# Bachelor of Commerce

# BCOM 404

# COMPANY LAW

Directorate of Distance Education
Guru Jambheshwar University of Science & Technology

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## Contents

**LESSON 1**

**MEANING, FEATURES AND TYPES OF COMPANIES**

## STRUCTURE



## 1.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Understand the meaning of a company and its features.

- Get the insight of lifting the corporate veil.
- Know how companies are classified on various basis.

## 1.1 INTRODUCTION

Limitations of traditional forms of business organisations i.e. sole proprietor and partnership, led to the advent of company form of organisation. The traditional forms of organisations failed to meet the increasing requirements of capital and skills needed for large-scale business enterprises. The industrial revolution brought about revolutionary changes in the methods of production. The production was not confined to the local limits of a city, town or village but became international in character. This, in turn, resulted in an ever growing need for capital and managerial skills which was never experienced before. Another key factor which led to the rapid development of the company form of organisation was the reluctance on the part of the sole traders or partners in the partnership firms, to bear the brunt of unlimited liability.

The company form of organisation furnished the organisers with twin advantages of limited liability and huge capital resources, besides, free transferability of shares and a separate legal entity. The last two, combined with other characteristics of the company form of organisation, enabled greater mobilisation of capital resources and a longer life-perpetual existence of the company, irrespective of the life of the members of the company constituting it.

## 1.2 MEANING OF A COMPANY

According to Section 2 (20) of the Companies Act, 2013 "company" means a company incorporated under this Act or under any previous company law. A company incorporated under any previous company law means an existing company.

The definition given above fails to reveal what a company is or what its salient characteristics are. Chief Justice Marshall of U.S.A. has defined a company in the following words: "A corporation is an artificial being, invisible, intangible and existing only in the contemplation of law. Being a mere creation of law, it possesses only the properties which the charter of its creation confers upon it, either expressly or as incidental, to its very existence."

According to Prof. Haney, “A company is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal.” This definition given by Prof. Haney very clearly reveals what a company is and what its essential characteristics are.

### 1.2.1 FEATURES OF A COMPANY

Following are the essential characteristics of a company:

**1. Incorporated association.** A company is an incorporated or registered association. It is created either by an Act of Legislature or by registration under the Companies Act. An unincorporated association cannot be called a company in the strict legal sense of the word. Only after a company is incorporated or registered, it becomes a separate entity.

**2. Artificial legal person.** A company is an artificial person as against a natural person. It is created by a process of law. It has no physical existence. It has no body and as such you cannot shake it down in a fit of anger. It has no soul, no conscience and hence, it is called an artificial person. At the same time, it enjoys certain rights and has some obligations like a natural person. It can transfer property, enter into contracts, sue or be sued and fined for violating the provisions of the Companies Act.

**3. Separate entity.** A company, after it is incorporated, acquires a separate entity or what is called a juristic personality, entirely distinct from the individual members constituting it. It has the right to own and transfer property. It can sue and be sued in its own name by its members as well as outsiders. Even if a shareholder owns virtually the whole of its capital, the company is a separate legal entity in the eyes of law, as distinguished from a shareholder.

This principle was enunciated in the famous case of Salomon v. Salomon & Co. Ltd. (1897) A. C. 22. One Salomon, a leather merchant, sold his business for £ 30,000 to Salomon & Co. Ltd. The Salomon & Co. consisted of Salomon himself, his wife, four sons and one daughter. The purchase consideration was paid by the company to Salomon by allotment of 20,000 fully paid shares of £ 1 each and £ 10,000 worth of debentures carrying a floating charge over all the assets belonging to the company. One share each was allotted to the other six members comprising his wife, four sons and one daughter. Salomon, thus, had an absolute control over the company. After a period of only one year, the company ran into financial difficulties and was ordered to be wound-up. The creditors of the company sought priority over the debenture holders on the ground that the company and Mr. Salomon were one and the same person. They further contended that the company was a mere ‘alias’ or an agent for Salomon. The business was, solely his, conducted solely for him and by him and the company was mere 'sham' and 'fraud'. Hence, Salomon was liable to indemnify the company against its trading debts. The House of Lords, however, held that the existence of a company is quite independent and distinct from its members and that the company's assets must be applied in payment of the debentures first in priority to unsecured creditors.

The following observations made by Lord Macnaghten in this connection are worth noting: "The company is at 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 it was before, and 'the same persons are managers, and the same hands receive the profits, the company 'is not in law the agent of the subscribers or trustee for them'. Nor are the subscribers, as members, liable in any shape or form, except to the extent and in the manner provided by the Act."

**4. Perpetual existence.** A company has a continued existence. As a company has a separate entity, it is comparatively more stable than a sole proprietorship or partnership. The life of the company is not dependent upon the life of the individual members constituting it. The death, insolvency, insanity or retirement of any member or director does not affect the life of the company. Even the death of all the members will not mean the death of the company.

During the war all the members of one private company, while in general meeting, were killed by a bomb. But the company survived, not even a hydrogen bomb could have destroyed it.

**5. Common seal.** Since a company is an artificial person it cannot act by itself. It has to act through natural persons the directors. The directors, while entering into contracts on behalf of the company are required by law to affix the company's seal, if there is any, as a token of its signature.

**6. Limited liability.** Perhaps, the most important advantage for which a company is formed, is the limited liability. The liability of every member of the company is limited to pay the face or nominal value of a share. If he has paid the full amount due on his share, he will not be required to pay anything more to meet company's liability. For example, if the face value of a share in a company is ₹ 10 and the shareholder has paid ₹ 8, his liability to the company is for the remaining balance of ₹ 2 only and no more. In case of a company limited by guarantee, the liability of the member is limited to the amount he has guaranteed to contribute to the assets of the company, in the event of its being wound-up.

**7. Transferability of shares.** One of the important characteristics of a company is transferability of its shares. The shares of a public company are freely transferable. The Articles of a public company cannot and of a private company must impose restrictions on the transfer of shares. However, a company cannot impose absolute restrictions on transfer of its shares. Such a restriction would be void. As per the Companies Act, 2013, a public company, whose shares are listed on a recognised stock exchange cannot refuse to register transfer of its shares.

**8. Separate property.** It is a corollary of the concept of separate entity. A company is regarded as a separate entity distinct from its members. Such a company is capable of owning, enjoying and also of transferring property in its own name. Although, its members or shareholders contribute its capital, yet they are not the joint owners of the property of the company. No member can claim himself to be the owner of the company's property during its existence or on its winding-up. The shareholders do not even have an insurable interest in the property of the company.

**9. Capacity to sue.** A company is a separate legal entity. As such, it can sue and be sued in its own name.

## 1.2.2 LIFTING THE CORPORATE VEIL

A company is regarded as a separate entity distinct from its members [Salomon v. Salomon Co. Ltd. (1897) A.C. 22]. As such, the members cannot be held liable for the acts of the company. Thus, there is a veil (curtain or cloak) between the company and its members. Ordinarily, the Court or Tribunal will not look behind the corporate entity i.e., the Court or Tribunal will not see who are the real persons controlling the company.

However, this concept of separate entity cannot be misused by the members of the company to evade taxes or play fraud on people. In such cases, the Court or Tribunal cannot be a silent spectator. As such, the Court or Tribunal can and ought to lift or pierce the corporate veil to look or find out the real persons doing the mischief under the garb of corporate personality. This is known as "lifting or piercing the corporate veil".

The circumstances under which the Court or Tribunal can lift the corporate veil may be broadly divided into two categories:

(A) Cases falling under judicial decisions.

(B) Cases falling under express statutory provisions.

**(A) Under Judicial Decisions**

**L Protection of revenue.** The Courts have lifted the corporate veil where it was used to evade taxes or circumvent tax obligations.

Santanu Roy v. Union of India (1988) 38 E.L.T. (Del.). In this case show cause notices were issued to individual directors of M/s Duncan Agro Industries Ltd. by the Central Excise authorities for alleged evasion of excise duty by reason of fraud. This was challenged by the directors on the ground of the liability being that of the company. The High Court lifted the corporate veil to determine the liability of the directors. The Court observed that any director, who is a party to the fraud or commissioning of any tort, is personally liable.

**2. Prevention of fraud or improper conduct.** If the separate entity of the company is misused for defrauding people or avoiding legal obligations, the Court or Tribunal can lift the corporate veil.

Gilford Motor Co. v. Horne (1913) 1 Ch. 935, Horne was appointed as a managing director of Gilford Motor Co. The service agreement imposed a condition that Horne shall not solicit the customers of the company. Horne formed a company which solicited the plaintiff s customers. Held, the company was a mere cloak or sham for the purpose of enabling Horne to commit breach of his service agreement to solicit customers. The Court restrained Horne, as well as the defendant company, from soliciting customers.

**3. Determination of enemy character of a company.** When the management of a company is in the hands of persons residing in an enemy country, the Court or Tribunal may lift the corporate veil as the company acquires an enemy character. In such cases to allow alien enemies to trade under the garb of corporate entity, will be against public policy.

**4. Avoidance of welfare legislation.** The Court or Tribunal can lift the corporate veil if it finds that the company is misusing its corporate entity to avoid welfare legislation.

**5. To determine contempt of Court.** Where corporate veil is used to avoid contempt of Court or Tribunal, the Court or Tribunal can pierce the corporate veil and punish the guilty persons for contempt of Court.

**6. Determination of technical competence of the company.** Just as to determine enemy character of a company corporate veil can be pierced, similarly, to determine technical competence of the company, its corporate veil can be pierced.

**(B) Under Express Statutory Provisions**

The Companies Act, has also made certain express provisions under which the corporate veil can be lifted. Some of the important cases are as follows:

**1. Reduction of members below the statutory minimum.** If at any time the number of members of a public company falls below 7 (below 2 in case of a private company) and the business of the company is carried on for more than 6 months, while the number is so reduced, every member who is aware of the fact shall be severally liable for all debts of the company contracted after the said period of 6 months However, the members who left the company during the said 6 months period will not be liable. It should be noted that members who continue after 6 months period shall be liable only when they are aware that the number of members has fallen below the statutory minimum. Thus, it would be seen that the Company Law lifts the corporate veil in such cases and makes the members personally liable despite the fact that company is a separate entity and the liability of the members is limited.

**2. Misrepresentation in prospectus [Sec. 35 (I) and 447].** If misrepresentation is made in a prospectus, every person, who authorised the issue of the prospectus, shall be personally liable to those who subscribed on the faith of untrue statements made in the prospectus.

**Criminal liability for misstatements in prospectus (Sec.34).** Where a prospectus, issued, circulated or distributed under this Chapter, includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus shall be liable under section 447:

**Civil liability for misstatement in a prospectus. (Sec. 35) (1).** Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who:

(a) is a director of the company at the time of the issue of the prospectus;

(b) has authorised himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

(c) is a promoter of the company;

(d) has authorised the issue of the prospectus; and

(e) is an expert referred to in sub-section (5) of Section 26, shall, without prejudice to any punishment to which any person may be liable under Section 36, be liable to pay compensation to every person who has sustained such loss or damage.

(2) No person shall be liable under sub-section (1), if he proves:

(a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

(c) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

**3. Fraudulently inducing persons to invest money (Sec. 36).** Any person who, either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into:

(a) any agreement for, or with a view to acquiring, disposing of, subscribing for, or underwriting securities; or

(b) any agreement, the purpose or the pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities; or

(c) any agreement for, or with a view to obtaining credit facilities from any bank or financial institution shall be liable for action under section 447.

**4. Failure to return application money [Sees. 39 (3)].** If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board, the amount received under sub-section (1) shall be returned within such time and manner as may be prescribed.

In case of any default to return application, the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less. [Sec. 39(4)].

**5. Improper use of "Limited" or "Private Limited" words after the name of a company (Sec. 453).** If any person or persons trade or carry on business under any name or title, of which the word "Limited" or the words "Private Limited" or any contraction or imitation thereof is or are the last word or words, that person or each of those persons shall, unless duly incorporated with limited liability, or unless duly incorporated as a private company with limited liability, as the case may be, punishable with fine which shall not be less than five hundred rupees but may extend to two thousand rupees for every day for which that name or title has been used.

**6. Holding and subsidiary companies [Sec. 2(46)].** A "holding company" is one which controls the management of the other company while the other company is called its subsidiary. In the eyes of law, holding and subsidiary companies are separate entities. It has been held that even a 100% subsidiary is a separate entity and its holding company will not be liable for its acts.

However, the Court or Tribunal may lift the corporate veil in order to establish the relationship of holding and subsidiary company to find out the real persons who control the affairs of the company. As such, in some cases the law may not treat a subsidiary company as an independent company. For example, every holding company shall attach to its Balance Sheet, copies of the Balance Sheet, Profit and Loss Account, Directors Report and Auditor's Report in respect of each of its subsidiary company. Again, when a private company becomes a subsidiary of a public company, virtually it is treated as a public company.

**7. For investigation of affairs of a company (Sections 90 and 216).** In case, an inspector is appointed to investigate the affairs of a company he is empowered to investigate the affairs of anybody corporate under the same management or group. For the purpose of fixing responsibility for mismanagement, fraud etc. the corporate veil or personality can be disregarded, i.e., the persons behind the legal facade can be identified and punished.

**8. For investigation of ownership of a company (Sections 90 and 216).** The Central Government may appoint one or more inspectors to investigate and report on the membership of any company for the purpose of determining the true persons (a) who are, or have been, financially interested in the company;

and (b) who are, or have been, able to control or materially influence the policies of the company. For this purpose, the corporate veil can be lifted so as to identify the real persons controlling the company.

**9. To check fraudulent trading (Sec. 447).** If during the winding-up of a company, it appears that the business of the company has been carried on with intent to defraud the creditors of the company or any other person, or for fraudulent purposes, the Court or Tribunal can lift the corporate veil to find out the real persons responsible for it. The Court or Tribunal may hold those persons personally liable for all or any debts of the company without any limitation of liability.

# 1.3 TYPES OF COMPANIES

These are various kinds of companies and these can be classified on a number of basis. The important basis on which these companies can be classified is as follows:

## 1.3.1 On the Basis of Creation

There are three principal modes in which a company may be created. These are:

**(i) Chartered companies.** In olden times, kings by virtue of the powers vested in them, used to create companies by granting Royal Charter. Such companies were known as 'Chartered Companies', and were governed by their Charters. Example of such companies are The Bank of England, The East India Company, etc. The Companies Act did not apply to them. Such companies are not created now-a-days.

**(ii) Statutory companies.** Such a company is created by statutes or special Acts of Parliament or State Legislatures. Such companies are incorporated to carry on business of national importance. For example, The Reserve. Bank of India, The Life Insurance Corporation of India, The Food Corporation of India, etc. These companies are conferred special powers and are governed by the provisions of the Acts by which such companies are created. However, provisions of the Companies Act may also apply to these companies in so far as they are not inconsistent with the provisions of the Special Acts under which these companies are created. Such companies need not use the word 'Limited' at the end of their names.

**(iii) Incorporated or registered companies.** A company registered under the Companies Act is known as a registered or incorporated company. By far the largest number of companies is created in this manner. Such companies may be public or private; with limited or unlimited liability; having share capital or no capital.

### 1.3.2 On the basis of Liability

On the basis of liability, companies are classified under the following three heads: (i) Limited by shares, (ii) Limited by guarantee and (iii) Unlimited company.

**(i) Limited by Shares Sec. 2 (22).** 'Company limited by shares' means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them." The shareholders are liable to pay unpaid amount, if any, due on the shares held by them. There is no danger of private property of the members being used for the payment of creditors of the company. The unpaid amount on the shares may be called up by the company at any time. By far, the largest number of companies is of this type.

**(ii) Limited by Guarantee Sec. 2(21).** "Company limited by guarantee' means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up." Companies formed for non-trading purposes, e.g., for the promotion of art, science, culture, sports, etc. are limited by guarantee. The liability of its members is limited, by its Memorandum, to such an amount as the members have respectively undertaken to contribute to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member as the case may be. The amount guaranteed by each member cannot be demanded until the company is wound up. Such members are liable in case the present members are unable to contribute the guaranteed amount. Such companies may be granted exemption by the Government from using the word 'Limited' or 'Private Limited' as part of their name.

**(iii) Unlimited Company.** Just as the liability of sole traders or partners is unlimited, the liability of the members of an unlimited company may be unlimited. A member can be called upon to pay an unlimited amount to pay off the creditors in proportion to his interest in the company. However, there is an important difference in the nature of liability of the members of an unlimited company. Creditors of an unlimited company cannot file suit against the individual members directly. In case of a partnership firm, creditors can directly sue the partners. A company limited or unlimited is regarded as a separate entity from its members. Such companies are rarely found these days.

### 1.3.3 On the Basis of Number of Members

On the basis of number of members, companies are classified under the following heads:

**(i) Private Company Sec. 2(68).** A 'Private company' is defined by Sec. 2(68) (iii) as .a company which by its articles

(i) restricts the right to transfer its shares;

(ii) except in case of One Person Company, and Producer Company, limits, the number of members to 200, and

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this clause, be treated as a single member.

Provided further that:

(A) persons who are in the employment of the company; and

(B) persons who, having been formerly in that employment and have continued to be members after the employment ceased, shall not be included in the number of members; and

(iii) prohibits any invitation to the public to subscribe for securities of the company

Ownership and control of a private limited company is confined to a close friends and relatives. Thus, a private company is an organisation which enables a family or association of close friends to get the benefits of limited liability vis-a-vis all the advantages of a partnership organisation i.e. close control and secrecy of business, etc. The name of a private company must end with the words 'Private Limited' or its abbreviation "(P) Ltd.". A private company does not employ public funds and is usually run as a family concern. Therefore, in comparison to a public company, a private company enjoys certain privileges.

**(ii) One person Company Sec. 2(62).** 'One person company' means a company which has only one person as a member. It shall be a private company.

The Companies Act, 2013 vide Sec. 3(1) has introduced the new concept of One Person Company. Provided that the memorandum of One Person Company shall indicate the name of the other person, with his prior written consent in the prescribed form, who shall, in the event of the subscriber's death or his in capacity to contract become the member of the company and the written consent of such person shall also be filed with the Registrar at the time of incorporation of the One Person Company alongwith its memorandum and articles:

Provided further that such other person may withdraw his consent in such manner as may be prescribed.

Provided also that the member of One Person Company may at any time manage the name of such other person by giving notice in such manner as may prescribed.

Provided also that it shall be the duty of the member of One Person Company to intimate the company the change, if any, in the name of the other person nominated by him by indicating in the memorandum or otherwise within such time and in such manner as may be prescribed, and the company shall intimate the Registrar any such change within such time and in such manner may be prescribed:

Provided also that any such change in the name of the person shall not be deemed to be an alteration of the memorandum.

Such a company i.e. One Person Company may be either:

(a) a company limited by shares; or

(b) a company limited by guarantee; or

(c) an unlimited company.

**(iii) Public Company Sec. 2(71).** 'Public company' means a company: which is not a private company. Provided that a company which is a subsidiary of a company not being a private company shall be deemed to be public company for the purposes of this Act even where such subsidiary companies continues to be a private company in its articles. In simple words, a private company which is a subsidiary of a public company will become a public company.

Thus, the restrictions which apply to a private company are not applicable to a public company. There is no restriction on transfer of shares—its shares are freely transferable. There is no restriction on the maximum number of members and it can offer its shares and debentures to the public for subscription through a prospectus. Thus the ownership and control of a public company is in the hands of public at large.

**PRIVILEGES OF A PRIVATE COMPANY**

One of the important objects of company law is to protect the interests of the public. As such, to safeguard the interest of the shareholders of a public company which raises its capital from the public, a large number of provisions have been made. However, in case of private companies, no such public interest is involved as these companies do not raise their capital from the public. Hence, private companies have been granted a number of privileges and exemptions. The exemptions available to private companies are as follows:

(1) It can be started only with two members as against seven required for a public company.

(2) It can work with only two directors in place of three as are required in case of a public company.

(3) It is not required to file a prospectus.

(4) It can allot shares without waiting for the minimum subscription.

(5) It need not issue right shares to the existing members.

(6) It need not keep an index of members.

(7) Only two persons personally present will form the quorum unless the Articles provide for a larger number.

(8) Poll can be demanded by one member if not more than 7 members are present, and by 2 members if more than seven members are present.

(9) Unless the Articles of the company provide otherwise, a member of a private company cannot appoint more than one proxy to attend the meeting on the same occasion.

(10) Directors need not file their consent to act as director or to take up qualification shares and pay for them.

(11) Directors of a private company holding office for life before 1st April, 1952 cannot be removed.

(12) A private company can give financial assistance directly or indirectly for purchase or subscription of its own shares.

