aware of a false statement in the prospectus, and he publicly withdrew his consent in writing and gave the reasons thereof;

(iii) that he was competent to make the statement and had reasonable grounds to believe and did upto the allotment of shares believe that the statement was true.

Right of contribution (Section 62(5))

Where any director or officer of the company is compelled to pay damages under section 62, he is entitled to recover pro rata contribution from any other person who would have been liable had the proceedings been instituted against him, unless the former person was, and the latter person was not guilty of fraudulent misrepresentation.

2. Damages for non-compliance with Section 56

The omission from prospectus of a matter required to be included by Section 56, may give rise to an action for damages at the instance of a shareholder who has suffered the loss thereby, even if the omission does not make the prospectus false or misleading.

It should be noted that the remedy to the subscriber is only of recovering damages and not of rescission. Where, however, omission amounts to fraud or misrepresentation, a right of rescission will also be available as provided by section 19 of the Indian Contract Act, 1872.

However the person would not be liable if he proves that

(a) he had no knowledge of the matter not disclosed in the prospectus

(b) the non-compliance arose from an honest mistake of fact on his part. or
The non-compliance was not material and the court thinks that he ought to be excused.

3. Damages under general law

An allottee may bring an action for deceit against the directors under general law as provided by section 19 of the Indian Contract Act, 1872. The remedy under general law shall be available even where:

(i) the right of rescission as against the company is lost either through laches or negligence; or

(ii) the company goes into liquidation.

But the plaintiff will have to establish the following:

(a) There was a fraudulent misstatement. In a suit for deceit against the directors the allottee must prove affirmatively that the statement upon which he acted was false and which was known to the directors to be false, or was made by them recklessly or without care, whether it is true or false. But directors would not be liable for damages for false statements in a prospectus if they honestly believed them to be true, even if there was no reasonable ground for such belief.

(b) False representation related to some existing material facts. The aggrieved shareholder must also prove that the fraudulent statement was made in respect of some existing facts which are material to the contract of purchasing shares.

(c) Plaintiff was the original allottee. A false statement in a prospectus will render the directors liable to the original allottees only and not to subsequent purchasers from them.

Criminal liability of directors. Every person who authorized the issue of a prospectus containing untrue statement shall be punishable with imprisonment which may extend to
two years or with fine which may extend to Rs.5,000 or with both. The accused person, however, may not be liable if he proves—

(a) that the statement was immaterial, or

(b) that he had reasonable ground to believe and did believe up to the time of the issue of the prospectus that the statement was true. (Section 63).

The punishment for issuing an application for shares or debentures which is not accompanied by a prospectus is a fine up to Rs.5,000.

**Penalty for fraudulently inducing persons to invest money (Section 68).** Any person who makes an untrue, deceptive, or misleading statement in a prospectus with a view to inducing persons to invest money shall be liable for imprisonment for a term which may extend to five years or fine up to Rs.10,000 or both. This section attempts at preventing fraud in connection with obtaining capital from public.

**Issue and allotment of shares in fictitious names (Section 68-A)**

Benami shareholding and shareholding in the name of fictitious or non-existing persons are common. The object is to avoid tax. Section 68-A makes it an offence to make applications for shares in the name of, or to induce the allotment or transfer of shares to fictitious persons. The punishment in such cases is imprisonment which may extend to five years.

The company has to reproduce in every prospectus and application form the provisions of section 68-A(1).

**12.5 MINIMUM SUBSCRIPTION**

When a public company invites the public to subscribe for its shares, it cannot allot those shares until the minimum amount stated in the prospectus has been subscribed. This amount stated in the prospectus is known as the ‘minimum subscription’.

The minimum subscription is not a sum fixed by the articles or calculated as a percentage of the shares issued under the prospectus. It is the minimum amount stated in
the prospectus which in the opinion of the directors must be raised to provide for the matters specified below:

(a) the purchase price of any property purchased or to be purchased;
(b) the preliminary expenses and any underwriting commission payable to the company;
(c) repayment of money borrowed by the company in respect of any of the foregoing matters;
(d) working capital; and
(e) Any other expenditure stating the nature and purpose thereof and the estimate amount in each case.

The object of the minimum subscription provision is to prevent the company getting underway until it has raised the capital needed to carry out the objects for which it has invited the public to participate. This also affords protection to the creditors by ensuring that a limited company is not able to incur commitments if it is grossly undercapitalized.

A company making any rights/public issue of shares/debentures shall not make allotment unless it receives a minimum of 90 per cent subscription against the entire issue within 90 days from the date of closure of the issue. If the subscription to this extent is not received, the entire amount collected with applications would have to be refunded to the applicants at the end of 120 days from the closure of issue. The refund is to be made without interest within 10 days from the 120th day. If the refund is delayed, then interest @ 15 per cent per annum is also to be paid.

Consequences when minimum subscription is not received

All moneys received from applicants for shares must be deposited and kept deposited in a scheduled bank until the certificate to commence business is obtained.
When the minimum subscription is received within the stipulated period, the ban imposed by sec. 69(5) disappears and the company is free to make allotment even after the expiry of 120 days subject to the other requirement of the Act.

An allotment made in contravention of the restriction of the minimum subscription is not void but only voidable and the applicant may avoid the allotment within the time specified in section 71(1).

**Example** : The company by mistake allotted 40,000 shares before the minimum subscription had been subscribed. It was held that the allottees had a right to rescind the allotment and on option given by the company to every allottee to have the allotment cancelled and money returned was valid. (Finance and Issue Ltd. V. Canadian Produce Corporation Ltd. (1905) 1 Ch. 37).

**Underwriting Commission (Section 76)**

When a company offers its shares to public, it often wants that the whole issue should be taken up. Consequently, a company is usually willing to pay a small commission on all the shares offered to the public to any one who undertakes to take all the shares, if the public do not take. This is known as ‘underwriting’. It consists of an undertaking by some person or persons that if the public fails to take up the issue, he or they will do so. In return for this undertaking, the company agrees to pay the underwriters a commission on all shares, whether taken by the public or by the underwriters. It is, thus in the nature of an insurance against the possibility of inadequate subscription. It is usual to underwrite even when a company is sound and the shares are popular, since changes in the international situation or financial state of the country can affect an issue adversely.

A company may pay a commission to any person in consideration of his subscribing or agreeing to subscribe for shares, or procuring or agreeing to procure, subscriptions for any shares in the company. Underwriting commission may be paid only if the following conditions are present:

1. The payment of the commission must be authorized by the articles of association.
2. The underwriting commission paid or agreed to be paid shall not exceed 5 per cent of the issue price of shares. In case of debentures, it shall not exceed 2-1/2 per cent of the issue price. The amount of commission shall also not exceed the amount authorized by the articles of association.

The percentage of commission fixed by section 76 only indicates the quantum and not the source from which it is to be paid, i.e. the commission may be paid out of capital or profits.

3. The amount paid or agreed to be paid must be—
   (a) disclosed in the prospectus if shares are offered to the public, or
   (b) in other cases, disclosed in the statement in lieu of prospectus delivered to the Registrar.

4. The number of shares or debentures which persons have agreed for a commission to subscribe for absolutely or conditionally is disclosed in the prospectus or statement in lieu of prospectus.

5. A copy of the contract for the payment of the commission must be delivered to the Registrar along with the prospectus or statement in lieu of prospectus. Where shares or debentures are not offered to the public commission cannot be paid to a person for his subscribing or agreeing to subscribe for the same.

If default is made in complying with the provisions of section 76, the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs.500.

12.6 SUMMARY

A document inviting offers from the public for the subscription of shares or debentures of a company is known as prospectus. The prospectus is a document from which a prospective investor can have an idea of the future prospectus of the company he is going to invest in. Section 56 of the Companies Act states that every prospectus shall
contain the matters specified in Schedule II of the Act. A public company having a share capital which does not issue a prospectus is required to deliver to the Registrar a statement in lieu of prospectus, at least three days before the allotment of shares. It is the duty of those persons who issue or authorize the issue of prospectus to take reasonable care that there is no misrepresentation or concealment of any material fact. This is known as the golden rule as to the framing of a prospectus. If there is any misstatement of a material fact in the prospectus or if the prospectus is wanting in any material fact, there may be civil liability or criminal liability. When a public company invites the public to subscribe for its shares, it cannot allot those shares until the minimum amount stated in the prospectus has been subscribed. This amount stated in the prospectus is known as minimum subscription.

12.7 KEYWORDS

Prospectus: A document inviting offers from the public for the subscription of shares in on debentures of a company is known as a prospectus.

Minimum Subscription: Minimum subscription is the amount which, in the opinion of the board of directory, must be raised by the issue of share capital.

12.8 ASSESSMENT QUESTIONS

1. What is a prospectus? Discuss its contents.
2. What is the golden rule of framing a prospectus and discuss the consequences of a mis-statement in a prospectus?
3. Explain the term ‘minimum subscription’. What is the effect of allotting shares without minimum subscription having been subscribed?
4. Explain the civil and criminal liabilities for mis-statement in a prospectus.
5. When should a statement in lieu of prospectus be issued? Do you notice any substantial differences between a prospectus and a statement in lieu of prospectus.
6. Write short notes on:
   
   (a) Statement in lieu of prospectus
   
   (b) Minimum subscription

12.9 SUGGESTED READINGS

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.


LESSON 13
SHARE AND SHARE CAPITAL

STRUCTURE
13.0 Objective
13.1 Introduction
13.2 Meaning of Share
13.3 Stock and Shares
13.4 Types of Shares
13.5 Application and Allotment of Shares
13.6 Calls on Shares
13.7 Share Certificates and Share Warrants
13.8 Transfer of Shares
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13.11 Forfeiture of Shares
13.12 Share Capital
13.13 Further Issue of Capital
13.14 Voting Rights
13.15 Summary
13.16 Keywords
13.17 Self Assessment Questions
13.18 Suggested Readings
13.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Define a share and explain the different types of share.
(b) Discuss the general principles regarding allotment of shares.
(c) Describe the requisites of a valid call.
(d) Distinguish between share certificate and share warrant.
(e) Explain the procedure of transfer of shares.
(f) Discuss the different types of share capital.
(g) Explain the steps to be taken for raising additional equity capital.

13.1 INTRODUCTION

Shares constitute the share capital of a company. The prima facie evidence of the title of members to the shares held is the share certificate. Share certificate is issued by the company under its common seal specifying the number of shares held by a member. Share capital is not an essential condition for the incorporation of the company under the Companies Act, but where the memorandum provides for share capital, it must state the amount of capital and its division into the various types of shares and the number and value of those shares.

13.2 MEANING OF SHARE

A share is the interest of a shareholder in a definite portion of the capital. It expresses a proprietary relationship between the company and the shareholder. A shareholder is the proportionate owner of the company but he does not own the company’s assets which belong to the company as a separate legal entity. Section 2(46) defines a share as, “A share in the share capital of a company and includes stock except where a distinction between stock and shares is expressed or implied.” An exhaustive
A definition of share has been given by Farwell J. in Borland’s Trustee V. Steel Bros in the following words:

“A share is the interest of a shareholder in the company, measured by a sum of money, for the purpose of liability in the first place, and of interest in the second, but also consisting of a series of mutual covenants entered into by all the shareholders inter se in accordance with the Companies Act.”

A share is a personal estate capable of being transferred in the manner laid down in the articles of association. It is a movable property which can either be mortgaged or pledged. Share is included in the definition of ‘goods’ under the provisions of the Sale of Goods Act, 1930.

Every share issued by a company must be numbered so that one share may be distinguished from another share. A certificate of shares issued by a company under its common seal specifies the shares held by any member. The share certificate is the prima facie evidence of the title of the member to such shares. (Section 84(1)). The share certificate is not a negotiable instrument.

13.3 STOCK AND SHARES

Stock

When shares are fully paid up, they may be converted into stock. Stock is simply a set of shares put together in a bundle. It is the aggregate of fully paid shares legally consolidated. The aggregate can be split up into fractions of any amount without regard to the original nominal amount of shares. The issue of partly paid up stock is invalid.

The use of the term ‘stock’ merely denotes that a company has recognized the fact of the complete payment of the shares and that the time has come when these shares may be assigned in fragments, which for obvious reasons, could not be permitted before.

A company limited by shares, may, if so authorized by its articles, convert all or some of the fully paid-up shares into stock or reconvert its stock into fully paid up shares.
of any denomination. A company cannot issue stock directly but can only convert fully paid-up shares into stock.

**Stock and shares distinguished.** The terms ‘shares’ and ‘stock’ differ in many respects. “The difference between shares and stock has been likened to the difference between a bucket full of peas one of which, though, capable of being handled along with others, retain its identity as a separate unit, and a bucket full of water, each drop of which coalesces with the rest.”

The main points of distinction between the two are as under:

1. A share is one of a number of individual units into which the capital of a company is divided. Stock is the capital in the form of a fund which may be divided into any desired amount. Thus, shares are in units, whereas stock is in lump holding.

2. Shares may be partly or fully paid-up, but stock must be fully paid.

3. Shares can be issued directly but stock cannot be issued directly.

4. Share has a nominal value, whereas stock has none.

5. Shares must bear distinctive numbers, while stock is never numbered.

6. Shares are of equal denomination while stock may be split into unequal amounts.

**13.4 TYPES OF SHARES**

According to Section 86 of the Companies Act, a company can issue only two types of shares –

(a) Preference shares; and

(b) Equity shares.

A private company which is not a subsidiary of a public company or shares issued before April 1, 1956, are not covered by this section. The company which issued shares of different kinds before 1st April, 1956, will be able to retain these shares.
Preference shares. A preference share must satisfy the following two conditions:

(i) It shall carry a preferential right as to the payment of dividend at a fixed rate; and

(ii) In the event of winding up, there must be a preferential right to the payment of the paid up capital.

These are two dominant characteristics of preference shares. A preference share may or may not carry such other rights as:

(a) a preferential right to any arrears of dividend;
(b) a right to share in surplus profits by way of additional dividend;
(c) a right to be paid a fixed premium specified in the memorandum; and
(d) a right to share in surplus assets in the event of a winding up, after all kinds of capital have been repaid.

Equity shares. All shares which are not preference shares are equity shares. Equity shareholders have the residual right of the company. They may get higher dividend than preference shareholders if the company is prosperous or get nothing if the business of the company flops. In the winding up, the equity shares are entitled to the entire surplus assets remaining after the payment of the liabilities and the capital of the company, unless the articles confer right on the preference shares a right to participate in the distribution of surplus assets.

Kinds of preference shares. Following are the various kinds of preference shares:

1. **Cumulative and non-cumulative preference shares.** With regard to the payment of dividend, preference shares may be cumulative or non-cumulative. In the case of cumulative preference shares, if the profits of the company in any year are not sufficient to pay the fixed dividend on the preference shares, the deficiency must be made up out of the profits of subsequent years. The accumulated arrears of dividend must be paid before anything is paid out of the profits to the holders of any other class of shares. In the case of non-cumulative preference shares, the
dividend is only payable out of the net profits of each year. If there are no profits in any year, the arrears of dividend cannot be claimed in the subsequent year. Preference shares are presumed to be cumulative unless expressly described as non-cumulative. Any ambiguous language in articles will not be enough to make them non-cumulative.

2. **Participating and non-participating preference shares.** Participating preference shares are those shares which are entitled, in addition to preference dividend at a fixed rate, to participate in the balance of profits with the equity shareholders after they get a fixed rate of dividend on their shares. The participating preference shares may also have the right to share in the surplus assets of the company on its winding up. Such a right must be expressly provided in the memorandum or the articles of association of the company. The articles may provide for the creation of cumulative and participating preference shares conferring on the holders of such shares a right to participate in surplus profit up to a fixed percentage.

Non-participating preference shares are entitled only to a fixed rate of dividend and do not share in the surplus profits. The preference shares are presumed to be non-participating unless expressly provided in the memorandum or the articles or the terms of issue.

3. **Convertible and non-convertible preference shares.** Convertible preference shares are those shares which can be converted into equity shares within a certain period. Those shares, which do not carry the right of conversion into equity shares are called non-convertible preference shares.

4. **Redeemable preference shares.** According to Section 80, a company limited by shares, if so authorized by its articles, may issue redeemable preference shares. Such shares may be redeemed either after a fixed period or earlier at the option of the company. In the case of irredeemable shares, the capital is to be returned on the winding up of the company.
13.5 APPLICATION AND ALLOTMENT OF SHARES

A prospectus issued by a company inviting the public to subscribe to the shares of a company is a mere invitation. An application for shares is an offer by a prospective shareholder to take shares. When an application is accepted it is an allotment. It is generally neither more nor less than the acceptance by the company of the offer to take shares. Allotment creates a binding contract between the parties.

Allotment as such has not been defined in the Companies Act. It is an appropriation by the directors out of the previously unappropriated capital of a company of a certain number of shares to a person. Till such allotment is made, shares as such do not exist. It is only by an allotment in this sense that shares come into existence. Where forfeited shares are reissued, it is not an allotment but a sale.

**General principles regarding allotment.** The ordinary law of contracts applies to agreements to take shares in a company. Thus, the allotment to be valid must be made in accordance with the principles of the law of contract relating to offer and its acceptance. An offer to take share must be made in writing which may be accepted by the company by allotting the shares to the applicants.

1. **Proper authority.** Allotment must be made by the directors at a properly constituted Board meeting or by a committee of the Board where the directors have power to delegate their powers to such a committee. Where the directors delegate their powers to make allotment to the general managers of the company and there is no such provision in the articles the allotment made by the general manager is void.

2. **Absolute and unconditional.** The allotment must be absolute and unconditional. If an application for shares is made subject to a condition, such a condition becomes the part of the offer and an allotment disregarding the condition may be repudiated by the allottee.

3. **Within reasonable time.** An application for shares must be accepted within a reasonable time. If there is undue delay in the allotment the offer lapses.
4. **Must be communicated.** Allotment by itself does not constitute acceptance of offer for shares. It must be communicated to the applicant. Notice of allotment may be given by post and in such a case the contract is complete when the letter is posted even though it is never received.

5. **Revocation of the offer.** An application for shares can be revoked at any time before acceptance is communicated.

**Example:** H applied for shares in a company. Shares were allotted to him. The letter of allotment was sent to the company’s agent to deliver by hand to H. Before the letter was delivered, H withdrew his application. It was held that there was no allotment. (Re National Savings Bank Association (1867) L. R. Eq. 9).

The above rule is now subject to an exception. Where an application is made in response to a prospectus issued generally, the application cannot be withdrawn until after the expiration of the fifth day after the time of the opening of the subscription list. (Section 72(5)). This has been provided to lessen the inconvenience caused to companies by ‘stags’ who withdraw their application before allotment when they feel that the issue has not been successful.

**Effect of Non-compliance of general provisions**

The allotment will be null and void if general provisions are not complied with.

**Statutory provisions**

As far as private companies are concerned the Companies Act does not prescribe any restrictions on them as to the allotment of shares and debentures. However, the Companies Act prescribes certain restrictions regarding the allotment of shares and debentures by public companies. Such restrictions may be discussed under the following two heads:

(i) When no public offer is made.

(ii) When public offer is made.
(i) **When no public offer is made.** A company having a share capital which has not issued a prospectus or which has issued a prospectus but has not proceeded to allot the shares, shall not make a first allotment of its shares unless it has delivered a statement in lieu of prospectus to the Registrar at least 3 days before the allotment. The statement shall be signed by every person who is named therein as a director or proposed director of the company. (Sec. 70(1)).

If a company acts in contravention of this section, the allotment shall be irregular and voidable at the option of the allottee. Further, the company and every officer in default shall be punishable with fine which may extend to one thousand rupees. (Sec. 70(4)).

(ii) **When public offer is made.** In the case of a public company offering shares and debentures to the public for subscription, the provisions relating to allotment may be discussed under the following three heads:

1. **First allotment of shares**

The Companies Act, 1956, prescribes the following restrictions which must be complied with before a public company proceeds to make allotment of shares:

(i) **Registration of prospectus.** The company must deliver a copy of the prospectus to the Registrar on or before the date of its publication. the prospectus must be signed by every person who is named therein as a director or proposed director of the company. (Sec. 60(1)).

(ii) **Minimum subscription.** No shares which are offered to the public for subscription can be allotted until the minimum subscription stated in the prospectus has been subscribed and the amount payable on application has been received in cash by the company. (Section 69(1)).
The amount stated in the prospectus shall be reckoned exclusively of any amount payable otherwise than in cash. (Section 69(2)).

A company making any rights or public issue of shares debentures etc. must receive a minimum of 90 per cent subscription against the entire issue before making an allotment of shares or debentures to the public. If minimum amount of 90 per cent is not received, the entire amount collected with applications shall be refunded to the applicants at the end of 90 days from the closure of the issue. If there is a delay in refund of such amount by more than 10 days, the company will pay interest at the rate of 15 per cent annum for the delayed period.

(iii) Application money. The money payable on application for each share shall not be less than 5 per cent of the nominal value of the shares (Section 69(3)). All moneys received from applicants for shares must be deposited and kept deposited in a scheduled bank (i) until the certificate to commence business is obtained or (ii) where the certificate of commencement has been received until the entire amount payable on applicable for shares in respect of the minimum subscription has been received. (Section 69(4)). A condition requiring an applicant for shares to waive a breach of the above requirements is void. (Sec. 69(6)).

(iv) Opening and closing of the subscription list. Where shares are offered by a prospectus no allotment shall be made until the beginning of the fifth day after the day on which prospectus is first issued or on such later day as may be specified in the prospectus. This date is known as the ‘opening of the subscription list’. The object of this is to give time for consideration before submission of applications. Where after the issue of the prospectus a public notice is given by some responsible person, disclaiming his responsibility for the issue of the prospectus, no allotment shall be made until the beginning of the fifth day after that on which such public notice is first given. (Section 72(1)). The prospectus shall be construed to have been issued generally from the date it is first issued as a newspaper advertisement or if it has not been so issued from the date on which it is first issued in any manner. (Section 72(2)).
A company may proceed to allot shares soon after the opening of the subscription list. In case of listed shares, however, the subscription list must be kept open for at least 3 days under the rules of recognized stock exchanges. The prospectus generally states the time when the subscription lists will be closed.

The allotment of shares in contravention of these provisions is valid. But the company and every officer who is in default shall be liable to a fine upto Rs.5,000 (Section 72(3)).

An application for shares shall not be revocable until after the expiry of the fifth day after the opening of the subscription list. (Section 72(5)). The object of these provisions is to discourage the activities of stags.

(v) Shares and debentures to be dealt on a stock exchange. It is usual for companies to state prominently on the face of the prospectus that an application has been made or will be made to a stock exchange for quotation of the shares or debentures offered for subscription. The object underlying this statement is to give an assurance to the intending investor that the shares become marketable and to induce him to subscribe for them on that basis. Although there is no guarantee that the application for quotation will be granted by the stock exchange authorities, the public assumes that the permission is likely to be granted and is thereby encouraged to subscribe. In many cases inspite of this statement contained in the prospectus the necessary permission is not sought or sought only after considerable delay.

To remove this lacunae the Companies Act has been amended in 1988 to provide for compulsory listing of public issues. The provisions of section 73 are as under:

Every company issuing shares or debentures to the public by issue of prospectus, shall before such issue, make an application to one or more recognized stock exchanges for permission for enlistment of its shares or debentures (Sec. 73(1)).

Where a prospectus states that an application under Section 73 (1) has been made for permission for the shares or debentures offered thereby to be dealt in on one or more recognized stock exchanges, such prospectus shall state the name of the stock exchanges.
Any allotment made on an application in pursuance of such prospectus shall be void if the permission has not been granted by the stock exchange before the expiry of ten weeks from the date of closing of subscription list. Where an appeal against the decision of any recognized stock exchange refusing permission for the shares or debentures to be dealt in on that stock exchange has been preferred under Section 22 of the Securities Contracts (Regulation) Act 1956, such allotment shall not be void until the dismissal of the appeal.

If the application for permission made is not disposed of within the time specified in Section 73(1) then it shall be deemed that permission has not been granted (Sec.73(5)).

Where the permission has not been applied under Section 73(1) or such permission having been applied for, has not been granted, the company shall forthwith repay all moneys received from the applicants. Failure to repay the money within 8 days will make the company and its officers liable to repay that money with interest between 4 to 15 per cent having regard to the period of delay. (Sec. 73(2)).

**Return of excess money where permission granted**

Where permission has been granted by the recognized stock exchange or stock exchanges for dealing in any shares or debentures, in such stock exchange or each such stock exchange, and the moneys received from applicants for shares or debentures are in excess of the aggregate of the application moneys relating to the shares or debentures in respect of which allotments have been made, the company shall repay the money to the extent of such excess forthwith without interest. If such money is not repaid within eight days from the day company becomes liable to pay it, the company and every director of the company who is in default shall on and from the expiry of the eighth day, be jointly and severally liable to repay that money with interest at a rate between four to fifteen per cent, having regard to the period of delay. (Sec. 73(2-A)).

If default is made in complying with this provision, the company and every officer in default shall be punishable with fine upto Rs.5,000 and where repayment is not made
within 6 months from the expiry of 8\textsuperscript{th} day, also with imprisonment for a term which may extend to one year.(Sec. 73(2-B)).

**All money to be kept in a scheduled bank**

If prospectus states that application has been or will be made for permission to deal in the shares on a recognized stock exchange, the money received from applicants must be paid into separate bank account maintained with a scheduled bank. The object of this provision is to provide protection to persons who pay the money on the faith of a promise.

If default is made in complying with this provision, the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs.5,000 (Sec. 73(3)).

**Utilisation of moneys kept in the separate account.**

Money standing to the credit of the separate bank account cannot be utilized for any purposes other than :

(i) for adjustment against allotment of shares, or

(ii) for repayment of the moneys received from the applicants when the company is unable to make the allotment either because stock exchange permission could not be obtained or for any other reason. (Sec. 73(3-A)).

An agreement or condition that the applicant for shares or debentures will waive any non compliance with the provisions of section 73 will be void (Section 73(4)).

Section 73 applies only to cases in which a company issues prospectus inviting the public to subscribe for its shares and it is represented in that prospectus that application has been made to one or more recognized stock exchanges for enlistment. It may not apply to the right as well as further issues made by a company, otherwise than through a prospectus.
2. **Subsequent allotment of shares**

In case of subsequent allotment of shares all the ‘statutory provisions’ regarding ‘first allotment of shares’ apply equally except:

1. minimum subscription (Sec. 69(1))
2. application money must be deposited in a scheduled bank (Sec. 69(4)).

3. **Allotment of debentures**

In case of issue of debentures all the ‘statutory provisions regarding ‘first allotment of shares’ apply equally, except:

(a) minimum subscription (Sec. 69(1));
(b) the amount payable on application; (Sec. 69(3)) and
(c) application money must be deposited in a scheduled bank. (Sec. 69(4)).

**Irregular allotment**

An allotment of shares is irregular if it is made by a company in violation of section 69 or 70, i.e.

(a) Where the company has issued a prospectus:

(i) without receiving the minimum subscription; (Sec. 69(1)).
(ii) without collecting application money which shall not be less than 5 per cent of the nominal value of shares (Sec. 69(3)); and
(iii) without keeping the money so received in a scheduled bank (Sec. 69(4)).

(b) Where the company has not issued a prospectus, without filing with the Registrar, a statement in lieu of prospectus at least three days before the first allotment of shares.

**Effect of irregular allotment**

Allotment voidable at the option of the applicant. An irregular allotment is voidable at the option of the applicant. Such an option must be exercised:
(a) within 2 months of the holding of statutory meeting; or;

(b) where the company is not required to hold a statutory meeting or where the allotment is made after the statutory meeting, within two months after the date of allotment and not later. (Sec. 71(1)).

**Liability of directors**

Where the directors knowingly contravene the provisions as to allotment, they are liable to compensate the company and the allottee for any loss or damage suffered thereby. Proceedings against the directors must be commenced within two years of allotment. (Sec. 71(3)). However, an allotment improperly made by the directors can be subsequently ratified by the shareholders in a general meeting.

**Return as to allotments.** Section 75 of the Act requires a company having a share capital to file with the Registrar return of allotment within 30 days of the allotment, whenever the company makes any allotment of shares. However, the Registrar can extend the period for filing the return on application made by the company. The object of the section is to require full disclosures of the allotment of shares. There is no need to file a return of the issue and allotment of shares forfeited for non-payment of calls.

On default every officer of the company shall be liable to a fine upto Rs.500 for every day during which the default continues.

**13.6 CALLS ON SHARES**

When shares are issued the full amount of each share is not generally payable at once. A part is payable on application, a part on allotment and the remainder by instalments when called for. A call may be defined as a demand by the company on its shareholders to pay whole or part of the balance remaining unpaid on each share. It is, thus, an intimation to the shareholder to discharge his obligation by paying the whole or part of the amount which remains unpaid on the shares. Call may be made at any time during the life time of the company or the liquidator may make a call on the shareholder
during the course of winding up. All moneys payable by any member to the company under the memorandum or articles is a debt due from him to the company. But he is not bound to pay unless a call has been made.

**Requisities of a valid call.** A call to be valid must be made in accordance with the provisions of the Companies Act and the articles of association of the company. Further, the following conditions must be satisfied:

1. **Resolution of the Board.** A call must be made under a resolution of the Board of directors. Such directors must be duly appointed and qualified. The meeting of the directors must be duly convened and proper quorum must be present.

2. **Amount, place and time of payment.** The resolution making the call must be passed. It must specify the amount of the call, the time and place of payment and to whom the call is to be paid. Thus, where the directors of a company resolved to make a call but failed to specify the date and amount of payment and the blanks were subsequently filled by the secretary, the call was held to be invalid.

3. **Bona fide and for the benefit of the company.** The power to make a call is in the nature of a trust to be exercised for the benefit of the company. If it is exercised malafide i.e. for the benefit of directors the call may be prevented by an injunction or the directors may be compelled to hand over the benefit or the advantage gained by them. Thus, where the directors deliberately postponed the date on which a call was deemed to be made, with the intention of disposing their shares in the mean time, in order to avoid the payment of the call, the notice of call will be invalid. Similarly, where the directors paid into the company’s account the amount due on their shares and immediately thereafter withdrew it as their fee, it was held that payment was not in good faith for the benefit of the company and they remained liable to pay.

4. **Uniform basis.** The must be made on a uniform basis. A call cannot be made on some of the members only. (Section 91). It is essential that the call be made equally on all the shareholders of the same class unless the terms of issue and the articles otherwise
provide. Shares of the nominal value on which different amounts have been paid up shall not be deemed to fall under the same class.

If a call is made on some shareholders but not on others or a call of a greater amount is made on some shareholders than on others, the call is void.

5. **Calls in advance.** Section 92 provides that a company, if authorized by its articles, can accept advance payment from any shareholder in respect of the shares held by him. For such payment he becomes a creditor of the company and is entitled to interest. Such interest must be paid out of capital if there are no profits. But because of such payment the shareholder cannot claim any extra voting rights. The power of the directors to accept calls in advance must be exercised bona fide. Call may not be made until the company becomes entitled to commence business. Calls must be paid in cash. The articles may provide that interest shall accrue on calls not paid. If a person fails to pay money on a call for six months, he will be disqualified from holding the office of a director. (Section 274).