(13) No restrictions on loans to directors apply to private companies.

(14) No restrictions on the appointment, payment of remuneration to Directors or Managing Directors.

(15) No restrictions on the number of companies to be managed by a director. In case of a public company one person cannot become director in more than 20 companies and managing director in more than 2 companies.

(16) All the Directors can be permanent and need not retire by rotation.

(17) Provisions regarding general meetings, voting, etc. need not be followed by a private company.

(18) No restrictions on loans to other companies under the same management

(19) No right of appeal to the Company Law Tribunal in case a private company does not register a transfer or transmissed of shares.

(20) Restriction regarding inter-company investment of funds in the same group do not apply to private companies.

(21) Company Law Tribunal cannot prevent change in the Board of Directors of an independent private company if in its opinion such change is prejudicial to the interest of the company.

(22) Only members of a private company can inspect and copy its Profit and Loss Account filed with the Registrar of Companies.

(23) A private company may provide for additional grounds for disqualifications of directors.

(24) A private company may provide for additional grounds for vacation of office by a director.

(25) No restrictions on interested director to participate or vote in Board's proceedings.

**Conversion of Companies**

**(A) Conversion of a Private Company into a Public Company**

A private company may become a public company either by defaulter or choice.

**1. Conversion by default.** If a private company makes a default in complying with the conditions of Sec. 2 (68) (e.g. exceeding the limit of 200 members or inviting public to purchase its shares or debentures), it ceases to be a private company and shall be treated as a public company. It shall not be entitled to the privileges and exemptions conferred on private companies under the Act.

However, if the Company Law Tribunal is satisfied that the non-compliance was accidental or due to inadvertence or other sufficient cause, it may grant relief from such consequences. It may also grant relief on just and equitable grounds. While granting relief, it may impose such terms and conditions as seem to it just and equitable.

**2. Conversion by choice or volition.** When it is desired to convert a private company into a public company, it can be done by altering the articles to this effect so as to remove the restrictions imposed upon a private company.

It will be necessary for the company to increase its paid-up share capital by passing an ordinary resolution. Again, necessary changes in the Articles to suit the needs of a public company e.g. provisions regarding general meetings, election of directors, annual accounts and audit etc. are made. It is usual to prepare new Articles or to adopt Table A in such cases.

The company is required to file with the Registrar of Companies, within 15 days of alteration of Articles, the following documents:

1. a copy of the special resolution;
2. a printed copy of the altered or new Articles, as the case may be;
3. a copy of the prospectus;
4. a copy of the ordinary resolution to increase the share capital, if increased.

After conversion, the company shall cease to be a private company and will lose all of its privileges and exemptions.

**(B) Conversion of Public Company into a Private Company**

Likewise a public company can be converted into a private company. A special resolution is to be passed to alter the Articles so as to:

(1) restrict the right to transfer shares of the company;

(2) limit the number of members to two hundred excluding:

 (a) present employees who are member.

 (b) ex-employees who are still members of the company.

(3) prohibit invitation to public to subscribe for any shares in or debentures of the company or to make deposit.

After obtaining the approval of the Tribunal, the following documents with necessary fees should be filed with the Registrar of Companies within 15 days of the order granting permission:

(1) a copy of Special Resolution;

(2) a printed copy of altered Articles;

(3) a copy of Tribunal's order granting approval to convert the company into a private company.

### 1.3.4 On the Basis of Ownership

On the basis of ownership, companies may be classified into (i) Government company and (ii) Non-Government company.

**(i) Government Company [Sec. 2(45)].** Government company means any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government or partly by any State Government or Government and includes a company which is a subsidiary company of such a Government Company. The Companies Act is applicable to such companies subject to the modification as approved by both Houses of Parliament.

**(ii) Non-Government Company.** Companies which are not Government companies i.e. which are not owned and controlled by the Central or any State Government(s) are called Non- Government companies. A public limited company is usually a non-Government company.

### 1.3.5 On the Basis of Control of a Unit

On the basis of control of a unit, companies can be classified into (i) Holding company and (ii) Subsidiary company.

**(i) Holding company [Sec. 2(46)].** A holding company in relation to one or more other companies means a company of which such companies are subsidiary companies.

**(ii) Subsidiary company [Sec. 2(87)].** "Subsidiary company" or "subsidiary" in relation to any other company (that is to say a holding company), means a company in which the holding company:

A company is a subsidiary of another if-

(i) controls the composition of the Board of Directors, or

(ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.

Provided such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such number as may be prescribed.

**Explanation:** For the purposes of this clause:

(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or (ii) is of another subsidiary of the holding company;

(b) the composition of the Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some powers exercisable by it at its discretion can appoint or remove all or a majority of the directors.

The Act defines a holding company and a subsidiary company by explaining the circumstances in which a company shall be deemed to be subsidiary of another.

### 1.3.6 On the Basis of National Interest

On the basis of national interest companies can be classified as (i) Indian Company, (ii) Foreign Company.

**(i) Indian Company.** A company incorporated in India and having a place of business in India is an Indian company. However, all other companies, unless those are foreign companies, are Indian companies.

**(ii) Foreign Company [Sec. 2(42)].** Foreign company means any company or body corporate incorporated outside India which:

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner.

However, a foreign company in which fifty percent or more of the paid-up share capital (equity or preference or both) is held by Indian citizens and/or companies incorporated in India, shall comply with such other provisions as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India. (Sec. 379)

## 1.3.7 Companies not for Profit

Sec. 4 requires a company formed for profit to use the word ‘Limited’ or ‘Ltd.’ at the end of its name if it is a public company and ‘Private Limited’ or ‘Pvt. Ltd.’ if it is a private company. However, a company formed for promoting commerce, art, science, religion, charity or any other useful object, not for profit, with limited liability, can be exempted (under a license under Sec. 8 from the Central Government) from using the word limited or private limited at the end of its name. Such companies are popularly called ‘Licensed Companies’. Such a company has to apply its profits, if any, or other income in promoting its objects. It cannot pay any dividend to its members [Akil Deshastha, etc. Mandal v. Joint Charity Commr., (1973) 43 Comp. Cas. 361]. The Central Government can grant a license on such terms and conditions as it thinks fit. The Central Government may also direct that these conditions shall be inserted (given) in the Memorandum or in the Articles of Association of the company or, partly in one and partly in the other. The company is under an obligation to abide by these conditions and regulations.

Such a company cannot alter the object clause of its Memorandum without the previous approval of the Central Government. If the company contravenes this provision, its license can be revoked.

### 1.3.8 Illegal Association

A body of persons for the achievement of some common object is called an "association". Broadly, such an association may be (i) for profit, or (ii) not for profit, i.e., for the promotion of art, culture, religion, etc. To protect the public from the mischief of large trading associations, whose membership may be constantly changing, the Companies Act, 2013 provides for their compulsory registration.

According to Sec. 464 every association of persons consisting of more than prescribed number of persons for the purpose of carrying on any business for gain, must be registered under the Companies Act, 2013 or be formed under some other Indian Law (e.g. an association may be registered under the Co-operative Societies Act, 1912). In case such an association is not registered, it will be called an illegal association and it has no legal existence. However, a Hindu Undivided Family carrying on any business with more than the prescribed number of persons will not be an illegal association even if it is not registered under the Companies Act, 2013 or any other law. But in case two or more joint Hindu families form a partnership, then a joint family shall not count as one person but all the adult members of both the joint families shall be counted. The number of minors in both the joint families will be ignored. It is because a partnership firm has no separate legal entity, its partners will be counted as separate members of the company. However, the number of person that may be prescribed under this section shall not exceed 100.

## 1.4 Check Your Progress

Fill in the blanks

1. The name of company can be changed by…………. .
2. The Reserve Bank of India is an example of a ……….. .
3. The company is an ………… legal person.
4. A company registered under the Companies Act is known as……….. .

5. On a share of Rs.100 of a company, a shareholder has already paid Rs.30. His liability is now limited to ………… .

## 1.5 SUMMARY

A company is a voluntary association of persons formed for the purpose of doing business having a distinct name and limited liability. The life of a company does not depend on the death, insolvency or retirement of any or all shareholders or directors. Lifting the corporate veil means disregarding the corporate personality and looking behind the real person who control the companies affairs. It is the duty of the Court to lift the veil to protect public policy and prevent transactions contrary to public policy. Companies Act recognises different types of companies that can be registered under the Act. There are various factors on the basis of which companies can be classified.

## 1.6 KEYWORDS

**Company:** It is a voluntary association of persons formed for the purpose of doing business having a distinct name and limited liability.

**One Person Company:** It is a one shareholder corporate identity, where legal and financial liability is limited to the company only.

**Company limited by Guarantee:** These are such companies where shareholders promise to pay a fixed amount to meet the liabilities of a company in the case of liquidation.

**Statutory Companies:** These are the companies incorporated by a special Act of Parliament and activities of these companies are governed by respective Act.

Public Company: It means a company which is not a private company.

## 1.7 SELF ASSESSMENT TEST

1. Define a company. Explain its characteristics.
2. “A company is an artificial person created by law with a perpetual succession and a common seal.” Comment on the above statement and clearly explain the characteristics of a company.
3. “A company is a separate entity.” Do you agree? Under what circumstances corporate veil can be pierced?

4. Define a private company. What privileges and exemptions are granted to a private company?
5. What is a private company? How can a private company be converted into a public company and vice-versa?
6. Distinguish between:

   (a) A company limited by shares, and A company limited by guarantee.

   How the above two differ from an unlimited company?
7. Write short notes on:

   (a) Chartered company, (b) Illegal association,

   (c) Holding company (d) Subsidiary company,

   (e) Government company, (f) Foreign company.

## 1.8 Answers to Check Your Progress

1. A special resolution
2. Statutory company
3. Artificial
4. Registered or Incorporated Company
5. Rs. 70

## 1.9 REFERENCES/SUGGESTED READINGS


- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.
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# LESSON 2

# CONVERSION OF PUBLIC AND PRIVATE COMPANY

## STRUCTURE



## 2.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Know the procedure of conversion of Private Company into Public Company.
- Explain the procedure of Conversion of a Public Company into Private Company.
- Describe the procedure of Conversion of one Person Company into a Public Company or Private Company.
- Highlight the procedure regarding Conversion of Private Company into a One Person Company.

## 2.1 INTRODUCTION

A company is an association of several persons. Decisions are made in a company according to the view of the majority. Various matters are discussed and decided upon in meetings, which take place between members and between the directors. The Companies Act, 2013 contains several provisions for such meetings for conversion of a private company into public company and vice-versa.

## 2.2 CONVERSION OF COMPANIES

### 2.2.1 A PRIVATE COMPANY INTO PUBLIC COMPANY

A private company may become a public company in any of the following three methods:

(a) Conversion by default;

(b) Conversion by choice.

**(a) Conversion by default (Section 14)**

Where a private company makes a default in compliance with the statutory requirement as laid down in section 2(68) of the Act (i.e., if its membership exceeds 200 or it permits free transferability of shares or extends invitation to public to subscribe to shares or debentures or extends invitation to accept deposits for persons other than its members, directors or their relatives) it becomes a public company and loses the privileges of a private company.

However, the Tribunal can grant relief in the following cases: (i) If non-compliance was accidental or inadvertent, or (ii) If it is just and equitable to grant relief only on application made by the company or an interested below.

**(b) Conversion by choice (Sec. 14)**

(i) Alteration of Articles. A private company may voluntarily become a public company by altering the Articles of Association in such a manner that they no longer contain the restrictions and provisions of Sec. 2(68) and other provisions inconsistent with the needs of a public company:

(ii) Change of name. A private company shall change the name of the company by passing a special resolution u/s 13.

(iii) Increase the number of members. If the number of members is below seven, steps should be taken to increase the number of members to a minimum of seven.

(iv) Increase the number of directors. If the number of directors is only two, the number of directors should be increased to atleast three.

(v) Filing of documents with ROC. The following documents are required to be filed with ROC with in 30 days of passing of Resolution:

- Altered Articles and Altered memorandum
- A copy of the special resolution.
- A prospectus or a statement in lieu of prospectus.

(vi) Issue of Certificate by ROC. ROC will issue a fresh certificate of incorporation.

(vii) Change to be noted in MOA and AOA. The change of name is to be noted in the Memorandum and Articles of Association, letterheads, bills, invoices, seals, etc.

(viii) Effective date of conversion. The company becomes a public company from the date of passing the special resolution.

However, change in name by deleting the word ‘Private’ becomes effective only on the issue of a fresh certificate of incorporation by ROC.

## 2.2.2 CONVERSION OF A PUBLIC COMPANY INTO PRIVATE COMPANY

Public company can be converted into a private company. The following procedure prescribed under section 14 of the act has to be adopted for this purpose:

**(i) Alteration of Articles of Association by Special Resolution**

The articles have to be altered by passing a special resolution to include the statutory restrictions imposed by the act on private companies specified in [Sec. 2(68)].

Any provision in the articles which is inconsistent with the requirements of a private company shall also be altered, e.g. the power to issue share warrant to a bearer.

**(ii) Petition under Section-14**

A petition is to filed for conversion of public company into a private company within 3 months from the date of passing of the special resolution to the Tribunal in Form-NCLT-1, accompanied by necessary documents.

**(iii) Change of name**

The name of the company shall be changed by passing the special resolution as required by Sec. 13.

The name of the company must be changed so as to include the word 'Private Limited' at the end of its name.

**(iv) Approval of the Central Government**

The approval of the Central Government shall be obtained for the conversion of Public into Private Company. [The Companies (Amendment) Act, 2019]

**(v) Approval to be filed with the Registrar**

A copy of the approval along with a printed copy of the altered articles is to be filed with the Registrar within one month of the receipt of the Government approval. Any alteration in the incorporation document of a public company which has the effect of converting it into a private company, has to be approved by the Central Government.

## 2.2.3 CONVERSION OF ONE PERSON COMPANY INTO A PUBLIC COMPANY OR PRIVATE COMPANY

One Person Company can convert itself into a public company or a private company in certain cases:

[Clause 6 of the Companies (Incorporation) Rules, 2014]

**(i) Increase in Paid up Share Capital and Annual turnover beyond limits**

One person company shall cease to entitle as OPC if the paid up share capital of OPC exceeds 50 lakh rupees or its average annual turnover during the relevant period exceeds 2 crore rupees.

**(ii) Conversion within six months**

One Person Company shall be required to convert itself, within six months of the date on which its paid up share capital is increased beyond 50 lakh rupees or the last day of the relevant period during which its average annual turnover exceeds 2 crore rupees as the case may be, into either a private company with minimum of two members and two directors or a public company with at least of seven members and three directors in accordance with the provisions of section 18 of the Act.

**(iii) Alteration of MOA and AOA**

The One Person Company shall alter its memorandum and articles by passing a resolution in accordance with sub-section (3) of section 122 of the Act to give effect to the conversion and to make necessary changes incidental thereto.

**(iv) Notice to Registrar**

The One Person Company shall within period of sixty days from the date of applicability of sub rule (1), give a notice to the Registrar in Form No. INC.5 informing that it has ceased to be a One Person Company and that it is now required to convert itself into a private company or a public company by virtue of its paid up share capital or average annual turnover, having exceeded the threshold limit.

**(v) Penalty on Contravention**

If One Person Company or any officer of the one Person Company contravenes the provisions of these rules, One Person Company or any officer of the One Person Company shall be punishable with fine which may extend to ten thousand rupees and with a further fine which may extend to one thousand rupees for every day after the first during which such contravention continues.

**(vi) Fulfilment of requirement of private company or public company**

A One Person company can get itself converted into a private or public company after increasing the minimum number of members and directors to two or minimum of seven members and two or three directors as the case may be, and by maintaining the minimum paid-up capital as per requirements of the Act for such class of company and by making due compliance of section 18 of the Act for conversion.

## 2.2.4 CONVERSION OF PRIVATE COMPANY INTO A ONE PERSON COMPANY

[Clause 7 of the Companies (incorporation) Rules, 2014]

**(i) Decrease in Paid up Share Capital and Annual turnover below limits**

A private company other than a company registered under section 8 of the Act having paid up share capital of 50 lakhs rupees or less or average annual turnover during relevant period is 2 crore rupees or less may convert itself into one person company by passing a special resolution in the general meeting.

**(ii) Obtaining No Objection Certificate**

Before passing such resolution, the company shall obtain no objection certificate in writing from members and creditor.

**(iii) Filing special resolution and application with the Registrar of Companies**

The one person company shall file copy of the special resolution with the Registrar of Companies within thirty days from the date of passing such resolution in Form No. MGT-14.

The company shall file an application in Form No. INC. 6 for its conversion into One Person Company along with fees as provided in the Companies (Registration offices and fees) Rules, 2014, by attaching the following documents, namely:

- The directors of the company shall give a declaration by way of affidavit duly sworn in confirming that all members and creditors of the company have given their consent for conversion, the paid up share capital company is fifty lakhs rupees or less or average annual turnover is less than two crores rupees, as the case may be;
- The list of members and list of creditors;
- The latest Audited Balance Sheet and the Profit and Loss Account; and
- The copy of No Objection letter of secured creditors.

**(iv) Issue of Certificate by Registrar**

On being satisfied and complied with requirements states herein the Registrar shall issue the certificate.

## 2.2.5 SPECIAL PRIVILEGES OF A PRIVATE COMPANY

There are a number of regulations and restrictions which apply to a public company under the Company Act, 2013 but which do not apply to private companies. The reason for this is that the need for safe guards in relation to public companies which raise money from the public is greater than those companies which have small number of members. In view of this, the law bestows some benedictions on a private company by granting certain privileges and exemptions to it. These privileges and exemptions may be discussed under two heads:

I. Exemptions and privileges available to all private companies.

II. Exemptions and privileges available to an independent private company (i.e., one which is not the subsidiary of a public company).

I. Exemptions and Privileges Available to All Private Companies

1. **Number of Members:** A private company may have only 2 members.
2. **Minimum Numbers of directors:** A private company need not have more than 2 directors.
3. **Minimum Subscription:** It can allot shares before the minimum subscription is subscribed or paid.
4. **Prospectus:** It may allot shares without issuing a prospectus.
5. **Issue of New Shares:** A private company is not bound to offer its new share capital to its existing shareholders. It means that a private company can issue its further shares to new members also.
6. **Quorum:** Only 2 persons personally present will form the quorum unless the Articles provide for a large number.
7. **Demand for Poll:** Poll can be demanded by one member if not more than 7 members are present and by 2 members if more than 7 members are present.
8. **Index of Members:** It need not keep an index of members.
9. **Qualification Shares for Directors:** Directors need not file their consent to act as a director or to take up qualification shares and pay for them.

**II. Privileges and Exemptions enjoyed by Independent Private Companies**

An independent private company is one which is not a subsidiary of a public company. The following special privileges and exemptions are available to an independent private company.

1. **Financial Assistance:** It may give financial assistance for purchase of, subscription for, shares in the company itself.

2. **Transfer of Shares:** A transferor or transferee of shares in an independent private company has no right to appeal to the Company Law Tribunal against refusal by the company to register a transfer of its shares.
3. **Provisions as to General Meeting:** Provisions regarding general meeting are not applicable to an independent private company if it makes its own provisions by the Articles.
4. **Limit of Managerial Remuneration:** No restriction on the payment of remuneration to directors or managing directors.
5. **Profit & Loss and Balance Sheet:** No person other than a member of an independent private company is entitled to inspect or obtain copies of, the Profit and Loss Account of the company filled with the Registrar.
6. **As to Directors:**
   i. The provisions relating to the appointment, retirement, re-appointment etc. of directors who are to retire by rotation and procedure relating thereto are not applicable to it.
   ii. A private company need not take the permission of Central Government for increasing the number of directors while a public company cannot increase the number of its directors unless it gets the permission of Central Government to do so.
   iii. A private company can appoint two or more directors by a single resolution. It need not pass a separate resolution for the appointment of every director.
   iv. If a private company appoints a director other than the retiring one, the newly appointed director need not file his written consent with the Registrar of the Companies.
   v. A private can appoint the managing director or full time director without getting the permission from the Central Government.
   vi. There is no restriction regarding the powers and rights of a private company.
   vii. A private company can finance its directors while a public company cannot do so.
   viii. The directors of a private company can participate ate the discussion and can also vote on the proposal in which they themselves are interested.

ix. A private company is empowered to appoint any person as its managing director even if he is already working as a managing director in one or more other companies.

x. A private company is not bound to get the permission of the Central Government to increase the remuneration of its directors while a public company cannot do so without getting the permission of the Central Government.