13.7 **SHARE CERTIFICATES AND SHARE WARRANTS**

The holder of share or shares is issued a share certificate by the company. A certificate under the common seal of the company, signed by one or more of directors, specifying shares held by the member and the amount paid up on the shares shall be prima facie evidence of the title of the member to such share or shares.

The company shall, within three months after the allotment of any of its shares, debentures or debenture stock and within two months after the application for the registration of the transfer of any such shares, debentures to debenture stock complete and have ready for delivery the certificates of all shares, the debentures and the certificates of all debentures stock allotted or transferred.

If default is made, the company and every officer of the company who is in default, shall be punishable with fine which may extend to Rs.5,00/- for every day during which the default continues.
The person may make an application to the court if default is not made good by the company within 10 days after the service of the notice. The court may order the company and any officer of the company to make good the default.

**Objects and Advantages**

Since a share certificate is prima facie evidence of title, a shareholder is able to show his title to the shares by producing his share certificate. Thus it is very easy for a shareholder to sell his share in the market by producing a share certificate showing his title to these shares. Besides it would be very easy for a lender to lend money to the shareholder taking the possession of his share certificate by way of security.

**Duplicate Certificate.** Section 84(2) provides that a company may renew or issue a duplicate certificate if it is proved to have been lost or destroyed or having been defaced, mutilated or torn is surrendered to the company. The articles may provide other terms and conditions like requiring the allottee to give an indemnity bond (Clause 89 Table A).

The Central Government may prescribe rules regarding the issue or renewal of certificates and duplicates, fees, etc. (Sec. 84(4)). The rules so made override the provisions in the articles.

**13.7 SHARE WARRANTS (SECTION 114 AND 115)**

A public company limited by shares may issue share warrants under its common seal in the following circumstances:

(i) if it is authorized by its articles;
(ii) shares are fully paid up;
(iii) previous approval of the Central Government is obtained.

A share warrant is a document which shows that the bearer of the warrant is entitled to the shares specified therein. It is a substitute for the share certificate. A shares warrant may have coupons attached to it to provide for the payment of future dividends on the shares specified in the warrant.
A shares warrant shall entitle the bearer thereof to the shares specified therein. The shares may be transferred by delivery of the warrant. On issue of a share warrant, the company shall strike out of its register the name of the member then entered therein as holding the shares specified in the warrant as if he had ceased to be a member. The following particulars shall be entered in the register:

(i) the fact of the issue of the warrant;
(ii) a statement of the shares specified in the warrant, distinguishing each share by its number; and
(iii) the date of the issue of the warrant.

The bearer of a share warrant shall subject to the articles of the company be entitled to have his name entered as a member in the register of members on surrendering the warrant for cancellation and paying such fee to the company as the board of directors may from time to time determine.

The bearer of the share warrant may, if the articles of the company so provide, be deemed to be a member of the company.

**Distinction between share warrant and share certificate**

1. A share warrant can be issued only when the shares are fully paid up whereas a share certificate can be issued at any stage without the shares being fully paid up.

2. A share warrant is a negotiable instrument but a share certificate is not. In other words, a share warrant can be transferred by mere delivery, but a share certificate cannot be so transferred.

3. A share certificate is a document showing prima facie title to the shares represented thereby but a share warrant is the share security itself capable of easy transfer.

4. A holder of a share certificate is a member of the company but the holder of a share warrant is not, unless the articles otherwise provide.
5. A share certificate can be issued both by a public and a private company but a share warrant is issued only by a public company.

6. Coupons for dividends may be attached to the share warrant and dividend is paid to the bearer of the coupons. But no such coupons are attached to the share certificates.

7. Holding a share warrant is not enough where the articles require a director to hold a specified share qualification. But the shares specified in the share certificate are counted for this purpose.

8. The issue of a share certificate does not require the approval of the Central Government. A share warrant can be issued only if the articles authorize its issue and the Central Government has accorded its previous approval.

9. The holders of a share certificate can present a petition for winding up, but the holder of a share warrant cannot do so.

10. No stamp duty is payable on the transfer of a share warrant. Whereas stamp duty is payable on the transfer of shares specified in a shares certificate.

13.8 TRANSFER OF SHARES

According to Section 82, the shares of a company are movable property. The right of a member to transfer his shares is absolute and inherent in the ownership of shares. The articles may, however, impose certain restrictions on the right to transfer but there can be no absolute prohibition on this right. Also, they cannot be transferred by mere delivery. The transfer of shares can be made only in the manner provided in the Companies Act and the articles of the company.

A transfer of shares is said to take place “when a registered shareholder transfers his shares voluntarily to another either by sale or otherwise”. Thus involuntary transfers by way of court auction or sale of forfeited shares do not fall within the purview of transfer. Sections 108 to 112 of the Act contain the provisions relating to the transfer and transmission of registered shares.
Procedure for transfer of shares

Ordinarily, shares can be transferred by a person whose name appears in the register of members and who is the holder thereof. As per Section 109, a legal representative of a deceased member, although not a member at the time of transfer, can also transfer shares.

Shares may be transferred by executing an instrument of transfer (called the ‘transfer deed’). The instrument of transfer must be in the prescribed form. Before it is signed by or on behalf of the transferor and before any entry is made therein, it shall be presented to the prescribed authority which shall stamp or otherwise endorse on it the date of presentation.

The instrument of transfer shall be then executed by the transferor and the transferee and completed in all respects. Thereafter, it shall be presented to the company for registration within the following time limits :-

i) Where the shares of the company are listed/dealt in/quoted on a recognized stock exchange, the instrument of transfer must be presented for registration at any time before the register of members is closed for the first time after the date of presentation of the instrument to the prescribed authority or within 12 months thereof, whichever is later.

ii) In any other case, the instrument of transfer shall be presented to the company within 2 months of the date of presentation to the prescribed authority. (Section 108(1A)).

The Central Government may, however, on application extend the period by such further time as it may think fit to avoid any hardship (Section 108(1-D)).

When a duly executed and stamped transfer deed is delivered to the company within the prescribed time, the transfer is complete irrespective of whether the company registers it or not. But the transferee becomes a member only when the transfer is registered. Pending registration, the transferor is a trustee of the shares for the transferee.
The transferor continues to be the holder of the shares until his name is struck off the register and that of the transferee substituted in its place. The transferor must pay over to the transferee any dividends or other rights which he may receive from the company after the date of the transfer deed.

The application for transfer of shares may be made either by the transferor or the transferee. In case any application is made by the transferor and relates to partly paid shares, the transfer shall not be registered unless the company gives notice of application to the transferee and the latter raises no objection to the transfer within two weeks from the receipt such of notice.

No such notice needs to be given where fully paid shares are transferred or where the application for the registration of transfer is made by the transferee.

In case a company refuses to register the transfer of shares, it must give notice to the transferor and the transferee within 2 months from the date on which the instrument of transfer was delivered, giving reasons for such refusal.

**Issue of new share certificate (Sec. 113)**

On the approval of the transfer, the company shall cancel the old share certificate and issue a new one made out in the name of the transferee. Normally, it is done by making an endorsement on the back of the share certificate.

The transfer when registered has retrospective effect from the time when the transfer was first made. It should be noted that the seller of the shares is not bound to procure registration. He will simply hand over to the transferee a duly executed transfer form and the share certificate or the letter of allotment.

**Certificate of Transfer**

‘Certification’ is an act of endorsement on the instrument of transfer by the company that the share certificate relating to the shares under transfer has been lying with the company.
Certification is needed when a shareholder makes a part disposal of shares or when there are multiple purchasers, but he has only one certificate for all his shares. For a valid transfer, the relevant share certificate is required to be attached to the instrument of transfer. If he wants to transfer his shares to more than one person or wants to transfer only some of the shares, a single share certificate can not serve his purpose. To solve this problem, there are two alternatives. Either he requests the company to cancel the original certificate and issue split certificates of the desired denominations. The other alternative is to obtain certification of transfer and it is considered more convenient. In it, the transferor presents the instrument of transfer together with the share certificate to the company. The company keeps the share certificate but returns the instrument of transfer with the ‘balance ticket’ showing that the share certificate has been kept by it. The ‘balance ticket’ is retained by the transferor and the instrument of transfer is given to the transferee. When the shareholder sells off his entire shareholding, ‘no balance ticket’ is issued.

But it should be noted that company is under no legal obligation to certify any instrument of transfer.

**Blank transfer**

When transfer is made by means of a blank instrument of transfer, it is called ‘blank transfer’. It occurs when an instrument of transfer duly signed and completed by the transferor but leaving the name and signature of the transferee blank is delivered to the transferee along with the relevant share certificate. As a consequence, the shares can be further transferred merely by delivering the blank transfer form and the relevant share certificate. It saves the trouble of having a new transfer form for each transfer. But blank transfer does not confer the ownership of shares on the transferee. If he wants to retain the shares, he can fill in his name and date in the transfer deed and get himself registered as a shareholder. Until such registration, the original transferor continues to be the owner and remains liable for any amount remaining unpaid on the shares. Morally, he is a trustee for the dividends declared and received. But it does not confer any right on the
transferee to prefer any claim against the company in the event of the transferor’s failure to pay him the dividends etc.

A blank transfer, however, can remain in circulation only for 12 months after its signing by the prescribed authority or up to the time of closure of the register of members by the company, whichever is later. This provision has been made to curb the abuse of this system.

**Forged transfer**

An instrument of transfer on which the signature of the transferor is forged is called a forged instrument. Any transfer on the basis of such an instrument is called a ‘forged transfer’.

Such transfer is void even though it may have been registered and it does not confer any legal title on the transferee. The true owner can ask the company to restore his name on the register of members since he never ceased to be the owner of the shares.

So, the company should be very cautious while registering transfers in order to avoid complications. The company should compare the signature of the transferor with his specimen signatures and notice of every transfer must be given to the concerned transferor.

**13.9 TRANSMISSION OF SHARES**

Transmission of shares means transfer of property or title in the shares by the operation of law. It implies succession of shares on the death or insolvency of an individual shareholder, or if the member is a limited company, on its going into liquidation. On the death, insolvency or lunacy of a shareholder, his shares would vest in his legal representative, official assignee/receiver and the administrator respectively. Since this is an involuntary assignment of shares, the property in the shares passes by the operation of law without a formal instrument of transfer and without consideration being paid by the person who succeeds to the estate of the deceased.
**Procedure of transmission**

In the case of transmission, the person entitled to the shares can become a member by making an application to the company and attaching thereto the relevant share certificates and the succession certificate. There is no need to execute a formal ‘transfer deed’ for this purpose. On being satisfied, the company deletes the name of the deceased member and enters the name of the legal representative in the register of members.

The person entitled to transmission shall have the same right to dividend and other advantages and privileges as if he were the original holder except that before his registration as a member, he can not exercise any membership rights at a meeting of the company.

In case the legal representative does not want to become a member, he can transfer the shares to any other person although he himself may not be a member on the date of execution of the transfer deed. For making a transfer, he has to follow the usual procedure of transfer with the difference that he has to attach a succession certificate with the transfer deed.

**13.10 SURRENDERS OF SHARES**

The Companies Act does not provide for surrender of shares. Shares are said to be surrendered when they are voluntarily given up. The articles of a company may authorize the directors to accept surrender of shares. Surrender of shares is valid where it is done to relieve the company from going through the formality of forfeiture of shares and the shareholder is willing to surrender the shares. A surrender and forfeiture have practically the same effect, the only difference being that the former is done with the assent of the shareholder while the latter is done at the instance of the company.

A surrender of partly paid shares not liable to forfeiture, is unlawful, as it:

(a) releases the shareholder from further liability in respect of the shares;

(b) amounts to a purchase by the company of its own shares; and
(c) is a reduction of capital without the sanction of the court.

13.11 FORFEITURE OF SHARES

If a shareholder, having been called upon to pay any call on his shares, fails to pay, the company may sue him to recover the amount of the call. But the articles often provide that the company may forfeit the shares of a shareholder, who has made a default. However, the shares may be forfeited if the following conditions are satisfied:

1. Conform to the provisions of Articles of Association

A company has no inherent power to forfeit shares. The power to forfeit shares must be contained in the articles. Where a shareholder fails to pay the amount due on any call, the directors may, if so authorized by the articles, forfeit his shares.

2. Notice prior to forfeiture

Before the shares are forfeited the shareholder:

(i) must be served with a notice requiring him to pay the money due on the call together with interest.

(ii) the notice shall specify a date, not being earlier than the expiry of 14 days from the date of service of notice, on or before which the payment is to be made and must also state that in the event of non payment within that date will make the shares liable for forfeiture.

3. Resolution of the Board

If the member does not comply with the notice, the board of directors will pass a formal resolution of forfeiture and a notice of the same will be served on the defaulting shareholder. But it must be exercised by properly appointed directors at their meeting with requisite quorum. A small or insignificant irregularity will make the forfeiture void.
4. **Good faith**

The power of forfeiture is a power of trust and the board must exercise the same bonafide for the good of the company, and not to give some personal advantage to a director or shareholder. Thus where the shares are declared forfeited for the purpose of relieving a friend from liability, the forfeiture may be set aside.

An invalid forfeiture can be restrained by injunction. An invalid forfeiture cannot be validated by the lapse of time or acquiescence.

13.12 **SHARE CAPITAL**

In order to finance its activities the company needs to have capital. The words ‘capital’ and ‘share capital’ are synonymous in the case of a company. Share capital means the capital raised by a company by the issue of shares. The memorandum of every limited company must state the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount. An unlimited company and a company limited by guarantee may not have a share capital.

The word ‘capital’ has several different meanings. It may mean the nominal, issued, paid-up or reserve share capital of the company.

1. **Nominal, registered or authorized capital.** The nominal or authorized capital is the amount of share capital which a company is authorized to issue. The amount is set out in the memorandum in the case of companies limited by shares or companies limited by guarantee and having a share capital. This is the maximum amount which a company is authorized to raise by the issue of shares and upon which it pays stamp duty and registration fees. Nominal capital is divided into shares of a fixed amount. The amount of the company’s nominal capital depends on its business requirements. Nominal capital can be increased or reduced by following the prescribed procedure.
2. **Issued capital.** It is the part of the nominal capital which is actually issued by the company for public subscription. A company is not obliged to issue all its nominal capital at once. It may have unallotted residue to be allotted in the near future as and when the company needs further capital. The difference between the nominal and the issued capital is known as the ‘unissued capital’.

The issued capital can never be more than the nominal capital. It can at the most be equal to the nominal capital; it can so happen when all the shares have been issued to the public.

3. **Subscribed capital.** It is the total amount of the nominal value of shares which have been actually taken up, i.e., subscribed for by the public. It is that part of the nominal capital which has actually been taken up by shareholders who have agreed to give consideration in cash or kind for the shares issued to them. The subscribed capital is thus a reality. Where the shares issued for subscription are wholly subscribed for, issued capital would mean the same thing as ‘subscribed capital’.

4. **Called-up capital.** It is that amount of the nominal value of shares subscribed for, which the company has asked its shareholders to pay by means of calls or otherwise.

5. **Paid-up capital.** The paid-up capital is that part of the issued capital which has been paid-up by the shareholders. The money received on each share as a result of calls is said to be paid-up and the total amount that has been paid upon the company’s shares is the paid-up capital which can never exceed the issued capital.

6. **Uncalled capital.** This is the amount which remains uncalled on shares. The company may, at any time, call upon the shareholders to pay the uncalled capital in accordance with the provisions of the articles. When shares are fully paid there is no uncalled capital.
7. **Reserve Capital.** A company may resolve by special resolution that a part of the whole or the uncalled capital shall not be called upon except in the event of winding up. This amount is called ‘the reserve capital’ or ‘the reserve liability’. Section 99 of the Companies Act deals with the question of reserve capital. Reserve capital cannot be turned into ordinary capital without leave of the court and it cannot be dealt with or charged by the directors.

**Classes of Capital**

Section 86 provides that after the commencement of the Act share capital of a company limited by shares shall be of two kinds only namely:

(a) Preference share capital, and
(b) Equity share capital.

(a) **Preference share capital.** It is that part of share capital which carries a preferential right as to the payment of the dividend at a fixed rate and also a preferential right to the repayment of the paid-up capital.

(b) **Equity share capital.** It means all share capital which is not preference share capital.

Section 86 does not apply to a private company unless it is a subsidiary of a public company. It means that such a private company may issue share capital of such other kinds as it may think fit.

**Alteration of Capital**

Under Section 94 a company limited by shares may in general meeting, if so authorized by its articles, alter the conditions of its memorandum relating to share capital in order to:

(a) increase its share capital by issuing new shares;
(b) consolidate and divide all or any of its share capital into shares of larger amount than its existing shares;
(c) convert all or any of its fully paid-up shares into stock or reconver its stock into fully paid-up shares of any denomination;

(d) sub-divide its shares into shares of smaller amount than is fixed by the memorandum, provided the paid up amount will remain at the same proportion to the unpaid amount of the shares;

(e) cancel share which have not been taken by any person and diminish the amount of its share capital.

No sanction or confirmation of the Central Government or the court is required for this alteration. Cancellation of shares under the provision of section 94 does not amount to reduction of capital. Within 30 days of passing the resolution for alteration of share capital, notice must be given to the Registrar who shall thereupon make necessary changes in the company’s memorandum or articles or both. On failure to give notice to the Registrar, the company and every officer in default shall be liable to a fine which may extend up Rs.50 for every day during which the default continues.

A notice to the Registrar shall be given by a company where its share capital has been increased beyond the authorized capital. A company having no share capital shall inform by similar notice any increase in its membership (Sec.97).

**Reduction of capital**

A company may wish to reduce its capital for a number of reasons namely:

1. The capital of the company may be more than enough for its needs, and so, it may return the surplus capital to the shareholders.

2. The paid-up capital of the company is sufficient and it may refrain from calling up the unpaid portion of share money.

3. Some of the capital may in fact have been lost or diminished e.g., share of Rs.100 may represent assets worth Rs.50. The company may wish to write off the lost capital.
Reduction of capital may be effected in several ways which may be classified under two heads:

1. **Reduction without the consent of the court.** There are a number of cases where a company may reduce its capital without the sanction of the court.
   (a) Where redeemable preference shares are redeemed in accordance with the provisions of section 80.
   (b) Where unissued shares are cancelled.
   (c) Where any shares are forfeited for non-payment of calls.
   (d) Where there is a surrender of shares or a gift is made to the company of its own shares.

   In all these cases the procedure laid down under section 100 of the Companies Act is not required to be followed.

2. **Reduction with the consent of the court.** Section 100 gives a company limited by shares or a company limited by guarantee and having a share capital the power to reduce its share capital in any way. A company, if so authorized by its articles, may be special resolution, reduce its share capital subject to the conformation of the court in any one of the following ways:
   (a) Extinguish or reduce the liability on any of its shares in respect of share capital not paid-up.
   (b) Cancel any paid-up share capital which is lost or is unrepresented by the available assets.
   (c) Pay-off any paid-up share capital which is in excess of the wants of the company.

**Procedure for reducing share capital**

The procedure for reducing the share of company is as follows:
1. **Special resolution.** A company shall pass a special resolution for reduction of share capital. (Sec. 100).

2. **Application to the court.** After having passed the special resolution for reducing the share capital, sanction of the court shall be obtained by the company for an order confirming the reduction. (Sec.101(1)).

**Interests of the creditors.** The primary duty of the court is to look after the interests of creditors. Creditors are entitled to object if the reduction of share capital involves (a) reduction of liability in respect of uncalled capital, (b) payment of any share holder of any paid-up capital and (c) in any other case if the court so directs. (Sec.101(2)(a)).

However, it may be noted that only such creditors are entitled to object to whom the company owes a debt which would have been provable in the winding up of the company. The creditors have, however, no right to object to the proposed reduction of capital where no asset out of which their claims could be satisfied is being given up or returned to the shareholders.

The court shall settle a list of creditors who may object to such reduction. The court may publish notices fixing a day or days within which the creditors not entered on the list or to claim to be so entered or are to be excluded from the right of objecting to the reduction. Where a creditor, whose name appears on the list, objects to the reduction, the court may confirm the reduction if it is satisfied that his debt or claim has been discharged, or has been determined or secured.

Under special circumstances, the court may sanction such reduction without settling the list of creditors or without securing the debt of any creditor. (Sec.101(3)).

Where the court is satisfied that the interests of the creditors have been secured, it may confirm the reduction on such terms and conditions as it may think fit. The court may, at the time of confirmation, direct the company to add to its name the words ‘and reduced’ for a specified period and these words will be deemed to be part of the company’s name for such specified time. The court may also make an order requiring the
company to publish the reasons for such reduction for the information of the public. (Sec.102).

**Interests of shareholders.** The second duty of the court is to protect the interests of the shareholders. The proposed scheme of reduction must be reasonable and fair between all the classes of shareholders in the company.

3. **Registration of the order of court with Registrar.** The company shall deliver to the Registrar a certified copy of the court’s order and a minute approved by the court showing the following details for registration:

   - (a) the amount of the share capital;
   - (b) the number of shares into which it is to be divided;
   - (c) the amount of each share; and
   - (d) the amount, if any, at the date of registration deemed to be paid-up on each share. (Sec.103(1)).

   The Registrar will, thereupon register the order and the minute. On such registration, the resolution for reducing the capital takes effect. (Sec.103(2)). Notice of the registration shall be published in such manner as may be directed by the court. (Sec.103(3)). The Registrar shall certify the registration of the order and the minute under his hand. Such certificate shall be conclusive evidence that all the requirements of the Act have been complied with though it appears afterwards that the company has no power under the articles to reduce its capital; or that the special resolution was invalid.

   The reduction takes effect as from the date of registration by the Registrar. The minute when registered is deemed to be substituted for the corresponding part of the memorandum of association and is deemed to be an alteration of the memorandum of association. (Section 103(5)).

   If any officer of the company knowingly conceals the name of any creditor entitled to object, or knowingly misrepresents the amount or nature of his claim or abets
or is privy to such concealment or misrepresentation, he will be liable to imprisonment upto one year or both. (Section 105).

**Liability of members on reduction.** On reduction of capital, the members of a company whether present or past are not liable beyond a certain limit. The liability of the members is limited to the difference, if any, between the amount of the share as fixed by the minute and the amount paid. However, in certain cases the liability of the members will not be reduced even though there has been a reduction of capital. If the company is unable to pay the claim of any creditor entitled to object who was ignorant of the proceedings for reduction or of their nature and effect and who was not entered on the list of creditors then :

(a) every member of the company at the date of the registration of the order for reduction will be liable to contribution for the payment of the claim an amount not exceeding the amount, which he would have been liable to contribute if the company had commenced to be wound up on the day before that registration; and

(b) if the company is wound up, the court on the application of such creditor may settle a list of members so liable to contribute and enforce calls on them as if they were ordinary contributories in winding up. (Section 104).

**13.13 FURTHER ISSUE OF CAPITAL**

A company may desire to expand its activities or it may stand in need of more capital even in the absence of expansion of activities. Section 94 empowers a company to issue a part or whole of its unissued share capital. The time at which and the persons to whom new shares are to be allotted is an important question. If the directors or the majority shareholders are allowed to distribute the new issue at their discretion, they may offer it to their nominees, thus, adding to their own majority and reducing the strength of the minority. Section 81 deals with this kind of situation.
Pro-rata offer to the existing shareholders

Section 81 covers a case where the directors decide to increase the subscribed capital of a company by the allotment of further shares after the expiry of two years from the formation of the company, or after the expiry of one year from the first allotment of shares whichever is earlier.

In other words, any issue or allotment of shares within two years, of the formation of a company or within one year after the first allotment, whichever is earlier, will not be affected by the requirements of section 81.

Where the board decides to increase the subscribed capital of a company by allotment of further shares such shares shall be offered to existing equity shareholders pro-rata, i.e., in proportion, as nearly as circumstances admit to the capital paid up on those shares at that date. (Sec. 84(1)(a)). Where the existing shareholders are given the right to apply for new shares in proportion to the shares which they already hold, the issue is called a ‘right issue.’

Notice of offer

The offer to the existing shareholders must be made by notice specifying the number of shares offered and the time within which it should be accepted. Such time should not be less than 15 days. If the offer is not accepted within the prescribed period, it shall be deemed to have been declined. (Sec.81(1)(b)).

Notice to contain right of renunciation

The notice shall also inform the shareholders that the offeree may renounce the whole or part of the offer in favour of any other person unless the articles otherwise provide (Sec.81(1)(c)).

Board’s powers on refusal by shareholder

After the expiry of the time specified in the notice aforesaid or on receipt of earlier intimation from the person to whom such notice is given that he declines to accept the
shares offered, the board of directors may dispose of them in such manner as they think most beneficial to the company. (Sec.81(1)(d)).

**Offer to outsiders**

The new shares of a company may be offered to outsiders or any person, (including the equity shareholders):

(a) where a special resolution is passed to that effect by the company general meeting; (Sec.81(1A)(a)) or

(b) Where no such special resolution is passed, if the company at the general meeting passes an ordinary resolution to that effect and the approval of the Central Government is obtained. The Central Government will accord its approval if it is satisfied on an application by the board of directors that the proposal is most beneficial to the company (Sec.81(1A) (b)).

(c) if the new shares are issued within 2 years from the formation of the company or one year of the allotment made for the first time; (Sec.81(1)) or

(d) if any shareholder to whom the shares are offered declines to accept the shares or does not apply within the period specified in the notice. (Sec.81(d)).

**Exemptions**

The provisions of section 81 do not apply to

(a) a private company; or

(b) an allotment of shares on conversion of debentures or loans into shares, or creditors subscribing for shares in terms of the loan raised. Such conversion of debentures issued or loans taken by the company into shares in the company will be subject to the following conditions:

(i) the terms of the issue of the debentures of the loans must include a term providing for the option to convert the debentures or the loans into the shares of the company;
(ii) the terms must either have been approved by the Central Government or be in conformity with the rules made by the Central Government, and

(iii) in the case of debentures or loans other than the debentures issued to or loans obtained from the Government, the terms must also have been approved by special resolution passed by the company in general meeting before the issuing of the debentures or the raising of the loan. (Section 81(3)).

The provisions of Sec.81 will not apply to a private company which has become a public company by virtue of Sec.43-A but has retained in its articles the three matters referred to in Sec.3(1)(iii).

**Issue of shares in contravention of Section 81**

The allotment of shares made contrary to the provisions of Section 81 is not invalid, rather is voidable at the option of the director or a shareholder who is aggrieved by such an allotment. Such an allotment may be used as a weapon of defence when any right or liability arising out of such allotment is sought to be enforced.

**Conversion of debentures or loans into shares.** Debentures issued to Government or loans obtained from the Government may be converted into shares, in spite of the fact that the terms of the issue of the debentures or loans do not contain such a provision. The Central Government in public interest may order that any such debentures or loans may be converted into shares on such terms and conditions as in the opinion of the Central Government are reasonable in the circumstances. (Sec.81(4)).

In determining the terms and conditions the Central Government shall have the regard to the financial position of the company, the terms of the issue of debentures or loans, the rate of interest payable, the capital of the company, its loan liabilities, its reserves, its profits during the preceding five years and the current market price of the shares. (Section 81(5)).

The order of the Central Government directing the company to convert the debentures of loans into shares shall be laid in draft before each House of Parliament for
thirty days while it is in session (Section 81(6)). The company may appeal to the court within 30 days of the receipt of the order of the Central Government if the terms and conditions are not acceptable to it. The decision of the court shall be final and subject to the decision of the court, the order shall be final and conclusive. (Section 81(7)).

**Share capital to stand increased where an order is made under Section 81(4) (Section 94-A)**

Section 94-A inserted by the Companies Amendment Act, 1974 provides that where the Central Government has directed that any debentures or loans be converted into shares in a company, the capital of the company will stand increased by an amount equal to the value of such shares and its memorandum of association will also stand automatically altered.

Where there is an option attached to debentures issued to public financial institutions, such institutions may apply to the Central Government proposing to convert such debentures or loans into shares in the company. On such application, the Central Government may direct that the conditions contained in the memorandum of the company shall stand altered and the nominal share capital of such company shall stand increased.

Where the memorandum of association of a company stands altered in the above case the Central Government shall send a copy of its order to the Register so that he may effect the necessary alteration in the company’s memorandum.

**Notice of increase of share capital or of members (Sec.97)**

A company having a share capital shall within thirty days of the resolution authorizing the increase of capital give notice to the Registrar. Such notice shall include particulars of the classes of shares affected and the conditions on which new shares are to be issued. A company having no share capital shall inform by similar notice any increase in its membership. The Registrar shall upon receipt of the notice record the increase and
also make any alternation which may be necessary in the company’s memorandum or articles or both.

The notice shall include particulars of the classes of shares affected and the conditions, if any, subject to which the new shares have been or are to be issued.

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 fine which may extend to Rs.50 for every day during which the default continues.

**Re-organization of capital**

The re-organization of share capital of a company may take place

(1) by the consolidating of the shares of different classes, or

(2) by the division of shares of one class into shares if different classes;

(3) by both these methods. (Sec. 390(b)).

Where a compromise or arrangement is proposed between a company and its creditors, or any class of them or its members or any class of them, the court may on the application of the company, or any creditor of the company, or any member of the company and in the case of a company which is being wound up, of the liquidator, order a meeting of the creditors or class of creditors, or of the members or class of the members to be called, held and conducted in the manner directed by the court.

A majority in number representing three-fourths in value of the creditors, or class of creditors or members or class of members present voting in person or by proxy must agree to the compromise or arrangement. If the court sanctions the re-organization of capital it becomes binding on all the creditors, all the members and also on the company, or on the liquidator and contributories in the case of a company which is being wound up.

The order of the court will not be effective unless a certified copy of the order is filed with the Registrar. (Sec.391).
13.14 VOTING RIGHTS

Equity shareholders’ rights. Every holder of the equity share shall have right to vote with regard to such capital, on every resolution placed before the company. (Section 87(i)(a)). His voting right on a poll shall be in proportion to his share of paid-up equity capital of the company. (Section 87(i)(a)).

Preference shareholders’ rights. Every holder of the preference share capital shall have in respect of such capital, a right to vote only on resolutions which directly affect rights attached to the preference shares. A resolution for winding up or repayment or reduction of share capital shall be deemed to be one affecting directly the rights of preference shareholders.

The cumulative preference shareholders shall have a right to vote on every resolution placed before the meeting where such dividend has remained unpaid for an aggregated period of not less than two years before the date of the meeting. Holders of non-cumulative preference shares have a right to vote on all the resolutions of the company at any meeting if their dividend remained unpaid for the two financial years, immediately preceding the meeting or for any three years during a period of six years ending with the financial year preceding the meeting. (Section87(b)(ii)).

The voting rights of each holder of preference shares of either class will be in proportion in which the capital paid-up on his shares bears to the total equity capital of the company.

Section 87 does not apply to a private company which is a subsidiary of public company.

Shares not to carry disproportionate rights. No company formed or issuing capital after the commencement of this Act shall issue any or equity shares carrying voting rights or rights as to dividend, capital or otherwise which are disproportionate to the rights attaching to the holders of other shares (not being preference shares). This section
does not apply to a private company which is not a subsidiary of a public company. (Section 88).

**Termination of disproportionately excessive voting rights.** Excessive voting right on shares issued before the commencement of this Act should be terminated within one year from the commencement of this Act. Other disproportionate rights as to dividend, capital or otherwise attached to existing shares may continue. In other words, all existing differential rights other than excessive voting rights are allowed to continue as before. This section does not apply to a private company unless it is a subsidiary of public company. (Section 89). According to Section 90, the distinction made by the Companies Act, 1956, between the preference shares issued by a public company before and after the commencement of the Act is removed and now all the preference shares are placed on the same footing and no extra voting right is enjoyed by preference shares issued before April 1, 1956.

**Variation of shareholders rights.** Rights especially given to shares of a particular class by the terms of the memorandum or articles are referred to as the special rights of a class or class rights. Special class rights may likewise be created by the terms of issue or by a special resolution. These rights are usually concerned with dividend, voting or the distribution of assets in a winding up.

The rights of the holders of a class of shares may be varied with the written consent of the holders of at least three fourths of the issued shares of that class. Such rights can also be varied by a special resolution passed at a separate meeting of such shareholders provided that:

- (a) the memorandum or articles provide for such variation; or
- (b) where there is no such provision, such variation is not prohibited by the terms of issue of the shares or the class of shares (Section 106).

**Rights of dissenting shareholders.** Where the rights of a class of shareholders are varied the holders of not less than 10 per cent of the issued shares of that class affected, may
apply to the court to have the variation cancelled provided they did not consent or vote for the variation. The application must be made within 21 days after the giving of the consent or passing of the resolution. Once such an application is made, the variation is not to take effect unless and until it is confirmed by the court. On hearing such application, the court may disallow the variation, if it is satisfied that the variation would unfairly prejudice the shareholders of the class in question. The decision of the court shall be final.

The company must send a copy of the court’s order within 30 days to the Registrar. If default is made, a fine upto Rs.50 may be imposed.(Section 107).

13.15 SUMMARY

The share capital of a company is divided into shares of different denominations. These denominations are called ‘shares’. The holder of a share is issued a share certificate. A share certificate shall be a prima facie evidence of the title of the member to such shares. Shares can be converted into stock when they are fully paid. Stock symbolize the complete payment of shares of the company in fact. A company can issue only two kinds of shares namely preference shares and equity shares. An applicant for share makes the offer (in writing on the application forms) and the company accepts or rejects it. Acceptance of the applicant’s offer is an allotment and results into a contract between the company and prospective shareholder. A call may be defined as a demand by the company on the shareholders to pay whole or part of the balance remaining unpaid on each share made at any time during the life-time of the company. A share warrant is a document which shows that the bearer of the warrant is entitled to the share specified therein. It is a substitute for the share certificate. According to Section 82, the shares of a company are movable property. Therefore, they are freely transferable, of course, subject to the provision of the articles, memorandum and the Companies Act. Transmission of shares means transfer of property or title in the shares by the operation of law. Surrender of shares means voluntary return of shares by the shareholder to the company for
cancellation while forfeiture of shares means confiscation of the shares. Share capital means the capital raised by accompany by the issue of shares. A limited company having a share capital, if authorised by its articles, can alter the capital clause of the memorandum of association. A company may it any time by passing an ordinary resolution at its general meeting resolve to increase its capital by such amount as it thinks expedient by issuing new shares. There are voting rights for all classes of share holders.

13.16 KEYWORDS

Share: The share capital o a company is divided into shares of different denominations. These denominations are called shares.

Share Capital: Share capital is the money raised by the issue of shares by a company limited by Shares.

Share Warrant: Share warrant is a document which shows that the bearer of the warrant is entitled to the shares specified therein.

Stock: Stock is an aggregate of fully paid shares that have been legally consolidated into one mass for the sake of convenience.

Share Certificate: As soon as a shareholder is allotted shares, he must be issued a share certificate by the company within the specified time.

13.17 SELF ASSESSMENT QUESTIONS

1. Define share. What are the different kinds of shares which a company may issue.
2. What is meant by allotment of shares? Discuss the rules relating to the allotment of shares.
3. What is a share warrant? How does it differs from a share certificate?
4. Explain the different methods by which a company can alter its share capital.
5. How can the share capital of a company be reduced? What is the liability of the members in respect of reduced shares?

6. Discuss in detail the steps a public company has to take for raising additional equity capital.

13.18 SUGGESTED READINGS

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.


Lesson - 14

BORROWING POWER OF MANAGEMENT AND MEETINGS

STRUCTURE

14.0 Objective
14.1 Introduction
14.2 Borrowing power of a company
14.3 Characteristics of lawful borrowing
14.4 Restriction on borrowing power of company.
14.5 Ultra vires borrowing
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14.7 Definition of Meeting
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14.9 One man meeting
14.10 Significance of meeting
14.11 Kinds of Meeting
14.12 Summary
14.13 Keywords
14.14 Self Assessment Questions
14.15 Suggested Readings

14.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Explain the borrowing power of the company

(b) Discuss the legal provisions and procedure relating to meetings of the companies.
14.1 INTRODUCTION

The Companies Act, 1956, does not contain any provisions granting powers to the companies to borrow money for their business. A company can borrow only if it is so authorised by its Memorandum. In the case of a trading company, it is not, however, necessary that the objects clause of its Memorandum of Association should expressly authorise it to borrow. As borrowing is incidental to trading, every trading company has an implied power to borrow for its business. But in the case of non-trading companies, such power must be expressly provided in their Memorandum or Articles of Association. The power to borrow is not confined to borrowing money with or without interest. It also includes the contracts by which machinery, raw material etc., are purchased on credit. Further, the power to give security for the debt is also incidental to the power to borrow.

The Company is an artificial legal person in the eyes of the law having a separate entity distinct from its owners. Being an artificial person, it cannot take decisions on its own. It has to take decision on matters relating to its well being by way of resolutions passed at properly constituted and conveyed meetings of its shareholders or directors. The decisions about a company’s management are taken by the directors in their meetings and they are to be ratified in the general meetings of the company by the shareholders. The first general meeting is called the statutory meeting which is convened to inform the members of important facts concerning the promotion of the company as well as its prospects. A general meeting is to be held each year, so it is called the annual general meeting in the subsequent years. It is convened to consider routine matters relating to the appointment of directors and auditors, remuneration of directors, accounts and declaration of dividend. Sometimes, an extraordinary general meeting is also summoned to transact some urgent or special business which cannot be postponed till the next annual general meeting.
14.2 BORROWING POWER OF THE COMPANY

Finance is the life blood of a business. Main sources of the company’s finance are its share capital and borrowed funds. Companies have some borrowing power prescribed by the Company Act, 1956. Let us put a light on such power.

Sometimes companies require some additional capital to run their business. The company can meet its requirement by issuing the shares, by issuing the debentures or by raising loans. It is always not possible for a company to issue share for additional capital. In that case company may exercise their borrowing powers to arrange such required additional capital.

Normally most companies are empowered by their articles of association to borrow money for the purpose of the business. A company’s memorandum of association defines the maximum limits which a company can borrow and articles of association describe the procedure for raising such loans.

Every company can exercise its borrowing power only within the defined limits. If a company borrow money out of these limits that is called “borrowing beyond the authority of the company”. In such cases loan taken by the company is not considered as a debt, even after the confirmation of the all members of the company.

14.3 LAWFUL BORROWING

According to the Section 159 of Companies Act” 1956, a company can’t exercise its right to take loan until it is not authorized to commence its business. Thus a private company can exercise its right to take a loan when it receives its ‘certificate of incorporation’ and a public company can exercise this right only on receiving the certificate of commencement of the business. A public company can however offer its shares and debentures simultaneously after its commencement of business.

It is normally provided in the articles of a company that the power to
borrow is exercised by its director or such decision is taken by the company’s
general meeting. In practice the board of director are empowered to borrow upto a
specified limit and if the amount required is more the decision to borrow can be
taken in the company’s general meeting.

According to section 293, any borrowing by the director of a company
should not exceed the aggregate of its paid up capital and free reserves. The
director of a public company or its subsidiary can’t, except with the consent of the
company or subsidiary in a general meeting, borrow money which together with
those already borrowed is more than its paid up capital and free reserves.

14.4 RESTRICTION ON BORROWING POWER OF A COMPANY

The restrictions on the borrowing power of company are as under.

1. According to section 149, a public company after obtaining the certificate
of the commencement of business and a private company after taking the
certificate of incorporation may exercise its borrowing powers to get any loans. A
public company can however issue its share and debentures simultaneously on the
receipts of the certificate of the commencement of business.

2. A company cannot borrow more money than the aggregate of its paid up
capital and free reserve. Here free reserve implies any reserve which is set aside
for a specific purpose.

3. Although every company has the implicit right to borrow, money, no
company may borrow any money in contravention of the provision of the
memorandum or, articles of association. Any borrowing which is not in
accordance with, such provision shall be deemed to be unauthorized.

4. A company has the right to borrow money and that borrowing creates a
liability on the company’s properties. Unless it is otherwise provided in the
company’s memorandum and articles. Its borrowing are also a liability on the
company’s unpaid capital. But a company’s borrowings do not creates any liability
on its reserve capital. A company cannot, therefore take any loan against its reserve capital.

14.5 ULTRA VIRES BORROWING

When a company exercise its power to borrow funds which are beyond the limits specified in its memorandum or article it is said ultra vires borrowing or borrowing beyond the powers. Such borrowing can be:

- Borrowing which are ultra vires of the company beyond the authority of the company.
- Borrowing which are ultra vires of the company beyond the authority of the director.

(1) Borrowing ultra vires the company

Any borrowing by a company which do not conform to its authority or which are more than the amount company is authorised to borrow are void. Any guarantee given for such borrowing is also void and is not legally binding by any means.

- **Consequence:** In the eye of law borrowing which are ultra vires are not recognised as a debt against the company and no security can be given for such loan.

- **Remedies available to lender:** the remedies available to the lender of ultra vires borrowing are as follows:

  (i) **Identification and tracing:** If the lender can trace and identify the asset purchased by his money or identify the money he has right to claim that money or assets.

  (ii) **Injunction:** In case the company has not, used that money yet then the lender can give a notice to the company or make an appeal to the court to restraining the company form spending the money.
(iii) **Subrogation:** If the borrowed money is used by the company in the payment of the lawful debts then the lender may step into the shoe of the creditors who have been paid off and subrogate to their rights.

(2) **Borrowing ultra vires the directors**

Any borrowing which is within the authority of the company but is beyond to the directors authority is said to be ultra vires the director. In case the company ratifies such borrowing the loan shall become valid and binding on the company. When the company does not ratify the borrowing the doctrine of the indoor mgt. and the accepted principles of agency protect the lender if he can prove that he had given the loan in good faith. The company in such case can claim for losses from the directors.

**Remedies:** If the director of a company borrow any amount beyond the authority specified in the articles and memorandum of the company the lender of such money is entitled to recover damage from the director.

### 14.6 METHODS OF BORROWINGS

By getting authorization of its memorandum or the articles a company can adopt one or more of the following method to borrow money.

(i) When the loan is to be taken for a, short period the company can take an overdraft from its bankers against the documents, promissory notes, or pledge its movable, assets as security for the loan.

(ii) When the loan is required for a longer period the company can use one or more of the following methods:

- It can mortgage its immovable property like land, building, machinery or plant.
- It can charge its uncalled capital by way of the security for the loan.
- It can establish a floating charges on it assets.
It can issue debentures to the public.

It can seek public deposits or ordinary loans.

It is all about the topic Borrowing Power of the Management. Let us discussed the second topic of the lesson ‘Company Meeting’.

14.7 DEFINITION OF MEETINGS

A ‘meeting’ is said to take place when two or more than two persons meet. For a meeting to take place, it is essential that two or more than two persons are present because a meeting implies that one person meets another persons; but technically, A ‘meeting’ may be defined as the gathering of two or more persons by previous notice or by mutual agreement for discussion and transaction of some business.

In the context of a ‘company meeting’, a ‘meeting’ is a get-together of the company’s members, shareholders, directors and debenture holders with a previous notice and a time and place previously defined.

“Any gathering, assembly or coming together of two or more persons for the transaction of some lawful business of common concern is called ‘meeting’.” – P.K. Ghosh

“A concurrence or coming together of at least a quorum of members by previous notice or mutual agreement for transacting business for a common interest is a ‘meeting’.” – K. Kishore.

From the above definitions, it can be concluded that a meeting is the coming together of two or more persons, or a quorum of members of a company by a prior notice and mutual agreement at an agreed place and time for transacting some lawful business of the company.

14.8 CHARACTERISTICS OF A COMPANY MEETING

From the above definitions, the following characteristics of a meeting are
1. A company’s meeting is a get-together of two or more persons who are members of the company.

2. The members of the company get together for discussing and taking a decision on some lawful business of the company.

3. Before a meeting is held, the members are given a notice about the meeting and the time & place of the meeting.

4. A company’s meeting is held according to the provisions of the Companies Act.

14.9 ONE-MAN MEETING

For a meeting to be there, the presence of two or more than two persons is required. According to the general law, there cannot be a one-man meeting. But there are some exceptions stated in the Companies Act where a meeting is deemed to have been held by the presence of only one person. These exceptions are as under:

1. **Meeting Convened by Central Government:** According to Section 167, if a default is made in holding annual general meeting in accordance with the provisions of Section 166, the Central Government may direct that one member of the company, present personally or by proxy, shall be deemed to constitute a meeting.

2. **Absence of Quorum in an Adjourned Meeting:** In case there is no quorum in a meeting called by the directors of a company within half an hour of the time specified for such meeting, the directors may adjourn the meeting to be held at the same place and the same time after one week, and again a time of half an hour would be allowed for the quorum to attend the meeting. If, after the expiry of this time, no member of the company comes to attend the meeting, then the meeting would be deemed to have been held even if there is only one member is present for such meeting.
3. **Meeting Convened by Company Law Board:** A general meeting held according of Section 167 (1) of the Act shall, subject to the directions of the Company Law Board, be deemed to be an annual general meeting of the company even if only one member of the company is present in such meeting, personally or by proxy.

4. **Meeting Convened by Court:** Where the court orders that a meeting to be convened, it can also order that such meeting shall be deemed to have been held even if only one member of the company is present personally or by proxy.

5. **Class Meetings of Shareholders or Creditors:** When, out of the various classes of shareholders and creditors of a company, one class of shareholders or creditors has only one member, the presence of such shareholder or creditor shall constitute a meeting.

6. **Meeting of One-man Committee of Board of Directors:** According to clause 77 of Table A of the Act, the Board of Directors may, subject to the provisions of the Act, delegate any of its powers to committees consisting of such members, or one such member, of its body as it thinks fit. The presence of one such member constituting the committee is deemed to be a meeting.

7. **Insolvency of the Company:** If only one creditor of a company makes a claim to the company to pay its debt to him in the case of the company being declared insolvent, it shall be deemed to be a meeting.

14.10 **SIGNIFICANCE OF MEETING**

All important decisions regarding the functioning of a company are made at its meetings. A company’s meetings may be of its shareholders or its directors- but the meetings have an important bearing on the company’s conduct of its business.

14.11 **KINDS OF MEETINGS**

A company has the following four kinds of meetings.
A company’s shareholders are its *de facto* owners; but, since they are scattered over a wide area and are too many in number, they are not in a position to run the affairs of the company, that is why there is the Board of Directors to manage the company’s business. To ensure that the shareholders are informed of the company’s affairs, periodic meetings of the shareholders are called. These are general meetings of a company, and are referred to as ‘company meetings’.

1. **Statutory Meeting**

    According to Section 165 of the Companies Act, “Every company limited by shares and limited by guarantee and having a share Capital, shall, within a period of not less than one month and not more than six months from the date of which the company is entitled to commence business, hold a general meeting of the members of the company, which shall be called ‘the statutory meeting’. “This meeting is called only once in the lifetime of a company.

**Necessity of Statutory Meeting**

A statutory meeting must necessarily be called by a company limited by shares or a company limited by guarantee and having a share capital. The following companies do not need to call a statutory meeting:

(a) A private company
Object and Importance of Statutory Meeting

Statutory meeting is the first meeting of a company, and is only held once in the company’s lifetime immediately after the company is incorporated. The object of the statutory meeting is to make familiar the company’s shareholders with its objectives, its operational tactics and its future plans so that the members get an overall picture of the company and its future. The statutory meeting of a company is important because the members want to know how much capital the company has acquired for its operations, what properties it has acquired, or plans to acquire, and what are its plans for the future. The shareholders are thus in a position to contribute whatever they can do to the achievement of the company’s goals.

2. Annual General Meeting

*Meaning:* Every company must hold in each year, in addition to any other meetings, a general meeting of its member, which is called the company’s ‘annual general meeting’. In the normal course, such meeting is called by the company only. But in some special circumstance, the Central Government, in exercise of the powers vested in it, may also call a company’s annual, general meeting. According to Section 166, every company shall call its annual general meeting once in a year, and the notice of such meeting being called must clearly state that it is the company’s annual general meeting.

*Objects and Importance of the Meeting:* The main object of calling the annual general meeting is that, at least once in a year, the company’s members get
together and have an opportunity to collectively examine the affairs of the company. Thus, from the point of view of the shareholders, the annual general meeting of the company is especially important because, besides other things, the company declares the dividend that is payable to its shareholders, which is of primary interest to all its members. The directors and the auditors report is also presented to the members, which gives them all information about the company’s activities in the preceding year. In this manner, the members are appraised of the company’s performance and its profits or losses. The members are free to move any resolution which relates to them in the meeting. It is mandatory for the company to present its final accounts in the annual general meeting, and any member can ask any question to the chairman of the meeting.

Business of the Meeting: The issue relating to general meeting can be classified as:

(1) **General Business:** The general business of the meeting constitutes the following:

(a) To discuss the final accounts and profit and loss account of the company, and the ‘directors and auditors’ report of the previous year.

(b) To declare the dividend for the year.

(c) To appoint new directors to replace those who retire by rotation.

(d) To appoint auditors.

(2) **Special Business:** Any other business besides what is normally conducted in the meeting is called ‘special business’. The approval of the general meeting for any special business of a company must necessarily be there. Such business may include:

(a) The appointment, renewal of appointment and remuneration of directors.

(b) Increasing the company’s share capital.

(c) Altering the company’s articles of association.
When some special business has to be conducted in the annual general meeting, the notice for the meeting must contain a statement of the important aspects of such business and must specify the authority vested in any director or manager (if any) with respect to the business. If such business involves another company, and a director of the company holds 20 per cent or more share capital of such other company, it must be specifically clarified in the notice. In case a resolution is to be passed, the notice for the meeting must specify the time and place where any documents relating to the resolution can be inspected.

Since 17 October, 1994, the Board of Directors must also provide information about the following in a company’s annual general meeting:

(a) The name and address of every officer of the company who has been receiving a monthly remuneration of Rs.25,000, or more, and has received a remuneration totaling Rs.3,00,000 in the preceding year (previously this figure was Rs. 3,000 per month or Rs.36,000 per annum).

(b) If any person who has received such remuneration in the preceding year is related to any director of the company, the name of such director and particulars regarding such relationship.

(c) Any clarifications with respect to the auditors report to the Board of Directors.

3. Extraordinary General Meeting

Besides the statutory and the annual general meetings, any meeting of the company’s shareholders called for whatever purpose is an ‘extraordinary general meeting’. In other words, an extraordinary general meeting of a company is any meeting of its shareholders which is called during the period between its two consecutive annual general meetings.

When an Extraordinary General Meeting may be called

The need to call an extraordinary general meeting of a company arises when any such matter has to be decided which cannot wait till the next annual
general meeting of the company is to be held. An extraordinary general meeting of a company may be called in the following circumstance:

(1) To make an alteration in the company’s memorandum or articles of association.

(2) To issue fresh debentures.

(3) To increase, reduce or reorganise the company’s share capital.

**Who may call such Meetings**

An extraordinary general meeting of a company can be called: (1) by the directors, (2) by the directors on requisition of the members, (3) by the requisitions themselves and (4) by the Company Law Board.

**By the Directors:** In case it is authorised by the company’s articles, the directors may, convene an extraordinary general meeting by passing a resolution to that effect in the Board’s meeting. According to Rule 48 of Table A, the Board may, whenever it thinks fit, call on extraordinary general meeting. Such meeting is called by the directors to do any special and necessary act which must be done before the next annual general meeting of the company.

In case any such meeting is called by the directors, it is necessary to give a 21-day notice for the meeting. It is also necessary to state the purpose for which the meeting is being called. If the purpose of the meeting is to seek the support of members for some resolution, the notice for the meeting must specify the time and place where the members can examine such resolution. Although it is necessary to give a 21-day notice for an extraordinary general meeting of the company, it is possible, under the following circumstances, to call such meeting by a notice which is less than the prescribed 21 days. These circumstances are:

(a) When the members of a company with share capital who are entitled to vote and hold 95 per cent of the company’s capital agree that a meeting be called.

(b) When 95 per cent of the members of a company without share capital agree to
(2) **By the Directors on Requisition or Members:** In case the directors do not call a general meeting of the company as required under the provisions of the Act, the members mentioned here under can bind the directors to call an extraordinary general meeting.

(a) In case of a company having a share capital, members who hold ten per cent of the company’s paid-up share capital and have the right to vote.

(b) In case of a company that does not have share capital, ten per cent of the members who have the right to vote.

When two or more than two persons are the joint owners of a share or shares of a company, the consent of one or more than one such persons shall be deemed to be the consent of all the joint holders of shares.

When the above mentioned members of a company demand that an extraordinary meeting of the company be held, it becomes mandatory for the directors to call such meeting. The requisition notice must state the issues for discussing which the demand for the extraordinary general meeting is being made. The demand notice must bear the signatures of the members making such demand, and the notice must be delivered to the company’s registered office. After a valid requisition for such meeting has been delivered, the Board of Directors shall initiate the procedure to call such meeting within twenty one days of the receipt of the requisition and the meeting should actually be held within 45 days from the date of the requisition.

(3) **By the Requisitionists Themselves:** If the directors fail to call the meeting within aforementioned time limits, the requisitionists may themselves convene a meeting within three months from the date of the deposit of the requisition. A meeting called by the requisitionists must be called in the same manner as a meeting called by the Board of Directors. Any reasonable expenses incurred by
the requisitionists by reason of the Board’s failure to call a meeting shall be repaid to the requisitionists by the company, and the company shall retain such amount out of any sums due or to become due by way of fees or other remuneration of the directors who were in default.

(4) **By Company Law Board:** If, for any reason, it is impractical to call a meeting of a company other than an annual general meeting, the Company Law Board may, either of its own motion or on the application of any director of the company, or of any member of the company who would be entitled to vote, order a meeting of the company to be held in such manner as the Company Law Board thinks fit and give such directions as it thinks expedient in relation to the calling of such meeting. The directions may include a direction that one number of the company present in person or by proxy shall be deemed to constitute a meeting. – Section 186

4. **Class Meetings**

When a company issues different types (classes) of shares, and calls a meeting of a particular type of shareholders. Such meeting is called a ‘class meeting’. These meetings are called to alter or define the rights and obligations of a class of shareholders-for example, to convert one class of shares .to another, like a class meeting of the shareholders needs to be called to convert preference shares into equity shares. Only those members of a company who hold that class of shares for which the meeting is called may participate in such meetings. The articles of a company normally define the conditions and the provisions for calling class meetings. The rights and obligations of any class of share holders can only be altered up to the limits defined in the company’s articles and memorandum of association. In other words, any alteration about any class of shares can only be made according to the conditions under which the shares were issued. If any alteration is to be made in such rights and obligations of a class of shareholders, it can only be done in a meeting of that class of shareholders by the members of the
class passing a special resolution to that effect, i.e. the resolution must be passed by a majority of three-fourths of the members of that class.

According to Section 106, where the share capital of a company is divided into different classes of shares, the rights attached to the shares of any class may be varied with the consent in writing of the holders of not less than three-fourths of the issued shares of that class or with the sanction of a special resolution passed at a separate meeting of the holders of issued shares of that class.

(B) Board of Directors’ Meetings

A company, being an ‘artificial person’, performs all its actions through its directors. In fact, it is the directors who manage the affairs of a company. A company’s policy, its management and other important issues are decided in the meetings of its Board of Directors. It is, therefore, necessary that meetings of the company’s Board of Directors are held to take decisions relating to its policy and management. Except for the issues on which the decision-making right rests with the shareholders, all matters of the company are dealt with in the meetings of its Board of Directors.

The meetings of a company’s directors can be categorized as:

(a) Meetings of Board of Directors and
(b) Meetings of Directors’ Committees.

(a) Meeting of Board of Directors

Statutory Provision Regarding Board’s Meetings

The main provisions of the Act related to the meetings of a company’s Board of Directors are as under:

(1) **Power to convene the Meeting:** A meeting of the Board of Directors may be convened by any director of the company. The director who wants to convene
the meeting requests the managing director or the chairman of the board to call such meeting. As a general rule, the managing director or the chairman directs the company’s secretary to call the meeting.

(2) **Period of Meeting:** The provisions relating to the periodic meetings of a company’s Board of Directors have been defined in the Act, but the directors have the right to call such meetings as and when the need arises. Besides this, each meeting of the Board decides when the next meeting is going to be held.

The meetings of the Board of Directors of a company, depending upon the nature of the company’s business, may be called weekly, monthly or after any other period of time but, according to Section 285 of the Act, in the case of every company, a meeting of its Board of Directors should be held at least once in every three months and at least four such meetings should be held in a year.

(3) **Notice and Agenda of the Meeting:** A written notice of each meeting of the Board of Directors must be sent to each director of the company who is a resident in India by registered post. If any director of the company is not in India for the time when the meeting is to be held, such notice is not necessary.

The notice must state the date, time and place of the meeting. If the articles of a company provide that the meeting of its Board of Directors shall be held in a specific period, on a specific day and at a specific place, such notice is not required to be sent. Normally, however, a notice is always sent for the meeting. In case a notice is not sent to any director, as a result of which he is not present in the meeting, the meeting is deemed to be illegal, and all decisions taken by such meeting are void. But if the subsequent meeting of directors ratifies the decisions taken, they shall be deemed to be valid decisions. In case a default is made in sending such notice, then the officer guilty of such default can be fined rupees one hundred.

It is not necessary, under the provision of the Act, to send the agenda for
the meeting with the notice, but in practice it is done so.

(4) **Quorum:** By ‘quorum’ is meant the minimum number of directors must be present for lawful meeting. The required quorum for such meetings of the Board of Directors is defined in the company’s articles. If there is no such provision in the company’s articles, then the quorum for a meeting of the Board of Directors of a company shall be one-third of its total strength (any fraction contained in’ that one-third being rounded off as one), or two directors, whichever is higher.

> – Section 287

If a meeting of the Board could not be held in absence of quorum, then it shall automatically stand adjourned till the same day in the next week, at the same time and place. If that day is a holiday, it will held on the succeeding working day at the same time and place.

> – Section 288

According to Section 300 of the Act, no director of a company can take part in the discussion of, or vote on, any contract or agreement if he is in any way concerned or interested in the contract or agreement. His presence will not count for the purpose of forming a quorum.

> – Section 300

(5) **Chairman of the Meeting:** Every meeting of the Board of Directors of a company must be presided over by a chairman. The company may name the chairman, other directors of the company may elect a chairman to preside over the meetings.

**Business to be transacted in Meetings:** All such business which is within the company’s authority is transacted in the meetings of its Board of Directors. But the Board of Directors cannot transact any business which, according to the provisions of the Companies Act, or the memorandum or articles of the company, must be transacted in a general meeting of the company’s shareholders. The main business to be transacted in the meetings of a company’s Board of Directors can be:
(a) Issue and allotment of the company’s shares.
(b) Making calls on shares.
(c) Accepting the transfer or transmission of shares.
(d) Forfeiture and re-issue of shares.
(e) Calling meetings of the company’s member.
(f) Making decisions about the company’s management and its business.
(g) Deciding the rate of dividend to be paid to shareholders.
(h) Considering the general problems faced by the company.
(i) Making contracts with third parties on behalf of the company.

(6) Decision-making Procedure: Generally, decisions in a meeting of the Board of Directors are taken by a majority vote. Every member of the Board present in the meeting has the right to vote; but if any director has a personal interest in any matter that is being discussed by the Board, he does not have the right to vote on such matter. In case the votes for and against an issue being discussed are equal, normally, under the articles of the company, the chairman of the meeting may cast the deciding vote for or against the issue. In other words, the vote of the chairman is the deciding factor in such a case. But, if the articles of the company do not give authority to the chairman of the meeting to cast the deciding vote, it is deemed the resolution being voted is not passed and the matter remains undecided.

There are some situations where a unanimous verdict of the directors is must for decision-making. These are as follows:

(a) Acceptance of the company’s prospectus.
(b) Election or appointment of a person as managing director or director of the company who holds such position in another company.
(c) Investment in shares or debentures of another company.

(7) **Decision without Meeting:** Ordinarily, resolutions are passed in a meeting of the Board of Directors of the company; but there may be situations under which, because of shortage of time or for any other reason, it may not be possible to convene a meeting of the Board of Directors for taking a decision on some important matter about which the decision making authority vests with the directors. In such cases, the resolutions may be passed by circulation According to Section 289 of the Act, the acceptance of a resolution may be obtained from the directors by circulating the resolution. The chairman and the secretary prepare the text of the resolution, which is sent to the directors along with the necessary documents. Any director who is not in India at such time is posted the text of the resolution at his registered address. The directors may send their acceptance or non-acceptance in writing to such resolution, and the resolution shall be passed if the majority wants it to be passed. It is important to note here that the purpose and the text of the resolution must be sent to such number of directors that constitute the quorum of the Board of Directors.

(8) **Minutes of Meetings:** Minutes are a list of the proceedings of a meeting. They constitute a summery of the proceedings of a meeting. Every company have to keep minutes of all proceedings of Board Meetings Such books are called ‘minutes books’. The pages of the ‘minutes books’ must be consecutively numbered. Each page of a ‘minutes book’ must be initiated or signed. In case of a meeting of the Board of Directors, it must contain the names of the directors present at the meeting; and, in case of each resolution passed at the meeting, the names of the directors (if any) disagree from the resolution. – *Section 193*

Minutes of meetings kept in accordance with the provisions of Section 193 shall be evidence of the proceedings recorded therein. – *Section 194*

(b) **Meetings of Director’s Committees**
Companies which are big and have diversified fields of activity need to call meetings of the Board of Director very often. Such companies also have many directors, and it becomes difficult for all the directors to attend these frequent meetings. The company, therefore, constitutes committees of its directors to deal with different issues, and, when a particular issue is to be discussed, only the directors of the concerned committee need to meet and make a decision. Such committees are constituted by the Board of Directors, and imply the transference of the rights of some directors on some issues to other directors. This can only be done if the articles of the company authorise.

If a company has two or three directors, there cannot be any committees of directors. The articles of the companies authorise the directors to transfer their rights with respect to some issues to other directors and these committees can function on behalf of the Board of Directors. Such committees are of two types: (a) permanent committees, and (b) temporary committees:

**Permanent Committees:** The foremost permanent committee is the company’s working committee. The main function of this committee is the day-to-day administration of the company. The committee meets frequently and takes decisions about the company’s administration. The members of the committee are selected from the members of the Board, and its chairman is the chairman of the Board of Directors. The other members of the committee are the directors of specialized fields-like financial, marketing or technical directors.