7. **Manager:** An independent private company can appoint manager to any incorporated institution, firm or union.
8. **Inter-Corporate Investment:** Restrictions regarding inter-company investment of funds in the same group do not apply to private companies.
9. **Power to Prevent Changes in Board of Directors:** Company Law Tribunal cannot prevent change in the Board of Directors of an independent company if in its opinion such change is prejudicial to the interest of company.

## 2.3 DISTINCTION BETWEEN PUBLIC COMPANY AND PRIVATE COMPANY

Following are the differences between a public company and a private company:

**Distinction Between Public Company and Private Company**

| Basis | Public Company | Private Company |
|---|---|---|
| 1. Number of Members | There must be at least 7 members for formation of a public company. There is no maximum limit over the number of its members. | There must be at least 2 members to form a private company. The maximum limit is 200. |
| 2. Number of Directors | There must be at least 3 directors in a public company. | A private company must have at least two directors. |
| 3. Invitation to Public to Subscribe for Shares | A public company invites application from the public to purchase shares of the company. | It does not invite applications from the public to subscribe its shares. |

| | | |
|---|---|---|
| 4. Transfer ability of shares | In public companies shares are freely transferable from one person to another. | In a private company shares are restricted to be transferred. |
| 5. Minimum Subscription | A public company cannot allot shares unless it has received the minimum subscription. | A private is not required to wait for minimum subscription. |
| 6. Issue of Prospectus | A public company has to issue a prospectus. | A private company cannot issue a prospectus. |
| 7. Right Shares | In certain cases a public company must issue further shares to the existing members. | A private company is not required to do so. |
| 8. Shares with Disproportionate Voting Rights | A public company cannot issue shares with disproportionate voting rights. | There is no such restriction on a private company. |
| 9. Index of Members | A public company having more than 200 members must maintain an index of members. | A private company is not required to maintain an index of members. |
| 10. Quorum | For the meetings of a public company a quorum of at least 5 members personally present is necessary. | For the meetings of a private company a quorum of only 2 members (unless provided otherwise in it Articles( is necessary. |
| 11. Restriction on Managerial Remuneration | Overall managerial remuneration in case of a public company cannot exceed 11% of its net profits. | There is no such limit on private companies. Besides restriction on the appointment ore re-appointment of directors, managing directors etc. which are applicable in case of a |

| | | |
|---|---|---|
| | | public company are not applicable to a private company. |
| 12. Use of Word or Words | A public company has to use the word 'Limited with its name. | A private company has to use the words 'Private Limited' with its name. |
| 13. Loan to Directors | A public company cannot sanction any loan to its directors unless it is permitted by the Central Government. | A private company can sanction loan to its director without permission from the Central Government. |
| 14. Submission of Document | A public company has to submit the list of directors, their content and the contract entered into by the company with them. | A private company has not to submit any such documents. |
| 15. Signature on the Memorandum | The Memorandum of a public company must be signed by at least 7 members. | The Memorandum of a private company should be signed by 2 persons only. |
| 16. Issue of Share Warrant | A public company can issue share warrant only if the shares are fully paid. | It cannot issue share warrant. |
| 17. Articles of Association | A public company is not bound to have its own Articles of Association. If a public company does not have its Articles, Schedule 'F' applies to it. | A private company is bound to have its own Articles of Association. |
| 18. Vote by directors | The Directors of a public company cannot vote on a proposal in which they are interested. | The Directors of a private company can vote on such proposals also. |

| | | |
|---|---|---|
| 19. Increase in Number of Directors | A public company cannot increase the number of Directors without the permission of the Central Government. | A private company can increase the number of its Directors without such permission. |
| 20. Accounts for Public Inspection | Accounts of a public company must be open to public for inspection. | A private company is not bound to offer its accounts for public inspection. |
| 21. Investment in same Group of Company | A public company cannot invest in the same group of companies. | A private company can do so. |

## 2.4 CHECK YOUR PROGRESS

Fill in the blanks

1. Central government permission is required in case of ……….. conversion ………… .
2. Under which section a private company can automatically converted into a public company ………. .
3. Minimum number of member in case of private company ……… .
4. If a company which is formed with unlimited liability wants to convert to limited liability then it should pass ………. .
5. According to section ……….. name of the company should end with "Ltd" or "Pvt Ltd.".

## 2.5 SUMMARY

Company means a company formed and registered under this act or an existing company. A private company can be converted into a public company by default and by choice. Public company can be converted into a private company by following procedure prescribed under section 14 of the act has to be adopted for this purpose. One Person Company can convert itself into a public company or a private company in certain cases.

## 2.6 KEYWORDS

**Company:** It is an association of persons formed for the purpose to achieve some common objects.

**Public Company:** Public company is that company which is not a private company.

**One-person Company:** One-person company is that company that has only one person as to its member.

## 2.7 SELF ASSESSMENT TEST

1. What is the procedure of conversion of Private Company into Public Company? Explain.
2. State the procedure of conversion of one Person Company into a Public Company or Private Company.
3. Explain the procedure conversion of One Person Company into a Public Company or Private Company.
4. What is the procedure of conversion of Private Company into a One Person Company?
5. State the distinction between Public Company and Private Company.

## 2.8 ANSWERS TO CHECK YOUR PROGRESS

1. Public to Private
2. Section 43
3. 2
4. Special Resolution
5. Section 13

## 2.9 REFERENCES/SUGGESTED READINGS

1. M.C. Kuchhal, Mercantile Law; Vikas Publishing House, New Delhi.
2. P. P. S. Gogna, A Textbook of Business Law; Sultan Chand & Company, New Delhi.
3. D. Chandra Bose, Business Laws; PHI Learning Pvt. Ltd.

# LESSON 3

# INCORPORATION OF A COMPANY

**STRUCTURE**



## 3.0 LEARNING OBJECTIVES

Upon competing this lesson, you should be able to:

- Get insights of the legal position of promoters, their status, duties and liabilities.
- Understand the procedure of incorporation of a company.
- Explain the effect of getting the Certificate of Incorporation.

## 3.1 INTRODUCTION

A company is an artificial person but does not take birth like natural people. A company is a creature of law. The formation of a company is a legal process, which involves a series of steps and legal formalities. These steps are to be taken by a person or a group of persons interested in the formation of a company. There are three stages in the formation of a company namely promotion, incorporation and commencement of business. The present lesson discusses in detail the process of incorporation of a company in India.

## 3.2 PROMOTION OF A COMPANY

Promotion is the very first stage in the formation of a company. Promotion begins when someone discovers an idea or when the idea comes to the mind of someone regarding some business. Promotion includes the analysis and feasibility of converting the idea into reality. Any person who assumes the responsibility of promotion is called ‘Promoter’.

Promotion has been defined as:

(1) According to Prof. E.S. Mead, “Promotion includes four elements - discovery, investigation, assembling and financing”.

(2) According to C.W. Gerstenberg, “Promotion may be defined as 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.”

**Stages in Promotion**

There are four stages involved in promotion:

**(1) Discovery of an Idea:** An individual or a group of persons may discover an idea of starting a new business or expanding an existing business. For example, one may discover an idea to start a Cinema Hall in a particular area. There may not be a Cinema Hall in that area or the idea may be to break the monopoly of an existing Cinema Hall in that area.

**(2) Investigation:** Discovered business opportunities have to be investigated thoroughly before any money can be invested to exploit them. The person discovering the idea may be very optimistic. His optimism may be because of his over enthusiasm or for other reasons. Continuing our previous illustration of a Cinema Hall, investigation will be done to ascertain:

(i) Whether necessary size of plot of land for the Cinema is available or not.

(ii) Whether necessary permission to run the Cinema Hall will be available from the local authorities, i.e., Delhi Development Authority, Delhi Municipal Corporation etc. if the hail is to be constructed in Delhi.

(iii) How much capital would be required?

(iv) How much income would be generated?

(v) Whether the capital invested would give a reasonable rate of return and so on.

**(3) Assembly:** Having discovered and investigated the profitability of a business proposition, steps will be taken to put the idea into practice. This will involve acquisition of land and buildings, plant and machinery, patent rights etc. At this stage promoters associate other persons who also act as first directors of the proposed company. Later on, the promoters enter into pre-incorporation contracts for the assembly of the necessary assets and properties to run the company.

**(4) Registration or Incorporation of a Company:** For the purpose of registration of the company, the promoters have to take the following steps:

(i) To prepare the Memorandum of Association and Articles of Association.

(ii) To get certificate of incorporation.

(iii) To get certificate of commencement of business.

**Promoter**

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

Chronologically, the first persons who controls a company's affairs are its promoters. It is they who conceive the idea of forming the company with reference to a given object and then to set it going and it is they who take necessary steps to incorporate it.

In Whaley Bridge Calico Printing Co. Vs. Green Smith (1880) 5 QBD, 109, Lord Bowen stated that the term 'promoter' is a term not of law, but of business operations familiar to the commercial world, by which a company is generally brought into existence.

According to Lord Lindley, "With respect to the word, we are of opinion that it has no very definite meaning. As used in connection with companies the term 'promoter' involves the idea of exertion for the purpose of setting up and starting a company."

**Who are Promoters**

A registered company may act as a promoter 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. A person who does not play a prominent role may also be a promoter if he has so acted. But if a person is employed merely in a professional or technical capacity such as solicitor, accountant, valuer or business consultant, he will not be a promoter. It also excludes such persons who act in a professional capacity or persons engaged in procuring the formation of a company. But if any such person acts beyond the scope of professional duty and helps in any way in the formation of a company or in preparations for the management of its affairs, he will become a promoter.

**Types of Promoters**

The promoters may be of the following types:

**(1) Accidental Promoters:** Some persons are not the professional promoters. Sometimes some idea strikes to their mind accidentally and they try to convert it into reality. They are known as accidental promoters.

**(2) Professional Promoters:** These promoters take the promotion as their profession. They usually perform the work of promotion for various business undertakings. Professional promoters may be an individual, partnership firm, an association of persons and even a company.

**(3) Financial Promoters:** Some are the promoters who undertake the promotion of a company, complete the professional activities and then purchase the entire share capital of the company promoted. They provide financial certainty and assurance to the company. Later on, they may sell the shares at some profit.

**Functions of a Promoter**

Promoters are the persons who give birth to a company. They are the founders of a business enterprise. They have many functions to perform, which are as follows:

(1) To get the idea of the formation of a company.

(2) To analyse the idea.

(3) To consult the experts of the field regarding the feasibility of idea.

(4) To search out the persons who may agree to be the first directors of the company and to sign the Memorandum of Association.

(5) To decide the name, the place of registered office, the places of the offices, the object of the company, the amount of capital and its composition.

(6) To prepare and enter into contracts with underwriters.

(7) To select and decide the bankers, auditors, brokers and legal experts.

(8) To prepare the Memorandum of Association, Articles of Association and Prospectus.

(9) To file the necessary documents with the Registrar of Companies.

(10) To get the certificate of incorporation

(11) To get the permission and to arrange for the use of capital.

(12) If the company has to purchase a going concern business, to finalise the purchase contract of such business.

(13) To enter into contracts with the vendors, underwriters, brokers and managing agents.

(14) To collect the amount on the issue of share capital.

(15) To get the certificate of commencement of business.

(16) To pay the preliminary expenses.

(17) To appoint the required number of personnel for the whole process.

To sum up, it can be concluded that a promoter performs all activities right from conceiving the idea in his mind to the commencement of business by the company. Thus, the promoter after establishment of company, comes out of the picture and lets the company go on with its business.

**Rights of Promoters**

Promoters have the following rights in the company:

**(1) Right to Receive the Preliminary Expenses:** Promoters are empowered to receive the preliminary expenses that they have incurred in the process of formation of company. It should be remembered that the promotes cannot file a suit to recover the preliminary expenses from the company. They can recover it only if there is a contract between them and the company and such a contract can take place after the company comes into existence i.e. certificate of incorporation and after certificate of commencement of business have been obtained and the contract is adopted (not ratified) by the company. Therefore, the promoters must have a valid contract entered into by the company after incorporation with them. Only in that case they can recover their preliminary expenses.

**(2) Right to Receive Proportional Amounts from Fellow Promoters:** Sometimes, the company is promoted by more than one promoter. In such a case, the company, if under contract, can make the full payment of their remuneration to any of the promoters. In that case, other promoters are empowered to collect their proportionate remuneration from their co-promoters.

**(3) Right to Receive Remuneration:** Promoters have to take a lot of pains for the promotion of a company. For this, they are entitled to get some remuneration from the company, they promote. The remuneration may be in cash, in the form of shares or debentures in the form of commission etc. Whatever mode of payment has been decided, they must get their remuneration according to that after disclosing it to an independent board of direction.

**Liabilities of Promoters**

The promoters have the following liabilities:

**1. Promoters are the Founders of a Company:** Therefore, they are under certain obligations which are as under:

**(a) To Disclose and Repay the Secret Profits:** If the promoter has made any profit out of a transaction, a promoter is bound to disclose it.

**(b) Profit:** As a corollary of the duty of full disclosure of material facts, a promoter is duty bound not to make any secret profit directly or indirectly. In case, he makes any secret profit he is liable to return the same to the company.

In Gluckstein Vs. Barnes (1900) A.C. 240, a syndicate purchased the Olympia Company for £ 1,40,000 with a view to forming a company and reselling it to the new company. The syndicate promoted a new company and sold the Olympia to it for £ 1,80,000 making a profit of £ 40,000. Before the syndicate purchased the Olympia, it had purchased its debenture at a discount knowing that the debentures would be paid in full if the sale to the new company materialised. The new company paid the debentures in full with the result the syndicate made a profit of £ 40,000 and not the profit of £ 20,000 made on account of debentures. The House of Lords held that the promoters must pay £20,000 to the company as they have not made full disclosure.

**2. Liability of Full Disclosure Material Facts:** If the promoter fails to make a full disclosure of all relevant facts including any profit and his personal interest in a transaction with company, the company may sue him for damages for breach of his fiduciary duty and recover from him any secret profit mode directly or indirectly.

It should be noted that the disclosure to be made effective must be real and express, constructive disclosure is not enough. In case the promoters fail to do so, the company may rescind the contract and sue the promoters to return the money paid. Erlanger Vs. New Sambrero Phosphate Co. (1878) 3 A.C. 1218 well illustrates the point.

A syndicate, of which E was the head, purchased an island containing phosphate mines. E promoted a company and named fictitious persons as its directors. E sold the property to the new company by a contract between a nominee of the syndicate and the company at double the price originally paid by him (E). The purchase agreement was approved at the shareholders meeting. However, no material facts were disclosed at the meeting. The company went into liquidation and the liquidator sued E to recover the profit made. E argued that the directors had full knowledge of the transaction. The Court rejected his plea on the ground that the disclosure was not made to an independent Broad of Directors.

**3. Liability for Preliminary Contracts:** A promoter remains personally liable for preliminary contracts made by him because such contracts are not legally binding on the company even after incorporation. Since the company was not in existence when such contracts were made, the company cannot ratify them. The promoters may not be liable if such contracts are either adopted by the company or specifically enforced by the Court under the Specific Relief Act, 1963.

**4. Liability for Misstatement in Prospectus:** A promoter will be liable for any omission of any material facts or misstatement made in the prospectus if he was a party to the issue of the prospectus. In case, the promoter is guilty of omission or misstatement of facts in the prospectus, he will be liable to pay compensation to every person who suffered any loss or damage because of such a prospectus. The promoter may also become liable to criminal proceedings.

**5. Liability in Course of Winding-up:** If during the winding-up proceedings an application is made by the official liquidator, the Tribunal may make a promoter liable for misfeasance or breach of trust committed by him in the promotion or formation of the company [Sec. 300].

If the official liquidator has made a report to the Tribunal alleging fraud, the Tribunal may order public examination of the promoter. The Court or Tribunal having jurisdiction to wind up a company is empowered to suspend him for a period extending upto 5 years from becoming a director or taking part in the promotion, formation or management of a company, if he is found guilty of fraudulent conduct in the course of winding-up of the company.

**Remuneration of the Promoter**

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

**(1) Cash Payment:** The very first and the traditional method of making the payment for the services of promoters is to pay in cash.

**(2) Shares and Debentures:** The second method for making the payment to promoter is to allot them the shares and debentures of the company promoted by them.

**(3) Commission:** Promoters may also be paid for their services by way of commission in the net profits of the company for a certain period.

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

Any remuneration paid to the promoters must be disclosed in the prospectus.

**Pre-incorporation or Preliminary Contracts:** The promoters of a company usually enter into contracts to acquire some property or right in the company which is yet to be incorporated, such contracts are called pre-incorporation or preliminary contract. The promoters generally enter into such contracts as agents for the company about to be formed. The legal position is that "Two consenting parties are necessary to a contract whereas the company, before incorporation, is not an entity."

According to law of agency, a person cannot act as an agent for another who is not in existence. Thus, a company is not bound by a pre-incorporation contract.

A solicitor was engaged to prepare the necessary documents and to obtain the registration certificate of a company. He paid the registration fee and incurred the necessary expense. After registration the company refused to pay for the services and expenses. The Court held that, "the company could not be sued in law for those expenses, in as much as it was not in existence at the time when the expenses were incurred." [English and Colonial Produce Co. (1906)2 Ch. 435].

**Position of Promoters as Regards Pre-incorporation Contracts**

Following is the position of a promoters regarding pre-incorporation contracts:

**(1) Company not Bound by Pre-Incorporation Contracts:** A company when it comes into existence is not bound by a pre-incorporation contracts even where it takes the benefit of the contract entered into on its behalf.

**(2) Company cannot Enforce Pre-incorporation Contracts:** A company cannot after incorporation enforce the contract made before its incorporation.

The leading case on the point is in Natal Land and Colonization Co. Ltd. Vs. Pauline Colliery Syndicate Ltd. (1904) A.C. 120. N. Co. entered into a contract with A, who was acting as the nominee of the syndicate (which was not yet incorporated) to grant a lease of coal mining rights. After the syndicate was registered, it sued N. Co. for specific performance of the agreement. It was held that the syndicate was not entitled to the lease as the company was not in existence when the contract was signed.

**(3) Promoter Personally Liable:** The promoters remain personally liable on a contract made on behalf of 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 company's name.

**(4) Ratification of a Pre-incorporation Contract:** A company cannot ratify a contract entered into by promoters on its behalf before its incorporation. Therefore, it cannot by adoption or ratification obtain the benefit of the contract purported to have been made on its behalf before it comes into existence. The adoption of the pre-incorporation contracts by the company will not create a legal contract between the company and the other parties even though the adoption of the contract is made as one of the objects of the company in its Memorandum and Articles. In such a case, it is safer for the promoters acting on the behalf of the company about to be formed to provide in the contract that:

(i) If the company makes a fresh contract in terms of the pre-corporation, the liability of the promoters shall come to an end; and

(ii) If the company does not make a fresh contract within a limited period, either of the parties may rescind the contract.

However, Specific Relief Act, 1963 provides some relief in this direction. Sec. 15(h) and 19(c) of the Specific Relief Act provide that when the promoters of a company have, before its incorporation, entered into a contract for the purposes of the company, such contract may be specifically enforced by or against the company. The important condition in this connection is that these contracts should be for the purposes of the company. Thus, in Imperial Ice Manufacturing Co. Vs. Manchershaw 13 Mum, L.R. 165 it was observed that such contracts should be for the working purposes of the company such as a contract for the supply of machinery for making ice, etc.

## 3.3 INCORPORATION OF COMPANY AND COMMENCEMENT OF BUSINESS

### INCORPORATION OF COMPANY

Incorporation or registration of the company is the second stage in the formation of a company. Any seven or more persons (two or more in case of a private company) can form the company. Even one person can also form a company. Association for any lawful purpose may form an incorporated company with or without limited liability. Companies limited by shares are the most popular form of companies.

**Lawful Purpose:** The purpose for which a company is proposed to be established must be lawful. It must not be in contravention of the general law of the country.

**Documents to be Filed with Registrar:** Before a company is registered, it is desirable to ascertain from the Registrar of the companies if the proposed name of the company is approved. Then, the following documents duly stamped together with the necessary fees are to be filed with the Registrar of the Companies of the State in which the registered office of the company is to be situated:

**(1) Filing Documents with the Registrar [Sec. 71]:** These shall be filed with the Registrar within whose jurisdiction the registered office of a company is proposed to be situated, the following documents and information for registration, namely:

**(a) Memorandum and Article:** The Memorandum and Articles of the company duly signed by all the subscribers to the Memorandum in such manner as may be prescribed.

**(b) Declaration in Prescribed Form:** A declaration in the prescribed form by an advocate, a chartered accountant, cost accountant or company secretary in practice, who is engaged in the formation of the company, and by a person named in the Articles as a director, manager or secretary of the company, that all the requirements of this Act and the rules made thereunder in respect of registration and matters precedent or incidental thereto have been complied with.

**(c) Affidavit from the Subscriber:** An affidavit from each of the subscribers to the Memorandum and from persons named as the first directors, if any, in the Articles that he is not convicted of any offence in connection with the promotion, formation or management of any company, or that he has not been found guilty of any fraud or misfeasance or of any breach of duty to any company under this Act or any previous company law during the preceding five years and that all the documents filed with the Registrar for registration of the company contain information that is correct and complete and true to the best of his knowledge and belief.

**(d) Address for Correspondence:** The address for correspondence till its registered office is established.

**(e) Detail Particulars:** The particulars of name, including surname or family name, residential address, nationality and such other particulars of every subscriber to the Memorandum alongwith proof of identity, as may be prescribed, and in the case of a subscriber being a body corporate, such particulars as may be prescribed.

**(f) Particulars of First Director:** The particulars of the persons mentioned in the Articles as the first directors of the company, their names, including surnames or family names, the Director Identification Number, residential address, nationality and such other particulars including proof of identity as may be prescribed; and

**(g) Particulars of the Interests of the First Directors:** The particulars of the interest of the persons mentioned in the Articles as the first directors of the company in other firms or bodies corporate alongwith their consent to act as directors of the company in such form and manner as may be prescribed.

**(2) Registrar to Issue Certificate of Incorporation:** The Registrar on the basis of documents and information filed under sub-section (1) shall register all ie documents and information referred to in that sub-section in the register and issue a certificate of incorporation in the prescribed form to the effect that the proposed company is incorporated under this Act.

**(3) Allotment of Corporate Identity Number:** On and from the date mentioned in the certificate of incorporation issued under sub-section (2), the Registrar shall allot to the company a corporate identity number, which shall be a distinct identity for the company and which shall also be included in the certificate.

**(4) Preservation of Documents:** The company shall maintain and preserve at its registered office copies of all documents and information as originally filed with Registrar till its dissolution under this Act.

**(5) Action against False Particulars:** If any person furnishes any false or incorrect particulars of any information or suppresses any material information, of which he is aware in any of the documents filed with the Registrar in relation to the registration of a company, he shall be liable for action under Section 447.

**(6) Liable for Action under Section 447:** Without prejudice to the provisions of sub-section (5) where, at any time after the incorporation of a company, it is proved that the company has been got incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company, or by any fraudulent action, the promoters, the persons named as the first directors of the company and the persons making declaration under clause (b) of sub-section (1) shall each be liable for action under Section 447.

**(7) Power of Tribunal:** Without prejudice to the provisions of sub-section (6), where a company has been got incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company or by any fraudulent action, the Tribunal may, on an application made to it, on being satisfied that the situation so warrants:

(a) pass such orders, as it may think fit, for regulation of the management of the company including changes, if any, in its Memorandum and Articles, in public interest or in the interest of the company and its members and creditors; or

(b) direct that liability of the members shall be unlimited; or

(c) direct removal of the name of the company from the register of companies; or

(d) pass an order for the winding-up of the company; or

(e) pass such other orders as it may deem fit:

Provided that before making any order under this sub-section:

(i) the company shall be given a reasonable opportunity of being heard in the matter; and

(ii) the Tribunal shall take into consideration the transactions entered into by the company, including the obligations, if any, contracted or payment of any liability.

**Effect of Registration [Section 9]**

From the date of incorporation mentioned in the certificate of incorporation, such subscribers to the Memorandum and all other persons, as may, from time to time, become members of the company, shall be a body corporate by the name contained in the Memorandum, capable of exercising all the functions of an incorporated company under this Act and having perpetual succession with power to acquire, hold and dispose of property, both movable and immovable, tangible and intangible, to contract and to sue and be sued, by the said name.

**COMMENCEMENT OF BUSINESS**

A company both public as well as private after its incorporation, cannot start its business immediately. These have to obtain one more certificate known as certificate to commence business.

Certificate to commence business is issued by the Registrar of Companies after the following conditions are complied with (Sec. 11):

**(1)** A company having a share capital shall not commence any business or exercise any borrowing powers unless:

**(a) Filing of declaration:** A declaration is filed by a director in such form and verified in such manner as may be prescribed, with the Registrar that every subscriber to the Memorandum has paid the value of the shares agreed to be taken by him on the date of making of this declaration; and

**(b) Filing of verification its Registered office:** The company has filed with the Registrar a verification of its registered office as provided in sub-section (2) of section 12.

**(2) Penalty:** If any default is made in complying with the requirements of this section, the company shall be liable to a penalty which may extend to five thousand rupees and every officer who is in default shall be punishable with fine which may extend to one thousand rupees for every day during which the default continues.

**(3) Action for removal of Name:** Where no declaration has been filed with the Registrar under clause (a) of sub-section (1) within a period of one hundred and eighty days of the date of incorporation of the company and the Registrar has reasonable cause to believe that the company is not carrying on any business or operations he may, without prejudice to the provisions of sub-section (2), initiate action for the removal of the name of the company from the register of companies under Chapter XVIII.

## 3.4 CHECK YOUR PROGRESS

Fill in the blanks

1. Private company can start its business immediately after the issue of ……
2. Public company should start business only getting the certificate of ……..
3. …… members should sign the MOA in case of public company.
4. ……… stands in the fiduciary position of the company.
5. Pre- incorporation contract is also known as ………. .

## 3.5 SUMMARY

Formation of a company is a lengthy process broadly divided into promotion, incorporation and commencement of business. The persons who bring the company into existence are known as promoters. A promoter is not entitled to any remuneration unless the company agrees to make such payment after incorporation. Incorporation or registration is the second stage in the formation of a company. It involves preparation of Memorandum and Articles of Association, making of statutory declaration and filing of these documents and consent of directors alongwith the necessary registration and stamp fees. When the Registrar of Companies is satisfied that all the requirements of the Act have been complied with, he will register the company and issue a certificate of incorporation. Thereupon, the company comes into existence. The certificate of incorporation is a conclusive evidence that the company has been duly registered. A company can commence business only after it has obtained certificate to commence business.

## 3.6 KEYWORDS

**Promoter:** He is a person who bring the company into existence.

**Preliminary Contracts:** Contracts which are entered into, by agents on behalf of a prospective company before it has come into existence.

**Incorporation of a Company:** It means the fulfilment of those legal requirements which bring a company into existence.

## 3.7 SELF ASSESSMENT TEST

1. Explain the procedure for the incorporation of a company and state the name of documents that are to be filed with the Registrar of the company.
2. Discuss the legal formalities that are to be complied with under Indian Companies Act regarding the formation of the company.
3. Set out the different steps in the formation of a limited liability company from promotion to the commencement of business.
4. What is meant by incorporation of a company? Describe the process of incorporation of a company.
5. Who is a company promoter? Discuss the work of a company promoter and his relationship with the company promoted by him.
6. What do you mean by Promoters? Explain the functions, rights and liabilities of company promoters.

## 3.8 ANSWERS TO CHECK YOUR PROGRESS

1. Certificate of incorporation
2. Commencement of business
3. 7
4. Promoters
5. Preliminary

## 3.9 REFERENCES/SUGGESTED READINGS


- Avtar Singh, Company Law, Eastern Book Company, Lucknow.

- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
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LESSON 4

MEMORANDUM OF ASSOCIATION

## STRUCTURE



## 4.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Explain the meaning and purpose of Memorandum of Association;
- Understand the provisions of Companies Act as to clauses of the memorandum;
- Describe the procedure of alteration of the clauses of the memorandum; and
- Discuss the doctrine of ultra vires and effects of ultra vires acts.

# 4.1 INTRODUCTION

The memorandum of association is one of the basic documents required to be originally framed by every company and filed with the Registrar for its registration. It sets out the constitution of the company and provides the foundation on which the structure of the company is built. It defines the scope of the company's activities and its relations with the outside world. Memorandum of association decides the type of activities a company can do and also its relationship with the outside world.

# 4.2 MEANING OF MEMORANDUM OF ASSOCIATION

The first step in the formation of a company is to prepare Memorandum of Association. According to Sec. 2(56) of Indian Company Act, 2013, "Memorandum means the Memorandum of Association of a company as originally framed or as altered from time to time in pursuance of any previous company law or of this Act".

It is the most important document of a company. It is called 'Charter of the Company' because it contains the object of the company and limits the powers of the company. It is compulsory to file this document at the time of registration of the company.

**A Fundamental Document:** The Memorandum of Association is a document of great importance in relation to the company. It contains the fundamental conditions on which alone the company is allowed to be incorporated. It lays down the area of operation of the company. It also regulates the external affairs of the company in relation to the outsiders. The purpose is to enable shareholders and those who deal with the company to know the permitted range of the enterprise. It not only shows the object of the formation of a company but also the utmost possible scope of it.

## 4.2.1 PURPOSE OF MEMORANDUM OF ASSOCIATION

The purpose of the Memorandum is two fold:

(1) The prospective shareholders shall know the field to or the purpose for which their money is going to be used by the company and what risk they are undertaking in making investment.

(2) The outsiders dealing with the company shall know with certainty as to what the objects of the company are and as to whether the contractual relations into which they contemplate to enter with the company is within the objects of the company.

The Memorandum of a company shall be in respective forms specified in Table A, B, C, D and E in Schedule I as may be applicable to such company.

Each subscriber shall sign and add his address, description and occupation, if any, in the presence of at least one witness.

## 4.2.2 CONTENTS OF MEMORANDUM OF ASSOCIATION

The Memorandum of any company shall contain the following clauses:

(I) Name clause (II) Situation clause (III) Object clause

(IV) Liability clause (V) Capital clause (VI) Subscription clause

**I. Name Clause**

The first clause of the Memorandum shall state the name of the proposed company. The name of a company establishes its identity and the symbol of its existence.

**Rules regarding Name:** A company may, subject to the following rules, select any suitable name:

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

(a) Too similar to the name of another company, or

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

**(2) Injunction if Identical Name Adopted:** If a company gets registered with a name which resembles the name of an existing company, the other company with whom the name resembles can apply to the Court for an injunction to restrain the new company from adopting the identical name [Ewing Butter Cup Margarine Co. Ltd. (1917) 2 Ch. 1]. This is of because of the reputation and company gains a monopoly of the use of that name and no other company can be registered under a name identical with it or so nearly resembling it as is calculated to deceive.

An injunction will not be granted to prevent the use of a purely descriptive word with a definite meaning and in common use. However, the Court or Tribunal will not grant an injunction to prevent the use of a purely descriptive word with a definite meaning and in common use.

In the case of Aerators Ltd. Vs. Tollitt (1902) 2 Ch. 3191, a company registered as Aerators Limited sought to restrain the registration of another company under the name of 'Automatic Aerators Patents Limited'. The main object of both the companies was the manufacture of apparatus for the instantaneous automatic aeration of liquids although the patents and apparatus of the two companies were distinct. The Court refused to grant injunction.

**(3) Limited or 'Private Limited' as the Last Word or the Words of the Name:** The Memorandum shall state the name of the company with 'Limited' as the last word in case of a public limited company and with the 'Private Limited' as the last word of the name in case of a private limited company.

The omission to use word 'Limited' as part of the name of a company shall make the name incorrect. If a company makes the contract without the use of the word 'Limited', the officers of the company who make the contract would be deemed to be personally liable. The omission to use the word 'Limited' as part of the name of a company must have been deliberate and not merely accidental. Note the following case:

In the case of Dermatine Co. Ltd. Vs. Ashworth (1905) T.L.R 510, a bill of exchange drawn upon a limited company in its proper name was duly accepted by two directors of the company. The rubber stamp by which the words of acceptance were impressed on the bill was longer than the paper of the bill and hence the word 'Limited' was missed. Held the company was liable to pay and directors were not personally liable. "It was an error of the most trifling kind and mischief aimed at by the Act did not exist."

**(4) Prohibition of Use of Certain Names:** The Emblems and Names (Prevention of Improper Use) Act, 1950 prohibits the use of or registration of a company with any name or emblem specified in the Schedule to that Act. The Schedule specifies the following items, i.e., the name emblem or official seal of the UNO, World Health Organisation, the United Nations Educational, Scientific and Cultural Organisation, the World Meteorological Organisation and the International Civil Aviation Organisation, the Indian National Flag, the name, emblem or official seal of the Central Government and State Government. The name emblem or official seal of the President of India or Governor of any State or connection with any local authority or any corporation or body constituted by the Government under any law for the time being in force.

Once a company is registered with a certain name, it must appear in a conspicuous manner on the outside of every office or place of work and on letters, notices and cheques etc. of the company. In case of one-person company, the name of the person who, in the event of death of the subscriber, shall become the member of the company.

**Penalty.** If default is made in complying with this provision, the company and every officer in default shall be liable to fine, which may extend to ₹ 1,000 per day till the default continues.

**II. Situation Clause**

The second clause of the Memorandum must mention the name of the State in which the registered office of the company is to be situated. This fixes the domicile of the company. It is sufficient to mention the name of the State in which the registered office of the company is to be situated. Actual address is not mentioned in the Memorandum. However, notice of its registered office and every change therein has to be given to the Registrar within 15 days of incorporation or change, as the case may be. It is usual to file the notice of registered office of the company along with the Memorandum at the time of registration. For default, the above penalty shall also apply in this case.

According to Sec. 12(3), every company shall:

(a) paint or affix its name, and the address of its registered office, and keep the same painted or affixed, on the outside of every office or place in which its business is carried on, in a conspicuous position, in legible letters, and if the characters employed therefore are not those of the language or of one of the languages in general use in that locality, also in the characters of that language or of one of those languages;

(b) have its name engraved in legible characters on its seal, if any;

(c) get its name, address of its registered office and the Corporate Identity Number alongwith telephone number, fax number, if any, e-mail and website addresses, if any, printed on all its business letters, billheads, letter papers and in all its notices and other official publications; and

(d) have its name printed on *hundies*, promissory notes, bills of exchange and such other documents as may be prescribed:

Provided that where a company has changed its name or names during the last two years, it shall paint or affix or print, as the case may be, alongwith its name, the former name or names so changed during the last two years as required under clauses (a) and (c):

Provided further that the words 'One Person Company' shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

**III. The Object Clause**

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

**Purpose of the Object Clause:** The purpose of object clause in the Memorandum is two-fold:

Firstly, it protects the investors who learn from it the purpose to which their money can be applied. It ensures that their money will not be risked in any business which is not authorised by the Memorandum. Secondly, it protects tile creditors and other persons who deal with the company as they can infer (know) from it the extent of the company's powers.

Any act done beyond the powers conferred by the Memorandum will be ultra vires. A Company is free to choose its objects but the objects should not be illegal, unlawful, against public policy or against the Companies Act, e.g. to trade with enemy etc.

The object for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof.

In Evans Vs. Brunner Mond & Co. (1921)1 Ch. 359, a company engaged in manufacture of chemicals, proposed to devote a substantial sum of money to the encouragement of scientific education. It was proved that this Act would ultimately benefit the company, but a shareholder objected on the ground that it was beyond the powers of the company. Held, the proposal was fairly incidental to the company's object.

**IV. Liability Clause**

The liability of members of the company whether limited or unlimited is stated in liability clause, and also state:

(i) in the case of a company limited by shares, that liability of its members is limited to the amount unpaid, if any, on the shares held by them; and

(ii) in the case of a company limited by guarantee, the amount upto which each member undertakes to contribute:

(A) to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and

(B) to the costs, charges and expenses of winding-up and for adjustment of the rights of the contributories among themselves.

**V. Capital Clause**

The Memorandum of a company, having a share capital, shall state the amount of the share capital with which the company is to be registered and the division thereof into shares of a fixed amount.

Sec. 4(i)(e) states that the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the Memorandum agree to subscribe which shall not be less than one share; and

(ii) the number of shares each subscriber to the Memorandum intends to take, indicated opposite his name;

(iii) in the case of One Person Company, the name of the person who, in the event of death of the subscriber, shall become the member of the company.

**VI. Subscription Clause**

Though this clause is not numbered in the Act, is generally given at the and of the Memorandum. This clause reads like this “we the several persons, whose names, addresses and occupations are subscribed, are desirous of being formed into a company in pursuance of this Memorandum of Association, and we respectively agree to take the number of shares in the capital of the company set opposite our respective names.”

In case of ‘One Person Company’, subscription clause reads like this “I, whose name and address is given below, am desirous of forming a company in pursuance of this Memorandum of Association and agree to take all the shares in the capital of the company.”

This clause states that the persons subscribing their signatures to the Memorandum are willing to form themselves into an association. One subscriber cannot attest the signature of the other. A subscriber is also required to take at least one share. He should mention against his name the number of shares taken by him. In case of a public company, the Memorandum shall be signed by at least seven persons (two in case of a private company).

### 4.2.3 ALTERATION IN MEMORANDUM OF ASSOCIATION

Memorandum of Association is the fundamental document of a company. It cannot be and should not be freely altered. Sec. 13 of this Act states the manner in which Memorandum of Association can be altered.

**I. Alteration in Name Clause**

Sec. 13, (1) save as provided in Section 61, a company may, by a special resolution and after complying with the procedure specified in this section, alter the provisions of its memorandum,

(2) Any change in the name of a company shall be subject to the provisions of sub-section (2) and (3) of Section 4 and shall not have effect except with the approval of the Central Government in writing:

Provided that no such approval shall be necessary where the only change in the name of the company is the deletion therefrom, or addition thereto, of the word ‘Private’, consequent on the conversion of any one class of companies to another class in accordance with the provisions of this Act.

(3) When any change in the name of a company is made under sub-section (2), the Registrar shall enter the new name in the register of companies in place of the old name and issue a fresh certificate of incorporation with the new name and the change in the name shall be complete and effective only on the issue of such a certificate.

**II. Alteration in Situation Clause**

A company can change its registered office from one place to another according to the provisions of this Act under section 13.

(1) The alteration of the Memorandum relating to the place of the registered office from one State to another shall not have any effect unless it is approved by the Central Government on an application in such form and manner as may be prescribed [Sec. 13(4)].

(2) The Central Government shall dispose of the application under sub-section (4) within a period of sixty days and before passing its order may satisfy itself that the alteration has the consent of the creditors, debenture-holders and other persons concerned with the company or that the sufficient provisions has

been made by the company either for the due discharge of all its debts and obligations or that adequate security has been provided for such discharge [Sec. 13(5).

(3) Save as provided in Section 64, a company shall, in relation to any alteration of its Memorandum, file with the Registrar:

(a) the special resolution passed by the company under sub-section (1);

(b) the approval of the Central Government under sub-section (2), if the alteration involves any change in the name of the company [Sec. 13(6)].

(4) Where an alteration of the Memorandum results in the transfer of the registered office of a company from one State to another, a certified copy of the order of the Central Government approving the alteration shall be filed by the company with the Registrar of each of the States within such time and in such manner as may be prescribed, who shall register the same, and the Registrar of the State where the registered office is being shifted to, shall issue a fresh certificate of incorporation indicating the alteration [Sec. 13(7)].

**III. Alteration in Object Clause**

Sec. 13 of the Companies Act, 2013 states a company can change its objects in furtherance of the objectives stated in the Memorandum.

An alteration should be made in accordance with the provisions and the manner prescribed. For changing the object clause, the company has to pass a special resolution and obtain the approval of the Central Government. Every change shall be noted in every copy of the Memorandum. A company, which has raised money from public through prospectus and still has any unutilised amount out of the money so raised, shall not change its objects for which it raised the money through prospectus unless a special resolution is passed by the company and:

(i) the details, as may be prescribed, in respect of such resolution shall also be published in the newspapers (one in English and one in vernacular language) which is in circulation at the place where the registered office of the company is situated and shall also be placed on the website of the company, if any, indicating therein the justification for such change;

(ii) the dissenting shareholders shall be given an opportunity to exit by the promoters and shareholders having control in accordance with regulations to be specified by the Securities and Exchange Board of India.

The Registrar shall register any alteration of the Memorandum with respect to the objects of the company and certify the registration within a period of 30 days from the date of filing of the special resolution in accordance with clause (a) of sub-section (6) of this section.

No alteration made under this section shall have any effect until it has been registered in accordance with the provisions of this section.

Any alteration of the Memorandum, in the case of a company limited by guarantee and not having a share capital, purporting to give any person a right to participate in the divisible profits of the company otherwise than as a member, shall be void.

**Penalty:** In case of default the company and every officer who is in default shall be liable to a penalty of ` 1,000 for every copy of the Memorandum or Article issued without such alteration [Sec. 15(2)].