**Temporary Committees:** Temporary committees are constituted to take decisions on matters that are important for the time, being. The Board of Directors considers the recommendations of the committees and makes the final decision.

(C) **Creditors Meetings**

When a company issues debentures on its incorporation, or issues any debentures later, and wants to make an agreement with the holders of debentures,
it calls a creditors’ meeting. A creditors’ meeting, in fact, is not the company’s meeting because such meeting is organized by the creditors. The provisions for such meetings are defined in Section 391 of the Companies Act. A creditor’s meeting may be called to make discussion on the following issues:

(a) To settle any suit between the creditors and the company or to reduce the amount of their credits or the interest payable.

(b) To get the creditors consent to the reorganisation or amalgamation of the company.

(c) To get the creditors’ agreement (consent) to the winding up of the company.

In all cases, the object of the company to call such meeting is to get the consent of the creditors to the company’s reorganization, amalgamation or to solve any problems facing by the company. In case the company is being wound up, the court shall appoint an Official Liquidator, and order a meeting of the creditors, or a class of creditors, to be called, held and conducted in such manner as the court directs.

(D) Debenture-holders Meeting

When a company issues its debentures, it also plans the meetings of the holders of its debentures. The rules governing such meetings are printed on the reverse of the debenture certificates issued by the company. The meetings of debenture-holders are called:

(a) When the terms of repayment of debentures need to be altered.

(b) When the rights of the holders of debentures need to be altered.

In short, such meetings are called when the company issues any fresh debentures or wants to alter the rate of interest on any debentures already issued.

In a company above types of meeting can be held and to hold a meeting all the statuary provisions should be followed.
14.12 SUMMARY

Public borrowing is the one of the source of the company’s capital. A company can borrow money by issuing debentures, by taking loans in lieu of providing mortgage of its moveable and immovable properties or uncalled share capital or public deposit. Company can take such loan upto a limit which is specified in the company’s Memorandum of the association or Article. Any borrowing beyond such specification is called Borrowing beyond the authority of the company and can considered as a debt of the company.

Meeting of the company is gathering of the quorum of the members of the company by a prior notice for discussing company’s issues. All important decisions regarding the functioning of the company are made in the meetings. In a company various types of meetings are conducted for the various purposes. Each type of the meeting has specified legal provisions which every company have to fulfill. Every meeting has its own objectives and importance. All proceeding of the meetings are recorded in a book called minute book. Every member of the company can check the minute book and get a Photostat copy of it to know the proceeding of that meeting.

14.13 KEYWORDS

**Ultra Vires Borrowing:** Where a company borrows money in excess of its powers, the borrowing would be ultra-vires the company.

**Statutory Meeting:** Every public company limited by shares and every company limited by guarantee and having a share capital, shall, within a period of not less than one month nor more than six months from the date on which the company is entitled to commence business hold a general meeting of the members of the company. This meeting is called the statutory meeting.

**Annual General Meeting:** Every company must in each year hold in addition to any other meeting, a general meeting as its annual general meeting.
**Extra Ordinary General Meeting:** Any meeting other than a statutory and an annual general meeting is called an Extra Ordinary General Meeting.

**Class Meeting:** Class meetings are separate meetings of holders of different classes of shares. They are held in cases where their rights are sought to be affected.

**14.14 SELF ASSESSMENT QUESTIONS**

1. Write a note on the Borrowing Power of the Management? What are the provisions for a lawful borrowing?

2. What do you mean by the Ultra Vires borrowing? Discuss the remedial measures regarding these?

3. What do you mean by a Meeting? Write down the brief notes on various kinds of meetings?

4. Can One Man Meeting is possible? If yes the how?

5. What do you understand by the Board of Directors meeting? Write various provisions regarding this.

6. How many types of the shareholder meeting held in a company? Discuss in detail.

**14.15 SUGGESTED READINGS**


• Sharma Ashok, Company Law and Auditing, V.K. Publication, New Delhi.
15.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Discuss the place where the account books are to be kept by the company and the period thereof.
(b) Explain the Form and Contents of a Balance Sheet and Profit and Loss Account.
(c) Significance of board’s report.
(d) Discuss the qualification and disqualification of an auditor.
(e) Explain the rights, powers and duties of an auditor.

15.1 INTRODUCTION

In the past the keeping of accounts by a company was considered as the private or domestic affair of the company and its shareholders. The law did not intend to interfere
with the internal administration and management of the company. However, the Company Act 1956 contained a number of provisions relating to accounts and audits designed—

a) Primarily, to ensure that members of a company are furnished with all necessary information relating to its affair.

b) Secondarily, to put such information which is at any rate, in large companies matter of public importance at the disposal of the creditors of the companies, employees and public at large.

15.2 BOOKS OF ACCOUNTS AND THEIR LOCATION

Section 209(1) of the act provides that every company shall keep at its registered office proper books of accounts with respect to:

(a) All sums of money received and expended by the company and matters in respect of which receipts and payments take place;

(b) All sales and purchases of goods by the company;

(c) All assets and liabilities of the company and

(d) In case of companies engaged in production, processing, manufacturing or mining activities, such particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if such class of companies is required by the central government to include such particular in the books of accounts.

Location of books of accounts: As noted in the preceding paragraph section 209 requires books of the accounts to be kept at the registered office of the company. However, the provisions of section 209(1) allows the keep its books of accounts or any of them at any other place in India as the board of directors may decide and when the board of directors so decides the company shall within seven days of the decision file with the registrar a notice in writing giving the full address of that other place.

Where a company has a branch office, books of accounts relating to the transactions effected at the branch office shall be kept at the branch and at intervals of not more than 3 months summarized accounts shall be sending to the company at its registered office.
The books of the accounts shall give a true and fair view of the state of affairs of the company and its branch office as the case may be. Section 209(3) provides that proper books of accounts shall not be deemed to be kept by a company or its branch, with respect to the matter specifies therein:

i) If there are not kept such books as are necessary to give true and fair view of the state of affairs of the company or its branch office as the case may be and to explain its transactions

ii) If such books are not kept on accrual basis and according to the double entry system of accounting.

15.3 PERIOD OF PRESERVATION
Section 209(4A) requires that the books of the accounts of every company relating to a period of not less than eight years immediately preceding the current year together with vouchers relevant to any entry in such books shall be preserved in good order.

Responsibility: The managing director or manager, if company has any manager shall be responsible for keeping the accounts. In all tigers cases the directors’ will be responsible for the same. These persons may charge any other competent and reliable person with the duty of seeing that the requirements in respect of books of account are compiled with. Section 209(6)

15.4 PENALTY FOR DEFAULT
Section 209(5) states that if any of the above persons charged with the responsibility fails to take reasonable steps to secure compliance by the company with requirements of this section or has by a willful act, been the cause of any default by the company, he shall be punishable with imprisonment for a term which may be extend to six months or with a fine which may extend to one thousand rupees or with both, in respect of each such offence.

15.5 INSPECTION OF BOOKS OF ACCOUNTS
Under Section 209(4), the books of the accounts and other books and papers shall be open to inspection by any director during business hours. Section 209A(1) lays down that
the registrar or any officer authorize by the central government may also inspect book of
the accounts and other books and papers of every company during business hours.

1. Duty of directors and officers to help: It is the duty of every director, other officer or
employee of the company to produce to the person making an inspection, all such books
of account and other books and papers of the company in his custody and control [Sec.
209A(2)]. It is also the duty of every director, other officer or employee of the company
to give all assistance to the person making the inspection. [Sec. 209A(3)]

2. Powers of inspecting officer: The person making the inspection under this section may
make copies of books of accounts and other books and papers and may also put any
marks of identification in token of inspection having been done. He shall have all the
powers that a Registrar has in relation to the making of inquiries under this Act.
Similarly, he shall have all the powers vested in a civil court under the Code of Civil
Procedure, 1908 as regards discovery and production of books of account and other
documents, summoning and enforcing attendance of persons and examining them on oath
and inspection of any books, registers and other documents of the company at any place.
After such inspection the person making inspection shall make a report to the Central
Government. [Sec. 209A (4) to (7)]

15.6 ANNUAL ACCOUNTS AND BALANCE SHEET
In the case of a company not conducting business for profit, an income and expenditure
account shall be laid before the company at its annual general meeting, instead of a profit
and loss account.

Period of accounts: The profit and loss account shall relate, in the case of the first annual
general meeting of the company, to the period from the date of incorporation to a date not
later than nine months previous to the date of meeting, and in the case of any subsequent
annual general meeting of the company, to the period beginning with the date
immediately after the date of the last accounts to a date not later than six months previous
to the date of the meeting.

The period of accounts which is called the 'financial year' of the company may be less
or more than a calendar year. It shall not exceed fifteen months but it may extend to
eighteen months if special permission has been granted in that behalf by the Registrar.
Form and Contents of a Balance Sheet and Profit and Loss Account

Form of balance sheet: Every balance sheet of a company shall give a true and fair view of the state of affairs of a company as at the end of the financial year. It must be in the form set out in Part 1 of Schedule VI or as near thereto as circumstances admit, or in such other form as Central Government may approve.

Form of profit and loss account: The profit and loss account shall give a true and fair view of the profit and loss of the company for the financial year and shall comply with the requirements of Part II of Schedule VI.

Companies exempt: The provisions shall not be applicable to any banking or insurance company or any company engaged in the generation or supply of electricity or any other class of company for which a form of balance sheet as well as profit and loss account has been specified in or under the Act governing such a class of company.

The Central Government may, by notification in the official gazette exempt any class of companies from compliance with any of the requirements in the schedule VI if, in its opinion it is necessary to grant such an exemption in the public interest. (Section 211)

Authentication of Balance Sheet and Profit and Loss Account

The balance sheet and profit and loss account of a Company shall be signed on behalf of the board of directors

(i) In the case of a banking company, by the persons specified in Section 29 of the Banking Companies Act. This section provides that the balance sheet and profit and loss account of a banking company shall be signed by the manager or the principal officer of the company and where there are more than three directors by at least three of those directors, or where there are not more than three directors, by all of them;

(ii) In the case of any other company, by its manager or secretary, if any, and by not less than two directors of the company one of whom shall be a managing director. Where only one of its directors is in India, for the time being, he shall sign the balance sheet and profit and loss account. But in such a case there shall be attached to the balance sheet and the profit and loss account, a statement signed by him explaining the reasons for non-compliance with the provisions of this section.

The board of directors shall approve the balance sheet and the profit and loss account
before they are signed on behalf of the board and before they are submitted to the auditors for their report thereon. (Sec. 215)
The profit and loss account shall be annexed to the balance sheet and the auditor's report is to be attached thereto. (Sec. 216)

15.7 BOARD'S REPORT

A report by the board of directors shall be attached to every balance sheet laid before the company in general meeting.

Contents of board's report: The board's report shall contain the following particulars: (a) the state of the company's affairs; (b) the amounts, if any, which it proposes to carry to any reserves in such a balance sheet; (c) the amount, if any, which it recommends should be paid by way of dividends; (d) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year to which the balance sheet relates and the date of the report; (e) conservation of energy, technology absorption and foreign exchange earnings and outgo. [Sec. 217(1)]

The board's report shall also deal with any changes, which have occurred during the financial year (a) in the nature of the company's business; (b) in the nature of business carried on by the company's subsidiaries; and (c) generally in the classes of business in which the company has an interest. [Sec. 217(2)]

Particulars of employees in board's report: The board's report shall also include a statement showing the name of every employee of the company who (a) if employed throughout the financial year, was in receipt of remuneration for that year which, in the aggregate, was not less than seventy-two thousand rupees; or (b) if employed for a part of the financial year, was in receipt of remuneration for any part of that year at a rate which, in the aggregate, was not less than six thousand rupees per month.

The statement shall also indicate whether any such employee is a relative of any director or manager of the company and if so, the name of such a director. (See. 217 (2A))

Fullest information to be given in the report: The board is also bound to give the
fullest information and explanations in its report or in an addendum to that report on every reservation, qualification or adverse remark contained in the auditor's report. [Sec. 217(3)]

*Signatures on the report:* Its chairman thereto shall sign the board’s report and any addendum if he is authorized, in that behalf by the board. Where he is not so authorized it shall be signed by such number of directors as are required to sign the balance sheet and profit and loss account. [Sec. 217(4)]

### 15.8 MEMBERS' RIGHT TO COPIES OF THE BALANCE SHEET AND AUDITOR'S REPORT

*Persons entitled to balance sheet:* Section 219 requires that a copy of every balance sheet together with a copy of the profit and loss account, the auditor's report and hoard's report, which is to be laid before a company in general meeting, shall be sent not less than twenty-one days before the general meeting, to every member of the company, to every trustee for the holders (If any debentures issued by the company and to all other persons entitled to receive notice of general meeting.

Balance Sheet, etc. on demand with a view to reducing the cost of servicing the shareholders, the Companies (Amendment) Act, 1988, dispenses with the requirement of sending detailed accounts to the shareholders of a listed company. It will now be enough in the case of listed companies, if the company sends abridged form of accounts in the prescribed form along with the notice of the meeting and the detailed annual accounts, auditor's report and annual report of directors are made available for inspection at its registered office during business hours for a period of 21 days before the date of the meeting.

However, any member or debenture holder or depositor is entitled to obtain copy of the detailed annual accounts at his request, free of cost. The company must fulfill the demand within seven days of Q1aking the demand.

*Default:* If default is made in complying with the above provision, the Company and every officer of the company who is in default shall be punishable with a fine, which may extend to five hundred rupees. The Company Law Board may also order that the copy demanded must for with be furnished to the person concerned.
15.9  FILING COPIES WITH THE REGISTRAR

Filing three copies within the prescribed time. After the balance sheet and the profit and loss account have been laid before a company at an annual general meeting, three copies of balance sheet and the profit and loss account have to be filed with the Registrar within thirty days of the date on which the balance sheet and the profit and loss account were so laid in the meeting. The Companies (Amendment) Act, 1977 has made it very clear that even if where the annual general meeting of a company for any year has not been held on account of any reasons, the annual accounts have still to be filed with the Registrar within thirty days from the latest day on or before which that meeting should have been held. If the annual general meeting of a company before which a balance sheet is laid does not adopt the balance sheet or is adjourned without adopting the balance sheet, or, if the annual general meeting of a company for any year has not been held, a statement of that fact and other reasons therefore should be annexed to the balance sheet and to the copies required to be filed with the Registrar. The managing director or manager or secretary of the company or in their absence by a director of the company must sign each such copy of the balance sheet and the profit and loss account.

Default: If default is made in complying with the above requirements the company and every officer who is in fault shall be punishable with a fine, which may extend to fifty rupees for every day during which the default continues.

Private company: In case of an independent private company, copies of the balance sheet and copies of the profit and loss account shall be filed with the Registrar separately. This is because a non-member shall not be entitled to inspect or obtain copies of the profit and loss account. (Sec.220)

15.10 ACCOUNTS OF HOLDING AND SUBSIDIARY COMPANIES
Sections 212 to 214 contain special provisions regarding accounts of holding and subsidiary companies.

Balance sheet of holding company: Section 212 provides that there shall be attached to the balance Sheet of a holding company the following documents in respect of its subsidiary company or each of its subsidiary companies as the case may be: (a) a copy of the balance sheet of the subsidiary; (b) a copy of its profit and loss account; (c) a copy of
the report of its board of directors; (d) a copy of report of its auditors; (e) a statement of the holding company's interest in the subsidiary company; if) if the board of directors of the holding company is unable to obtain information on any of the above matters, a report in writing to that effect must be attached to the balance sheet of the holding company; and (g) where the financial year of a subsidiary company does not coincide with the financial year of the holding company, a statement shall be attached to the balance sheet of the holding company showing any change in the latter's interest in the subsidiary between the end of the financial year of the subsidiary and the end of the holding company's financial year. The statement shall also show any material change that has taken place during this time in respect of the subsidiary's fixed assets, its investments, the money lent by it and borrowed by it for any purpose other than that of meeting current liabilities.

Financial year of holding company and subsidiary: Section 213 empowers the Central Government to direct a holding company or its subsidiary company to postpone the annual general meeting or the making of the annual return so that the financial year of the subsidiary company may end with the financial year of the holding company.

Rights of holding company's representatives: Section 214 lays down that a holding company's representatives appointed by a resolution at a general meeting may inspect the books of account of its subsidiaries. The books of account of any such subsidiary shall be open to inspection by those representatives at any time during business hours.

15.11 QUALIFICATION AND DISQUALIFICATION OF A COMPANY AUDITOR

The Companies Act makes it compulsory for every company to have its accounts audited by qualified auditors. The desirability of this provision can be based on the fact that Shareholders who contribute the capital of the company leave its management and control in the hands of directors. Auditors are there to safeguard the interest of shareholders.

Qualification of a company auditor

A person shall not be qualified for appointment as auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949. A
firm whereof all the partners practicing in India are qualified for appointment as aforesaid may be appointed by its firm name to be the auditor of a company. In such a case any partner so practicing may act in the name of the firm. [Sec. 226(1)]

Disqualifications
None of the following persons shall be qualified for appointment as auditor of a company: (a) a Body Corporate (b) an officer or employee pf the company (c) a person who is a partner or who is in the employment of an officer or employee of the company and (d) a person who is indebted to the company for an amount exceeding one thousand rupees or who has given any guarantee or provided any security in connection with the indebtedness of the third party to the company for an amount exceeding one thousand rupees. (Section 226(3))

A person shall also not be qualified for an appointment as auditor of a company if he is disqualified for such an appointment of any other company which is that company’s subsidiary or holding company or a subsidiary of that company’s holding company. (Section 226(4)).

15.12 APPOINTMENT OF AUDITOR

(1) First auditors: The first auditor or auditors of company shall be appointed by the board of directors within one month of the date of registration of the company. The auditor or auditors so appointed shall hold office until the conclusion of the first annual general meeting. The company may at general meeting remove the auditors appointed by the board and appoint others in their place of which notice has been given to the members of the company not less than fourteen days before the date of the meeting. if the board fails to make such an appointment, the company in general meeting may make it. [Sec. 224(5)]

(2) Subsequent auditors: The auditors are appointed at every annual general meeting of the company and they hold office from the conclusion of that meeting till the conclusion of the next annual general meeting. The company shall give intimation of appointment to every auditor within seven days of the appointment. [Sec. 224(1)]

Every auditor so appointed must give notice of his appointment to the Registrar of Companies within thirty days of receipt of the intimation informing the Registrar that he has accepted or refused to accept the appointment. [Sec. 224(1A)]
The Special resolution for appointment of auditors in certain cases: The appointment of auditors is made by an ordinary resolution passed at the annual general meeting of the company. But where twenty-five percent or more of the subscribed share capital of the company is held jointly or singly by a public financial institution, a government company, central government, any State Government, a nationalized bank or an insurance company carrying on general insurance business, the appointment or reappointment of an auditor shall be made by a special resolution at each annual general meeting. It is further provided that if a special resolution has not been passed, it shall be deemed that the appointment has not been made and the Central Government will appoint a person to fill the vacancy. (See. 224A)

Restriction on number of companies for appointment as an auditor: No Company shall appoint or reappoint any person as its auditor if such person is at the date of appointment or reappointment holding appointment as auditor of 20 companies. This means that a person cannot be an auditor of more than 20 companies at a time. As a result of the companies (Amendment) Act, 1988, a person in whole-time employment elsewhere will not be eligible to be appointed as auditor of a company. Similarly, any partner of a firm of Chartered Accountants, who is in fulltime employment elsewhere, shall not be taken into account form putting the ceiling on number of companies that can be under audit with the firm. Out of these 20 companies not more than 10 companies should have a paid-up share capital of Rupees twenty-five lakhs or more. The limit of 20 lakhs is for each auditor. Where a firm has five partners, the total number of companies that firm can audit will be 100 provided no partner of the firm is in full time employment elsewhere and no particular partner of the firm is assigned more than 20 companies. If a person is a partner in four firms, he will not be entitled to audit more than 20 companies in aggregate. If a person is appointed in his individual capacity as well as partner in a firm, the total number of companies in both capacities can not exceed 20. Partial audit or joint audit will be treated as one appointment of auditor and should be taken into the limit of 20 in respect of each of such auditor. [Sec. 224(IB)]

(3) Casual vacancy: The board may fill any casual vacancy in the office of an auditor. Where such a vacancy is caused by the resignation of an auditor, it shall only be filled by the company in general meeting. Any auditor appointed in a casual vacancy
shall hold office until the conclusion of the next annual general meeting. [Sec. 224(6)]

(4) Central Government to appoint auditors in certain cases: Whereat the annual general meeting, no auditors are appointed or reappointed, the Central Government may appoint a person to fill the vacancy. [Sec. 224(3)]

It is the duty of the company to inform the Central Government within 7 days if it fails to appoint or reappoint auditors at an annual general meeting. If the company fails to give notice, the company and every officer of the company who is in default, shall be punishable with a fine, which may extend to five hundred rupees. [Sec. 224(4)]

Similarly, where the appointment or reappointment is to be made by a special resolution as per Section 224A(1) and the company fails to pass, at its annual general meeting, any special resolution appointing an auditor or auditors, it shall be deemed that no auditor or auditors had been appointed by the company at its annual general meeting and the Central Government may appoint a person to fill the vacancy in such a case. [Sec. 224(2)]

(5) Appointment of auditors of a government company: The auditor of a government company shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor General of India. [Sec. 619(2)] Section 619-B also empowers the Central Government to appoint auditors on the advice of the Comptroller and Auditor General of India, in the same manner as is now adopted for government companies under Section 619, in all companies in which not less than fifty-one per cent of the paid-up share capital is held by one or more of the following or any combination thereof: (a) Central Government, (b) State Government, (c) Government Companies, (d) corporations owned or controlled by the Central Government or the State Government.

15.13 REMUNERATION OF AUDITORS

If the auditors by the board of directors or the central government, their remuneration may be fixed by the board or central government as the case may be. If the auditors have been appointed by the shareholders in general meeting, their remuneration shall be fixed by the company in general meeting or in such manner as the company In~ general meeting may determine Any sums paid by the company in respect of the auditors' expenses shall be deemed to be induced in the expression "remuneration." [Sec. 224(8)]
Removal of auditors

**First auditors.** The company may, at general meeting, remove the first auditors, appointed by the board and appoint in their place any other persons who have been nominated for appointment by any member of the company and of whose nomination notice has been given to the members of the company not less than fourteen days before the date of the meeting. [Sec. 224(5)(a)]

**Subsequent auditors.** Subsequent auditors may be removed from office before the expiry of their term only by the company in general meeting, after obtaining the previous approval of the Central Government in that behalf. [Sec. 224(7)]

Special notice of at least fourteen days shall be required for a resolution at an annual general meeting appointing, as auditor, a person other than a retiring auditor or providing expressly that a retiring auditor shall not be reappointed. [Sec. 225(1)]

On receipt of notice of such a resolution, the company shall forthwith send a copy thereof to the retiring auditor who shall be entitled to make representations, in writing and not exceeding a reasonable length to the company. The company must send a copy of the representation to the shareholders provided such a representation is received in time. If a copy of the representation is not sent to the members because it was received too late or because of the company's default, the auditor may require that the representation be read out at the meeting. If the court is satisfied that provisions of this section are being abused to secure needless publicity for defamatory matter, it may order that copies of the representation need not be sent out and that it need not be read out at the meeting. [Sec. 225(2, 3)]

**15.14 RIGHTS AND POWERS OF AUDITORS**

(1) **Right of access to books of account:** Every auditor of a company shall have the right of access at all times to the books and accounts and vouchers of the company, whether kept at in head office or elsewhere.

(2) **Right to call for information and explanation:** He shall be entitled to require from the officers of the company such information and explanations as the auditor may think necessary for the performance of his duties as auditor. [(Section 227(1)]

(3) **Right to receive notice of general meeting:** All notices of, and other
communications relating to, any general meeting of a company which any member of the company is entitled to have sent to him shall also be forwarded to the auditor of the company.

(4) **Right to attend general meetings:** He shall be entitled to attend any general meeting and to be heard at any general meeting, which he attends on any part of the business, which concerns him as auditor. (Sec. 231) audited by a person other than the company's auditor, the latter shall (a) be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor; and (b) have a right of access at all times to the books and accounts and vouchers of the branch office.[Sec. 228(2)]

(5) **Right to sign the audit report:** Section 229 provides that only the person appointed as auditor of the company or where a firm is so appointed, only a partner of the firm practicing in India, may sign the auditor’s report or sign or authenticate any other document of the company required by law to be signed or authenticated by the auditor.

### 15.15 DUTIES OF AN AUDITOR

The duties of an auditor may be discussed under the two heads, namely: (a) statutory duties; and (b) general duties.

**Statutory duties.** Following are the statutory duties of auditors:

(1) **Duty to make a report to the members:** The auditor shall make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit and loss account and every 10cument declared to be part of or annexed to the balance sheet or profit and loss account, which are laid before the company in general meeting during his tenure of office. The report shall state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by this Act in a manner so required and give a true and fair view, (a) of the state of the company's affairs at the end of its financial year in the case of the balance sheet; and (b) of the profit or loss for its financial year in the case of its profit and loss account, The object of this provision is to secure to the shareholders, independent and reliable information respecting the true financial position
of the company at the time of audit. If the auditors feel that proper books of account have not been maintained as required by the Act or the accounts do not represent a true and fair view, they must mention it in their report to the shareholders. Lindley L.J. in *Re London and General Bank (No.2)* observed as follows: "A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them, to ask for more.

An auditor who gives shareholders means of information, instead of information, in respect of a company's financial position does so at his peril and runs the very serious risk of being held, judicially, to have failed to discharge his duty."

In this connection it must be noted that the auditor shall be considered to have complied with his duty to report to the members, if he signs his report and the balance sheet and sends them to directors. It is not the auditor's duty to see that the directors call a meeting and that his report is sent or placed in the hands of shareholders.4

The auditor's report shall also state (a) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit; (b) whether in his opinion, proper books of accounts as required by law have been kept by the company and proper returns adequate for the purposes of his audit have been received from branches not visited by him; (c) whether the report on the accounts of any branch office audited by some person other than the company's auditor has been forwarded to him and how he had dealt with the same in preparing the auditor's report; and (d) whether the Company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns. (Sec. 227(3))

Where any of the above mentioned matters is answered in the negative or with a qualification, the auditor's report shall state the reason for the answer. (Section 227(4))

Section 227(4A) empowers the Central Government to direct that in the case of such class or description of companies as may be specified in the order, the auditor's report shall also include a statement on such matters as may be specified therein. In exercise of the power conferred by the above section, the Company Law Board issued on 7 September 1988 an order called "The Manufacturing and Other Companies (Auditor's Report) order, 1988 and it came into force on 1 November, 1988.
The auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company. (Sec. 230)

(2) **Duty to make enquiries:** Section 227(1A) introduced by the Companies (Amendment) Act, 1965, has imposed a duty on auditors to inquire:

(i) Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;

(ii) Whether transactions of the company, which are represented merely by book entries, are not prejudicial to the interests of the company;

(iii) Where the company is an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they are purchased by the company;

(iv) Whether loans and advances made by the company have been shown as deposits;

(v) Whether personal expenses have been charged to revenue account;

(3) **Duty to assist inspectors:** It shall be the duty of the auditor to preserve and produce for an inspector all books and papers at company which are in his custody or power. He shall also give the inspector all assistance in connection with the investigation, as he is reasonably able to give. [Sec. 240(1)]

(4) **Duty to certify statutory report:** The auditor has to certify the statutory report as correct, insofar as the report relates to the shares allotted by the company, the cash received by the company in respect of such shares and the receipts and the payments of the company. (Section 166(4))

(5) **Duty in relation to the issue of prospectus:** Section 56(1) provides that every prospectus issued by an existing company shall contain a report by the auditors of the company relating to the profit and loss and assets and liabilities of the company. The report must refer to the rates of dividends, if any, paid by the company in respect of each class of shares for each of the five financial years before the issue of the prospectus. The report of the auditor must also state separately the profits and losses of the company's subsidiaries and also its combined profits and losses.

(6) **Duty in relation to the declaration of solvency:** In case of members’ voluntary winding up, the declaration of solvency’s must be accompanied by a copy of the
auditors' report on the profit and loss account and the balance sheet of the company prepared up to the date of the declaration and should embody a statement of the company's assets and liabilities as on that date. [Sec. 488(2(b)]

The statutory duties of the auditors can be expanded but the articles or the directors of the company cannot restrict them.

**General Duties**

In addition to the above statutory duties, there are certain other duties of an auditor, which have been recognized by courts. These general duties are stated below:

1. An auditor must be honest, that is, he must not certify what he does not believe to be true.
2. He must exercise reasonable care and skill in the discharge of his duties.

What is reasonable care and skill depends upon the circumstances Of each case, Where there is nothing to excite suspicion, very little enquiry will be reasonable and sufficient; and when suspicion is aroused, more care is obviously necessary but still an auditor is not bound to exercise more than reasonable care and skill even in else of suspicion. He is perfectly justified in acting on the opinion of an expert where special knowledge is required. If he fails to exercise reasonable care and skill, he may be held liable for damages.

3. It is the duty of an auditor to verify not merely, the arithmetical accuracy of the balance sheet but its substantial accuracy. An auditor isn’t to be confined to mechanics of checking vouchers and making arithmetical computations. He must see that the books show a true and correct representation of company's affairs. The auditor must check cash in hand and also bank balance at bank by inspecting the pass-book or by obtaining certificate from the bank. Similarly, he should verify the existence of assets and not assume as true the particulars given in earlier balance sheets or the words of persons in management of the company. The professional standards have undoubtedly risen in recent years. **Controlled of Insurance v/s. H.C Das**, it was held that an auditor should not merely rely upon the statements of persons who constitute the management in matters capable of direct verification by him from books, accounts and vouchers.
4. An auditor is a watchdog, not a bloodhound. He is not a detective nor is he to approach his work with suspicion. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe into the bottom, but in the absence of anything of that kind, he is only bound to be reasonably cautious and careful. It was held that it was no part of an auditor's duty to take stock and that he is not guilty of negligence if he accepts a certificate of the manager as to the value of stock in the absence of suspicious circumstances.

5. An auditor must report all material facts and points to the shareholders. He is not bound to give advice either to directors or shareholders as to what they ought to do: He is not concerned with the policy of the company.

6. An auditor not only owes a duty of protecting shareholders but also owes a duty of care even to a non-member if he knows that his audited accounts are going to be produced in order to attract someone to invest in the company, unless there is an express disclaimer of responsibility.

15.16 AUDITING BRANCH OFFICE ACCOUNTS

Where a company has a branch office, the accounts of that office shall be audited by the company's auditor or by a person qualified for appointment as auditor of the company. Where the branch office is situated in a country outside India, the accounts shall be audited either by the company's auditor or by a person a qualified according to the provisions of the Act, or by an accountant duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country. [Sea. 228(1)]

Audit of branch accounts by a person other than the company's auditor: Where the accounts of any branch office are audited by a person other than the company's auditor, the latter shall (a) be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor; and (b) have a right of access at all times to the books and accounts and vouchers of the company maintained at its branch office.