**IV. Change in Liability Clause**

The liability of the members cannot be made unlimited without their consent in writing. By changing Memorandum or Articles, a member cannot be compelled to buy additional shares of the company. However an association, by altering its Memorandum or Articles can raise the periodical subscription without the consent of its members in writing. Further, liability of the directors, managing directors or manager can be made unlimited with their consent provided the Article so provide.

Further unlimited liability of the shareholders can be made limited by passing a special resolution and obtaining the approval by the Company Law Tribunal. In the alternative an, unlimited company may register itself as a limited company. However, it will not affect any debt, liabilities, obligations already incurred or contracts made before such registration.

**V. Alteration in Capital Clause**

Power of Limited Company to Alter its Share Capital [Sec. 61]

(1) A limited company having a share capital may, if so authorised by its Articles, alter its Memorandum in its general meeting to:

(a) increase its authorised share capital by such amount as it thinks expedient;

(b) consolidate and divide all or any of its share capital into share of a larger amount than its existing shares:

Provided that no consolidation and division which results in changes in the voting percentage of shareholders shall take effect unless it is approved by the Tribunal on an application made in the prescribed manner;

(c) convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;

(d) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the Memorandum, so, however, that in the sub-division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;

(e) cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled.

(2) The cancellation of shares under sub-section (1) shall not be deemed to be a reduction of share capital.

**Notice to be given to Registrar for Alteration of Share Capital [Sec. 64]**

(1) Where:

(a) a company alters its share capital in any manner specified in sub-section (1) of Section 61;

b) an order made by the Government under sub-section (4) read with sub-section (6) of section 62 has the effect of increasing authorised capital of a company; and or

(c) a company redeems any redeemable preference shares.

The company shall file a notice in the prescribed form with the Registrar within a period of 30 days of such alteration or increase or redemption, as the case may be, along with an altered Memorandum.

(2) If a company and any officer of the company who is in default contravenes the provisions of sub-section (1), it or he shall be punishable with fine which may extend to one thousand rupees for each day during which such default continues, or five lakh rupees, whichever is less.

## 4.3 DOCTRINE OF ULTRA VIRES

A company has the power to do all such thing as are:

(1) Authorised to be done by the Companies Act, 2013;

(2) Essential to the attainment of its object specified in the Memorandum; and

(3) Reasonable and fairly incidental to its objects.

Everything else is ultra vires the company. Ultra means 'beyond' and 'vires' means 'powers'. The term 'ultra vires' a company means that the doing of the act is beyond the legal power and authority of the company. All ultra vires acts of a company shall be fully null and void and can never be ratified and become valid even though, all the shareholders of the company agree to ratify such transactions. It is not necessary that an act to be considered ultra vires must be illegal; it may be and may not be. It cannot become ultra vires by reasons of estoppel, lapse of time, ratification, acquiescence or delay. The rule is meant to protect future shareholders and the public at large who deal with the company. The leading case on the point is Ashbury Rly. Carriage & Iron Company Ltd. Vs. Riche (1975) L.R. 7 H.L. 653, A company was incorporated with the objects:

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

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

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

The company entered into a contract with Riche for the financing of the construction of a railway line in Belgium. The question raised was whether that contract was valid. The House of Lords held that the contract was ultra vires the company and void so that not even the subsequent assent of the whole body of shareholders could ratify it.

The doctrine of ultra vires as laid down in the Ashbury's case was affirmed by the House of Lords in Attorney General Vs. Great Eastern Railway Co. (1880) 5 Ap. Cas 473. It was stated that the doctrine of ultra vires "ought to be reasonably and not unreasonably, understood and applied, and whatever may fairly be regarded as incidental to or consequential upon those things which the legislature has authorised ought not be held by Judicial construction to be ultra vires." Note the following case:

Deuchar Vs. Gas Light & Coke Co. (1925) A. (69)], a gas company was empowered to make and supply gas, manufacture and sell residuals and to provide such apparatus and materials as it deemed requisite for those purposes. After purchasing Caustic Soda for a number of years it decided to manufacture its own Caustic Soda. Held, it was not ultra vires the company.

The main feature of doctrine of ultra vires is that a company being a corporate person should not be punished for its own acts or acts of its agents, if they are beyond its powers and privileges. A contract of a company which is ultra vires is wholly void and of no legal effect. But there is nothing to prevent a company from protecting its property. The leading case on this point is:

National Telephone Co. Vs. St. Peter Port Constables (1900) A.C. 317. A telephone company put up telephone wires in a certain area. The company had no power in the Memorandum to put up wires there. The defendants cut them down. Held, the company could sue for damage to the wires.

Ultra-vires acts may be classified into the following parts:

(1) When an act is performed or a transaction is carried out which, though legal in itself, is not authorised by the object clause in the Memorandum or by statute. It is said to be ultra vires the company.

(2) If an act is ultra vires the company, it cannot be ratified even by the whole body of shareholders.

(3) If an act is ultra vires the directors i.e., beyond the scope and powers of the directors but intra vires that company, it can be ratified by the shareholders by a special resolution in a general meeting.

(4) If an act is ultra vires the Articles, it can be ratified by altering the Articles by a special resolution in a general meeting.

**Effects of Ultra Vires Transactions**

Ultra vires transactions are the acts for which a company or its directors are not authorised to do such acts have the following effects:

**(1) Company is not Bound by Ultra Vires Acts:** A company is not bound by the ultra vires acts and a company can never ratify these acts even though all the shareholders of the company agree to ratify their acts.

**(2) Personal Liability of Directors:** Any member of a company can maintain an action against the directors of the company to compel them to restore to the company the funds of the company that have been employed by them in ultra vires transactions. If any funds of the company are misapplied, the directors are personally liable to the company for breach of trust even when the misapplication by the directors is done is good faith or when it is not fraudulent.

In Sharpe Re (1892) 1 Ch. 154, case the directors of a company paid dividends on shares out of capital which is an ultra vires act. The company was afterwards wound-up. Held, the directors were liable to refund the money to the company.

**(3) Injunction Order:** If any member of the company feels that the company is going to do anything ultra vires, he may go to the Court and obtain an injunction order to get the work stayed.

**(4) Ultra Vires Contracts are Void and Illegal:** If company has entered into any contract which is ultra vires its Memorandum, all such contracts are completely void and hence can never be ratified.

**(5) Liability of the Directors for Breach of Warranty of Authority:** Directors are known as the agents of the company. They must work within the limits and powers of the company. If it is proved that they have induced any one to enter into any contract ultra vires the Memorandum of company, they will be held personally liable for such contracts and liable for breach of their duties. They will have to compensate all the losses of that person.

In the case of Weeks Vs. Propert (1873) LR & C.P 427, the directors of a railway company which had fully exhausted its borrowing powers advertised for money to be lent on debentures, 'W' lent £500 upon the footing of advertisement and received a debenture. Held, the debenture was void but 'W' could sue the directors for breach of warranty of authority.

**(6) No Suit can be Filed:** A company can not sue any person for its ultra vires act and similarly, it can not be sued by others.

**(7) Ultra Vires Acquired Property:** If a company has acquired some property under an ultra vires transaction, it has the right to hold that property and protect it against damages by other persons.

**(8) Ultra Vires Torts:** A company is not liable for torts (civil wrongs) committed by its agents or servants during the course of ultra vires transactions.

**Exceptions to the Doctrine of Ultra Vires**

Following are the exceptions to the doctrine of ultra vires:

1. If an act is ultra vires the directors of a company but is intra vires the company, the company may ratify it.

2. If an act is ultra vires the Articles of Association of a company, the Articles may be altered to include the act within the powers of the company.
3. It an act is intra vires but is irregularly done, the shareholders may ratify it.
4. If a person borrows money from a company under a contract which is ultra vires the company, the company can sue him for the recovery of the money.
5. If an act is ultra vires the company, the right arising independently thereon are not affected.
6. If a company takes an ultra vires loan and uses it to pay off intra vires debts, the lender who has lent money is substituted in place of creditors and as such he can recover the money.
7. If a company has taken an ultra vires loan through some misinterpretation of fact by the directors, the lender has the right to make directors personally liable on the ground of breach of implied warranty of authority.
8. If a director of a company makes payment ultra vires the company, the company can compel him to refund the amount.

## 4.4 CHECK YOUR PROGRESS

Fill in the blanks

1. A company can change its name at its own discretion by passing ……..
2. Any change in the address of the registered office must be communicated to the registrar with in ……….
3. Companies are now allotted a ……… in addition to their name.
4. MOA should be in form …….. in case of a unlimited liability.
5. Ultra vires means ………..

## 4.5 SUMMARY

Memorandum of Association of a company is the most important document of a company. It is the charter of a company. It defines and confines the powers of a company. Any act which is beyond the powers conferred by the Memorandum is called ultra vires. It contains name clause, situation clause, object clause, liability clause, capital clause and subscription clause. The name of the company can be altered by a special resolution and with the approval of Central Government in writing. By change of name, the constitution of the company is not changed, only the name changes. A company can change its registered office from one place to another within the local limits of the city, town or village, where it is situated, by merely passing a Board resolution. A company can change its objects clause by passing a special resolution. Companies Act permits a company, by a special resolution and after compiling with the procedure specified, alter the provisions of its memorandum.

## 4.6 KEYWORDS

**Memorandum of Association:** It is a charter of a company and defines the limitations of the powers of a company.

**Doctrine of Ultra Vires:** A doctrine declaring that any act contrary or in excess of the scope of the activity of the company will be null and void and not binding on the company.

## 4.7 SELF ASSESSMENT TEST

1. What is a Memorandum of Association? What are its contents?
2. "The Memorandum of Association is the fundamental law or a charter of the company defining the object and limiting the powers of a company." Explain.
3. What are the compulsory clauses in the Memorandum of Association? In what cases, in what mode and to what extent can a company alter these clauses?
4. Set out the restrictions imposed on the choice of a name for a company. How can a company change its name?
5. Explain the necessity of setting out clearly the objects in the Memorandum of Association as per the Companies Act, 2014.
6. Why is it necessary for a company to have a registered office? Can the registered office of a company be changed?
7. Discuss the doctrine of ultra vires vis-a-vis a company, the directors and the Articles. What is the legal effect of ultra vires acts?
8. "Memorandum of Association is the most important charter of a company." Discuss. How can it be altered?

## 4.8 ANSWERS TO CHECK YOUR PROGRESS

1. Special Resolution
2. 1 Month
3. CIN
4. Table E
5. Beyond the Power

## 4.9 REFERENCES/SUGGESTED READINGS


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# LESSON 5

# ARTICLES OF ASSOCIATION

## STRUCTURE



## 5.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Explain the meaning and contents of articles of association of a company.
- Describe the provisions and procedure of alteration of articles.
- Explain the relationship and difference between memorandum and articles of association.

- Discuss the legal effect of memorandum and articles of association.
- Throw light on the doctrine of constructive notice and indoor management.

## 5.1 INTRODUCTION

A company is an incorporated body so there have to be some rules and regulations for the management of its internal affairs and conduct of its business. It is equally important for a company to have some guidelines for managing its relationship with its members and also between the members. Moreover, the rights and duties of its members and the company are also to be recorded. A document which serve all these mentioned purpose is called the articles of association. Articles of association of a company are the internal rule book that every incorporated organisation must have and work by. It forms a part of the constitution of the organisation which establishes a contract between the members and organization and also among the members themselves. Articles also set out the rights and duties of directors and stockholders individually and in meetings.

## 5.2 MEANING OF ARTICLES OF ASSOCIATION

The Articles of Association are the rules, regulations and bye-laws for the internal management of the affairs of the company. They are framed with the object of carrying out the aims and objects as set out in the Memorandum of Association.

The Articles of Association have been defined by Sec. 2(5) of Indian Companies Act, 2013 as "Article means the Articles of Association of company as originally framed or as altered from time to time or applied in pursuance of any previous company law or of this Act."

The Article shall also contain such matters, as may be prescribed. Provided that nothing prescribed in this sub-section shall be deemed to prevent a company from including such additional matters in its Articles as may be considered necessary for its management.

The Article may contain provisions for entrenchment to the effect that specified provisions of the Articles may be altered only if conditions or procedures as that are more restrictive than those applicable in case of special resolution, are met or complied with.

The Article of a company shall be in respective forms specified in Table F, G, H, I and J in Schedule I as may be applicable to such company.

The Articles are next in importance to the Memorandum which contains the fundamental conditions upon which alone a company is allowed to be incorporated. They are as such subordinate to and controlled by the Memorandum. In Ashbury Railway Carriage & Iron Company Ltd. Vs. Riche (1875) L. R.7 H.L. 653, it was observed that the 'Articles' play a part subsidiary to the Memorandum of Association. They accept the Memorandum of Association as charter of the company and so accepting it. The Articles proceed to define the duties, the rights and the powers of the governing body as between themselves and the company at large, mode and term in which changes in internal regulation of the company may from time to time be made.

In framing the Articles of a company care must be taken that regulations framed do not go beyond the power of company itself as contemplated by the Memorandum of Association. They should also not violate any of the provision of the Companies Act. In Peveril Gold Mines Ltd. Re (1898) Ch 122 case, it was stated that the contents of the Articles should not violate the provisions of the Companies Act.

**5.2.1 Contents of Articles of Association**

Articles usually contain provisions relating to the following matters:

(1) The amount of share capital and its division.

(2) Amount of minimum subscription.

(3) Call money and procedure to call.

(4) Procedure for the allotment of shares.

(5) Procedure for the forfeiture and re-issue of shares.

(6) Provision for the reorganisation of shares capital.

(7) Procedure for the reduction of share capital.

(8) Procedure to confirm preliminary contracts.

(9) Right to borrow and the procedure of arranging loans.

(10) Commission payable on underwriting and brokerage.

(11) Types of meetings and the time to call them.

(12) Share certificates.

(13) Lien on shares and transfer of shares.

(14) Conversion of shares into stock.

(15) Voting rights of members, voting and poll procedures.

(16) Directors, their appointment, remuneration, qualifications, power and proceeding of Board of Directors.

(17) Rules regarding auditor, manager, secretary and treasurer.

(18) Rules regarding use of common seal.

(19) Rules regarding the keeping of books of accounts

(20) Rules regarding the capitalisation of profits.

(21) Rules regarding the creation of reserve funds

(22) Rules regarding the winding-up to company.

(23) Rules regarding the commission on shares and debentures.

(24) Rules regarding the issue of preference shares.

(25) Right to pay interest out of capital.

(26) Right to issue the share warrants.

(27) Right to appoint internal auditor.

(28) Right to declare interim dividend.

(29) Right to limit the rights of directors.

(30) Right to distribute the profits of the company.

In addition to the above matters, an un-limited company must disclose in Articles of Association the number of share with which the company is to be registered and the amount of share capital, if any, with which the company is to be registered. In case of a company limited by guarantee, Articles of Association must disclose the number of members with which the company is to be registered. It must also disclose the amount of guarantee that they have agreed to contribute in case of winding-up of company.

## 5.2.2 MODELS OF ARTICLES OF ASSOCIATION

Schedule I of the Companies Act gives various model forms of Articles of Association of various types of companies which are as follows:

Table F: Articles of Association of a company limited by shares.

Table G: Articles of Association of a company limited by guarantee and having a share capital.

Table H: Articles of Association of a company limited by guarantee and not having share capital.

Table I: Article of Association of an unlimited company and having share capital.

Table J: Article of Association of an unlimited company and not having share capital.

**Companies which must have their own Articles**

The following companies shall have their own Articles:

(a) Unlimited companies.

(b) Companies limited by guarantee.

(c) Private companies limited by shares.

The Articles must be signed by the subscribers of Memorandum and registered along with the Memorandum.

## 5.2.3 ALTERATION OF ARTICLES FO ASSOCIATION

For the alteration of Articles, Sec. 14 of Indian Companies Act, 2013 states that:

(1) Subject to the provisions of this Act and the conditions contained in its Memorandum, if any, a company may, by a special resolution, alter its Articles including alterations having the effect of conversion of:

(a) a private company into a public company; or

(b) a public company into a private company:

Provided that where a company being a private company alters its Articles in such a manner that they no longer include the restrictions and limitations which are required to be included in the Articles of a private company under this Act, the company shall, as from the date of such alteration, cease to be a private company:

Provided further that any alteration having the effect of conversion of a public company into a private company shall not take effect except with the approval of the Tribunal which shall make such order as it may deem fit.

(2) Every alteration of the Articles under this section and a copy of the order of the Tribunal approving the alteration as per sub-section (1) shall be filed with the Registrar, together with a printed copy of the altered Articles, within a period of fifteen days in such manner as may be prescribed, who shall register the same.

(3) Any alteration of the Articles registered under sub-section (2) shall, subject to the provisions of this Act, be valid as if it were originally in the Articles. As per Sec. 15 of this Act, alteration of Memorandum or Articles to be noted in every copy:

(1) Every alteration made in the Memorandum or Articles of a company shall be noted in every copy of the Memorandum or Articles, as the case may be.

(2) If a company makes any default in complying with the provisions of sub-section (1), the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every copy of the Memorandum or Articles issued without such alteration.

**Limitations of the Alteration**

Following are the limitations of the alteration of Articles:

**(1) Must not be in Consistent with the Act:** The alteration of the Articles must not be inconsistent with or go beyond the provisions of the Companies Act.

**(2) Must not Conflict with Memorandum:** The alteration of the Articles must not exceed the power given by the Memorandum or conflict with the provisions of the Memorandum. If it does, it will be ultra vires and wholly void or inoperative.

**(3) Must not Sanction Anything Illegal:** The alteration must not purport to sanction anything which is illegal. But if it is illegal and it is not clearly prohibited by the Memorandum it may be held to be valid even where it alters the whole structure of the company.

**(4) Must be for the Benefit of the Company:** The alteration must be bonafide for the benefit of the company as a whole. In Allen Vs. Gold Reefs of West Africa Ltd. (1900) Ch. 656, it was observed that the power of alteration must be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities.

**(5) Must not Increase Liability of Members:** The alteration must not in any way increase the liability of existing members, but where the company is a club or association, the Articles may be altered to provide for subscription or charge at higher rate.

**(6) Alteration by Special Resolution:** The alteration can be made only by a special resolution as defined in the Act. Even a clerical error in the Articles should be set right by a special resolution.

**(7) Approval of Central Government:** When a public company is converted into a private company. The alteration in the Articles which has the effect of converting a public company into a private company can be made only if it is approved by the Central Government.

**(8) Breach of Contract:** A company is not prevented from altering its Articles even if such an alteration would result in breach of a contract, however, the affected party may file a suit for damages for the breach of contract.

**(9) Must not Result in Expulsion of a Member:** An assumption by the directors of a company of any power to expel a member by altering its Articles is illegal and void.

**(10) No Power of the Court to Amend Articles:** The Court has no power to amend or rectify the Articles even where there is a mistake or drafting error which the Court would rectify in case of any other contract. The Court can only declare some clause to be ultra vires.

# 5.3 ARTICLE AND MEMORANDUM OF ASSOCIATION

## 5.3.1 ARTICLES AND MEMORANDUM: THEIR RELATION

The Articles are subordinate to Memorandum. The Articles cannot give powers to a company which are not conferred by the Memorandum. This is so because the object of the Memorandum is to state the purpose for which the company has been formed while the Articles provide the manner in which the internal management of the company is to be carried. The Articles may explain or supplement the Memorandum, but cannot extend or enlarge its scope.

The terms of the Memorandum cannot be modified or controlled by the Articles, so far as the fundamental conditions in the Memorandum are concerned, they cannot be explained with aid of the Articles. In this regard Brown L. observed, "The Memorandum contains the fundamental conditions upon which alone company is allowed to be incorporated. They are conditions introduced for the benefit of the creditors and the outside public as well as shareholders. The Articles are the internal regulations of the company".

## 5.3.2 DIFFERENCE BETWEEN MEMORANDUM AND ARTICLES OF ASSOCIATION

Following are the differences between memorandum and articles of association:

| | **Memorandum of Association** | **Articles of Association** |
|---|---|---|

| | | |
|---|---|---|
| (1) | It is the charter of the company. It also defines the company's relationship with outsiders. | They are the regulations for the internal management of the company and are subsidiary to Memorandum. |
| (2) | It defines the scope of the activities of the company or beyond which the actions of the companies cannot go. | They are the rules for carrying out the objects of the company as set out in the Memorandum. |
| (3) | It is the main document of the company. | They are subordinate to the Memorandum. If there is a conflict between the Articles and Memorandum, the Memorandum prevails. |
| (4) | Alteration in Memorandum of Association is very difficult and is not a common feature. | Articles of Association may be altered by passing a special resolution at the meeting. |
| (5) | Acts done by a company ultra vires the Memorandum are void and cannot be ratified by the shareholders. | Acts done by a company ultra vires the Articles but intra vires the Memorandum can be ratified by a company by passing a special resolution. |
| (6) | Outsiders are expected to be acquainted with the Memorandum of Association and if the company enters into any contract ultra vires the Memorandum, outsiders have no remedy against the company. | Outsiders are not expected to be acquainted with the Articles of a company and then can enforce the contract against the company if it is ultra vires the Articles of Association. |

### 5.3.3 LEGAL EFFECTS OF MEMORANDUM AND ARTICLES OF ASSOCIATION

Sec. 10 of Indian Companies Act, 2013 states:

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

(2) All monies payable by any member to the company under the Memorandum or Articles shall be a debt due from him to the company.

The above provisions of the Companies Act clearly defines that the Memorandum of Association and the Articles of Association, after the registration bind the company and its members with their provisions. The effect of these provisions is to constitute a contract between each member and the company. The legal implication of these documents may be discussed as to how far documents bind:

(1) Members to the company, (2) Company to the members,

(3) Member Inter Se, (4) Company to the outsiders.

**(1) Members to the Company:** As between the members and the company, the Memorandum and the Articles constitute a binding contract. The effect of this is that each member is bound to the company to conform to the Memorandum and the Articles as if each member has actually signed the same. Boreland's Trustee Vs. Steel Bros & Co. Ltd. (1901) 1 Ch 279, the Articles of a company as altered provided that the shares of any member who becomes bankrupt should be sold to certain persons at a fair price. B, a shareholder became bankrupt and his trustee in bankruptcy claimed that he was not bound by the altered Articles. Held, the Articles were a personal contract between B and the rest of the members and his trustee were bound by the contract.

**(2) Company to the Members:** A company is bound to the members in the same manner as the members are bound to the company. The company can exercise its rights as against any member, only in pursuance of, and in accordance with, the Memorandum and the Articles. A member can obtain an injunction restraining the company from doing an ultra vires act. In Wood Vs. Odessa Water Works' Co. (1889)42, Ch, D 636 case, the Articles of W. Company provided that the directors may with the sanction of the company at general meeting declare a dividend to be paid to the members. A resolution was passed to give the shareholders debenture bonds instead of paying dividend in cash. A member filed the suit to restrain the directors from acting on resolution as it was not in accordance with the Articles of the company. Held, the word 'to be paid' meant paid in cash and a shareholder could restrain the company from acting on resolution on the ground that it had contravened the Articles.

**(3) Member Inter Se:** Members are bound to each other but these documents do not create an express agreement between the members of the company. A member cannot bring a suit in his own name against another member to enforce the Articles. Otherwise, there may be a large number of cases against one defaulter, which will be absurd. However, where the member at fault holds the majority of shares he will not, therefore, be allowed to take an action in the name of the company. In such a case, an action may be brought against him by another shareholder in his own name.

This was established by Lord Herschell in Wettron Vs. Saffery (1897) A. C. 299. "It is quite true that the Articles constitute a contract between each member and the company, but the Articles do not regulate their rights inter se. Such rights can only be conferred by or against a member through the company or through the liquidator."

In some cases, where the Articles seek to regulate the rights of shareholders in their capacity as members, they constitute a contract between two members and in which case contract can be directly enforced by a member against another without joining the company as a party.

**(4) Company to the Outsiders:** Neither the company nor its members are bound to the outsiders. This is so even if the names of the outsiders are mentioned in these documents. Again, Articles do not confer any right even upon a member in a capacity other than that of a member. There must be an independent contract entered into between the company and the outsiders.

Eley Vs. Positive Govt. Security Life Ass. Co. (1876) EXD 88, the Articles of the company provided that E should be the solicitor of the company for life and could be removed from office only for misconduct. E took office and became a shareholder. After sometime, the company dismissed him without alleging misconduct. E sued the company for damages for breach of regulations in the Articles. Held, the Articles did not constitute any contract between the company and outsiders as such no action could be taken.

## 5.3.4 CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES

Every outsider dealing with a company is deemed to have notice of the contents of Memorandum and Articles. These documents, on registration with the Registrar, assume the character of public documents, this is known as Constructive Notice of Memorandum and Articles.

The Memorandum and Articles are open and accessible to all. It is the duty of every person dealing with a company to inspect these documents and see that it is within the power of the company to enter into the proposed contract. The legal effect of these constructive notices is that if a person deals with a company in a manner which is not inconsistence with the provisions of the Memorandum or Articles of the company, he must be deemed to have dealt with the company at his own risk and cost if he suffers any loss and because of such a deal, he will have to bear the loss himself.

Kolta Venkataswamy Vs. Ram Murthi (1934) 4 Comp. Case 289, the Articles of Association of a company contained a clause that all deeds and documents of the company shall be signed by the managing director, the secretary and a working director on behalf of the company. A deed of mortgage was signed by the secretary and a working director only. Held, the mortgage could not be enforced as the illegality appeared on the face of deed, and therefore, the deed was invalid notwithstanding that plaintiff acted in good faith and money was applied for the purpose of the company.

The doctrine of constructive notice of the Memorandum and Articles, however, is not a positive doctrine but a negative one. It is like the doctrine of estopple. It does not operate against the company. It operates only against an outsider dealing with the company. It prevents him from alleging that he did not know that the Memorandum and Articles rendered a particular act ultra vires the company.

## 5.3.5 DOCTRINE OF INDOOR MANAGEMENT

Though the doctrine of constructive notice assumes that the persons dealing with the company has gone through its Memorandum and Articles of Association, however, there is one exception to the above doctrine. The exception is that the persons dealing with the company are not bound to enquire into the regularity of the internal proceedings of the company. They are entitled to assume that the provisions of the Articles of Association of a company have been fully observed by its officers and outsiders cannot be expected to see that the company follows its internal regulations. Thus, whereas the doctrine of constructive notice protects the company against outsiders, the doctrine of indoor management seeks to protect outsiders against the company.

The Articles empowered the directors to borrow on bond such sums of money, as they were authorised by a proper resolution of the company. They issued a bond to Turquard without the authority of such a resolution. It was held that the company was bound by the loan. The plaintiff was entitled to assume that the necessary resolution had been duly passed. The reason for the rule is that the outsiders cannot know as to what has happened within the doors of the company that were closed to them. Memorandum and Articles are public documents but the minutes book of the director’s meeting or shareholder’s meeting. (from where a person could ascertain the internal irregularity). Thus, details of internal proceedings are not open to the public.

The gist of the rule is that persons dealing with limited liability companies are not bound to inquire into the regularity of the internal proceedings and will not be affected by irregularities of which they had no notice.

In Laxmi Ratan Cotton Mills Ltd. Vs. J. K. Jute Mills Co. Ltd (1957) 27 Comp. Case 660 (All) where the plaintiff sued the defendant company for a loan of 1,50,000 it was held that where the act done by a person, acting on behalf of the company is within the scope of his apparent authority. It binds company no matter whether the plaintiff has read the documents or not. In this case, the defendant company raised the place that the transaction was not bindings as no resolution sanctioning the loan was passed by the Board of Directors. The Court held, "A transaction entered into by the borrowing company cannot be defeated merely on the ground that no such resolution was in fact passed. The passing of such a resolution is a mere matter of indoor management and it cannot be used to defeat the just claim of a bonafide creditor".

**Exceptions to The Doctrine Indoor Management**

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

**(1) Knowledge of Irregularity:** Where a person dealing with the company has actual or constructive notice of the irregularity as regard internal management, he cannot claim the benefit under the rule of indoor management. The rule is based on common sense and any other rule would "encourage ignorance and condone dereliction of duty". In the case of Devi Dutta Mal Vs. Standard Bank of India, A.I.R. (1927) Lah, 797, a transfer of shares in a company was approved by two directors. One of these directors was not validity appointed. The other was disqualified by reason of transferor himself. These facts were known to the transferor. Held, the transfer was ineffective.

In another case of Maward Vs. Patent Ivory Co. (1888) 38 Ch. D. 156, the directors of a company could borrow any amount upto $ 1,000 without the approval of the shareholders in general meeting. But for any amount beyond $ 1,000 they had to obtain the consent of the shareholders in general meeting. The directors themselves lent to the company an amount in excess of borrowing powers of the company without the consent of the shareholders in general meeting. Held, the directors had the notice of the internal irregularity and hence the company was liable to pay only for $ 1,000.

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

In the case of Anand Bihari Lal Vs. Dinshaw & Co. A.I.R. (1942) Oudh 417, the plaintiff, in this case, accepted a transfer of company's property from its accountant. Held, the transfer was void as such a transaction was apparently beyond the scope of the accountant's authority.

**(3) Forgery:** Where the acts done in the name of company on the ground of forgery are void ab initio, the doctrine of indoor management does not apply. A company can never be held bound for forgeries committed by its officers. The leading case on the point is Ruben Vs. Great Fingall Consolidated Co. (1906) A.C. 439. The secretary of a company issued a share certificate under the company's seal with his own signature and the signature of a director forged by him. Held, the share certificate was no binding on the company. The person who advanced money on the strength of the certificate was not entitled to be registered as holder of the share.

**(4) No Knowledge of Articles:** A person should have knowledge of the Articles if he wants protection under the rule of 'indoor management'. The rule is based on the principle of estoppel and a person can be protected if he has relied on the Articles. As such if a person while entering into contract with a company has no knowledge of the company's Articles of Association, he cannot rely on those Articles as conferring ostensible or apparent authority on the agent of the company with whom he dealt. [Rama Corporation Vs. Proven Tin and General Investment Co. (1952) 2 Q.B. 1471].

## 5.4 CHECK YOUR PROGRESS

Fill in the blanks

1. The doctrine of indoor management is an ……. to the doctrine of constructive notice.
2. The doctrine of …….. does not apply to acts void ab initio.
3. Signature of memorandum and articles should be done by ……. number of person in public company.
4. Alteration of article must be done only by passing ………..
5. Signature of memorandum and articles should be done by …….. number of person in private company.

## 5.5 SUMMARY

Articles of association regulates the internal management of the affairs of the company by way of defining the powers of its officers and establishing a contact between the company and the members and between the members inter se. The articles of a company are subordinate to and subject to the memorandum of association. Therefore, any clause in the articles going beyond the memorandum will be ultra vires. The articles are only internal regulations, over which the members of the company have full control and may alter then according to what they think fit. Although a company has a statutory right to alter into articles of association yet the power to alter in subject to the provisions of Companies Act and to the conditions contained in Memorandum. The doctrine of constructive notice provides protection to the company against the outsiders. The principle of indoor management, on the other hand, operates to protect the outsiders against the company.

## 5.6 KEYWORDS

**Articles of Association:** A document containing rules and regulations and bye-laws for governing the internal affairs of a company.

**Doctrine of Constructive Notice:** A doctrine declaring that both Memorandum and Articles are public documents after being registered with the Registrar of Companies and everyone dealing with the company is deemed to have constructive notice of them.

**Doctrine of Indoor Management:** A doctrine declaring that the outsiders dealing with the company are entitled to presume that the internal formalities as required by the company's articles must have been observed by the management of the company.

## 5.7 SELF ASSESSMENT TEST

1. What are Articles of Association? How can they be altered?
2. What is the legal effect of the Articles of Association between:

   (a) Members and the company, (b) Members inter se (c) Company and outsiders.
3. What are the main point of distinction between the Memorandum of Association and Articles of Association?
4. "The power of altering Articles is wide yet it is subject to a large number of limitations." Explain.

5. Discuss the scope of the 'doctrine of indoor management'. To what extent has the doctrine been incorporated in the Companies Act, 2013?
6. "The doctrine of indoor management is silver lining to strangers dealing with a company." Comment.
7. "The doctrine of constructive notice relating to Memorandum and Articles of Association is not a positive doctrine but a negative one". Discuss.

## 5.8 ANSWERS TO CHECK YOUR PROGRESS

1. Extension
2. Indoor management
3. 7
4. Special Resolution
5. 2

## 5.9 REFERENCES/SUGGESTED READINGS


- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

# LESSON 6

# PROSPECTUS AND COMMENCEMENT OF BUSINESS

## STRUCTURE

6.0 Learning Objectives

6.1 Introduction

6.2 Meaning of Prospectus

6.2.1 Prospectus

6.2.2 Public Offer

6.2.3 Contents of Prospectus

6.2.4 Registration of Prospectus

6.2.5 Issue of Prospectus

6.2.6 Variations in terms of Contract or Objects

6.3 Types of Prospectus

6.3.1 Abridged Prospectus

6.3.2 Deemed Prospectus

6.3.3 Shelf Prospectus

6.3.4 Red Hearing Prospectus

6.4 Misstatement or Untrue Statement in Prospectus

6.5 Check Your Progress

6.6 Summary

6.7 Keywords

6.8 Self-Assessment Test

6.9 Answers to Check Your Progress

6.10 References/Suggested Readings

## 6.0 LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- Define public offer, prospectus, abridged prospectus.
- Explain the contents of prospectus.
- Highlight the provisions of registration and issue of prospectus.
- Outline the provisions of shelf prospectus and red hearing prospectus.
- Outline the effects of misstatement in prospectus.

## 6.1 INTRODUCTION

Every company requires capital for its business activities. Therefore, every company issues its securities. But the public and private companies cannot use almost the same ways or methods for issuing their securities. The ways/modes of issuing securities by both the classes of companies are briefly described in the ensuing paragraphs.

A public company may issue securities in any one or more of the following ways:

1. To public through prospectus, i.e., 'public offer.'
2. Through private placement.
3. Through a rights issue.
4. Through bonus issue, that is, issue of bonus securities.

It should be clearly noted that a listed company or a company that intends to get its securities listed on any recognized stock exchange can make an offer of its securities to the public. While making such an offer, the company shall comply with the provisions of the Securities and Exchange Board of India Act (SEBI Act), 1992 and the Rules and Regulations made thereunder for issue of securities [Sec. 23(1)].

A private company may issue securities by any one of or all the following ways:

1. Through private placement.
2. Through a rights issue.
3. Through a bonus issue, i.e., issue of bonus securities [Sec. 23(2)].

It is clear from the above description that there is only one difference in the ways of issuing securities by the two classes of companies. All the public companies can issue securities through a prospectus but no private company can do so. But all public companies as well as private companies can adopt any of the remaining methods for issue of their securities.

It also becomes clear that a private company is not entitled to issue its securities through prospectus or to the public. Hence, the provisions of the SEBI Act and the Rules and Regulations made thereunder do not apply to private companies.

# 6.2 MEANING OF PROSPECTUS

## 6.2.1 PROSPECTUS

Prospectus means any document described or issued as a prospectus and includes a red herring prospectus (referred to in Section 32) or shelf prospectus (referred to in Section 31) or any notice, circular, advertisement, or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate [Sec. 2(70)].

In simple words, a prospectus is any document that is described or issued as a prospectus by a body corporate for inviting offers from public for subscription or purchase of its securities. It may be noted that the term prospectus include a red herring prospectus, shelf-prospectus, and any notice, circular, advertisement, or other document if it is described or issued as a prospectus. It is issued by a body corporate for inviting offers from public for the subscription or purchase of its securities.

**Characteristics/Features**

The main characteristics or features of a prospectus are as follows:

1. A prospectus is a document which is described or issued as prospectus by a company.
2. A prospectus. includes any red herring prospectus, shelf prospectus, notice, circular, advertisement, or any other document that is issued as prospectus.
3. It may be issued only by public companies. Private companies cannot issue prospectus.
4. It is issued as an invitation to the public by a public company for inviting offers from the public for the subscription or purchase of its securities.

5. A prospectus is a document in writing. It cannot be oral. An oral invitation to the public is not deemed to be a prospectus. Television and film advertisements cannot be treated as prospectus.
6. The date indicated in the prospectus shall be the deemed date of its publication.
7. Every prospectus issued must contain the matters and set out all the reports specified by the provisions of the Companies Act [Sec. 26].
8. A prospectus is signed by the directors or proposed directors and other persons of the company who authorize it to be issued [Sec. 26].
9. A prospectus can be issued to the public only after its registration with the Registrar.
10. The provisions relating to prospectus by a listed company and public company, which intends to get its shares listed on any stock exchange, are administered by SEBI [Sec. 24(1)].

**Who can issue prospectus?**

Prospectus may be issued by any of the following:

1. By a public company.
2. By any person on behalf of the public company.
3. By any person who is or who has been engaged or interested in the formation of a company.
4. By any person on behalf of a person who is or who has been engaged or interested in the formation of a public company [Sec. 26(1)].
5. A deemed prospectus may be issued by the person or the company to whom a company allots or agrees to allot securities with a view to the same securities being offered for sale to the public [Sec. 25].

**When issue of prospectus not needed?**

Issue of prospectus or abridged prospectus is not necessary in the following cases:

1. Where the securities of a public company are not offered to the public [Sec. 23]. This will be the case when the public company issues its securities through private placement offer letter [Sec. 42].
2. Where the securities are offered to the existing members of the company with or without the right of renunciation in favour of any other person.

3. Where the securities offered are uniform in all respects with securities previously issued and dealt in or quoted on a recognized stock exchange [Sec. 26(2)].

4. Where a bona fide invitation is made to a person to enter into an underwriting agreement with respect to the securities [Sec. 33].

   It should be noted that a private company cannot issue a prospectus.

## 6.2.2 PUBLIC OFFER

Public offer of securities means an offer of securities made to the public through a prospectus. The expression 'public offer' is quite comprehensive and it includes the following kinds of offers:

1. Initial public offer (IPO).
2. Further or follow up public offer (FPO). Both these public offers are made through the prospectus.
3. Offer for sale of securities to the public by an existing shareholder. Such offer is also made through issue of a prospectus. It may be both the initial public offer (IPO) and further or follow up public offer or FPO.

**1. Initial Public Offer (IPO):** When an unlisted company makes either a fresh issue of shares or company's promoters offer their holding of shares for sale or both for the first time to the public, it is called an IPO. This paves way for listing and trading of the company's securities in the stock exchanges. Thus, IPO means any of the following:

   (a) Issue of shares for the first time to the public by an unlisted company.

   (b) Offer of sale of shares for the first time by the promoters of a company out of their holding of shares.

**2. Further or Follow on Public Offer (FPO):** When an already listed company makes either a fresh issue of shares to the public or when promoters of a listed company make an offer for sale of their shareholding to the public, after an IPO, it is called a FPO. Thus, further public offer means any of the following:

   (a) Fresh issue of securities by a listed company at any time after an IPO to the public.

   (b) Offer of sale of securities by the promoters of a listed company out of their holding at any time after an IPO.

In case of any public issue of shares, an offer document is issued to the public, which is known as the prospectus. It is the document containing all the relevant information about the company, promoters, projects, financial details, objects of raising the money, terms of the issue, etc. It is used for inviting public for subscription for securities of a company being offered by the issuer.

Whenever a promoter or a member makes an offer for sale of his holding of securities, he is also required to issue a document for inviting public for subscription of securities of the company. Such a document is called the ‘offer for sale,’ which is ‘deemed to be a prospectus’ in legal terms. Legal experts sometimes call it a ‘prospectus by implication’.

### 6.2.3 CONTENTS OF PROSPECTUS

The Companies Act, 2013 does not contain any model prospectus. It only prescribes the contents of a prospectus. It also states that a prospectus shall also contain the matters as may be prescribed. According to the provisions of Companies Act and the Rules made thereunder, a prospectus to be issued shall contain the particulars with respect to the following matters:

I. **Date:** Every prospectus shall be dated. The date indicated in the prospectus shall be deemed to be the date of its publication.

2. **Signature:** Every prospectus shall be signed by all persons named therein as directors or proposed directors of the company or by his duly authorized agent.

3. **Information:** Every prospectus issued by a company or on behalf of a company shall contain the following information:

(a) Names and addresses of the registered office of the company, company secretary, chief financial officer, auditors, legal advisors, bankers, trustees, if any, underwriters and such other persons as may be prescribed.

(b) Dates of opening and closing of the issue.

(c) Declaration about the issue of allotment letters and refunds within the prescribed time. The Rules notified by Ministry of Corporate Affairs (MCA) prescribe that the declaration shall be made by the Board or the Committee authorized by the Board in the prospectus that the allotment letters shall be issued or application money shall be refunded within 15 days from the closure of the issue or such lesser time as may be specified by SEBI. In case of failure to do so, the application money shall be refunded to the applicants forthwith. If the money still remains unpaid, the company shall be liable to pay interest to the applicants at the rate of 15 per cent per annum for the delayed period.