In the case of a banking company having a branch office outside India, it shall be sufficient if the auditor is allowed access to such copies of and extract from, the books
and accounts of the branch as have been transmitted to the company's principal office in India. [Sec. 228(2)]

Where a company in general meeting decides to have the accounts of a branch office audited otherwise than by the company's auditor, the company in that meeting shall, for the audit of those accounts, appoint a person qualified for appointment as auditor of the company or, where the branch office is situated in a country outside India, a person who is either qualified as aforesaid or an accountant duly qualified to act as an auditor of the branch office accounts in accordance with the laws of that country, or authorize the board of directors to appoint such a person in consultation with the company's auditor. [Sec. 228(3)(a)]

**Powers and duties of branch auditor:** The person so appointed (hereafter referred to as the branch auditor) shall have the same powers and duties in respect of audit as the company's auditor has in respect of the same. [Sec. 228(3)(b)].

The branch auditor shall prepare a report on the accounts of the branch office examined by him and forward the same to the company's auditor, who shall, in preparing the auditor's report, deal with the same. In such manner as he considers necessary. [Sec. 228(3)(c)]

**Remuneration of branch auditor:** The branch auditor shall receive such remuneration and shall hold his appointment subject to such terms and conditions as may be fixed either by the company or by the board of directors, if so authorized, in general meeting. [Sec. 228(3)(d)]

**Exemption of branch audit:** The Central Government may make rules providing for the exemption of any branch office from the provisions of this section and, in making such rules, the Central Government shall have regard to all or any of the following matters, namely:

(i) The arrangement made by the company for auditing the accounts of branch office by a person otherwise qualified for appointment as branch auditor, even though such a person may be an officer or employee of the company;

(ii) The nature and quantum of activity carried on at the branch office during the preceding three years;

(iii) The availability at a reasonable cost of a branch auditor; and
(iv) Any other matter which in the opinion of the Central Government justifies the grant of exemption. [Sec. 228(4)]

15.17 SPECIAL AUDIT

Circumstances of special audit: Where the Central Government is of the opinion that (a) the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or (b) that any company is being managed in a manner likely to use serious injury or damage to the interests of the trade, industry or business to which it pertains; or (c) that the financial position of any company is such as to endanger its solvency, the Central Government may direct that a special audit of the company's accounts be conducted. The Central Government shall appoint either a chartered accountant or the company's auditor to conduct such special audit. [Sec. 233A(1)]

The chartered accountant or the company's auditor appointed for the purpose of special audit shall be known as a special auditor. [Sec. 233A(2)]

Powers and duties of special auditor: The special auditor shall have the same powers and duties as the auditor of the company has under the Act, except that he shall make his report to the Central Government and not to the members of the company. [Sec. 233A(3)]

Expenses of special audit: The expenses of any special audit shall be determined by the central Government and shall be payable by the company. [Section 233A(7)]

Report by special auditor: His report shall include all matters required to be included in an auditor's report under Section 227 and, if the Central Government so directs, shall also include a statement on any other matter which may be referred to him by that Government. [Sec. 233A(4)]

Action on the report: On receipt of the report of the special auditor, the Central Government may take such action as it considers necessary. If it does not take any action on the report within four months of the date of its receipt, a copy of the report shall be sent to the company requiring it to circulate or read the report to members at the next annual general meeting. [Sec. 233A(6)]

15.18 COST AUDIT

Audit of cost accounts: Section 233B empowers the Central Government to order the
conducting of cost audits of companies engaged in production, processing, manufacturing or mining activities for which maintenance of cost accounts had been prescribed under Section 209. The auditor must be either a cost accountant within the meaning of the Cost and Works Accountant Act, 1959, or any chartered accountant within the meaning of the Chartered Accountants Act, 1949. The conduct of audit shall take place in such manner as may be prescribed in the order. [Sec. 233B (1)]

*Appointment of cost auditor:* The auditor under this section shall be appointed by the board of directors of the company with the previous approval of the Central Government. The Companies (Amendment) Act, 1988, further provides that the provisions of Section 224(1B) applicable to the statutory auditors in regard to the number of companies in which a person can be appointed as an auditor, shall now apply to cost auditors too. Accordingly, before the appointment of any cost auditor is made by the board of directors, a written certificate shall be obtained from the auditor proposed to be appointed to the effect that the appointment, if made, will be in accordance with the provisions of Section 224(1B). [Sec. 223(B)2]

An audit conducted by an auditor under this section shall be in addition to the usual audit of the company accounts.[Section 223B(3)]

*Power and duties of cost auditor:* He shall have the same powers and duties in relation to the audit conducted by him as an auditor of the Company has under the Act. He shall make his report to the Central Government in such form and within such time as may be prescribed, and shall also forward a copy of the report to the company. [Sec. 233B(4)]

*Qualifications of cost auditor:* A person who is disqualified for appointment as an auditor according to the provisions of the Act shall not be appointed or reappointed for conducting the audit of the cost accounts of a company. Anyone appointed for conducting such an audit shall cease to do so if, after his appointment he (a) attracts any of the disqualifications of a company auditor; or (b) is appointed as the auditor of the company. [Sec. 33B(5)]

*Assistance to be given to cost auditor:* When the Central Government orders a company to conduct the audit of its cost accounts, it shall be the duty of the company to give all facilities and assistance to the person appointed for conducting such an audit. [Sec.
233B(6)

Information to be given to Central Government: On receipt of a copy of the report from the cost auditor, the company shall furnish the Central Government with full information and explanation on every reservation or qualification contained in such a report. [Sec. 233B(7)]

If the Central Government is of the opinion that any further information or explanation is necessary, the Government may call for such further information and explanations. [Sec. 233B(8)]

Action on the report: On receipt of the report of the cost auditor and the information and explanations furnished by the company, the Central Government may take such action on the report, as it considers necessary. [Sec. 233B(9)]

The Central Government may direct the company to circulate the report of the cost auditor to its members, along with the notice of the annual general meeting to be held for the first time after the submission of such a report. [Sec. 233B(10)]

15.19 SUMMARY

Every company has to keep at its registered office books of accounts. Where a company has branches, the principal company must get, at intervals of three months, summarised accounts of such branches. The financial year may be less or more than a calendar year, but it must not exceed 15 months. Sections 224 to 233 of the Act contain various provisions relating to appointment, removal and duties etc. of the auditors. The Central Government has powers to issue necessary directions for conducting cost audit of companies engaged in production, processing, manufacturing or mining activities.

15.20 KEYWORDS

Period of Preservation: Books of the accounts of every company relating to a period of not less than eight years immediately preceding the current year together with vouchers relevant to any entry in such books shall be preserved in good order.

Board's Report: A report by the board of directors shall be attached to every balance sheet laid before the company in general meeting.
15.21 SELF ASSESSMENT QUESTIONS

1. What are the provisions of the Companies Act relating to the maintenance, inspection, authentication and filling of accounts?

2. What are the books of account required to be kept by a company and where? Who are the persons who can inspect these books?

3. Distinguish between annual returns and annual accounts.

4. "There shall be attached to every balance sheet laid before a company in general meeting a report by its board of directors". What are the matters which are required by law to be mentioned in the Directors' Report?

5. What are the provisions of the Companies Act relating to the qualifications, appointment, remuneration and removal of auditors?

6. Examine the provisions for the appointment and/or reappointment of the auditors by:
   (i) A new company appointment of first auditors.
   (ii) A public company where public 'financial institutions/government etc., hold not less than twenty-five per cent of the subscribed capital.
   (iii) Government companies.

7. "An auditor is not bound to be detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong" Examine this statement with reference to powers and duties of auditors.

8. Discuss the powers and duties of an auditor under the Company Act.

15.22 SUGGESTED READINGS

Lesson - 16

COMPROMISES, ARRANGEMENTS AND RECONSTRUCTION

Structure

16.0 Objective

16.1 Introduction

16.2 Power of the High Court to Enforce Compromise and Arrangement

16.3 Reconstruction and Amalgamation

16.4 Takeover and Acquisition of Minority Interest

16.5 Summary

16.6 Keywords

16.7 Self Assessment Questions

16.8 Suggested Readings

16.0 OBJECTIVE

The main objective of this lesson is to make the students familiar with the provisions that provide the rulings about compromise, arrangements and reconstructions in corporate sector.

16.1 INTRODUCTION

Interpretation of Sections 391 and 393 for the purpose of compromise, arrangements and reconstructions are given hereunder:
(a) The expression “company” means any company liable to be wound up under this Act;

(b) The expression “arrangement” includes a reorganization of the share capital of the company by the consolidation of shares of different classes, or by the division of shares into shares of different classes or, by both these methods; and

(c) Unsecured creditors who may have filed suits or obtained decrees shall be deemed to be of the same class as other unsecured creditors.

Sections 391 to 393 deals with the provisions relating to compromises and arrangements and are applicable to all companies, which are going concerns. In term, ‘compromise’ means a settlement of dispute or controversy by the method of making mutual concessions. Compromise implies the parties agree not to try it out but to settle it between themselves by a give and take arrangement. As in the case of individuals, companies also enter into compromises with their creditors or members and the settlement arrived at is called ‘compromise’.

The term “arrangement” is wider in scope than the word ‘compromise’. It is not limited to compromise alone, and includes re-organization of share capital by the consolidation of shares of different classes, including modification of preferential and other special rights attached to shares. Arrangement may be made in anticipation of a dispute, whereas compromise is arrived at the conclusion of the dispute.

Power to compromise or make arrangements with creditors and members

Under section 391, there are following provisions:

(1) Where a compromise or arrangement is proposed (a) between a company and its creditors or any class of them; or (b) between a company and its members or any class of them; the Court may, on the application of the company or of any creditor or member of the company, or, in the case of a company which is being wound up, of the liquidator, order a meeting of the creditors or class of creditors,
or of the members or class of members, as the case may be, to be called, held and conducted in such manner as the Court directs.

(2) If a majority in number representing three-fourths in value of the creditors, or Class of creditors, or members, or class of members, as the case may be, present and voting either in person or, where proxies are allowed [under the rules made under section 643], by proxy, at the meeting, agree to any compromise or arrangement, the compromise or arrangement shall, if sanctioned by the Court, be binding on all the creditors, all the creditors of the class, all the members, or all the members of the class, as the case may be, and also on the company or in the case of a company which is being wound up, on the liquidator and contributories of the company.

(3) An order made by the Court under sub-section (2) shall have no effect until a certified copy of the order has been filed the Register.

(4) A copy of every such order shall be annexed, to every copy of the memorandum of the company issued after the certified copy of the order has been filed as aforesaid, or in the case of a company not having a memorandum, to every copy so issued of the instrument constituting or defining the constitution of the company.

(5) If default is made in complying with sub-section (4), the company, and every officer of the company who is in default, shall be punishable with fine, which may extend to ten rupees for each copy in respect of which default is made.

(6) The Court may, at any time after an application has been made to it under this section, stay the commencement or continuation of any suit or proceeding against the company on such terms as the Court thinks fit, until the application is finally disposed of.

(7) An appeal shall lie from any order made by a Court exercising original jurisdiction under this section to the Court empowered to hear appeals from the
decisions of that Court, or if more than one Court is so empowered, to the Court of inferior jurisdiction.

The Provisions of sub-sections (3) to (6) shall apply in relation to the appellate order and the appeal as they apply in relation to the original order and the application.

In fact, the spirit of section 391 empowers a company to compromise and settle disputes with its creditors and members without going to any arbitration for the purpose. A company either as a going concern in a winding up may compromise or enter into an arrangement with its creditor or by the member of the company and by the liquidator if the company is being wound up. The word ‘creditor’ here includes all persons having pecuniary claims against the company. The sales tax department if it has a claim, is a creditor. A worker whose salary is not paid is a creditor.

On such application, the court may order that a meeting of the creditors, class of creditors, or of the members or class of members, as the case may be, be called, held, and conducted in such manner as the court directs. The court shall fix the time and place of such meeting, appoint a chairman of the meeting, fix the quorum and the procedure to be followed at the meeting including voting by proxy, determine the values of the creditors and/or members, provide as to the persons whom a notice is to be given and fix the time within which the chairman is to report to the court the result of the meeting. The court has no power to dispense with the meeting even if all the creditors or members are in favour of the proposed compromise or arrangement.

Where a majority in number representing three fourths in value of the creditors, or of class of creditors, or members or class of members, as the case may be, assent to any compromise or arrangement, it will be sanctioned by the court. Those present at the meeting may vote in person, or by proxy. Such a compromise or arrangement will be binding on all the parties though the court will sanction of
compromise or arrangement which is fair and reasonably and made in good faith and if it could reasonable be supposed by intelligent and honest people to be for the benefit of each class of the members or creditors concerned.

The court may not sanction the compromise or arrangement unless it is satisfied that:

(i) the circumstances are such that the scheme should be sanctioned; and

(ii) the company or any other person by whom application has been made has disclosed to the court all material facts relating to the company; such as the latest financial position of the company, the latest auditor’s report on the accounts of the company, the tendency of any investigation proceedings in relation to the company under sections 235 to 251 and the like.

An order made by the court shall have no effect until a certified copy of the order has been filed with the registrar. A copy of every such order shall be annexed to every copy of memorandum issued by a company so that persons dealing with the company have notice of the scheme. Default in this regard shall make the company and every officer of the company, who is in default, punishable with fine upto Rs.10 for each copy in respect of which default is made.

The court has power, at any time after an application has been made to it, to stay the commencement or continuation of any suit or proceeding against the company until the application is disposed of.

Notice to central government. The court shall give notice of every application made to it under section 391 to the central government and shall also take into consideration the representations if any, made to it by that government before passing any order [Section 394-A].

16.2 POWER OF THE HIGH COURT TO ENFORCE COMPROMISE AND ARRANGEMENT

Where a High Court makes an order under section 391, sanctioning a
compromise or arrangement in respect of a company, it is empowered to supervise the carrying out of the compromise or arrangement and issue directions or make modifications in the compromise or arrangement necessary for the proper working of the scheme. [Section 392 (1)].

Where the court is satisfied that the scheme cannot be worked satisfactorily with or without modification, it may either on its own motion or on the application of any person interested in the affairs of the company, makes an order for compulsory winding up of the company. [Section 392 (2)].

Information as to compromise [Section 393]. Section 393 requires that with every notice calling a meeting of creditors or members under Section 391 there shall be sent a statement explaining the terms of the scheme and its effects. The material interests of the directors, managing director or manager of the company must also be stated, whether such interest arise in capacities as such, or as members or creditors of the company or otherwise. The effect of those interests shall be explained stating it and how they are different from the like interests of other persons.

If a meeting is convened by advertisement, the advertisement must include such a statement or it must state where and in what manner a copy of the statement may be obtained. If the rights of the debenture holders are affected by the scheme, the interest of the trustees shall also be disclosed. Copies of statement shall be furnished to members or creditors on application free of charge.

The company and every other officer who is in default shall be liable to a fine upto Rs.5,000/-. A person shall, however, not be liable if default is due to refusal to supply the necessary particulars to the director, managing director, manager or trustees for debenture holders.

Persons whose interest must be disclosed should give notice to the company of such matters relating to them as may be necessary. Default in doing so
is punishable with fine upto Rs.500.

### 16.3 RECONSTRUCTION AND AMALGAMATION

The words ‘reconstruction’ and ‘amalgamation’ have no definite legal meaning. Generally the expression ‘reconstruction’ or ‘reorganizations’ is used where only one company is involved and the rights of its shareholders or creditors as varied. ‘Amalgamation’ is used where two or more companies are amalgamated or where one is merged in another or taken over by another.

Where a company transfers its assets to a new company with substantially the same shareholders, with a view to its being continued by the transferee company, there is a reconstruction. It is thus a scheme under which an old company goes into liquidation for the specific purpose of selling its assets to a new company.

In fact it is just like putting old wine in a new bottle after being refined. The new company is formed with precisely the same objects, the similar name and composed of the same shareholders. The object to reconstruct is usually to reorganize capital, or to compound with creditors or to effect economies.

An amalgamation is the merger of two or more companies into one. “Amalgamation is a state of things under which either two companies are so joined as to form a third entity or one is absorbed into or blended with another”. Thus under an amalgamation two or more companies are merged either de jure by consolidation of either undertakings or de facto by the acquisition of the controlling interest in the share capital of one by the other or the capital of both by a new company.

**Reasons for amalgamation.** It may for large-scale production and thereby achieving economies or it may be to get assured supply of raw materials or channels of marketing. Amalgamation may also be to eliminate competitors from the market. It may be also for diversification of one activity and for expansion of
the business. A scheme of merger or amalgamation is put through sometimes for acquiring the assets of another company at a low price.

Sections 394 and 395 lay down two modes for carrying out a scheme of reconstruction and amalgamation namely; (i) by transfer of undertaking; and (ii) by transfer of shares.

Under section 394, the court is empowered to facilitate reconstruction of any company or the amalgamation of any two or more companies. Where an application is made to the court under section 391 for the purpose of sanctioning a compromise or arrangement and the court is shown that the same has been proposed for the purpose of reconstruction or amalgamation and the whole or any part of the undertaking, property or liabilities of any company concerned in the scheme is to be transferred to a transferee company, the court may make necessary orders. The order of the court may provide for the following matters:

1. Transfer of the whole or any part of the undertaking, property or liabilities of one company to another.

2. The allotment or appropriation by the transferee company of any shares, debentures, policies or other like interest.

3. The continuation of legal proceedings by or against the transferee company.

4. The dissolution of the transferor company without the procedure of winding up.

5. The provision to be made for any persons who dissent from the compromise or arrangement.

6. Such other incidental, consequential and supplemental matters necessary for effectively carrying out the scheme of reconstructions or amalgamation.

The court will not sanction the amalgamation of a company in winding up with any other company or companies unless the court has received a report from the Company Law Board or the registrar that the affairs of the company have not
been conducted in a manner prejudicial to the interests of its interests or to the public interest.

Further, an order for the dissolution of the transferor company shall not be made unless the court has received a report from the official liquidator that the affairs for the company have not been conducted in a manner prejudicial to the interests of its members or public interest. [Section 394 (1)].

The court shall also give notice of every such application to the central government and shall take into account the representation, if any, made by that government before sanctioning the scheme. [Section 394 - A].

An order of the court directing transfer will automatically vest the transferred properties and liabilities in the transferee company. It may also direct such transfer to be free from any charge, if the compromise or arrangement provides for the same. [Section 394 (2)].

Within 30 days from the date of order, a certified copy of the same shall be filed with the registrar for registration. Penalty for default is a fine upto Rs.50 for company and every officer who is in default. [Section 394 (3)].

16.4 TAKEOVER AND ACQUISITION OF MINORITY INTEREST

Section 395 provides for another form of arrangement or amalgamation and does not require any application to the court on the lines of section 391. Where the necessary majority has been obtained for the scheme, the court will only interfere in case any dissenting member makes application questioning the fairness of the scheme. This section applies if the scheme or arrangement involves transfer to a single transferee company and not where it involves transfer to two or more companies jointly. Section 395 provides for compulsory acquisition of shares of dissenting shareholders. The term ‘dissenting shareholder’, according to clause 5(a) of this section includes (i) one who has not assented to the scheme or contract for transfer, and (ii) any shareholder who has failed or refused to transfer his
shares to the transferee company in terms of the compromise or arrangement.

Where the scheme or contract involves the transfer of shares in a company to another company, the said scheme or contract may be placed before the shareholders of the company who have the option to approve the offer within four months. Approval must be accorded by at least nine tenths in value of the shares whose transfer is involved. The shares already held by the transferee company shall be excluded while calculating this number. The transferee company, may, within two months, after the expiration of the four months, give notice in the prescribed form to the dissenting shareholders of its desire to acquire his shares. Within one month from the date of the notice, any dissenting shareholder may apply to the court. The court may make an order as asked for or refuse it. If the court refuses the application or if no application is made, the transferee company becomes entitled and also become bound to acquire those shares on the same terms on which the shares of the approving shareholders are to be transferred.

Where the transferee company holds more than ten per cent of the shares to which the offer relates, the transferee company will not get the right to acquire the shares of the dissenting shareholders; unless -

(a) The offer is made to the remaining holders of the shares;
(b) The assenting shareholders hold ninety per cent of such shares;
(c) The assenting shareholders are not less than three fourths in number of the holders of such shares. [Sec. 395 (1)].

Where the shares transferred under the scheme or contract together with the shares held by the transferee company amount to nine tenths in value of the shares in the transferor company, the transferee company must, within a month after the transfer give notice of that fact to the holders of the remaining shares who have not assented to the scheme or contract. Thereupon the holders of such shares, within three months after the notice, require the transferee company to acquire the
shares in question on the terms on which the shares of the approved shareholders were transferred or on such terms as may be agreed or fixed by the court on the application of either the transferee company or the shareholder [Section 395 (2)].

Where the transferee company has given the notice under section 395 (1) and the court has made no order to the contrary, on the application of the dissenting shareholder, the transferee company on expiry of one month from the notice (and if application has been made to the court, on expiry of one month from disposal thereof) transmit to the transferee company a copy of the notice together with an instrument of transfer executed transferee company and pay the price thereof to the transferee company as the holder of these shares. It shall also within one month from the date of such registration 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. However, no transfer is required in case of shares for which warrant is outstanding. [Section 395 (3)].

The transferee company must pay into a separate bank account any money by way of consideration and it shall hold such money or any other consideration (as shares in the transferee company), in trust for the former shareholders. [Section 395 (4)].

In order to prevent malpractices relating to an offer of a scheme or contract involving the transfer of shares from one company to another, the Companies (Amendment) Act, 1965, has made the following provisions-

1. Every such offer or every circular containing the offer or every recommendation to the members of the transferor company by its directors to accept the offer shall be accompanied by such information as may be prescribed.

2. Every such offer shall contain a statement by or on behalf of the transferee company, disclosing the steps taken for payment of necessary money.
3. Every circular containing or recommending acceptance of such an offer shall be presented to the registrar for registration and no such circular shall be issued until it is so registered.

4. The registrar may refuse to register any such circular, which does not contain the prescribed information, or which sets out such information as is deceptive.

5. An appeal shall lie to the court against an order of the registrar refusing to register any such circular.

Any person who issues a circular without being registered shall be punished with fine, which may extend to Rs.500 [Section 395(4A)].

*Amalgamation in national interest.* Section 396 is a new provision and it is intended to provide, at the instance of the central government, for the amalgamation of two or more companies in the national interest. The power to order compulsory amalgamation is evidently and ancillary power intended to be used in cases of unsatisfactory situations in the private sector. Under such power the government, instead of nationalizing the whole of a particular industry, may, in the national interest, choose to improve operative efficiency and ensure better management by a process of amalgamation of small and inefficient units into larger companies with sounder capital structures and better system of management.

Where the central government is satisfied that an amalgamation of two or more companies is essential in the public interest, then it may, by order notified in the official gazette provide for the amalgamation of those companies into a single company. The amalgamated company shall have such constitution, property, powers, rights, interests, authorities and privileges together with it liabilities, duties and obligations as may be specified in the government’s order [Section 396 (1)]. The order may also contain such consequential and supplemental provisions as may be necessary to give effect to amalgamation. [Section 396 (2)].
Every member or creditor or each of the companies involved in the amalgamation shall have practically the same rights and interest in the amalgamated company as he had in its constituents. However, if his rights in the new company are less than those he shall be entitled to compensation. The new company, the amalgam, will pay the compensation. [Section 396 (3)].

Before making any order for amalgamation, the central government shall (i) send a draft order of such proposed amalgamation to each of the companies, and (ii) consider any suggestions and objections of the companies concerned or any class of shareholders or creditors thereof. The period for filing objections shall be fixed by the government, but shall not be less than two months from the date the draft is received. [Section 396 (5)].

Preservation of books and papers of amalgamated company. (Section 396-A). This section was introduced by the Companies (Amendment) Act, 1965. The amendment is based on the findings of the Vivian Bose Commission and the recommendations of the Daphtari-Sastri Committee. The object of the section is to prevent the company which has been amalgamated with another company or whose shares have been acquired by any other company cannot be disposed of without the prior permission of the central government may appoint a person to examine the books and papers of the amalgamated companies for the purpose of ascertaining whether they contain any evidence of the commission of any offence relating the promotion, formation or the management of the affairs of the company.

16.5 SUMMARY

Compromise implies the settlement of claims in disputes by mutual concessions. Arrangement on the other hand includes a re-organisation of the share capital of the company by the consolidation of share capital of the company by the consolidation of shares of different classes or by the division of shares into shares of different classes or by both these methods. An arrangement does not
presuppose any dispute. It is the re-arrangement of rights and liabilities of its members or creditors. The Company Act, 1956 empowers a company to make compromise or arrangement with its creditors or members and makes suitable provisions under Section 391 to 393. When the central Government is satisfied that it is essential in the public interest that two or more companies should amalgamate, it may, by order notify in the official Gazette provide for the amalgamation of these companies into a single company with such constitution, with such property, powers, rights, interests, authorities and privileges, and with such liabilities, duties and obligation as may be specified in the order.

16.6 KEYWORDS

**Compromise:** Compromise means an amicable settlement of differences by mutual concessions by the parties to dispute or difference by agreeing not to try it out.

**Arrangement:** Arrangement is of wider import than compromise and includes a recognition of the share capital of the company by the consolidation of shares of different classes, or by both these methods.

**Reconstruction:** When a company transfers its undertaking, property and business to another company with such an arrangement that the shareholders of the old company receive similar interests in the new company or that the new company carries on the same business and the same persons of the old company are interest in the new company, it is called reconstruction.

**Amalgamation:** Amalgamation arises when two or more companies join together to form a new company or where one company ‘takes over’ the control of two or more companies by acquiring its shares.

16.7 SELF ASSESSMENT QUESTIONS

1. State the provisions of the Companies Act regarding arrangements for the purpose or amalgamation of companies.

2. How can a company make a compromise or arrangement with its members and/or
creditors without recourse to liquidation?

3. Discuss the powers of the central government regarding compulsory amalgamation of companies in public interest.

4. Distinguish between compromise, arrangement and amalgamation and discuss briefly the ways in which reconstruction can be effected.

16.8 SUGGESTED READINGS

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.
PREVENTION OF OPPRESSION AND MISMANAGEMENT

Structure

17.0 Objective
17.1 Introduction
17.2 Prevention of Oppression
17.3 Prevention of Mismanagement
17.4 Powers of Company Law Board
17.5 Powers of the Central Government
17.6 Summary
17.7 Keywords
17.8 Self Assessment Questions
17.9 Suggested Readings

17.0 OBJECTIVE

The main objective of this lesson is to help the students gain knowledge of the relating provisions that provide the rulings about prevention of oppression and mismanagement in corporate sector.

17.1 INTRODUCTION

Dominance of the majority is the fundamental rule of Company Law. However, sometimes groups of unscrupulous persons or a particular person gains control of the majority of the shares and run the company serve his own benefit and ignore minority interest. The majority shareholders treat the company as their
own property to the detriment of the minority shareholders. Hence, a proper balance of the rights of majority and minority shareholders is essential for the smooth functioning of the company. In such cases of oppression of minority or mismanagement of companies by majority, the minority shareholders can adopt the following remedial measures.

1. Apply to the Court for the winding up of the company on the ground that it is just and equitable to do so.
2. Apply to the Company Law Board for appropriate orders giving relief without directing winding up, and
3. Apply to the Central Government for appropriate relief.

The first measure has been discussed in the lesson on ‘winding up’ and the last two measures are being discussed here in this lesson.

17.2 PREVENTION OF OPPRESSION

Section 397 of the Companies Act provides that when the affairs of a company are being conducted in a manner prejudicial to the public interest or in a manner oppressive to any member or members, an application may be made to the Company Law Board by the requisite number of members for appropriate relief. [Sec. 397 (1)]. The Company Law Board may, on being satisfied (a) that the company’s affairs are being conducted in the manner alleged, and (b) that to wind up the company, though justified on the facts, would unfairly prejudice such members, make such orders as it thinks fit with a view to bring to an end to the matters complained of [Sec. 397 (2)]. To succeed in obtaining relief under this section, the applications must establish the following:

1. that the affairs of the company are being conducted in a manner prejudicial to public interest or oppressive to any members or member;
2. that the Company law Board would be prepared to make a winding up order on the just and equitable ground;
3. but that such winding up would unfairly prejudice these members.

The word ‘oppression’ is not defined in the Companies Act. It is, therefore, left to the Company Law Board to decide whether there is any oppression or not. Oppression, according to the Dictionary meaning of the word, is any act exercised in a manner burdensome, harsh and wrongful. Oppression in the context of Section 397 exists where the majority shareholders by an abuse of their voting power treat the company and its affairs as their own property to the determent of the minority shareholders. In other words, it means that the complaining shareholder is under an unbearable burden due to unjust, harsh or tyrannical treatment of the majority shareholders.

**The scope and meaning of the expression**

The scope and meaning of the expression ‘oppression’ has been very well defined by Lord Cooper in Elder v. Elder and Watson Ltd.

“The essence of 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 ...is entitled to rely.”

Oppression may take different forms and need necessarily be for obtaining pecuniary benefit. It may be due to the desire to obtain power and control, or be merely vindictive. The oppression need not be by a controlling majority. Oppression by anyone in fact taking part in the affairs of the company is enough.

**Some instances of oppression**

(a) An attempt to force new and more risky objects upon an unwilling minority may amount to oppression.

**Example:** The life insurance business of a company was taken over by the Life Insurance Corporation of India in 1956 and compensation thereof was paid to the company. The directors, who had the majority voting power, refused to distribute
the amount of compensation and went ahead with a special resolution to undertake new and, more risky objects. This was held to be an ‘oppression’ as the minority had invested their money in a life insurance business with all its safeguards and statutory protections; but they were being forced to invest where there would be no such protections, or safeguards. (Re Hindustan CO-operative Insurance society Ltd. AIR Cal. 44).

(b) A majority controller persistently flouted the decision of the Board and made it impossible for the company to function, was held to be an oppression.

Example: Mr. H. the father and sole proprietor of a business had formed a company to carry on the business with his two sons, to whom he gave shares, and who were appointed directors of the company. The father was appointed chairman and life director. He and his wife held such a majority of votes that they, together could secure the passing of any ordinary and special resolution.

Mr. H. disregarded the resolutions of the board of directors, assumed powers which he did not possess and exercised them against the wishes of his sons who were shareholders as well as directors. On action brought by the two sons, the court held that the affairs of the company had been conducted in a manner oppressive to the sons. The Court (now Company Law Board) removed the father from his office as director and demoted him to the position of an expert adviser at a fixed salary [Re H.R. harmer Ltd. (1959 W.L.R. 62].

(c) An attempt to deprive a member of his ordinary membership rights is oppression.

Example: A public company doing forward business contracts altered its Articles under statutory direction in such a manner as to deprive the non-trading members of the company of their right to call meeting to elect directors and to declare dividends. The court (now Company Law Board) held it oppression within Section 397. Mahajan J. observed: “I cannot conceive of a worst oppression than the denial of a voting right to a shareholder… To take away the right of partaking in
dividends is not merely oppressive but even confiscatory.” [Mohan Lal Chandumal v. The Punjab Co. Ltd. AIR (1961) Punj. 485].

(d) An unreasonable refusal to accept a transfer or transmission of shares has been held to be oppressive.

**Example:** A shareholder of a private company bequeathed under a will some of his shares to the directors of company and some to his second wife. The directors transferred shares in favour of themselves as provided under the will but refused to register the shares in the name of the shareholder’s widow, oil account of a private dispute with the petitioners. It was held that the conduct of the directors amounted to oppression and the court directed the directors to transfer the shares to the petitioners as provided under the will. [Mrs. Gajarabai v. Patny transport Co. AIR. (1966) A.P. 226].

Majority too are entitled for Relief u/s 397. The provisions of Section 397 and allied sections of the Act nowhere specifically mention that the oppression complained of must be of the minority shareholders by the majority shareholders and not vice versa. Moreover, the law fixes the lower limit with regard to the number of petitioners, yet no upper limit has been contemplated. Hence, the remedy u/s 397 is also available to the majority shareholders, if, in the circumstances of the case, they have been completely nullified by the minority in control. In other words, oppression may be exercised by those in control even they lack in majority and section 397 provides protection in such cases too.

**Oppression by Members**

As stated earlier, section 397 gives no guidance as to the meaning of the word, “oppressive” but it does indicate that the victim or victims of the oppressive conduct must be a member or members of the company as such. In other words, the oppression complained of must be upon members in their capacity as members and not in any other capacity. The harsh treatment of a member who is a director
or other officer or employee, by the Board of Directors does not come within this section.

**Example:** A shareholder was also the director of the company. He was removed from the office, his petition alleging that he has been oppressed by removal from office was dismissed by the Court (Now Company Law Board) holding that no wrong was done to him as a member and it, therefore, outside the scope of the Section 397.

It may be noted that the petitioners must be shown as members in the ‘register of members’ of the Company. If the persons who intend to file a petition u/s 397 are not shown as members in the register, rightly or wrongly, they must get the register of members rectified first and get their names entered therein before they can file a petition.

**Facts must justify winding up**

It is an essential condition for the maintenance of a petition under Section 397 that the facts alleged must justify a winding up order on “just and equitable” grounds, as required by Section 433 (f) and must also amount to oppression. This is very difficult, though apparently simple condition which may not be satisfied in many cases. If a company is a sound concern, director’s misappropriation will not be a just and equitable ground for winding up. On the other hand, if the company is not a sound concern, it will be a just and equitable ground for winding up. So, the just and equitable ground is a varying factor depending on the facts of each case.

It may further be noted that proceedings under Section 397 arid Under Section 433 are distinct and separate and one does not depend upon the other though the ground of ‘just and equitable’ is common in both the sections. The cases which do not have requisite element of oppression do not fall U/S 397 even if acts would justify the making of a winding up order under the ‘just and
equitable’ rule. In other words, it not enough to show that there is a just and equitable cause for winding up the company thought that must be shown as preliminary to the application of Section 397. It must further be shown that the conduct of the majority of shareholders was oppressive to the minority as members.

**Oppression of continuing nature**

The facts alleged in the petition must reveal an oppression of continuing nature as is apparent from the phrase “the affairs of the company are being conducted” it means a persistent and persisting course of unjust conduct must be proved. In other words, there must be continuous acts on the part of the majority shareholders continuing upto the date of petition, showing that the affairs of the company were being conducted in a manner oppressive to some part of the members. Hence, one single isolated act of oppression will not normally be sufficient to justify relief u/s 397. In a case, M.H. Beg. J. observed that “whatever may have been the position in the past, the company was carrying on a profitable business, and, even if some bungling had taken place in the keeping of accounts in the past, it may not justify a winding up order where the company is a sound profit making concern.”

**Event relied upon must be within Limitation Period**

Article 137 of the Limitation Act, 1963, applies to application under Sections 397 and 398 and the petitioner cannot rely upon events more than 3 years prior to the date of the filing of the petition.

**17.3 PREVENTION OF MISMANAGEMENT**

Section 398 provides for relief in eases of mismanagement. Mismanagement means inefficient management. Where the company is run overriding the wished and interests of the majority of shareholders, the management is not in the interest of the company.
Any member of a company may apply to the Company Law Board for appropriate relief on the ground; (a) that the affairs of the company are being conducted in a manner prejudicial to 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 company it is likely that the affairs of the company will be conducted in a manner prejudicial to public interest or to the interest of the company. [Sec. 389 (1)].

The company Law Board may, if it is satisfied with the truth of the complaint, make such orders as it thinks fit in order to bring an end or preventing the matters complained of or apprehended. [Sec. 398 (2)].

**Example:** (i) An action was brought against a company by certain shareholders on the ground of mismanagement by directors. The court found that the vice chairman grossly mismanaged the affairs of the company and had drawn considerable amount for his personal purpose ... that machinery was in a state of disrepair and that the shareholders outside the group of chairman were mismanagement. The Company Law Board accordingly appointed two administrators for the management of the company for a period of six months vesting in them all the powers of the directorate. [Rajahmudary Electric Supply Corporation v. A Nageshwara Rao, A.I.R. 1956 S.C. 213].

No such order will, however, be made where the change in management of the company has been brought about in the interest of the creditors including debenture holders or any class of shareholders of the company.

**Example:** The arrangement was made with the creditors to become shareholders and directors, instead of being creditors, by a company in financial difficulties. It was held that this is not an act of mismanagement or oppression so far as the existing shareholders are concerned but done bonafide in the best interests of the company.
Further, a material change in the management or control, as contemplated in section 398, will be deemed to have occurred, if there is an alteration

(a) in the Board of directors; or

(b) in the ownership of the shares of the company; or

(c) in its membership in case company has no share capital; or

(d) in its management.

It is worth mentioning that in case of oppression, petitioners are required to show facts to justify the making of an order for winding up but no such facts are required to be shown in case of mismanagement. It is enough if the affairs of the company are conducted in a manner prejudicial to the interest of the company or to the public interest.

But termination of the services of a works manager who held only 20 shares was not in itself an act of mismanagement. Similarly, bona fide decision consistent with Company’s memorandum and articles are not to be equated with mismanagement even if they turn out to be wrong in the circumstances or they cause temporary losses. Also directors legitimate decision not to declare dividend and plough back profit i.e. to create reserves is not mismanagement. A director’s constant effort in cornering the shares of the company is also not mismanagement from the works, which was closed by the decision of the other directors, cannot complain mismanagement under Section 398.

Section 398 comes into operation only if there is actual mismanagement of the affairs of the company. Slight delay in the payment of full value of shares can in no case betaken to be so prejudicial to the interests of the company as to call for any action U/S 398 of the Act.

Further, there should be present and continuing mismanagement. The charges of mismanagement in the past but not existing at the time of petition cannot be a ground of petition under Section 398.
Who may apply for relief?

Sections 399 and 401 specify the persons who may apply to the Company Law Board for relief in cases of oppression and management, and they are as follow:

(1) In the case of a company having a share capital

(a) at least 100 members of the company or 1/10th of the total number of its members whichever is less; or

(b) any member or members holding at least 1/10th of the issued share capital on which all calls and other sums due have been paid. [Sec. 399 (1) (a)].

The applicant members may be holders of equity shares or preference shares. Where two or more members are entitled to hold one or more shares, they will be treated as one member for the purpose of the application. [Sec. 399 (2)].

(2) In the case of companies without share capital at least 1/5th of the total members of the company.

(3) Any lesser number of members, if so authorized by the Central Government. The Central Government will give its consent if in its opinion circumstances exist which make it just and equitable so to do. Such member or members before being so authorized, may however, be required to give such security as the Central Government may deem reasonable for the payment of any, cost. Moreover, the power of the Central Government in granting such authorization is purely administrative and not quasi-judicial and hence no prior notice or hearing need to be given to the company before such authorization is granted. [Sec. 399 (4) & (5)].

(4) The Central Government itself u/s 401: As stated earlier that the names of these members must be shown in the register of members of the company, otherwise they must have the register rectified before they can bring a petition under either of the two sections.
It is not necessary for all the members to apply for relief. Any member or members having obtained the consent in writing of the requisite number of members, he or they may make an application on behalf and for the benefit of all them. The consent must be given before the petition is made, for a consent given subsequent to the filing of petition is invalid.

Consent in writing. As stated earlier, obtaining of consent is condition precedent to the making of the application. The expression consent in writing implies that the writing itself should indicate that the persons who have affixed their signatures have applied their minds to the question before them and have given their consent to certain action being taken.

Where company is a shareholder, the consent must be given by board and not by officers of the Company.

Withdrawal of Consent. After the application is made, if such consent is revoked by some of the members, it does not affect maintainability of the application. The validity of the petition must be judged on the fact as they are at the time of its presentation. Neither the right of the applicant to proceed with the application, not the jurisdiction of the Company Law Board to dispose of it on its own merits, can be affected by events happening subsequent to the presentation.

Notice to be given to Central Government of applications under Sections 397 and 398. The Company Law Board shall give notice of every application made to it under section 397 or 398 to the Central Government and shall take into consideration the representations, if any, made it by the Government before passing a final orders. (Sec. 400).

17.4 POWERS OF COMPANY LAW BOARD

Powers of the Company Law Board under Section 402 to prevent oppression and mismanagement are very wide. It has an unfettered discretion to make such order as is necessary to do justice in the facts of the case. In fact, the
Company Law Board may make any order for the regulation of the conduct of the company’s affairs upon such terms and conditions as may, in the opinion of the Company Law Board, be just and equitable in all the circumstances of the case, though the powers of the Company Law Board are very wide, the application in each case under Section 397 or 398 must state in the prayer, the nature of the relief sought. It must contain enough to leave no doubt as to what the applicants want the Company Law Board to do. The order Company Law Board may provide for anyone or more of the following measures:

(a) The regulation of the conduct of the Company’s affairs in future. Thus, for example, in Life Insurance Corporation of India V. Haridas Mundra the Court (now Company Law Board) deemed it fit to appoint an advisory board to assist the special officer for managing the affairs of the company to the total exclusion of the shareholders.

(b) The Company Law Board may order for the purchase of the shares or interest of any members of the company by other members or by the company.

(c) The Company Law Board may order for the reduction of the share capital of the company, provided the company has purchased its own shares under the orders of the Company Law Board as aforesaid. And when the Company Law Board directs purchase of shares by company the further proceeding under Section 100 to 104 for reduction of share capital is not required to be observed and no notice to the directors will be necessary.

(d) The Company Law Board may order for the termination, setting aside or modification of any agreement, howsoever arrived at, between the company on the one hand and any of the following persons, on the other:

(i) the managing director,

(ii) any other director, and

(iii) the manager.
(e) The Company Law Board may order for the termination, setting aside or modification of any agreement between the company or any other person not referred to in clause (d) above provided the consent of the party has been obtained.

It may be noted that for setting aside or terminating a contract, notice is necessary and not consent. But if the Company Law Board wants to modify that can be done only with the consent of the party concerned.

Where an order of the Company Law Board terminates, sets aside or modifies an agreement, no person can claim against the company any damages or compensation for loss of office or in any other respect. Further, no managing director, director or manager can without the leave of the Company Law Board be appointed for a period of five years from the date of the order to act as such [Section 407 (1)].

Penalty. Any person who knowingly acts as managing director, director or manager, even after the termination of his agreement with the company, and every other director of the company who is a party to such contravention, will be punishable with imprisonment for a term which may extend to one year, or with fine of Rs.5,000/- or both. [Section 407 (2)].

(f) The Company Law Board may also set aside any fraudulent preference made within three months before the date of application. It would make such order only if the circumstances are such that the transaction would have been deemed to be a fraudulent preference in an insolvency proceeding against an individual.

The date of the execution of the sale deed must be excluded in determining the period “within three months”. In other words, there should a net period of three months between the date of transfer and that of application.

Example: A sale transferring the assets of a company was executed on May 24, 1974, and the application under section 398 of the Act for relief under clause (f) was made on August 24, 1974, it was held that the application was filed within
time. The Court excluded the date of transfer in computing the period of three months. [Roshan Lal Agarwal v. Sheo Ram Butna (1980) 50 Compo Cas. 243].

(g) The Company Law Board may also make provision for any other matter which appears to the Company Law Board to be just and equitable under the circumstances of a particular case, even if it amounts to interference in internal management.

Interim Order by Company Law Board. Pending the making by it of a final order under Section 397 or 398, as the case may be, the Company Law Board may make on the application to any party to the proceeding, any interim order, which it thinks fit or regulating the conduct of the company’s affairs upon such terms and conditions “as may appear to be just and equitable. [Section 403]. Interim relief, however, cannot be granted where such relief cannot be given even if the petition succeeds.

Effect of alteration of memorandum or articles of company. Where the order of the Company Law Board makes any alteration in the memorandum or articles of the company, the company shall have no power to make any alteration in memorandum or articles inconsistent with the order of the Company Law Board.

But such alteration can be made with the leave of the Company law Board. The alterations made by the court will have the same effect as if they have been made by company in accordance with the provisions of the Act. [Sections 404 (1) and (2)].

Filling. A certified copy of every order altering, or giving leave to alter a company’s memorandum or articles, shall within 30 days from the making of the order, be filed with the Registrar of Companies. [Sec. 404 (3)]. However, the time taken in obtaining the certified copy is to be excluded in counting 30 days.

Penalty. In case of default the company and every other officer of the company who is in default, shall be punishable with the fine which may extend to
17.5 **POWERS OF CENTRAL GOVERNMENT TO PREVENT OPPRESSION OR MISMANAGEMENT**

Where there is oppression or mismanagement, the Central Government has been empowered to appoint directors on an order passed by the Company Law Board to effectively safeguard the interests of the company or its shareholders or the public interest to prevent mismanagement or oppression. The power is in the nature of a preventive action and can be exercised by the Company Law Board either on a reference made by the Central Government or on an application made by—

(a) at least 100 members or (b) members holding at least 10% voting powers. But it is worth noting that the Company Law Board has no *suo motu power* i.e. the power to act at its own. The Central Government may appoint any number of directors in a company as it may deem fit, for a period not exceeding 3 years at a time. It is a condition precedent that the Central Government should be satisfied that the affairs of the company are being conducted (i) either in a manner oppressive to any member or (ii) in a manner prejudicial to the interests of the company or the public interest. [Sec. 408 (1)].

The Company Law Board does not have absolute discretion to appoint directors only on its subjective opinion and such power cannot be arbitrary since the exercise of power under Sect 408 (1) has grave consequences and must inevitably have serious consequences on the reputation and credibility of the management of the company, it must be exercised sparingly and only when the conditions specified in section 408 (1) are fully complied with.

The power under section 408 is attracted when the company is being managed in a manner prejudicial to the interests of the company or to the public interest even though there may be no oppression or mismanagement. Moreover, it
is not required that before a particular person is appointed as a director, his name
should be communicated to majority shareholders for their comments and
objection.

As stated earlier, the powers of the Central Government under Sec. 408 (1)
is preventive in nature. The power must be so exercised to see that in future the
affairs of the company are conducted in a manner which is not prejudicial to the
interests of the company, its members or to the public interest. An order under
Sec. 408 (1) 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 try and
prevent repetition of such acts in future by the appointment of directors of the
company.

The powers under section 408 are extra ordinary and are exercised only
where Company Law Board is satisfied that the affairs of a company are grossly
mismanaged or where the minority shareholders are unduly oppressed and where
it is felt that quick action is needed. The Company Law Board will take great care
to see that the section is not invoked lightly be disgruntled shareholders to satisfy
their own private ends.

Appointment of Additional Directors until new directors are appointed. If
the Company Law Board recommends to the Central Government for appointment
of directors under section 408, it may, if it thinks fit, direct that until new directors
are appointed in pursuance of order passed by it u/s 408 (1), such number of
persons as the Company Law Board may, be order specify as being necessary to
effectively safeguard the interests of the company, or its shareholders or the public
interest, shall hold office as additional directors of the company and no such
directions, the Central Government shall appoint such additional directors. [Sec.
408 (2)].

Alternatively the Company Law Board may direct the company to amend
its articles so as to adopt the system of proportional representation for the
appointment of directors (under section 265) and made fresh appointments in pursuance of the amended articles within the specified time [Sec. 408 (1)].

*Reckoning of two thirds.* For the purpose of reckoning two third or any other proportion of the total number of directors of the company, any director or directors appointed by the Central Government shall not be taken into account. [Section 408 (3)].

*Share qualification of the Central Government nominee directors.* The directors or additional directors appointed by the Central Government shall not be required to hold any qualification shares. [Section 408 (4)].

*Retirement by rotation.* The directors/additional directors appointed by the Central Government shall not be liable to retire by rotation. But any such director may be removed from office by the Central Government at any time and another person may appointed by the Government in his place to hold office as a director. [Section 408 (4)].

*Appointment of directors requires Central Government’s permission.* After, the Central Government has appointed directors or additional directors under section 408, so long as such directors remain in office, no change in the Board of directors shall have effect unless confirmed by the Company Law Board [Section 408 (5)]. It means that at annual general meetings, unless the same directors as retire by rotation happen to re-appointed, no new candidates will have chance of being appointed without confirmation by the Company Law Board. Even additional directors cannot be co-opted by the Board unless confirmed by the Company Law Board.

*Other directions to the company:* When the Central Government appoints a person as a director or additional director, it has the right to issue such directions to the company as it may consider necessary or appropriate in regard to its affairs. Such directions, may include direction (a) to remove an auditor already appointed and to
appoint another such auditor in his place or (b) to alter the articles of the company and 
upon such direction being given, the appointment, removal or alteration as the case 
may be, shall be deemed to have come into effect as if the provisions of this Act in 
this behalf have been complied with without requiring any further act or thing to be 
done. [Sec. 408 (6)].

The Government can also require such person to report to the Government 
from time to time with regard the company. [Section 408 (7)].

Power of Company Law Board to prevent change in Board of Directors 
(Section 409): The managing director or any other director or the management of 
the company may complain to the Company Law Board that as a result of change 
which has taken place or is likely to take place in the ownership of any shares of 
the company, a change in the Board of directors is likely to take place and such 
change would affect prejudicially the affairs of company and pray for necessary 
relief.

It may be noted that complaint under Section 409 can be made by a director 
or managing director or manager and not by any other person. Further, the 
jurisdiction of the Company Law Board under this section arises only in case 
where the change in Board of directors is likely to take place because of a change 
in the ownership of shares. A change in the Board resulting from any other reason 
is not within the purview of this section.

The Company Law Board may after such inquiry as it thinks fit to make, direct 
that no resolution passed or that might be passed or action taken or that might be 
taken to effect a change in the Board of directors after the date of the complaint shall 
have effect unless confirmed by the Company Law Board.

Any such order shall have effect notwithstanding any thing to the contrary 
contained in any other provision of the Companies Act or in the Memorandum or 
Articles of the company or in any agreement or resolution.
Interim Order. The Company Law Board shall have power when any such complaint is received by it, to make an interim order until completion of enquiry. [Sec. 409 (2)].

Private Ltd Company. The provisions of Section 409 do not apply to a private ltd. company unless it is subsidiary to a public ltd. company [Section 409 (3)].

17.6 SUMMARY

The principle of rule by majority is made applicable to the management of affairs of the company. The shareholders pass resolutions on various subject either by simple majority or by three-fourths majority. Once a resolution is passed, then it is binding on all the members of the company. As a resultant corollary, the court will not intervene to protect the minority against the resolution, as on becoming a member, the shareholder agrees to submit to the will of the majority of the members. Thus, if wrong is done to the company, it is the company which is legal entity having its own personality, which can institute a suit against the wrongdoer; and shareholders do not have a right to do so. Like prevention to oppression, a specified number of members of a company may apply to the court for reasonable relief of prevention of mismanagement ground too. Section 408 empowers the Central Government to prevent oppression or mismanagement by nominating directors on the Board of directors of a company.

17.7 KEYWORDS

Oppression: The conduct of shareholders may be treated as oppressive if it involves 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.

Mismanagement: Mismanagement means inefficient management. Where the
company is run overriding the wishes and interest of the majority of shareholders, the management is not in the interest of the company

17.8 SELF ASSESSMENT QUESTIONS

1. State the provisions of Companies Act, 1956 for prevention of oppression and mismanagement in a company.

2. Majority will have its way but the minority must be allowed to have its say’. Discuss it with reference to oppression and mismanagement in a company.

3. What remedies are available to the minority shareholders of a company against oppression and mismanagement?

4. Discuss briefly whether it is competent for the majority shareholders to apply to the court for relief against the oppression by the majority shareholders.

5. “The conduct must be burdensome, harsh and wrongful and the mere lack of confidence between the majority shareholders and the minority shareholders would not be enough”. Comment and discuss the remedies available to the minority shareholders against oppression and mismanagement.

6. When can the oppression or ‘mismanagement’ be complained in a company? What are the powers of the Central Government to prevent oppression or mismanagement of the Company?

7. State the powers of Central Government to prevent oppression or mismanagement in a company? What are the criteria by which the Central Government should be satisfied for exercise of the powers?

8. “Sections 397 and 398 are intended to avoid winding up, if possible, and keep the company going, while at the same time receiving the minority
shareholders from oppression and mismanagement.” Discuss.

17.8 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.
N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.
WINDING UP OF A COMPANY

Structure

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18.0 OBJECTIVE

After reading this lesson, you should be able to:

(a) Explain the concept of winding up

(b) Discuss the different modes of winding up of a public company

(c) Describe the consequences of winding up.
18.1 INTRODUCTION

Winding up is the process for the realization of the assets, the payment of creditors, and the distribution of the surplus, if any, among the shareholders, so that the company may be finally dissolved.

The concept of winding up of a company may be defined in the following words:

“Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator called a liquidator is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights.”

Thus winding up is the last stage in the life of a company. It means a proceeding by which a company is dissolved. Winding up should not be taken as if it is dissolution of a company. The winding up of a company precedes its dissolution. Before dissolution and after winding up, the legal entity of the company remains and it can be sued in a Court of law. On dissolution the company ceases to exist, its name is actually struck off from the Register of Companies by the Registrar and the fact is published in the official Gazette.

18.2 MODES OF WINDING UP

A company can be wound up in three ways:

1. Compulsory winding up by the Court;

2. Voluntary winding up: (i) Members voluntary winding up; (ii) Creditors’ voluntary winding up;

3. Voluntary winding up subject to the supervision of the Court [Sec. 425].

Winding Up by the Court: A company may be wound up by an order of the Court. This is called compulsory winding up or winding up by the Court.
Section 433 lays down the following grounds where the Court may wind up a company.

A petition for winding up may be presented to the Court on any of the grounds stated below:

1. **Special resolution**: A company may be wound up by the Court if it has, by a special resolution, resolved that it be, wound up by the Court. But it is to be noted that the Court is not bound to order for winding up merely because the company by a special resolution has so resolved. Even in such a case it is the discretion of the Court to order for winding up or not.

2. **Default in filing statutory report or holding statutory meeting**: If a company has made a default in delivering the statutory report to the Registrar or in holding the statutory meeting, a petition for winding up of the company may be presented to the Court. A petition on this ground may be presented to the Court by a member or Registrar (with the previous sanction of the Central Government) or a creditor. The power of the Court is discretionary and generally it does not order for winding up in first instance. The Court may, instead of making an order for winding up, direct the company to file the statutory report or to hold the statutory meeting but if the company fails to comply with the order, the Court will wind up the company.

3. **Failure to commence business within one year or suspension of business for a whole year**: Where a company does not commence its business within one year from its incorporation or suspends its business for a whole year, a winding up petition may be presented to the Court. Even if the business is suspended for a whole year, this by itself does not entitle the petitioner to get the company wound up as a matter of right but the question whether the company should be wound up or not in such a circumstances entirely is the discretion of the Court depending upon the facts and circumstances of each case. Even, if the work of all the units of the company has been suspended then too it will still be open to
the Court to examine as to whether it will be possible for the company to continue its business. Before the order of winding up on this ground the Court is required to see what are the possibilities of resumption of the business of the company. The suspension of the business, for this purpose, must be the entire business of the company and not a part of it.

The Court will not order for winding up on the grounds, if: (a) suspension of business is due to temporary causes; and (b) there are reasonable prospects for starting of business within a reasonable time.

4. **Reduction of membership below the minimum:** When 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, a petition for winding up of the company may be presented to the Court.

5. **Company’s inability to pay its debts:** A winding up petition maybe presented if the company is unable to pay its debt. ‘Debt’ means definite sum of money payable immediately or at future date. A company will be deemed to be unable to pay its loan in the following conditions (Section 434):

   (a) A creditor of more than Rs. 500 has served, on the company at its registered office, a demand under his hand requiring payment and the company has for three weeks thereafter neglected to pay or secure or compound the sum to the reasonable satisfaction of the creditor; or

   (b) Execution or other process issued on a judgement or order in favour of a creditor of the company is returned unsatisfied in whole or in part; or

   (c) It is proved to the satisfaction of the Court that the company is unable to pay its debts, taking into account its contingent and prospective liabilities, i.e. whether its assets are sufficient to meet its liabilities.

6. **Just and Equitable (Sec. 433(1))**: The Court may also order to wind up of a company if it is of opinion that it has just and equitable that the company should
be wound up. What is ‘just and equitable’ depends on the facts of each case. The words ‘just and equitable’ are of wide connotation and it is entirely discretionary on the part of the Court to order winding up or not on this ground.

Thus the Court itself works out the principles on which the order for winding up under the section is to be made.

Winding up by the Court on ‘just and equitable’ grounds may be ordered in the cases given below:

(a) When the substratum of the company has gone: In the words of Shah, J. in Seth Moham Lal v. Grain Chambers Ltd. the substratum of the company is said to have disappeared when the object for which it was incorporated has substantially failed, or when it is impossible to carry on the business of the company except at a loss, or the existing and possible assets are insufficient to meet the existing liabilities. The substratum of a company will be deemed to have gone when

(i) The object for which it was incorporated has substantially failed or has become impossible or

(ii) It is impossible to carry on business except at a loss or

(iii) The existing and possible assets are insufficient to meet the existing liabilities of the company.

(b) When there is oppression by the majority shareholders on the minority, or there is mismanagement.

(c) When the company is formed for fraudulent or illegal objects or when the business of the company becomes illegal.

(d) When there is a deadlock in the management of the company. When there is a complete deadlock in the management of the company, it will be wound up even if it is making good profits. In Re Yenidjee Tobacco Co. Ltd. A and B the only shareholders and directors of a private limited company became so hostile to each
other that neither of them would Speak to the other except through the secretary. Held, there was a complete deadlock and consequently the company be wound up.

(e) When the company is a ‘bubble’, i.e. it never had any real business.

18.3 WHO MAY FILE PETITION

The Court does not choose to wind up a company at its own motion. It has to be petitioned. Section 439 of the Companies Act enumerates the persons those can file a petition to the Court for the winding up of a company. The petition for winding up may be brought by anyone of the following:

1. Petition by Company

A company can make a petition only when it has passed a special resolution to that effect. However, it has been held that where the company is found by the directors to be insolvent due to circumstances that ought to be investigated by the Court, the directors may apply to the Court for an order of winding up of the company even without obtaining the sanction of the general meeting of the company.

2. Petition by Creditors

The word ‘creditor’ includes secured creditor, debenture holder and a trustee for debenture holder. A contingent or prospective creditor (such as the holder of a bill of exchange not yet matured or of debentures not yet payable) is also entitled to petition for a winding up of the company.

Before a petition for winding up of a company presented by a contingent or prospective creditors is admitted, the leave of the Court must be obtained for the admission of the petition. Such leave is not granted (a) unless, in the opinion of the Court, there is a prima facie case for winding up the company; and (b) until reasonable security for costs has been given.

Notice that a creditor has a right to winding up order if he can prove that he
claims an undisputed debt and that the company has failed to discharge it. When a creditors’ petition is opposed by other creditors, the Court may ascertain the wishes of the majority of creditors.

3. Contributory Petition

The term ‘contributory’ means every person who is liable to contribute to the assets of the company in the event of its being wound up. Section 428 makes it clear that it includes the holder of fully-paid shares. A fully-paid shareholder will not, however, be placed on the list of contributors, as he is not liable to pay any contribution to the assets, except in cases where surplus assets are likely to be available for distribution.

A contributory is entitled to present a petition for winding up a company if:

(a) The number is reduced, in the case of a public company below seven and in the case of private company below two; and

(b) The shares in respects of which he is a contributory either were originally allotted to him or have been held by him; and

(c) The shares have been registered in his name, for at least six months during the period of 18 months immediately before the commencement of the winding up; and

(d) The shares have been devolved on him during the death of a former holder [Sec. 439 (4)].

4. Registrar’s Petition

The Registrar can present a petition for winding up a company only on the following grounds, viz.,

(a) if a default is made in delivering the statutory report to the Registrar or in holding the statutory meeting;

(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 seven and in the case of a private company below two;

(d) if the company is unable to pay its debts; and

(e) if the Court is of opinion that it is just and equitable that the company should be wound up.

Note that the Registrar can file a petition for winding up only with prior approval of the Central Government. The Central Government before sanctioning approval must give an opportunity to the company for making its represent actions, if any.

Again a petition on the ground of default in delivering the statutory report or holding the statutory meeting cannot be presented before the expiration of 14 days after the last day on which the statutory meeting ought to have been held.

5. **Petition by any Person Authorised by the Central Government**

If it appears to the Central Government from any report of the inspectors appointed to investigate the affairs of the company, that it is expedient to wind up the company because its business is being conducted with intent to defraud creditors, members or any other person, or its business is being conducted for a fraudulent or unlawful purpose, or the management is guilty of fraud, misfeasance or other misconduct, the Central Government may authorise any person to present to the Court a petition for winding up of the company that is just and equitable that the company should be wound up.

**18.4 COMMENCEMENT OF WINDING UP (SECTION 441)**

Where before the presentation of a petition for the winding up of a company by the Court, a resolution has been passed by the company for voluntary winding up, the winding up of the company will be deemed to have commenced
from the date of the resolution. In all other cases (i.e. where the company has not previously passed a resolution for voluntary winding up), the winding up will be deemed to commence from the time of the presentation of the petition for the winding up.

The Court may dismiss or allow the petition for winding up and also can adjourn its hearing or pass conditional order of winding up. In the case of *Misrilal Dharamchand Ltd; v. B; Patnaik Mines Ltd. (1978)* the Court ordered for winding up but stayed the operation of the order for six months so as to enable the company to pay the petitioner, if it could do so within this period and in case of failure the order was to come in force.

**Powers of the Court:** On hearing a winding up petition, the Court may dismiss it or adjourn the hearing or make interim orders or make an order for winding up the company, with or without costs or any other order that it thinks fit (Section 443).

**Consequences of winding up:** (i) Where the Court makes an order for winding up of company, the Court must forthwith cause intimation thereof to be sent to the Official Liquidators and the Registrar (Section 444).

(ii) On the making of a winding up order it is the duty of the petitioner in the winding up proceedings and of the company to file with the Registrar a copy of the order of the Court within 30 days from the date of the making of the order [Section 445(1)].

(iii) The winding up order is deemed to be notice of discharge to the officers and employees of the company, except when the business of the company is continued [Section 445(3)].