(d) A statement by the Board of directors about the separate bank account with a scheduled bank. This statement shall include that all monies received out of the issue are to be transferred to this account. Moreover, disclosure of details of all monies including utilized and unutilized monies out of the previous issue shall be made in the prescribed manner.

(e) Details about underwriting of the issue. The Rules notified by MCA prescribe that the names, addresses, telephone numbers, fax numbers, and e-mail addresses of the underwriters and the amount underwritten by them shall be stated in the prospectus.

(f) Consent of the directors, auditors, bankers to the issue, expert’s opinion, if any and of such other persons, as may be prescribed. The Rules notified by MCA also prescribe that the prospectus shall contain the consent of trustees, solicitors or advocates, merchant bankers to the issue, registrar to the issue, lenders, and experts.

(g) The authority for the issue and the details of the resolution passed therefore.

(h) Procedure and time schedule for allotment and issue of securities.

(i) Capital structure of the company in the prescribed manner.

(j) Main objects of public offer, terms of the present issue and such other particulars as may be prescribed [Sec. 26(1) (a)].

(k) Main objects and present business of the company and its location, schedule of implementation of the project [Sec. 26(1) (a)].

(1) Minimum subscription, amount payable by way of premium, issue of shares otherwise than on cash [Sec. 26(1) (a)].

(m) Details of directors including their appointments and remuneration, and such particulars as to the nature and extent of their interests in the company as may be prescribed [Sec. 26(1) (a) and Rule PAS-3 (5)].

(n) Disclosures in such manner as may be prescribed about sources of promoter’s contribution [Sec. 26(1) (a) and Rule PAS-3 (6)].

4. **Particulars of Project:** The prospectus shall also contain the following particulars relating to the project:

   (a) Management perception of risk factors specific to the project.

   (b) Gestation period of the project.

   (c) Extent of progress made in the project.

   (d) Deadlines for completion of the project.

5. **Particulars of Litigation:** The prospectus shall also contain the particulars relating to any litigation or legal action [Sec. 26(1) (a) and Rule PAS-3(4)].

6. **Reports:** Every prospectus shall also set out the following reports for the purposes of the financial information:

(a) Reports by the auditors of the company with respect to its profits and losses and assets and liabilities and such other matters as may be prescribed.

(b) Reports relating to profits and losses for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding the financial year of the issue of prospectus. Such reports shall also include such reports of its subsidiaries. The reports shall be in such a manner as may be prescribed.

(c) Reports made in the prescribed manner by the auditors (i) upon the profits and losses of the business of the company for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding the issue and (ii) assets and liabilities of its business on the last date to which the accounts of the business not exceeding 180 days before the issue of the prospectus.

(iv) Reports about the business or transaction to which the proceeds of the securities are to be applied directly or indirectly [Sec. 26(1)(b)].

7. **Declaration:** Prospectus shall also include a declaration made about the compliance of the provisions of this Act. This apart, a statement shall also be included in it to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation) Act, and the SEBI Act and the rules and regulations made thereunder [Sec. 26(1) (c)].

8. **Any Other Matters:** A prospectus shall also state such other matters and set out such other reports, as may be prescribed [Sec. 26(1) (d)].

**Other Contents**

Certain other matters including the following shall also be included in the prospectus:

1. **Additional Matters to be Stated in the Document Issued by Issue House:** The offer for sale by an issue house shall state the following additional particulars:

   (i) The net amount of the consideration received or to be received by the company in respect of the securities to which the offer relates.

   (ii) The time and place at which the contract under which the said securities have been or are to be allotted may be inspected [Sec. 25(3)].

2. **Matters to be Stated on the Face of the Prospectus:** Every prospectus issued shall contain on its face the following matters:

   (a) That a copy has been delivered for registration to the Registrar.

   (b) Specify any documents required by this Section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents [Sec. 26(6)].

3. **Reproduction of Provisions Relating to Personation for Acquisition of Securities:** The provisions relating to personation for acquisition etc. of securities shall be prominently reproduced in every prospectus issued by company and in every form of application for securities [Sec. 38].

**Conditions for Inclusion of Expert's Certificate**

A prospectus issued shall include a statement purporting to be made by an expert subject to the following conditions:

(i) The expert shall not be the person who is and has been engaged, or interested in the formation or promotion or management of the company.

(ii) He has given his written consent to the issue of the prospectus and has not withdrawn such consent before the delivery of a copy of the prospectus to the Registrar for registration.

(iii) A statement of the above fact (consent) has been included in the prospectus [Sec. 26(5)].

**Punishment for Non-Inclusion of Contents in Prospectus**

If a prospectus is issued in contravention of the provisions relating to contents of prospectus [Section 26], the following shall be punished:

**(i) The Company:** The company shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh.

**(ii) Every Person who is Party to the Issue:** Every person who is knowingly a party to the issue of such prospectus shall be punishable with imprisonment for a term which may extend to 3 years or with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh, or with both [Sec. 26(9)].

**Advertisement of Prospectus**

Sometimes, an advertisement of any prospectus of a company is published in any manner. But it shall be necessary to specify therein the contents of its memorandum as regards to the following:

(i) The objects.

(ii) The liability of members.

(iii) The amount of share capital of the company.

(iv) The names of the signatories to the memorandum.

(v) The number of shares subscribed by signatories.

(vi) The capital structure of the company [Sec. 30].

**Application of Provisions to Every Prospectus and Application Form**

The above stated provisions as to contents of prospectus shall apply to a prospectus or a form of application, whether issued on or with reference to the formation of a company or subsequently [Sec. 26(3)].

**Exceptions/Exemptions**

None of the above provisions as to content of a prospectus shall apply in the following cases:

(a) To issue to existing members or debenture-holders of a company. It shall be immaterial whether an applicant has a right to renounce the shares or not in favour of any other person.

(b) To issue a prospectus or form of application relating to shares or debentures which are, or are to be, in all respects uniform with shares or debentures previously issued and for the time being dealt in or quoted on a recognized stock exchange [Sec. 26(2)].

## 6.2.4 REGISTRATION OF PROSPECTUS

A prospectus can be issued only after its registration. The main provisions with respect to registration of prospectus are as follows:

1. **Preparing Prospectus:** A prospectus needs to be prepared for its registration. It should contain all the matters specified by Section 26 and the Rules made thereunder. In addition, it should set out the following documents, reports, and declaration:

   (i) Consent of directors, auditors, and bankers to the issue and other specified persons.

   (ii) Reports by the auditors of the company with respect to its profits and losses and assets and liabilities and such other prescribed matters.

   (iii) Reports relating to profits and losses for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries.

   (iv) Reports by the auditors upon the profits and losses of the business of the company for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding issue and assets and liabilities of its business on the last date to which the accounts of the business were made up.

   (v) A declaration to the effect that the provisions of this Act have been complied with.

   (vi) A statement to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation) Act, and the SEBI Act and the rules and regulations made thereunder.

2. **Dating of Prospectus:** A prospectus should be dated. The date indicated in the prospectus shall be taken as the date of publication of prospectus.

3. **Signing of Prospectus:** The copy of the prospectus which is to be delivered for registration must be signed by every person who is named therein as a director or proposed director of the company. Alternatively, it may be signed by his duly authorized agent in writing [Sec.26].

4. **Approval by Various Agencies:** As per the rules and regulations of SEBI, the draft prospectus has to be approved by the following agencies/authorities:

   (i) The lead manager to the issue.

   (ii) Each of the stock exchanges where the securities of the company are listed or proposed to be listed.

   (iii) The lead financial institution underwriting the issue.

5. **Vetting by SEBI:** A prospectus is vetted by SEBI to ensure adequacy of disclosures. As per the directions of the MCA, the Registrar shall not register a prospectus before it is vetted by SEBI. After vetting, if SEBI is satisfied, it shall certify that the contents of the prospectus are not in contravention of any law or rules and regulations. However, SEBI does not take any responsibility to the correctness of statements made or opinions expressed in the prospectus.

6. **Delivery to the Registrar:** The next step is the delivery of the prospectus along with all documents, approvals, and vetting certificate to the Registrar for its registration. It should be delivered to the Registrar on or before the date of its publication [Sec. 26].

7. **Registration of Prospectus:** The Registrar shall register the prospectus if all the formalities required for registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus. The registration shall be done on or before the date of its publication [Sec. 26].

## 6.2.5 ISSUES OF PROSPECTUS

The main provisions with respect to the issue of prospectus to public are as follows:

1. **Issue Only after Registration:** No prospectus shall be issued to the public unless it is duly registered by the Registrar. Therefore, only duly registered prospectus must be issued [Sec. 26(4)].

2. **Matters to be Stated on the Face of Prospectus:** Every prospectus issued shall contain on its face the following matters:

(a) That a copy of it has been delivered for registration to the Registrar.

(b) Specify any documents required by this Section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents [Sec. 26(6)].

3. **Issue of Prospectus within 90 Days:** The prospectus must be issued within 90 days of the date on which a copy thereof is delivered to the Registrar. If a prospectus is issued after 90 days of the date of registration, it shall not be a valid prospectus [Sec. 26(8)].

4. **Penalty for Issue of Prospectus in Contravention of These Provisions:** If a prospectus is issued in contravention of the above provisions, the company shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh. Moreover, every person who is knowingly a party to the issue of such prospectus shl1 be punishable with imprisonment for a term which may extend to 3 years or with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh or with both [Sec. 26(9)].

5. **Furnishing a Copy of the Prospectus on Request:** Where a request for a copy of the prospectus is made by any person, it shall be furnished to him before the closing of the subscription list and offer. If a company makes any default in complying with this provision, it shall be liable to a penalty of ` 50,000 for each default [Sec. 33].

## 6.2.6 VARIATION IN TERMS OF CONTRACT OR OBJECTS

Sometimes, a company, which has raised money from public through prospectus, still has any unutilized amount out of the money so raised. If such a company intends to alter or vary the terms of contracts referred to in the prospectus or objects for which the prospectus was issued, it can do so if it satisfies the following conditions:

**1. Special Resolution:** The company shall pass a special resolution through postal ballot for effecting such variation change. The notice of the proposed special resolution through postal ballot shall contain the following particulars:

(a) The original purpose or object of the issue.

(b) The total money raised.

(c) The money utilized for the objects of the company stated in the prospectus.

(d) The extent of achievement of proposed objects (that is 50 per cent, 60 per cent, etc).

(e) The unutilized amount out of the money so raised through the prospectus.

(f) The particulars of the proposed variation in terms of contracts referred to in the prospectus or objects for which prospectus was issued.

(g) The reason and justification for seeking variation.

(h) The proposed time limit within which the proposed varied objects would be achieved.

(i) The clause-wise details as were required with respect to the originally proposed objects of the issue.

(j) The risk factors pertaining to the new objects.

(k) The other relevant information which is necessary for the members to take an informed decision on the proposed resolution.

2. **Publication of Notice of Resolution:** The company shall publish an advertisement of the notice in respect of such resolution to shareholders. It shall also be published in Form No. PAS- 1 in the newspapers (one in English and one in vernacular language) circulating in the city where the registered office of the company is situated. It shall be indicating clearly the justification for such variation. Such advertisement shall be published simultaneously with dispatch of postal ballot notices to shareholders [Sec. 27 and Rule PAS-7(2)].

   The notice shall also be placed on the website of the company, if any.

3. **Opportunity to Exit to the Dissenting Shareholders:** The promoters and shareholders having control on the company shall give an opportunity to the dissenting shareholders to the resolution to exit from the securities in which they have invested their money. The exit offer shall be given at such price, and in such manner and conditions as may be specified by the SEBI [Sec. 27].

# 6.3 TYPES OF PROSPECTUS

## 6.3.1 ABRIDGED PROSPECTUS

An abridged prospectus means a memorandum containing such salient features of a prospectus as may be specified by the SEBI by making regulations in this behalf [Sec. 2(1)].

**Application Form to be Accompanied by Abridged Prospectus:** No form of application for the purchase of any of securities of a company shall be issued unless such form is accompanied by an abridged prospectus [Sec. 33(1)].

**Exceptions:** But no one shall be required to issue a copy of the abridged prospectus with the form of application in the following cases:

(i) Where the form is issued in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to such securities.

(ii) Where it is issued in relation to securities which were not offered to the public [Sec. 33].

**Copy of Prospectus on Request:** A copy of the prospectus shall, on a request being made by any person before the closing of the subscription list and the offer, be furnished to him [Sec. 33(2)]

**Penalty:** If a company makes any default in complying with this provision it shall be liable to a penalty of ` 50000 for each default [Sec. 33].

The SEBI Regulations make it clear that the Lead Merchant Banker is responsible for compliance with the provisions in respect of the abridged prospectus.

## 6.3.2 DEEMED PROSPECTUS

Now-a-days, it is a common practice that the securities of a company are allotted or agreed to be allotted to some intermediary known as the 'issuing house.' The issuing house, in turn, is required to offer all or any of these securities to the public by means of some document. Such a document issued by an issuing house is known as offer for sale of securities. For all purposes it shall be and deemed to be a prospectus issued by the company. The provisions relating to offer for sale of securities by an issuing house are summarized here.

**1. Deemed Prospectus:** Sometimes, a company allots or agrees to allot any securities of the company to another company or firm with a view to all or any of those securities being offered for sale to the public. In such a case, any document by which such offer for sale is made by that another company or firm shall be and deemed to be a prospectus issued by the company.

Since, the offer document issued by another company or firm is a deemed prospectus, it shall have the following consequences:

(i) All the provisions with respect to contents of the prospectus shall apply to the document.

(ii) The provisions as to registration and issue of prospectus shall also apply to this document.

(iii) Any misstatement in the document or omission of any material fact from the document shall have the same effect as in case of a prospectus.

(iv) The liability of the persons authorizing the issue of a false or misleading document to the subscribers of securities shall be the same as that of the persons authorizing the issue of such prospectus [Sec. 25(1)].

**2. Presumption of Intention to Offer Securities to the Public:** Generally, the agreement with the issuing house contains the clauses that securities shall be offered to the public. But in the absence of any express provision in the agreement, the intention to offer securities to the public shall be presumed in the following cases unless the contrary is proved:

(i) If the offer of the securities or any of them for sale to the public (by issuing house) is made within six months of allotment or agreement to allot (to the issuing house) the securities.

(ii) If at the date of offer (by issuing house) to the public, the whole consideration to be received by the company in respect of the securities has not been received by it [Sec. 25(2)].

**3. Additional Matters to be Stated:** The offer for sale must state all the matters and set out all the reports as specified by Section 26. Besides these, the following additional particulars should be stated in the offer for sale:

(i) The net amount of the consideration received or to be received by the company in respect of the securities to which the offer relates.

(ii) The time and place at which the contract under which the said securities have been or are to be allotted may be inspected [Sec. 25(3)).

**4. Persons Offering to be Named in the Prospectus as Directors:** The persons making the offer shall be named in the prospectus as directors of the company [Sec. 25(3)].

**5. Signing of Offer for Sale:** Where a person making an offer (i.e., issuing house) is a company, it shall be sufficient if the offer document is signed on behalf of the company by two directors of the company or if it is a firm, it is signed on behalf of the firm by not less than one-half of the partners in the firm [Sec. 25(4)].

### 6.3.3 SHELF PROSPECTUS

The provisions of shelf prospectus have been incorporated in the Act for the convenience of certain class or classes of companies such as the public financial institutions, public sector banks, or scheduled banks. With the introduction of the provisions of shelf prospectus, they will not be required to prepare prospectus for every issue of securities and file it with the Registrar. This will save a lot of money and time required for complying with many formalities.

'Shelf prospectus' means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus [Explanation to Sec. 31].

**Provisions Regarding Shelf Prospectus**

The provisions with respect to shelf prospectus are as follows:

1. **Any Class of Companies to File:** Any class or classes of companies may file a shelf prospectus with the Registrar at the stage of the first offer of securities. The SEBI has been authorized to make regulations for preparing and filing a shelf prospectus.
2. **Validity Period:** The shelf prospectus shall indicate a period not exceeding one year as the period of validity of such prospectus. The period of validity shall commence from the date of opening of the first offer of securities under that prospectus.
3. **No Need to File Again during the Validity Period:** A company filing a shelf prospectus shall not be required to file a further prospectus in respect of a second or subsequent offer of such securities issued during the period of validity of that prospectus [Sec. 31(1)].
4. **Filing of an Information Memorandum:** A company filing a shelf prospectus shall be required to file an information memorandum containing the following information:
   (i) All material facts relating to new charges created.
   (ii) Changes in the financial position as have occurred between the first offer of securities or the previous offer of securities and the succeeding offer of securities.
   (iii) Such other changes as may be prescribed.

5. **Time of Filing Information Memorandum:** The information memorandum shall be filed within the prescribed time, prior to the issue of a second or subsequent offer of securities under the shelf prospectus. [Sec. 31(2)].

6. **Applications for Securities Received before Making Such Changes:** Sometimes, a company may receive applications for the allotment of securities along with advance payments of subscription before the making of any such change through information memorandum. In such a case, the company shall intimate the changes to such applicants. If they express a desire to withdraw their application, the company shall refund all the monies received as subscription within 15 days thereof [Sec. 31(2)].

7. **Information Memorandum and Shelf Prospectus to be Deemed Prospectus:** An information memorandum is filed at the time of making every offer of securities. Such memorandum together with the shelf prospectus shall be deemed to be a prospectus [Sec.31(3)].

## 6.3.4 RED HERRING PROSPECTUS

In the recent years, the issue of securities to the public is being made through the process of book building. In this process, the issuer company may file a red herring prospectus with the Registrar.

Red herring prospectus means a prospectus which does not have complete particulars on the quantum or price of the securities offered and the quantum of securities included therein [Sec. 32].

**Provisions Regarding Red Herring Prospectus**

The main provisions with respect to the red herring prospectus are as follows:

1. **Issue Prior to the Issue of Prospectus:** A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus [Sec. 32(1)].

2. **Filing with the Registrar:** A company proposing to issue a red herring prospectus shall file it with the Registrar at least three days prior to the opening of the subscription list and the offer [Sec. 32(2)].

3. **Same Obligations as are Applicable to Prospectus:** A red herring prospectus shall carry the same obligations as are applicable to a prospectus.

4. **Highlighting the Variations in Prospectus:** Every company shall highlight the variations if any variation between the red herring prospectus and a prospectus as variations in the prospectus [Sec. 32(3)].

5. **Filing of Prospectus with the Registrar and SEBI:** Upon the closing of the offer of securities, a prospectus shall be filed with the Registrar and the SEBI. The prospectus shall state therein the following information:

   (i) The total capital raised whether by way of debt or share capital.

   (ii) The closing price of the securities.

   (iii) Any other details as are not included in the red herring prospectus [Sec. 32].

**The Golden Rule for Framing Prospectus**

A prospectus is a document issued by a company inviting offers from the public for subscription of shares or debentures. Thus, it is a very important document. It may have far-reaching effects on the goodwill of the company as well as the relation between the company and its members. Such a document, therefore, must be complete and accurate in every respect and must not conceal or omit any material fact. In short, the 'golden rule' as to the framing of prospectus must be observed.

The 'golden rule' was enunciated by Kindersely, VC in New Brunswick etc. Co v. Muggeridge (1860) 3 LT 651. This was described as the golden legacy. The rule may be summed up in the following words:

Those who issue a prospectus hold out to the public are of great significance to the persons who will subscribe securities of the company. Public is invited to subscribe securities on the faith of representation made in the prospectus. The company and the persons who authorize the issue of a prospectus are therefore bound to state everything with strict accuracy. They must not omit any material fact within their knowledge which may adversely affect the nature, extent, or quality of the privileges and advantages which the prospectus assures to the subscribers.

## 6.4 MISSTATEMENT OR UNTRUE STATEMENT IN PROSPECTUS

A misstatement or an untrue or false statement is one which is misleading in the form and context in which it has been included in a prospectus. A prospectus shall also be deemed to have untrue statement or deemed to be misleading if any matter is omitted from it which should have been included in it. In simple words, a prospectus is said to be a 'misleading prospectus' in the following cases:

(i) Where a prospectus includes a statement which is untrue in the form and context in which it is included.

(ii) Where a prospectus omits any matter which is calculated to mislead those who act on the faith of the prospectus [Sec. 34].