(iv) When a winding up order has been made, no suit or other legal proceedings can be commenced against the company except with the leave of the Court. Suits pending at the date of the winding up order cannot be further proceeded without the leave of the Court. According to sub-section (2) of Section 446 the Court
which is winding up the company has jurisdiction to entertain or dispose of (a) any
suit or proceeding by or against the company; (b) any claim made by or against the
comp any; (c) any application made under Section 391 by or in respect of the
company; (d) any question of priorities. or any other question whatsoever which
may relate to or arise in course of the winding up of the company.

(v) An order for winding up operates in favour of all the creditors and of all die
contributories of the company as if it .had been made. on the joint petition of a
creditor and of a contributory (Section 447).

(vi) According to Section 536 any disposition of the property (including
actionable claims) of the company, any transfer of shares in the company or
alteration in the status of its members, made after the commencement of the
winding up shall be void, unless the Court otherwise orders.

Thus the Court can direct that any such disposition of property or
actionable claims or transfer of shares or alteration of status of the members will
be valid. But unless the court so directs, such disposition, transfer or alteration will
be void.

(vii) Section 537 declares that any attachment and sale of the estate or effects of
the company, after the commencement of the winding up, win be void In the case
of winding up by the Court any attachment, distress or execution put in force,
without leave of the Court, against the estate or effects of the company after the
commencement of the winding up will be void. Similarly any sale held, without
leave of the Court, of any of the properties or effects of the company after the
commencement of the winding up will be void. With leave of the Court,
attachment and sale of the properties of the company will be valid even if such
attachment and sale are made after the commencement of the winding up of the
company. Besides this section does not apply to any proceedings for the recovery
of any tax imposed or any dues payable to the Government Thus I.T.O. can
commence assessment proceedings witll10ut leave of the Court.
(viii) It is to be noted that winding up order does not bring the business of the company to an end. The corporate existence of the company continues through winding up till the company is dissolved. Thus the company continues to have corporate personality during winding up. Its corporate existence come to an end only when it is dissolved.

(ix) An order for winding up operates in favour of all the creditors and of all the contributories of the company as if it had been made on the joint petition of a creditor and of contributory.

(x) On a winding up order being made in respect of a company, the Official Liquidator, by virtue of the office, becomes the liquidator of the company (Section 449).

18.5 OFFICIAL LIQUIDATORS

Under the present Act, the only person who is competent to act as the liquidator in a winding up is the official liquidator. For the purpose of winding up, there shall be attached to each high Court an official liquidator appointed by the Central Government, who may be either a whole time or part time officer depending upon the volume of work. In district courts the official receiver will be the official liquidator. The Central Government may appoint one or more deputy or assistant official, liquidators to assist the official liquidator in the discharge of his functions. There is no provision in the Act, for the removal of the official liquidator [Sec. 448 (1) & (1-A)].

Liquidator: On a winding up order being made, the official liquidator, by virtue of his office, becomes the liquidator of the company (Sec. 449). 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.

A liquidator shall be described by the style of “The official liquidator” of the particular company in respect of which he acts and not by individual name.
[Sec. 452].

**Provisional Liquidator:** The Court may appoint the official liquidator to be the liquidator provisionally at any time after the presentation of the petition for winding up and before making winding up order [Sec. 450 (1)]. Before making such an appointment notice must be given to the company and a reasonable opportunity must be given to it to make representation. The Court may dispense with such notice where there are special reasons. Such reasons must be recorded in writing. A provisional liquidator is as much liquidator as a liquidator in the winding up of a company. But where a provisional liquidator is appointed by the Court, the Court may limit and restrict his powers. On a winding up order being made, the official liquidator shall cease to be provisional liquidator and shall become liquidator of the company.

**General provisions for liquidators:** The liquidator shall conduct the proceedings in winding up the company and perform such duties as the Court may impose. The official liquidator gets his remuneration from the Central Government and as such he is not entitled to any further remuneration. For the services rendered by the official liquidator to the company, the Central Government shall pay such fees out of the assets of the company as may be prescribed.

The acts of a liquidator shall be valid, notwithstanding any defect that may afterwards be discovered in his appointment or qualification. But his acts shall not be valid if they are done after it has been shown that his appointment was invalid [Sec. 451].

**Statement of Affairs (Sec. 454):** The company must make out and submit to the official liquidator a statement, as to the affairs of the company in the prescribed form verified by an affidavit and containing the following particulars:

(a) The assets of the company, stating separately the cash balance in hand and at the bank and the negotiable securities held by the company;
(b) Its debts and liabilities;

(c) Names, residences and occupation of its creditors, stating separately the amount of secured and unsecured debts;

(d) In the case of secured debts, particulars of securities given, their value and the dates on which they were given;

(e) The debts due to the company and the names, residences and occupations of the persons from whom they are due and the amount likely to be realised on account thereof; and

(f) Such further or other information as may be prescribed or as the official liquidator may require.

Note that the statement must be submitted and verified by one or more of the directors and by the manager, secretary or other chief officer of the company and it must be submitted within 21 days from the relevant date or within such extended time not exceeding three months [Sec. 454 (3)].

**Duties of the Liquidator**

(i) He must conduct equitably and impartially all proceedings in the winding up according to the provisions of the law.

(ii) He must submit a preliminary report to the Court as to:

(a) the amount of capital issued, subscribed and paid up and the estimated amount of assets and liabilities, giving separately, under the heading of assets such as (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) immovable and movable properties belonging to the company; and (v) unpaid calls;

(b) if the company has failed, as to the causes of the failure; and

(c) 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 the business
thereof.

Note that the Court may extend the period of six months for the submission of the above report by the official liquidator. The Court may also order that no such statement need be submitted.

(iii) The official liquidator may, if he thinks fit, make further reports, stating the manner in which the company was promoted or formed. He may state in the reports whether in his opinion any fraud has been committed by any person in its promotion or formation, or since the formation thereof. He may also state any other matters which, in his opinion, it is desirable to bring to the notice of the Court [Sec. 455(2)].

(iv) He must take into his custody and control the property of the company. Notice that so long as there is no liquidator, all the property and effects of the company are deemed to be in the custody of the Court [Sec. 456(2)].

(v) Control of powers: The liquidator must in the administration of the assets of the company and the distribution thereof among its creditors have regard to any directions which may be given by a resolution of the creditors or contributories at any general meeting or by the committee of inspection [Sec.460 (1)]. Any directions given by the creditors or contributories at any general meeting override any directions given by the committee of inspection.

(vi) To Summon Meetings of Creditors and Contributories: He may summon general meetings of the creditors or contributories for the purpose of ascertaining their wishes. But he shall be bound to summon such meetings, at such times, as the creditors or contributories may, by resolution, direct, or whenever requested in writing to do so by not less than one tenth in value of the creditors or contributories, as the case may be [Sec. 460 (3)].

(vii) Proper Books: The liquidator must keep proper books for making entries or recording minutes of proceedings at meetings and of 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 through his agent [Sec. 461].

(viii) He must, at least twice in each year, present to the Court an account of his receipts and payments as liquidator. The account must be in the prescribed form and must be made in duplicate. The Court gets the account audited, keeps one copy thereof in its records and delivers the other copy to the Registrar for filling. Each copy shall, however, be open to the inspection of any creditor, contributory or person interested. The liquidator must also send a printed copy of the accounts so, audited by post to every creditor and to every contributory.

(ix) Within two months from the date of the direction of the Court, the liquidator must call a meeting of the creditors for determining the persons who are to be members of the committee of inspection, if such committee is to be appointed. Within 14 days of the meeting of the creditors, the liquidator must call a meeting of the contributories to consider the decision of the creditors.

(x) Within two months of the expiry of each year from the commencement of winding up, the liquidator must file a statement duly audited, by a qualified auditor with respect to the proceedings in, and position of the liquidation.

The statement must be filed:

(a) in the case of a winding up by or subject to the supervision of the Court, in the Court; and

(b) in the case of voluntary winding up, with the Registrar.

Note that when the statement is filed in the Court, a copy must simultaneously be filed with the Registrar and must be kept by him along with the other records of the company [Sec. 551].

**Powers of the Liquidator:** A liquidator has two types of powers under the Act:

(a) Powers exercisable with the sanction of the Court; and
Powers exercisable without the sanction of the Court.

**Powers with the Sanction of the Court:** (a) to institute or defend any suit, prosecution or other legal proceedings, civil or criminal, on behalf of the company;

(b) to carry on the business of the company 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 any money required on the security of the assets of the company;

(e) to appoint an advocate, attorney or pleader to assist him in the performance of his duties;

(f) to do all such other things as may be necessary for winding up the affairs of the company and distributing its assets.

Note that the Court may by order provide that the liquidator may exercise any of the above powers without the sanction of the Court [Sec. 458).

**Powers without the Sanction of the Court:** The liquidator may exercise the following powers without the sanction of the Court, namely, powers:

(a) to execute documents and deeds on behalf of the company and use, when necessary, the company’s seal;

(b) to inspect the records and returns of the company or the files of the Registrar without payment of any fee;

(c) to draw, accept, make and endorse any bills of exchange, hundis or promissory notes with the same effect as if drawn, accepted, made, or endorsed by the company in the course of its business;

(d) to prove, rank and claim in the insolvency of any contributory for any balance against his estate and to receive dividends in respect thereof;
(e) to take out, in his official name, letters of administration to any deceased contributory;

(f) to appoint an agent to do any business which he is unable to do himself [Sec. 457(2)]. For example, he can appoint any advocate, attorney or pleader entitled to appear before the Court to assist him in the performance of his duties [Sec. 459], but with the sanction of the Court.

**Supervision and control over liquidators:** The following provisions discuss about the supervision and control over liquidators:

1. **Control by contributories and creditors:** The contributories and creditors exercise control over the liquidator in the performance of his duties through the medium of the meetings which it is his duty to call from time to time. Any creditor or contributory may subject to the control of the Court inspect the books which are maintained by the liquidator. The liquidator is also required to print and send a copy of the audited accounts to each creditor and contributory.

2. **Control by Court:** The liquidator shall apply to the Court for directions in relation to any matter arising in the winding up. The Court has the power to confirm, reserve or modify any act or decision of the liquidator if complained by any aggrieved person. The Court has the power to cause the accounts of the liquidator to be audited in such manner as it thinks fit.

3. **Supervision by committee of inspection:** The committee of inspection can inspect the accounts of the liquidator at all reasonable times. The liquidator is under an obligation to have directions from the committee of inspection.

4. **Control by Central Government:** Section 463 seeks to bring the conduct of the liquidators of companies where the control and scrutiny of the Central Government. Where a liquidator does not faithfully perform his duties and duly observe all the requirements imposed upon him by the Act or the rules there under with respect to the performance of his duties, or if any complaint is made to the
Central Government by any creditor or contributory in regard thereto, the Central Government shall enquire into the matter, and take such action thereon as it may think fit. The power includes the power to remove the liquidator from office.

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 any winding up in which he is engaged. It may also, if it thinks fit; apply to the Court to examine him or any other person on oath concerning the winding up. The Central Government may also direct a local investigation to be made of the books and vouchers of the liquidator.

The provisions of this section do not apply where the winding up has been completed after dissolution.

**Committee of Inspection (Sections 464, 465):** The Court may, at the time of making an order for the winding up or at any time thereafter, direct that there shall be appointed a committee of inspection to act with the liquidator. Where such a direction is given by the Court, the liquidator is required to convene, within 2 months from the date of the direction, a meeting of the creditors to determine who are to be the members of the committee, within 14 days from the date of the creditors’ meeting, the liquidator must call a meeting of the contributories to consider the creditors’ decision with respect to the membership of the committee. Contributories may accept the decision of the creditors with or without modification or reject it. If the contributories at their meeting do not accept the creditors’ decision in its entirely, the liquidator shall apply to the Court for directions as to what the composition of the committee should be and who shall be its members. The committee shall consist of not more than 12 members, being creditors or contributories of the company in such proportion as may be agreed on by the meetings of the creditors and contributories and in case of difference of opinion, as may be determined by the Court. The Committee may inspect the accounts of the liquidator at all reasonable time.
The committee will meet at such times as it may from time to time appoint and the liquidator or any member of the committee may also call a meeting of the committee as and when he thinks necessary. The quorum for a meeting of the committee will be one-third of the total number of the members or two, whichever is higher. The committee may act by a majority of its members present at a meeting but shall not act unless a quorum is present. A member may resign by notice in writing signed by him and deliver to the liquidator. If a member of the committee is adjudged as insolvent or compounds or arranges with his creditor or is absent from five consecutive meetings of the committee without leave of those members, who together with himself, represent the creditors or contributories, his office shall become vacant. A member of the committee may be removed at a meeting of the creditors, if he represents creditors, or at a meeting of contributories if he, represents contributories by an ordinary resolution of which seven days’ notice has been given stating the objects of the meeting. When any vacancy occurred in the committee, the liquidator will call a meeting of the creditors or contributories, as the case may be, and the meeting may reappoint the same person or appoint some other person in the vacancy. However, the liquidator may apply to the Court that the vacancy need not be filled in and if the Court is satisfied that in the circumstances of the case the vacancy need not be filled, it may make an order accordingly.

Dissolution of company in Winding up by the Court: The Court may make an order for the dissolution of a company in the following conditions: (a) When the affairs of the company have been completely wound up; or (b) when the Court is of opinion that the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason and it is just and equitable in the circumstances of the case that an order of dissolution of the company should be made. Where such an order is made by the Court, the company will be dissolved from the date of the order of the Court. Within 30 days from the date of the order,
the liquidator must send a copy of the order to the Registrar. On the dissolution, the corporate existence of the company comes to an end.

Company in liquidation exists as juristic personality until order of dissolution is based by the Court. After the order of dissolution, the legal personality of the company come to an end. The Court may declare the dissolution void within 2 years from the date of the dissolution.

18.6 VOLUNTARY WINDING UP

Winding up by the creditors or members without any intervention of the Court is called ‘voluntary winding up’. In voluntary winding up, the company and its creditors are left free to settle their affairs without going to the Court, although they may apply to the Court for directions or orders if and when necessary.

A company may be wound up voluntarily under the circumstances given hereunder:

1. when the period fixed for the duration of the company the articles has expired or the event has occurred on the occurrence of which the articles provide that the company is to be dissolved and the company in a general meeting has passed a special resolution to wind up voluntarily; or

2. the company has passed a special resolution to Wind up voluntarily. Thus a company may be wound up voluntarily at any time and for any reason if a special resolution to this effect is passed in its general meeting.

When a company has passed a resolution for voluntary winding up, it must within 14 days of the passing of the resolution gives notice of the resolution by advertisement in the official Gazette and also in some newspaper circulating in the district where the registered office of the company is situated.

Commencement of Voluntary Winding up: A voluntary winding up is deemed to commence at the time when the resolution for winding up is passed [Sec.486].
The date of the commencement of the winding up is important for several matters such as liability of past members and fraudulent preferences, etc.

**Consequences of Voluntary Winding up:** The consequences of voluntary winding up are:

1. From the commencement of voluntary winding up, the company ceases to carry on its business, except so far as may be required for the beneficial winding up thereof [Sec. 487].

2. The possession of the assets of the company vests in the liquidator for realisation and distribution among the creditors. The corporate state and powers of the company shall, however, continue until it is dissolved (Sec 456 and 487).

3. On the appointment of a liquidator, all the power of the board of directors cease and the liquidator may exercise the powers mentioned in Sec. 512 including the power to do such things as may be necessary for winding up the affairs of the company and distributing its assets. The liquidator appointed in a members’ voluntary winding up is merely an agent of the company to administer the property of the company for purposes prescribed by the statute.

**Kinds of Voluntary Winding up:** Voluntary winding up may be:

(a) A members’ voluntary winding up; or

(b) A creditors’ voluntary winding up.

**Members’ Voluntary Winding Up:** A members’ voluntary winding up takes place only when the company is solvent. It is initiated by the members and is entirely managed by them. The liquidator is appointed by the members. No meeting of creditors is held and no committee of inspection is appointed. To obtain the benefit of this form of winding up, a declaration of solvency must be filed.
Declaration of solvency: Section 488 provides that where it is proposed to wind up the company voluntarily the directors or a majority of them, may, at a meeting of the board, make a declaration verified by an affidavit that the company has no debts or that it will be able to pay its debts in full within a period not exceeding 3 years from the commencement of winding up as may be specified in the declaration. Such declaration shall be made within five weeks immediately preceding the date of the passing of the resolution for winding up and shall be delivered to the Registrar before that date. It shall also be accompanied by a copy of the auditors on the Profit and Loss Account and the Balance Sheet of the company prepared upto the date of the declaration and must embody a statement of the company’s assets and liabilities as on that date.

Where such a declaration is duly made and delivered, the winding up following shall be called members’ voluntary winding up. Where the same is not duly made, it shall be called creditors’ voluntary winding up.

Sections 490-98 of the Act deal with provisions applicable to members’ voluntary winding up. They are as follows:

1. Appointment and Remuneration of Liquidator: On the passing of the resolution for winding up, the company must in a general meeting appoint one or more liquidators and fix his or their remuneration. Any such remuneration cannot be increased at all, not even with the sanction of the Court and the liquidator cannot take charge of his office unless the remuneration is so fixed [Sec. 490].

2. Powers of the Board on Appointment of Liquidator: On the appointment of a liquidator, all the powers of the board and of a managing or whole-time director, and manager, if there be any of these shall cease, except for the purpose of giving notice of such appointment to the Registrar or in so far as the company in a general meeting or the liquidator may sanction the continuance thereof [Sec. 491].
3. **Office of the Liquidator Falling Vacant:** If a vacancy occurs by death, resignation or otherwise in the office of any liquidator appointed by the company, the company in a general meeting may fill the vacancy [Sec. 492].

4. **Notice of Appointment to Registrar:** The company must, within 10 days of the appointment of the liquidator, or the filling up of the vacancy, as the case may be, give notice to the Registrar of the event. Default renders the company and every officer (or liquidator) who is in default liable to fine upto Rs.100 for every days of default [Sec. 493].

5. **Calling Meeting of Creditors:** If the liquidator at any time is of opinion that the company is insolvent, he must summon a meeting of the creditors, and lay before the meeting a statement of the assets and liabilities of the company [Sec. 495]. Thereafter the winding up proceeds as if it were a creditors’ voluntary winding up and not a members’ voluntary winding up [Sec. 498].

6. **Calling General Meeting at the End of one Year:** In the event of the winding up continuing for more than one year, the liquidator must call a general meeting of the company at the end of the first year from the commencement of the winding up at the end of each-succeeding year, or at the first convenient date within three months from the end of the year or such longer period as the Central Government may allow, and must lay before the meeting an account of his acts and dealings and of the conduct of the winding up during the preceding year [Sec. 496].

7. **Final Meeting and Dissolution:** As Soon as the affairs of the company are fully wound up, the liquidator bakes up an account of winding up, showing how the winding up has conducted and how the property of the company has been disposed of. He then calls a general meeting, of the company and lays before it accounts showing how the winding up has been conducted. This is called the final meeting of the company.

The meeting must 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 where the registered office of the company is situated.

Within one week after the meeting, the liquidator is required to send to the Registrar and the official liquidator a copy of the accounts. He must also make a report to each of them of the holding of the meeting and of the date thereof. If at the final meeting no quorum was present, the liquidator is required to make a report that the meeting was duly called but no quorum was present at the meeting. On receipt of the accounts and the report, the Registrar will register them. On receipt of the accounts and report, the official liquidator will make a scrutiny of the books and papers of the company and make a report to the Court stating the result of the scrutiny. If the report shows that the affairs of the company have been conducted bonafide i.e. not in a manner prejudicial to the interests of its members or to the public interest, then from the date of the submission of the report to the Court, the company shall be deemed to have been dissolved. If the official liquidator in the report has stated that the affairs of the company have been conducted in a manner prejudicial to the interest of its members or to the public interest, the Court shall direct the official liquidator to make a further investigation of the affairs of the company and on the report of the official liquidator on such further investigation, the Court may either make an order that the company shall stand dissolved with effect from the date to be specified in the order of the Court or to make such other order as the circumstances of the case brought out in the report permit [Sec. 497].

Creditors’ Voluntary Winding Up (Sections 500-509): In creditors’ voluntary winding up, it is the creditors who move the resolution for voluntary winding up of a company, and there is no solvency declaration made by the directors of the
company. In other words, when a company is insolvent, that is, it is not able to pay its debts, it is the creditors’ voluntary winding up.

**Special provisions relating to Creditors’ Voluntary Winding up:** There are certain special provisions to be completed with creditors’ voluntary winding up. They are:

1. **Meeting of Creditors [Sec. 500]:** The company must call a meeting of the creditors of the company on the same day or on the next following day on which the general meeting of the company is held for passing a resolution for voluntary winding up. The company must send the notice of the meeting to the creditors by post simultaneously with the sending of the notice of the meeting of the company. The company must also cause the notice of the meeting of the creditors to be advertised once at least in the official, Gazettee and once at least in two newspapers circulating in the district where the registered office or principal place of business of the company is situated. At the creditors’ meeting, one of the directors shall preside. The board of directors is required to lay before the meeting of the creditors (a) a full statement of the position of the company’s affairs and (b) a list of creditors of the company with the estimated amount of their claims.

2. **Notice of Registrar [Sec. 501]:** Notice of any resolution passed at a 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 company at their respective meetings may nominate a person to be liquidator for the purpose of winding up the affairs and distributing the assets of the company. If the creditors and the company nominate different persons, the persons nominated by the creditors shall be the liquidator. If no person is nominated by the creditors, the person, if any, nominated by the company shall be the liquidator.
4. **Committee of Inspection [Sec. 503]**: The creditors at their first or any subsequent meeting may, if they think fit, appoint a committee of inspection of not more than five members. If such committee is appointed, the company may, either at the meeting at which the winding up resolution is passed or at a later meeting, appoint not more than five persons to serve at the committee. If the creditors object to persons appointed by the company, then the matter will be referred to the Court for the final decision. The powers of such committee are the same as those of a committee of inspection appointed in a compulsory winding up.

5. **Remuneration [Sec. 504]**: The committee of inspection or if there is no such committee, the creditors may fix the remuneration to be paid to the liquidator or liquidators. Where the remuneration is not fixed, it will be determined by the Court. Any remuneration fixed by the committee of inspection or creditors or the Court shall not be increased.

6. **Board’s Power to Cease [Sec. 505]**: On the appointment of a liquidator, all the powers of the board of directors shall cease except in so far as the committee of inspection, or if there is no such committee, the creditors in a general meeting, may sanction the continuance thereof.

7. **Vacancy in the Office of Liquidator [Sec. 506]**: If a vacancy occurs by death, resignation, or otherwise in the office of the liquidator (other than a liquidator appointed by or by the direction of the Court), the creditors in a general meeting may fill the vacancy.

8. **Final Meeting and Dissolution (Secs. 508-509)**: The liquidator must call a general meeting of the company and a meeting of the creditors every year within three months from the close of the liquidation year, if the winding up continues for more than one year. He must 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 winding up. He must call, in the same manner, a final meeting when the affairs of the company are fully wound up and place the same statements before it, as he
does in the case of a members’ meeting in a members’ voluntary winding up under Sections 496 and 497.

**Appointment of liquidator:** In a members’ voluntary winding up, the company in general meeting shall appoint one or more liquidators for the purpose of collecting the company’s assets and distributing the proceeds among creditors and contributories. If a vacancy occurs by death or resignation or otherwise in the office of the liquidator the company in general meeting may fill the vacancy. [Section 490 and 492].

In the case of a creditors’ voluntary winding up, the creditors and the members at their respective meetings, may nominate a person to be the liquidator of the company. However, the creditors are given a preferential right in the matter of the appointment of the liquidator with a power to the Court to vary the appointment on application made within seven days by a director, member or creditor. (Section 502).

**Power of the Court to appoint liquidator:** In a members’ or creditors’ voluntary winding up, if for any cause whatever there is no liquidator acting, the Court may appoint the official liquidator or any other person as a liquidator of the company. The Court may also appoint a liquidator on the application of the Registrar. (Section 515).

**Body corporate not to be appointed as liquidator:** A body corporate shall not be qualified for appointment as a liquidator of a company in a voluntary winding up. Any appointment of a body corporate as liquidator shall be void. (Section 513).

**Corrupt inducement affecting appointment as liquidator:** Any person who gives or agrees or offers to give, any member or creditor of the company any gratification with a view to securing his own appointment or nomination or to
securing or preventing the appointment of someone else, as the liquidator is liable to a fine which may extend up to Rs.1,000. (Section 514).

**Notice by liquidator of his appointment:** When a person is appointed as the liquidator and accepts the appointment, he shall publish in the official gazette a notice of his appointment, in the prescribed form. He shall also deliver a copy of such notice to the Registrar. The liquidator shall do this within 30 days of his appointment. When the liquidator fails to comply with the above provision, he is liable to a fine which may extend to Rs50 for each day of default. (Section 516).

**Effect of the appointment of liquidator:** On the appointment of a liquidator, in a members’ voluntary winding up, all the powers of the directors, including managing director, whole time directors as also the manager shall cease except so far as the company in general meeting or the liquidator may sanction their continuance. (Section 491).

On the appointment of a liquidator in creditors’ voluntary winding up, all the powers of the board of directors shall cease. The committee of inspection or if there is no such committee, the creditors’ meeting by resolution may sanction continuance of the powers of the board. (Section 505).

**Remuneration of liquidator:** In a members’ voluntary winding up, the general meeting shall fix the remuneration to be paid to the liquidators. Unless the question of remuneration is resolved the liquidators shall not take charge of the company. Once remuneration is fixed it cannot be increased. (Section 490).

In a creditors’ voluntary winding up, the remuneration of the liquidator is fixed by the committee of inspection and if there is no committee of inspection the by the creditors. In the absence of any such fixation, the Court shall determine his remuneration. Any remuneration so fixed shall not be increased (Section 504).

All costs, charges and expenses properly incurred in the winding up, including the remuneration of the liquidator, shall subject to the rights of secured
creditors, be payable out of the assets of the company in priority to all other claims (Section 520).

**Removal of Liquidator:** 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 place of removed liquidator. The Court may also remove a liquidator on the application of the Registrar.

### 18.7 WINDING UP SUBJECT TO SUPERVISION OF THE COURT

Voluntary winding up may be under the supervision of the Court. 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 such supervision of the Court. The Court may give such liberty to creditors, contributories or others to apply to the Court and generally on such terms and conditions as the Court thinks just (Sec. 522).

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 (Sec. 523).

The Court will not in general make a supervision order on the petition of a contributory, unless it is satisfies that the resolution for winding up was so obtained that the minority of members were overborne by fraud or improper or corrupt influence. Where the company is insolvent, the wishes of the creditors only are regarded or the investigation is required.

If a company is being wound up voluntarily or subject to 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) I the official liquidator [Sec. 440 (1)].
Where a supervision is made, the Court may appoint an additional liquidator or liquidators, or remove any liquidator at any time and fill any vacancy. The Court & may also appoint the official liquidator as an additional liquidator or to fill any vacancy. The Registrar is also given power to apply to the Court for the removal of a liquidator and the Court may do so (Sec. 524). The liquidator appointed by the Court will act as a voluntary liquidator (Sec. 525). In a voluntary liquidation brought under the Court’s supervision, the liquidator’s remuneration cannot be increased.

A liquidator appointed by the Court has the same powers, is subject to the same obligations, and in all respects stand in the same position, as if he had been duly appointed in accordance with the provisions of the Companies Act with respect to the appointment of liquidators in voluntary winding up (Sec. 525).

18.8 CONSEQUENCES OF WINDING UP

The consequences of winding up may be discussed under the following heads:

1. **Consequences as to Shareholders:** A shareholder is liable to pay the full amount upto the face value of the shares held by him. Not only the present, but also the past members are liable on the winding up of the company. The liability of a present member is the amount remaining unpaid on the shares held by him, while a past member can be called upon to pay if the present contributory is unable to pay.

2. **Consequences as to Creditors:** A company, whether solvent or insolvent, can be wound up under the Act. In case of a solvent company, all claims of its creditors when proved are fully met. But in case of an insolvent company, the rules under the law of insolvency apply.

A secured creditor need not prove his claim against the company. He may realise his security and satisfy the debts. For deficiency, if any, he may put his
claim before the liquidator. The secured creditor has also the option to relinquish his security and to prove the amount as if he were an unsecured creditor.

Where an insolvent company is being wound up, the insolvency rules will apply and only such claims shall be provable against the company as are provable against an insolvent person. (Section 529).

When the list of claims is settled the liquidator has to commence making payments. The assets available to the liquidator are applied in the following order:

a. Secured creditors.
b. Cost of the liquidation.
c. Preferential payments.
d. Debenture holders secured by a floating charge.
e. Unsecured creditors.
f. Balance returned to the contributories.

**Preferential payment:** Section 530 enumerates certain debts which are to be paid in priority to all other debts. Such payments are called preferential payments. It may however be noted that such payments are made after paying the secured creditors, and costs, charges and expenses of the winding up.

These preferential payments are: (a) All revenues, taxes, cesses and rates due from the company to the Central or State Government or to a local authority. The amount should have become due and payable within 12 months before the winding up. (b) All wages or salary of any employee in respect of services rendered to the company and due for a period not exceeding 4 months within 12 months, before the winding up and any compensation payable to any workman under any of the provision of Chapter V-A of the Industrial Disputes Act, 1947. The amount must not exceed Rs.20,000 in the case of anyone claimant. (c) All accrued holiday remuneration becoming payable to any employee or in the case of
his death to any other person, in his right, on the termination of his employment before or by the effect of the winding up. (d) All amounts I due in respect of contributions payable by the company as employer but this is not payable if the company is being wound up voluntarily for the purpose of reconstruction and amalgamation (e) All amounts due in respect of any compensation or liability for compensation in respect of death or disablement of any employee under the Workmen’s Compensation Act, 1923 but this is not payable if the company is being wound up voluntarily for reconstruction or amalgamation. (f) All sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employee maintained by the company. (g) The expenses of any investigation held in pursuance of Sections 235 and 237, in so far as they are payable by the company.

3. **Consequences as to servants and officers:** A winding up order by a Court operates as a notice of discharge to the employees and officers of the company except when the business of the company is continued. The same principle will apply as regards discharge of employees in a voluntary winding up. Where there is a contract of service for a particular period, an order for winding up will amount to wrongful discharge and damages will be allowed as for breach of contract of service.

4. **Consequences of proceedings against the company:** When a winding up order is made, or an official liquidator has been appointed as provisional liquidator no suit or legal proceedings can be commenced and no pending suit or legal proceeding continued against the company except with the leave of the Court and on such terms as it may impose. In the case of a voluntary winding up, the Court may restrain proceedings against the company if it thinks fit.

   It may be noted that law does not prohibit proceedings being taken by the company against others including directors, or officers or other servants of the company.
5. **Consequences as to cost:** Where the assets of the company are insufficient to satisfy the liabilities, the Court may make an order for payment out of the assets of the costs, charges and expenses incurred in the winding up. The Court may determine the order of priority in which such payments are to be made (Section 476).

6. **Consequences as to documents:** When a company is being wound up whether by or under the supervision of the Court or voluntarily, the fact must be made known to all those having any dealing with the company; every document in the nature of an invoice, order for goods or business letter issued in the name of the company, after the commencement of winding up must contain a statement that the company is being wound up (Sec. 547).

   Where a company is being wound up, all documents of the company and of the liquidators shall, as between the contributories of the company, be prima facie evidence of the truth of all matters recorded therein (Sec. 548).

   Where an order for winding up of the company by or subject to the supervision of the Court is made, any creditor or contributory of the company may inspect the books and the papers of the company, subject to the provisions made in the rules by the Central Government in this behalf.

18.9 **WINDING UP OF INSOLVENT COMPANIES**

   Section 529 of the Companies Act applies to winding up of the company which cannot pay all its debts i.e. to an insolvent company only in respect of the following:

   (a) debts provable:

   (b) the valuation of annuities and future and contingent liabilities; and

   (c) the respective rights of secured and unsecured creditors.
All persons who would be entitled to prove for, and receive dividends out of the assets of the company may come in under the winding up and made such claims against the company as they respectively are entitled to. But it is not necessary for a secured creditor to prove his debt in the winding up and he can stand wholly outside the winding up proceedings. However, if a secured creditor instead of giving up his security and providing for his debt proceeds to realise his security, he shall be liable to pay the expenses incurred by the liquidator for the presentation of the security before its realisation by the secured creditor.

The rules of insolvency in India are to be found in the Presidency Towns Insolvency Act, 1909 and Provincial Insolvency Act, 1920. Only such of the rules contained in these Acts as relate to the respective rights of the secured and unsecured creditors, and to debts provable and to the valuation of certain liabilities shall apply under Section 529. Apart from these provisions, in respect of other matters such as those relating to priority of debts, all questions have to be determined with reference to the Companies Act only.

Section 529 ceases to be applicable as soon as it is found the company in the course of winding up is not insolvent. The provisions of the laws of insolvency applicable to insolvent companies will not apply to such company and it will be treated as having been solvent throughout the winding up proceedings.

**Unregistered Companies (Sections 582-583):** The term “Unregistered Company” includes any partnership, association of company consisting of 8 or more members at the time when the petition for winding up is presented, but it does not include a railway company incorporated under any Act of Parliament or other Indian Law or any Act of Parliament of U.K., a company registered under the present Indian Companies Act or any of the previous Indian Companies Acts. An unregistered company may be wound up under the provisions of this Act and with some exception all the provisions relating to the winding up are applicable to it. However such a company can only be wound up by the Court and cannot be
wound up voluntarily or subject to the supervision of the Court. Such a company may be wound up if (a) the company is dissolved or has ceased to carry on business or is carrying on business only to wind up its affairs; (b) the company is unable to pay its debts; and (c) the Court is of opinion that it is just and equitable that the company should be wound up.

18.10 EFFECTS OF WINDING UP ON ANTECEDENT AND OTHER TRANSACTIONS

1. **Fraudulent Preference (Sec. 531):** Any transfer of property, movable or immovable, delivery of goods, payment, execution or other act relating to property, within six months before the commencement of its winding up, shall be deemed a fraudulent preference of its creditors and be invalid accordingly.

   Fraudulent preference here relates similarly to fraudulent preference under insolvency law, where any individual transfers any property or makes any payment within three months before the presentation of an insolvency petition, such transfers shall be deemed a fraudulent preference in his insolvency. Under the Companies Act, 1956, the period is six months instead of three months.

2. **Avoidance of the Voluntary Transfer:** Section 531 A introduced by the Amendment Act, 1960, lays down that any transfer of property, movable or immovable, or any delivery of goods made by a company within a period of one year before the commencement of its winding up shall be void against the liquidator unless such transfer or delivery is made in the ordinary course of business or in favour of a purchaser or encumbrancer in good faith and for valuable consideration.

   Further, any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors in void (Sec. 532).

3. **Avoidance of Boating charge:** Section 534, prevents an insolvent company from creating a floating charge on its undertaking to secure past debts or
for moneys which do not come in the hands of the company. It provide that where a company is being wound up, a floating charge on the undertaking or property of the company created within the twelve months immediately preceding the commencement of the winding up, shall unless it is proved that the company immediately after the creation of the charge was solvent, be invalid except to the amount of any cash paid to the company at the time of or subsequently to the creation of, and in consideration, for the charge together with interest on that amount at the rate of five per cent, per annum or such other rate as may for the time being be notified by the Central Government in this behalf in the official gazette.

Section 534 makes the charge invalid but the debt is not affected. The debt secured by such charge becomes an unsecured debt.

4. **Disclaimer of Onerous Property (Sec. 535):** Disclaimer means abandoning. Where any part of the property of a company which is being wound up consists of:

(a) land of any tenure, burdened with onerous covenants;

(b) shares or stock in companies;

(c) any other property which is unsaleable by reason of its binding the possessor thereof either to the performance of any onerous act or to the payment of any sum of money; or

(d) unprofitable contracts.

The liquidator of the company may, with the leave of the Court, by a writing signed by him, at any time within 12 months after the commencement of the winding up, disclaim the property.

The disclaimer shall release the company and the property from the rights, interests and liabilities. The disclaimer shall not affect the rights or liabilities of any other person.
The Court before or on granting leave to disclaim may require such notices to be given to persons interested.

18.11 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 ‘liquidator’ is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights. A company may be wound up in any of the following three ways: (a) Compulsory winding-up under an order of the Court. (b) Voluntary winding-up (c) Voluntary winding-up under supervision of the Court. A petition for winding-up may be made by a company by passing a special resolution to that effect, by creditors, by a contributory or contributories, by any of these jointly, by the Registrar, by any person authorised by the central Government. The only person who is competent to act as the liquidator in a winding up is the official liquidator. For the purpose of winding up, there shall be attached to each high Court an official liquidator appointed by the Central Government, who may be either a whole time or part time officer depending upon the volume of work. In district courts the official receiver will be the official liquidator. The Central Government may appoint one or more deputy or assistant official liquidators to assist the official liquidator in the discharge of his functions.

18.12 KEYWORDS

Winding-up: Winding-up is a proceeding for the realisation of the assets, the payment of creditors, and the distribution of the surplus, if any, among the shareholders so that the company may be finally dissolved.

Contributory: A contributory means any person liable to contribute to the assets of a company in the event of its being wound up.
Liquidator: A liquidator is a person who is appointed by the court to conduct the proceedings in winding up the company and perform such duties in reference thereto as the court may impose.

Voluntary winding-up: Winding-up the creditors or members without any intervention of the court is called voluntary winding-up.

Defunct Company: A defunct company means a company which has never commenced business or which is not carrying on any business.

18.13 SELF ASSESSMENT QUESTIONS

1. What are the different modes of winding up? Discuss in detail.

2. What is compulsory winding up? What are the grounds for compulsory winding up?

3. Who can petition for the winding up of a company? On what grounds can the Registrar of Companies petition for winding up of the company?

4. Who is a liquidator? What are the duties of a liquidator?

5. Explain the provisions of the Companies Act in respect of the creditors’ voluntary winding up. How does it differ from a members’ voluntary winding up?

6. What is winding up subject to the supervision of the Court? What are the advantages of a supervision order? What are the consequences of such a winding up?

18.14 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.


S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi
CONSUMER PROTECTION ACT, 1986 AND CYBER LAW IN INDIA

Structure

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19.0 OBJECTIVE

The objective of this lesson is to make the students gain knowledge of the relating provisions that provide the rulings about the Consumer Protection Act and Cyber Law in India.

19.1 INTRODUCTION

A number of important changes such as checking of unfair trade practices, grant of interim injunction and grant of compensation were enacted in the 1984 Amendment of the Monopolies and Restrictive Trade Practices Act, 1969 (MRTP
Act) to make it more effective and useful. However, nothing of much importance and use could come out of this exercise. Absence of time-bound disposal of cases, court-like proceedings of the MRTP commission’s work, centralization of MRTP Commission in Delhi, etc., continued to act as limitations of MRTP Act. Consequently, it was felt necessary to enact a more comprehensive legislation to protect the consumers’ rights and the speedy, simple and inexpensive redressal of consumer disputes. In this background, the Consumer Protection Act, 1986 was introduced aiming at protection of the interests of consumers as stated in the preamble of the Act. It provides for the establishment of consumer councils and other authorities for the settlement of consumers’ disputes.

Every human being is a consumer of one kind or other. In the distant past, the consumers were governed by the terms of contract between themselves and the traders. These terms were mostly one sided and obviously in favour of the traders. Moreover, the state showed least enthusiasm in coming to the rescue of consumers when, they were deceived, or cheated. The concept of absolute freedom of contract and the system of lassie fair appeared to be too bookish. All the more, for making huge profits or becoming rich overnight, the traders, businessmen, employers, producers and sellers, etc. at the cost of consumers’ interest were adopting all sorts of abominable means and methods, or malpractices. Even today, meeting of goods which are injurious to health and life, deception of the consumers through unfair trade practices such as, substandard quality, adulteration, non-supply of correct quantity, excess pricing, etc., are rampant in our society. The plight of the consumer in the country is worse confounded, because of his ignorance, illiteracy and weak economic position.

In order to protect the consumer from the unfair trade practices, the Union Government of India has enacted various legislations. But due to lack of proper co-ordination and integration among these legislations, it is observed that consumers are not fully and properly protected. Very prominently, this is because
of poor and inadequate implementing machinery of the government, and rampant corruption and dishonesty.

A silver line was traced in the era of consumer protection during 1986 as it was the year of dawning of visible and tangible consumer movement in India. It was the year when the Consumer Protection Act came into force. It really gave pep to the existing consumer protection activities in the country.

19.2 SCOPE OF THE CONSUMER PROTECTION ACT, 1986

The Consumer Protection Act, 1986 extends to the whole of India except the State of Jammu and Kashmir. The provisions of the Act are in addition to, and not in derogation of, the provisions of any other law for the time being in force. This Act applies to all types of goods and services unless specifically exempted by the central government by notification. The Act provides for setting-up of Consumer Protection Councils at Central and State levels and Consumers’ Complaints Redressal Agencies at Central, State and District levels of the country wherein states include union territories also.

19.3 CONSUMER PROTECTION COUNCIL AND DISTRICT-CONSUMER FORUM

The central government is empowered to constitute the Central Consumer Protection Council which consists of the following 150 members, viz.

1. The Minister in-charge of Department of Civil Supplies who shall be the chairman of the Central Council;

2. The Minister of State (where he is not holding independent charge) or Deputy Minister in the Department of Civil Supplies who shall be the vice-chairman of the Central Council;

3. The Minister of Food and Civil Supplies of Minister in-charge of consumer affairs in states;
4. Eight members of Parliament, five from the Lok Sabha and three from the Rajya Sabha;

5. The Commissioner from scheduled castes and scheduled tribes;

6. Representatives of the Central Government Department, autonomous organisation concerned with consumer interest not exceeding twenty;

7. Representatives of the consumer organisations or consumers, not less than thirty-five;

8. Representatives of women, not less than ten;

9. Representatives of farmers, trade and industries, not exceeding twenty;

10. Persons capable of representing consumer interest not specified above, not exceeding fifteen, and

11. The Secretary in the Department of Civil Supplies shall be the member secretary of the Central Council.

The term of the council shall be three years. The council may meet as and when necessary, but not less than three meetings of the council shall be held every year. Each meeting of the council shall be called by giving not less than 10 days notices in writing to every member, specifying the time, place and agenda of the meeting. However, no proceedings of the councils shall be invalid merely by reasons of existence of any vacancy in or defect in the constitution of the council.

The council is empowered to constituted from amongst its members, such working groups as it may deem necessary. Every working group so constituted shall perform such functions as are assigned to it by the central council. It seems that such working groups may prove to be more useful and effective in dealing with the specific problems allocated to them. The findings of such working groups are required to be placed before the council for its consideration. The resolutions by the council shall be recommendation in nature.
**Objectives of the Central Council:** The COPRA, 1986 provides that the objectives of the Central Council shall be to promote and protect the rights of the consumers, such as:

(a) The right to be protected against marketing of goods which are hazardous to life and property;

(b) The right to be informed about the quality, quantity, potency, purity, standard and prices of goods so as to protect the consumer against unfair trade practices;

(c) The right to be assured, wherever possible, access to a variety of goods at competitive prices;

(d) The right to be heard and to be assured that consumer interests will receive due consideration at appropriate fora;

(e) The right to seek redressal against unfair trade practices or unscrupulous exploitation of consumers; and

(f) The right to consumer education.

The central council may have a significant role in the formulation of the Central Government’s Economic Policy. In addition, it may respond to request for information and advice on particular issues relating to the protection of consumers. Though the decisions of the council are recommendation, they have a significant impact on several authorities concerned with the matters of consumer protection.

**State Consumer Protection Councils:** The state governments are also empowered to establish Consumer Protection Councils for their respective states. The State Councils shall consist of such members as may be notified by the state governments by notification from time to time. The objectives of every State Council (like Central Council) shall be to promote and protect within the state, the rights of the consumers as laid down in its clauses (a to b) of Section 6. So far, 22 states and Union Territories have set up the consumer Protection Councils under
the Act. How far these councils have been successful in protecting the consumer interest is not free from doubt.

**District Forum:** A Consumer Disputes Redressal Forum to be known as the District Forum is required to be established by the state government with the prior approval of the central government in each district of the state.

i) **Composition of the District Forum:** The Act provides that each district forum shall consist of a president, who is required to be a qualified district Judge nominated by the state government. It shall consist of two members; among them, one should be a woman social worker. The members may hold the office for a period of five years or up to the age of 65 years whichever is earlier and they are not eligible for re-appointment. Vacancy occurred by members’ the state government may fill resignation and it has entire authority about deciding salary or honorarium to be paid to the members.

ii) **Jurisdiction of the District Forum:** District Forum has the jurisdiction to entertain the complaints where the value of the goods or services or compensation claimed is less than Rs.5,00,000 (earlier it was Rs.1,00,000). It can take complaints where opposite party/parties reside/s or carries on business in the district and the cause of action, wholly or in part, arises.

iii) **Procedure to be followed by the District Forum:** Section 13 of the COPRA, 1986 lays down the procedure to be followed for the settlement of consumer dispute by the District Forum. After receiving a complaint from the complainant, it refers a copy of the complaint to the opposite party directing him to give his version within 30 days or such extended period not exceeding 15 days. If the opposite party denies or disputes the allegations contained in the complaint or omits or fails to take any action to represent his case within the time given by the District Forum, then the forum shall take the following if the complaint relates to goods. If complaint alleges a defect in the goods which cannot be determined by proper analysis, then the District Forum shall take a sample and send it to a
laboratory with prescribed fee (from the complainant) and then it has to send a copy of the laboratory report to the opposite party of the complainant disputes with the correctness of report of the laboratory, then they may submit in writing their objections and then the District Forum gives a reasonable opportunity to the parties of being heard and issue an appropriate order.

If the complaint relates to service and where the opposite party on receipt of a copy of the complaint denies or disputes the allegations contained in the complaint, or omits or fails to take any action to represent his case within the time given by the Forum, the Forum shall proceed to settle the consumer dispute on the basis of:

(i) Evidence brought to its notice by the complainant and the opposite party denies or disputes the allegations contained in the complaint, or

(ii) Evidence brought to its notice by the complainant where the opposite party omits or fails to take any action to represent his case within the time given by the Forum.

If the District Forum is satisfied that the goods complained against any of the defects specified in the complaint or that any of the allegations contained in the complaint about the services are proved, it shall issue an order to the opposite party directing him to take one or more of the following things:

(i) to remove the defect pointed out by the appropriate laboratory from the goods in question;

(ii) to replace the goods with new goods of similar description which shall be free from any defect;

(iii) to return to the complainant the price, or as the case may be the charges paid by the complainant; and

(iv) to pay such amount as may be awarded by it as compensation to the consumer for any loss or injury suffered by the consumer due to the negligence of the opposite party.
The person (whether complainant or opposite party) dissatisfied with the order made by the District Forum may prefer an appeal against such order to the State commission within a period of 30 days from the date of order.

19.4 STATE COMMISSION FOR CONSUMER PROTECTION

The state commission is the consumer disputes redressal agency at the state level which is established by the state government with the prior approval of the central government. It consists of a president who is or has been a Judge of a High Court and two members one of them is a woman.

i) Jurisdiction of the State Commission: The State Commission can entertain the complaints where the value of the goods and compensation if any, claimed exceeds Rs.5,00,000 but does not exceed Rs.20,00,000 (earlier it was Rs.1,00,000 and Rs.10,000,000 respectively). It can entertain appeals against the orders of any District Forum within the state and it can call for the records and pass appropriate order in any consumer dispute which is pending before or has been decided by any District Forum within the state, where it appears to the State Commission that such District Forum has exercised a jurisdiction not vested in it by Law or has failed to exercise a jurisdiction legally or with material irregularity. Hence, the jurisdiction of the State Commission is original as well as appellate.

ii) Procedure: While disposing of the complaints, State Commission have to follow the Sections 12,13 and 14 and the rules made hereunder with such modifications as may necessarily be applicable to it. The Rule 10 of the Consumer Protection Act as are vested to the District Forum regarding the production documents, search and seizure. It may, however, be noted that the State Governments have yet to make their own rules in exercise of their powers under Section 30 (2) of the Act. It is submitted that the State Government may adopt the similar rules as laid down by the central government, viz., Consumer Protection Rules, 1987. It will help in maintaining uniformity in Law all over the country.
Appeal against the Orders of the State Commission: Section 19 of the Act provides that the person aggrieved by an order made by the State Commission on a complaint may prefer an appeal against such order to the National Commission within a period of 30 days from the date of the order. The National Commission may entertain an appeal after the expiry of the said period of 30 days if it is within that period.

It may be noted that an order made by the State Commission on an appeal against the orders of the District forum is not appealable to the National Commission. Thus, provision exists only for a single appeal to the State Commission, from the order of the State Commission to the National Commission.

19.5 NATIONAL COMMISSION FOR CONSUMER PROTECTION

This is the highest authority to settle the consumer disputes under the Act. It is an independent statutory body.

i) Composition of the National Commission: The National Commission shall consist of a president appointed by the central government who is or has been a Judge of Supreme Court and four other members who are eminent in any field of knowledge - one of whom should be a woman. However, no sitting judge of the Supreme Court shall be appointed under the previously mentioned provisions except after consultation with the Chief Justice of India. The COPRA and the Rules have laid down many provisions to rescue the independence of National Commission. The terms and conditions of the service to the president and the members should be varied to their disadvantage.

ii) Jurisdiction of the National Commission: Jurisdiction of National Commission is original as well as appellate. The original jurisdiction is limited to the complaints where the value of the goods or service and compensation exceeds Rs.20,00,000 (earlier, it was Rs.10,00,000). The appellate jurisdiction is confined to appeal against the orders of any State Commission. Further, the commission is
empowered to call for records and pass appropriate orders in any consumer dispute where it appears that the State Commission has acted illegally or with material irregularity or exceeded its jurisdiction or has exercised its jurisdiction.

iii) Procedure: The procedure to be followed in dealing with the complaints is specified by Section 22 of the COPRA, which is similar to the powers of a civil court. It may also follow the procedure, which is prescribed by the central government. Accordingly, the procedure has been laid down in the Rule 14 of the consumer Protection Rules. These rules provide that a complaint containing the following particulars should be presented by the complainant in person or by his agent to the National Commission or be sent by registered post to the Commission:

(a) the name, description and address of the complainant;
(b) the name, description and address of the opposite party or parties;
(c) the facts relating to the complaint and when and where it arose;
(d) documents in support of the allegations contained in the complaint, and
(e) the relief which the complainant claims.

On receipt of a complaint, the National Commission has to follow the same procedure as is to be followed by the District Forum under Section 13 of the Act. The procedure to be followed by the National Commission for hearing the appeal has been prescribed in Rule 15. Accordingly, a memorandum should be presented by the appellant or his agent to the National Commission in person or by post addressed to the commission. The memorandum must be set forth on the grounds of appeal without any arguments or narrative and must be accompanied by a certified copy of the order of the State Commission appealed against and such of the documents as may be received to support grounds of objection mentioned in the memorandum. However, under Section 19 of the Act, the appeal is to be preferred within a period of 30 days from the date of the order of the State
Commission. When such an appeal is presented after the expiry of the period of limitation, the memorandum must also be accompanied by an application supported by an affidavit setting forth the facts on which the appellant relies to satisfy the National Commission that he has sufficient cause for not preferring the appeal within the period of limitation.

It is obligatory for the parties or agents to appear before National Commission on the date of hearing or any other day to which hearing may be adjourned. If the appellant/respondent or his agent fails to appear on such date, the commission may in its discretion either dismiss the appeal or decide expert on merit.

iv) Appeal against the order of the National Commission: A person dissatisfied with the order made by the National Commission may prefer an appeal against such order to the Supreme Court within a period of 30 days from the date of the order made by the National Commission and on an appeal preferred from the orders of the State commission shall be final and no further appeal against such orders should be preferred to the Supreme Court.

Filling of Complaints and Model Forms: Whoever wants to lodge a complaint either in the District Forum or State Commission or National Commission should use a form specifically meant for filling complaints in respective redressal agencies. They generally consist of name and addresses of both complainant(s) and the opposite party(ies), facts relating to the complaint, the value of the compensation claimed, and a declaration.

19.6 INTRODUCTION TO CYBER LAW IN INDIA

At no other time in the 20th century, there have been so drastic changes in human history which have such an impact on commerce – from a small proprietorship firm to an MNC having branches all over the world – from small varieties of tangibles to diverse varieties of un-countable tangibles and even
intangibles – from a market of few miles to a global market supported by Internet-from a local money-lender to a global finance company, no doubt, we have developed a lot. In the last few years, the methods and style of trading have changed. Trading electronically is no longer new now. It has flourished the idea of cost reduction and timesaving. The following have pushed the way for trading electronically:

(i) The pace of change in the computer system and computer software;
(ii) The growing use of PCs and internet, hence, instant response and convenience of getting informations;
(iii) The trend of globalisation;
(iv) The ever increasing volume of organisations;
(v) Rapid drop in telecommunication cost (STD & ISD); and
(vi) Business transformation, hence, personalised attention.

These are drastically pushing the graph of number and volume of transactions through Internet up and the graph of transaction cost down. The US Govt. decided five years ago that E-Commerce was the way to go. The UN has established an Internet based ‘Global Trade Point Network’ that assists-small and medium size companies eager to expand globally one estimate suggests that in 1998, one out of every seven trades taking place in US originated as an order over the Internet as opposed to none in 1992. Even in India, 95% of stock trading is done over the screen. The cost of such trading has reduced by at least 75%. Overall, trading volume has gone up by at least 100% over last five years. ICICI bank is the first bank, which has started net banking in India. A study of Nolan Norton, a computer consultancy firm, showed transaction cut time upto 90% and in-crease in transaction by 25-50% (Source: Finance Times Review). No doubt, E-Commerce will revolutionize trade and commerce. There are two types of goods,
which are traded electronically: (i) tangibles and (ii) intangibles i.e. computer software, books, games, education and training material in digitized form.

The significant point to be noted is that as defined above, e-commerce would include transactions involving delivery and payment in traditional manner if offer and acceptance of the offer is through a ‘network’. The above definitions of e-commerce are crucial from the perspective of understanding the nature of transactions and the manner in which such transactions change traditional business practices.

The importance of conducting business electronically cannot be undermined. Most businesses are gradually moving towards the digital market place as it offers infinite choices. This has led to the emergence of virtual marketplaces, which are the nothing but the blossoming of real world commercial and consumer transactions into the cyber world. This transition has changed the role of technology from being a mere enabler to being the backbone of business.

The virtual workplace has now graduated to being a versatile new marketplace in itself, spinning a whole new business sphere and accompanying models, revenue streams and growth spurts. The main businesses, spurring this shift to the digital marketplace are:

- Internet Service Providers
- Application Service Providers
- Business 2 Consumer segment
- Business 2 Business segment
- Consumer 2 Business segment
- Consumer 2 Consumer segment

The above discussion does indicate the relative extent of domestic and cross border e-commerce in India. All this requires the comprehensive cyber law
in place for regulating the electronic business in the country. This is with view in mind, the government of India brought Information Technology Bill 2000 in the Parliament and the bill has been passed in the same year.

In May 2000, both the houses of the Indian Parliament passed the Information Technology Bill. The Bill received the assent of the President in August 2000 and came to be known as the Information Technology Act, 2000. Cyber laws are contained in the IT Act, 2000.

This Act aims to provide the legal-infrastructure for e-commerce in India. And the cyber laws have a major impact for e-businesses and the new economy in India. So, it is important to understand what are the various perspectives of the IT Act, 2000 and what it offers.

The Information Technology Act, 2000 also aims to provide for the legal framework so that legal sanctity is accorded to all electronic records and other activities carried out by electronic means. The Act states that unless otherwise agreed, an acceptance of contract may be expressed by electronic means of communication and the same shall have legal validity and enforceability. Some highlights of the Act are listed below:

- Chapter-II of the Act specifically stipulates that any subscriber may authenticate an electronic record by affixing his digital signature. It further states that any person can verify an electronic record by use of a public key of the subscriber.

- Chapter-III of the Act details about Electronic Governance and provides inter alia amongst others that where any law provides that information or any other matter shall be in writing or in the typewritten or printed form, then, notwithstanding anything contained in such law, such requirement shall be deemed to have been satisfied if such information or matter is –

- Rendered or made available in an electronic form; and
The said chapter, also details the legal recognition of Digital Signatures.

Chapter-IV of the said Act gives a scheme for Regulation of Certifying Authorities. The Act envisages a Controller of Certifying Authorities who shall perform the function of exercising supervision over the activities of the Certifying Authorities as also laying down standards and conditions governing the Certifying Authorities as also specifying the various forms and content of Digital Signature Certificates. The Act recognizes the need for recognizing foreign Certifying Authorities and it further details the various provisions for the issue of license to issue Digital Signature Certificates.

Chapter-VII of the Act details about the scheme of things relating to Digital Signature Certificates. The duties of subscribers are also enshrined in the said Act.

Chapter-IX of the said Act talks about penalties and adjudication for various offences. The penalties for damage to computer, computer systems etc. has been fixed as damages by way of compensation not exceeding Rs.1,00,00,000 to affected persons. The Act talks of appointment of any officers not below the rank of a Director to the Government of India or an equivalent officer of state government as an Adjudicating Officer who shall adjudicate whether any person has made a contravention of any of the provisions of the said Act or rules framed there under. The said Adjudicating Officer has been given the powers of a Civil Court.

Chapter-X of the Act talks of the establishment of the Cyber Regulations Appellate Tribunal, which shall be an appellate body where appeals against the orders passed by the Adjudicating Officers, shall be preferred.

Chapter-XI of the Act talks about various offences and the said offences shall be investigated only by a Police Officer not below the rank of the Deputy Superintendent of Police. These offences include tampering with computer source
documents, publishing of information, which is obscene in electronic form, and hacking.

- The Act also provides for the constitution of the Cyber Regulations Advisory Committee, which shall advice the government as regards any rules, or for any other purpose connected with the said act. The said Act also proposes to amend the Indian Penal Code, 1860, the Indian Evidence Act, 1872, The Bankers’ Books Evidence Act, 1891, The Reserve Bank of India Act, 1934 to make them in tune with the provisions of the IT Act.

**Advantages of Cyber Laws**

- The IT Act 2000 attempts to change outdated laws and provides ways to deal with cyber crimes. We need such laws so that people can perform purchase transactions over the Net through credit cards without fear of misuse. The Act offers the much-needed legal framework so that information is not denied legal effect, validity or enforceability, solely on the ground that it is in the form of electronic records. In view of the growth in transactions and communications carried out through electronic records, the Act seeks to empower government departments to accept filing, creating and retention of official documents in the digital format. The Act has also proposed a legal framework for the authentication and origin of electronic records / communications through digital signature.

- From the perspective of e-commerce in India, the IT Act 2000 and its provisions contain many positive aspects. Firstly, the implications of these provisions for thee-businesses would be that email would now be a valid and legal form of communication in our country that can be duly produced and approved in a court of law.

- Companies shall now be able to carry out electronic commerce using the legal infrastructure provided by the Act.

- Digital signatures have been given legal validity and sanction in the Act.
• The Act throws open the doors for the entry of corporate companies in the business of being Certifying Authorities for issuing Digital Signatures Certificates.

• The Act now allows Government to issue notification on the web thus heralding e-governance.

• The Act enables the companies to file any form, application or any other document with any office, authority, body or agency owned or controlled by the appropriate Government in electronic form by means of such electronic form as may be prescribed by the appropriate Government.

• The IT Act also addresses the important issues of security, which are so critical to the success of electronic transactions. The Act has given a legal definition to the concept of secure digital signatures that would be required to have been passed through a system of a security Procedure, as stipulated by the Government at a later date.

• Under the IT Act, 2000, it shall now be possible for corporates to have a statutory remedy incase if anyone breaks into their computer systems or network and causes damages or copies data. The remedy provided by the Act is in the form of monetary damages, not exceeding Rs. 1 crore.

19.7 SUMMARY

The Consumer Protection Act, 1986 was enacted to provide effective, inexpensive simple and speedy redressal to the consumer grievances. In fact, the three-tier redressal agencies envisaged in the Act have started functioning in almost all the states and have been providing effective redressal to consumers. The agencies in fact have done a lot, but still a lot more is to be achieved. They are facing problems in delivering speedy justice. Some of the pressing difficulties include shortage of funds, staff, lack of infrastructure, etc. which are putting hindrances in the smooth functioning of redressal agencies. Due to lack of these essential facilities, the redressal machinery is imitating rather than competing with
the Civil Courts and, Civil Courts are known for giving adjournment dates. Strictly speaking adjournment may be made a rare exception and not a rule.

However, there are still so many drawbacks in the implementation itself. The Amendment Act of 1993 remedied In fact, some more shortcomings, and lapses in the original Act. It is shocking to note here that even after the lapse of 50 years of Independence, large number of consumers are lacking education and are ignorant about their rights and the provisions of the Act. Eventually, they are exploited by the goods gesture of social organisation. However, the real protection to the innocent consumers can only be given by streamlining the efforts from all directions viz., voluntary consumer organisations, the business houses and the government. They have to play a collective role. Otherwise, the very purpose of the Act will be defeated.

The Information Technology Act, 2000 aims to present for the legal framework so that legal sanctity is accorded to all electronic records and other activities carried out by electronic means. The Act states that unless otherwise agreed, an acceptance of contract may be expressed by electronic means of communication and the same shall have legal validity and enforceability.

19.8 KEYWORDS
Consumer Protection: Consumer protection means the protection of the consumers from their exploitation by the unfair trade practices of the producers/sellers.

Complaint: Complaint means any allegation in writing made by a complainant with a view to securing help or relief available under the Act.

Service: Service means services of any kind or description which are made available to prospective consumers.
**Information Technology Act:** Information Technology Act aims to provide for the legal framework so that legal sanctity is accorded to all electronic records and other activities carried out by electronic means.

### 19.9 SELF ASSESSMENT QUESTIONS

1. Discuss the nature, scope, and limitations of COPRA, 1986.

2. What do you mean by consumer protection council? Explain the role and functions of state consumer protection council.

3. Write an essay on consumer dispute redressal agencies and their main functions.

4. Write a detailed note on the present status of Cyber Law in India.

### 19.10 SUGGESTED READINGS