**Remedies or Consequences of Misleading Prospectus**

If a prospectus issued by a company contains false or misstatement or omits to include any material fact in it, it is said to be a misleading prospectus. In case a company issues such a misleading prospectus and the subscribers acting on the faith of such prospectus subscribe for the securities of the company, it will give rise to many consequences. The aggrieved subscribers acting on the faith of such prospectus shall have remedies against the following entities:

A. Remedies against the company.

B. Remedies against the directors, promoters, experts etc.

**A. Remedies against the Company**

A company has civil liabilities towards the subscribers, who subscribed for securities of a company acting on the faith of its misleading prospectus. Therefore, aggrieved subscribers are entitled to the following remedies against the company:

1. Rescission of contract.

2. Compensation for damages.

**1. Rescission of the Contract:** A person who subscribes for securities on the faith of a misleading prospectus may apply for the rescission of the contract. On rescission, the subscriber returns the securities allotted to him and gets his money back with interest.

The aggrieved subscriber can exercise the right or remedy to rescind the contract, if the following conditions are satisfied:

(i) The prospectus must have been issued by the company or by someone on behalf of the company.

(ii) There must be an untrue or misleading statement in the prospectus or omission of a material fact from the prospectus. For instance, the prospectus of a company stated that it had paid dividends during the five years of economic depression. But it was not disclosed that the dividends were paid out of the realized capital profits whereas there were considerable trading losses during those years. The Court held that the prospectus was false in material particulars

(iii) The misstatement must relate to the material fact. The fact should not be of law. Even it should not be an expression of opinion. For instance, a prospectus of a company stated that two leading businessmen of repute have agreed to become directors of the company. In fact, they had only expressed their willingness to help the company. The Court held that the prospectus contained misstatement of fact and subscribers could rescind the contract.

(iv) The subscriber must have relied and acted on the misstatement in the prospectus. It must have induced him to subscribe for shares. If a person subscribes for securities of a company without reading its prospectus, he is not entitled to rescind the contract.

(v) The right of rescission is available to the original allottees of securities. If a person buys shares in the open market, he has no remedy against the company even though he might have bought relying on the prospectus.

(vi) The right of rescission must be exercised within a reasonable time, before any proceedings to wind up the company have been commenced.

**Loss of right of rescission:** The right of rescission of contract is lost in the following circumstances:

(i) If the subscriber affirms or adopts the contract for purchase of shares. For instance, if the subscriber attempts to sell the shares allotted, receives dividends, pays calls or attends general meeting; he is said to have affirmed the contract.

(ii) If the subscriber fails to exercise his right of rescission within a reasonable time after becoming aware of the misstatement in the prospectus. In a case, an applicant became aware of misstatement in prospectus in July. But he applied for rescission of the contract in December. The Court held that the unexplained delay of five months debars him from obtaining relief.

(iii) If the right of rescission is not exercised before the commencement of proceedings of winding up of the company. But where a subscriber has started proceedings for rescission of the contract of shares, the passing of the winding up order would not prevent him getting the relief.

(iv) When the restitution or restoring the original position of the parties becomes impossible.

(v) Where the misrepresentation is of law and not of facts. For example, a prospectus states that the shares shall be issued at a discount of 25 per cent. It is a misrepresentation of law because no company can issue shares at a discount [Sec. 53].

(vi) When the subscriber misreads the prospectus.

**2. Compensation for Damages:** Another remedy available to every aggrieved subscriber is to claim compensation for damages or loss sustained by him. For availing this remedy, the aggrieved subscribers will have to prove the following facts:

(i) That he acted on the misleading prospectus and subscribed for securities of the company.

(ii) That the prospectus was issued by the company or someone on behalf of the company.

(iii) That he has actually sustained/suffered a loss or damage due to such misleading prospectus.

(iv) That he has rescinded the contract for the purchase of securities, that is, he has returned the securities allotted by the company [Sec. 35(1)].

Thus, the right to claim compensation is available only when an aggrieved subscriber rescinds the contract for purchase of securities. He cannot retain the securities as well as claim the compensation of damages. He will have to rescind the contract before he can claim the compensation.

**B. Remedies against the Directors, Promoters, Experts etc.**

The Act lists the persons who are liable for misleading prospectus. They are as follows:

(a) Every person who is a director of the company at the time of the issue of the prospectus.

(b) Every person who has authorized himself to be named and is named in the prospectus as a director of the company or has agreed to become such director.

(c) Every person who is a promoter of the company.

(d) Every person who has authorized the issue of the prospectus.

(e) Every person who is an expert and who is or has been engaged and interested in the formation, promotion, Or management of the company [Sec. 35(1)].

The liability of directors, promoters, experts etc. may be classified under the following two heads:

1. Civil liability.

2. Criminal liability.

**Civil Liability:** The directors, promoters, experts etc., (listed above) of the company shall have civil liability towards every person who subscribed for securities acting on the misleading prospectus. In other words, every aggrieved subscriber has the following remedies against the directors etc.:

1. Damages for misstatement and omission [Sec. 35(1)].

2. Unlimited personal liability for fraudulent prospectus [Sec. 3 5(2)].

**1. Damages for Misstatement or Omission:** Every aggrieved subscriber for securities of the company acting on any misleading prospectus (i.e. any misstatement included in the prospectus or omission of any matter from the prospectus) shall be entitled to hold liable every director, promoter, experts etc., (all listed above) to pay the compensation for any loss or damage sustained by him. To claim damages, the subscriber shall be required to prove the following facts:

(i) That he subscribed for the securities of the company acting on the misleading prospectus.

(ii) That he has suffered loss or damage due to such subscription [Sec. 35(1)].

**Defences Available:** No person shall be liable to pay compensation if he proves the following facts:

**(i)** **Withdrew Consent before Issue:** A director will not be liable, if he proves that he withdrew the consent to become director before the issue of the prospectus and the prospectus was issued without his authority or consent.

**(ii)** **Issued without Knowledge or Consent:** No person shall be liable, if he proves that the prospectus was issued without his knowledge or consent and on becoming aware its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent [Sec. 35(2)]

**2. Unlimited Personal Liability for Fraudulent Prospectus:** Sometimes, it is proved that a prospectus was issued with intent to defraud the applicants for the securities or any other person or for any fraudulent purpose. In such a case, every person who is director, promoter, expert, etc. shall be personally responsible without any limitation of liability. They shall be liable without any limit for all or any of the losses or damages that may have been sustained by any person who subscribed to the securities on the basis of such prospectus [Sec. 35(3)].

**Criminal Liability:** The criminal liability for a misleading prospectus is as follows:

**Liability/Punishment for Misstatement or Untrue Statement in Prospectus:** Where a misleading prospectus is issued, circulated, or distributed, every person who authorizes the issue of such prospectus shall be liable under Section 447 [Sec. 34].

According to Section 447, any person who is found to be guilty of fraud shall be punishable with imprisonment for a term which shall not be less than 6 months but which may extend to 10 years. This apart, he shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

Where the fraud in question involves public interest, the term of imprisonment shall not be less than 3 years [Sec. 447].

**Defences Available:** A person shall not be held liable under Section 447, if he proves any of the following facts:

(i) That such statement or omission was immaterial.

(ii) That he had reasonable grounds to believe and did up to the time of issue of the prospectus believe that the statement was true.

(iii) That he had reasonable grounds to believe that the inclusion or omission of any matter was necessary [Proviso to Sec. 34].

**OTHER IMPORTANT PROVISIONS**

**1. Entities Entitled to Take Action/Remedies:** The Act lists entities that are entitled to take action or claim remedies [under Sections 34, 35, and 36] against the company or every person liable for issue, circulation, and distribution of misleading or fraudulent prospectus. Any of the following entities affected by any misleading statement or the inclusion or omission of any matter in the prospectus are entitled to file a suit or take any other action:

(a) Any group of persons.

(b) Any association of persons [Sec. 37].

(c) Any person.

**2. Punishment for Fraudulently Inducing Persons to Invest Money:** Sometimes, a person either knowingly or recklessly makes any statement, promise, or forecast which is false, deceptive, or misleading, or deliberately conceals any material facts. If he does so with a view to induce another person to enter into, or to offer to enter into any of the following agreements, he shall be liable for action under Section 447:

(a) Any agreement for acquiring, disposing of, subscribing for, or underwriting of securities.

(b) Any agreement (the purpose or the pretended purpose of which is) to secure a profit for any of the parties from the yield of securities or by reference to fluctuations in the value of securities.

(c) Any agreement for or to obtaining credit facilities from any bank or financial institution [Sec. 36].

**3. Punishment for Personation for Acquisition, etc. of Securities:** Any person who

(a) makes or abets making of an application in a fictitious name to a company for acquiring, or subscribing for, its securities; or

(b) makes or abets making of multiple applications to a company in different names or in different combinations of his name or surname for acquiring or subscribing for its securities; or

(c) otherwise induces directly or indirectly a company to allot or register any transfer of, securities to him, or to any other person in a fictitious name shall be liable for action under Section 447.

**Reproduction in Prospectus:** The above provisions of shall be prominently reproduced in every prospectus issued by a company and in every form of application for securities.

**Disgorgement of Gain:** Where a person has been convicted under this Section, the Court may also order disgorgement of gain, if any, made by, and seizure and disposal of the securities in possession of such person. The amount received through disgorgement or disposal of securities shall be credited to the Investor Education and Protection Fund [Sec. 38].

## 6.5 CHECK YOUR PROGRESS

Fill in the blanks

1. ……. are the prospectus issued instead of full prospectus.

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

3. A company proposing to make an offer of securities may issue a ……… prior to the issue of a prospectus.

4. A document by which offer for sale of securities is made by a member of a company to the public is known as ……….. .

5. ………… is a document inviting deposits or offers from the public for the subscription of its securities.

## 6.6 SUMMARY

A prospectus is a document inviting deposits or offers from public for the subscription of its shares and debentures. Companies Act, 2013 does not contain any model prospectus but it only prescribes the contents of a prospectus. A prospectus can be issued only after its registration. If a company intends to alter or vary the terms of contract referred to in the prospectus or objects for which the prospectus was issued, it can do so if it has passed a special resolution, publish an advertisement of the notice in respect of such resolution and opportunity to exit to the dissenting shareholders has been given. A person who has been induced to subscribe the shares on the faith of misstatement made in a prospectus can sue the company, the directors and the promoters and experts, if any. Every company is entitled to commence its business as soon as it obtains its certificate of incorporation.

## 6.7 KEYWORDS

**Prospectus:** It is a document inviting deposits or offers from the public for the subscription of its securities.

**Red Hearing Prospectus:** A prospectus which does not include complete particulars of the quantum or price of the securities included therein.

**Public offer:** An offer of securities made to the public through a prospectus.

**Deemed Prospectus:** A document by which offer for sale of securities is made by a member of a company to the public.

## 6.8 SELF ASSESSMENT TEST

1. What do you understand by prospectus of a company? What particulars are given in a company prospectus? Explain.
2. What is a prospectus? Is the issue of a prospectus obligatory for a public company? Discuss the consequences of misstatement in a prospectus.

3. 'It is not compulsory for a public company to issue a prospectus, while a private company is even not permitted to issue it.' Explain this statement. What are the consequences of misstatement in prospectus?

4. Discuss the consequences of omission, misrepresentation, and fraud in connection with prospectus of a company. Also narrate the circumstances under which a director may be absolved from the liability.

5. Clearly explain the provisions relating to the registration and issue of a prospectus.

## 6.9 ANSWERS TO CHECK YOUR PROGRESS

1. Abridged
2. Red Herring
3. Red Herring Prospectus
4. Deemed Prospectus
5. Prospectus

## 6.10 REFERENCES/SUGGESTED READINGS


- Avtar Singh, Company Law, Eastern Book Company, Lucknow.
- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
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- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

**LESSON 7**

# PROCEDURE FOR ALLOTMENT, TRANSFER AND TRANSMISSION OF SHARES AND DEBENTURES AND SHARE CERTIFICATE VS. SHARE WARRANT

## STRUCTURE



## 7.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Define allotment and explain the provisions of allotment of shares.
- Describe the procedure of transfer and transmission of securities.
- Enumerate share certificate and share warrant.

# 7.1 INTRODUCTION

A prospectus is a document issued by a public company with a view to invite the public to make offers to the company for purchase of its securities. In response to this invitation, the applications are made by prospective purchasers of securities. These applications are in the nature of form made to the company, which the company might accept or reject. If the company accepts the applicant's offer, it results in the allotment of securities to the public. Any public company which does not want to invite public for subscription of its securities through prospectus and every private company (cannot invite public for subscription of its securities) may make allotment of securities after issue of offer letter for private placement of securities to persons exceeding the prescribed number of persons.

# 7.2 MEANING OF SHARE CAPITAL

Company, being an artificial person, cannot generate its own capital which has necessarily to be collected from several persons. These persons are known as shareholders and the amount contributed by them is called share capital. Since the number of shareholders is very large, a separate capital account cannot be opened for each one of them. Hence, innumerable streams of capital contribution merge their identities in a common capital account called as 'Share Capital Account'.

## 7.2.1 TYPES OF SHARE CAPITAL

From accounting point of view the share capital of the company can be classified as follows:

**1. Authorised Capital**: Authorised capital is the amount of share capital which a company is authorised to issue by its Memorandum of Association. The company cannot raise more than the amount of capital as specified in the Memorandum of Association. It is also called Nominal or Registered capital. The authorised capital can be increased or decreased as per the procedure laid down in the Companies Act. It should be noted that the company need not issue the entire authorised capital for public subscription at a time. Depending upon its requirement, it may issue share capital but in any case, it should not be more than the amount of authorised capital.

**2. Issued Capital**: It is that part of the authorised capital which is actually issued to the public for subscription including the shares allotted to vendors and the signatories to the company's memorandum. The authorised capital which is not offered for public subscription is known as 'unissued capital'. Unissued capital may be offered for public subscription at a later date.

**3. Subscribed Capital**: It is that part of the issued capital which has been actually subscribed by the public. When the shares offered for public subscription are subscribed fully by the public the issued capital and subscribed capital would be the same. It may be noted that ultimately, the subscribed capital and issued capital are the same because if the number of share, subscribed is less than what is offered, the company allot only the number of shares for which subscription has been received. In case it is higher than what is offered, the allotment will be equal to the offer. In other words, the fact of over subscription is not reflected in the books.

**4. Called up Capital**: It is that part of the subscribed capital which has been called up on the shares. The company may decide to call the entire amount or part of the face value of the shares. For example, if the face value (also called nominal value) of a share allotted is Rs. 10 and the company has called up only Rs. 7 per share, in that scenario, the called up capital is Rs. 7 per share. The remaining Rs. 3 may be collected from its shareholders as and when needed.

**5. Paid up Capital**: It is that portion of the called up capital which has been actually received from the shareholders. When the shareholders have paid all the call amount, the called up capital is the same to the paid up capital. If any of the shareholders has not paid amount on calls, such an amount may be called as 'calls in arrears'. Therefore, paid up capital is equal to the called-up capital minus call in arrears.

**6. Uncalled Capital**: That portion of the subscribed capital which has not yet been called up. As stated earlier, the company may collect this amount any time when it needs further funds.

**7. Reserve Capital**: A company may reserve a portion of its uncalled capital to be called only in the event of winding up of the company. Such uncalled amount is called 'Reserve Capital' of the company. It is available only for the creditors on winding up of the company.

## 7.2.2 NATURE AND CLASSES OF SHARES

Share refer to the units into which the total share capital of a company is divided. Thus, a share is a fractional part of the share capital and forms the basis of ownership interest in a company. The persons who contribute money through shares are called shareholders.

The amount of authorised capital, together with the number of shares in which it is divided, is stated in the Memorandum of Association but the classes of shares in which the company's capital is to be divided, along with their respective rights and obligations, are prescribed by the Articles of Association of the company. As per Section 87 of The Companies Act, a company can issue two types of shares (1) preference shares, and (2) equity shares (also called ordinary shares).

**Preference Shares:** According to Section 85 of The Companies Act, 1956, a preference share is one, which fulfils the following conditions :

(a) That it carries a preferential right to dividend to be paid either as a fixed amount payable to preference shareholders or an amount calculated by a fixed rate of the nominal value of each share before any dividend is paid to the equity shareholders.

(b) That with respect to capital it carries or will carry, on the winding up of the company, the preferential right to the repayment of capital before anything is paid to equity shareholders.

However, notwithstanding the above two conditions, a holder of the preference share may have a right to participate fully or to a limited extent in the surpluses of the company as specified in the Memorandum or Articles of the company. Thus, the preference shares can be participating and non-participating. Similarly, these shares can be cumulative or non-cumulative, and redeemable or irredeemable.

**Equity Shares**: According to Section 85 of The Companies Act, 1956, an equity share is a share which is not a preference share. In other words, shares which do not enjoy any preferential right in the payment of dividend or repayment of capital, are termed as equity/ordinary shares. The equity shareholders are entitled to share the distributable profits of the company after satisfying the dividend rights of the Accounting for Share Capital 7 preference share holders. The dividend on equity shares is not fixed and it may vary from year to year depending upon the amount of profits available for distribution. The equity share capital may be (i) with voting rights; or (ii) with differential rights as to voting, dividend or otherwise in accordance with such rules and subject to such conditions as may be prescribed.

## 7.2.3 ISSUE OF SHARES

A salient characteristic of the capital of a company is that the amount on its shares can be gradually collected in easy instalments spread over a period of time depending upon its growing financial requirement. The first instalment is collected along with application and is thus, known as application money, the second on allotment (termed as allotment money), and the remaining instalment are termed as first call, second call and so on. The word final is suffixed to the last instalment. However, this in no way prevents a company from calling the full amount on shares right at the time of application. The important steps in the procedure of share issue are :

**Issue of Prospectus**: The company first issues the prospectus to the public. Prospectus is an invitation to the public that a new company has come into existence and it needs funds for doing business. It contains complete information about the company and the manner in which the money is to be collected from the prospective investors.

**Receipt of Applications**: When prospectus is issued to the public, prospective investors intending to subscribe the share capital of the company would make an application along with the application money and deposit the same with a scheduled bank as specified in the prospectus. The company has to get minimum subscription within 120 days from the date of the issue of the prospectus. If the company fails to receive the same within the said period, the company cannot proceed for the allotment of shares and application money should be returned within 130 days of the date of issue of prospectus.

**Allotment of Shares**: If minimum subscription has been received, the company may proceed for the allotment of shares after fulfilling certain other legal formalities. Letters of allotment are sent to those whom the shares have been alloted, and letters of regret to those to whom no allotment has been made. When allotment is made, it results in a valid contract between the company and the applicants who now became the shareholders of the company.

Shares of a company are issued either at par, at a premium or at a discount. Shares are to be issued at par when their issue price is exactly equal to their nominal value according to the terms and conditions of issue. When the shares of a company are issued more than its nominal value (face value), the excess amount is called premium . When the shares are issued at a price less than the face value of the share, it is known as shares issued at a discount.

## 7.2.4 DEFINITION OF ALLOTMENT

The term ‘allotment’ has not been defined in the Companies Act. Simply stated, allotment means appropriation of a certain number of shares to a certain person/persons out of the unappropriated share capital of the company.

According to the Supreme Court of India, ‘Allotment means the appropriation out of previously unappropriated share capital of a company, of a certain number of shares to a person. In the words of

Justice Chitty, "Allotment is generally neither more nor less than the acceptance by the company of the offer to take shares." Thus, allotment is the acceptance of the applications (offers) made by persons to take shares in a company. It should be noted that re-issue of forfeited shares is not the allotment of shares because it is out of previously appropriated or allotted capital of the company.

**Effect of Allotment**

On allotment of shares, a contract is reached between the company and the allottee. Therefore, the company is bound to deliver shares to the allottee and the allotee is liable to make payment of unpaid amount on the shares as and when called by the company. But in case, if he fails to make the payment of the allotment money or the calls made on the shares, his shares may be forfeited by the company. Consequently, he loses all the rights of a member in the company.

## 7.2.5 MINIMUM SUBSCRIPTION

No public company inviting public for subscription of its securities (through prospectus) can allot securities unless the amount stated in the prospectus as minimum amount has been subscribed. The concept of minimum subscription has radically changed. According to the latest concept, minimum subscription is the amount which is stated as such in the prospectus. The amount of minimum subscription is mandatorily required to be received by a public company on or before the date of closure of the issue in order to become entitled to allot the securities.

**Minimum Amount of Subscription**

If the amount called on application is not full issue price, the amount of minimum subscription to be received shall be in proportion to the amount so called. It should be noted that while calculating the net issue amount, the amount of securities reserved for certain categories of persons and the amount of securities reserved for preferential allotment are excluded.

The SEBI Regulations have clearly given a formula for deciding the quantum of minimum amount of subscription. According to these regulations, an issuer company is required to receive minimum subscription of 90 per cent of the net issue amount (including devolvement of underwriters, if applicable). But in case of an initial public offer, the minimum subscription to be received shall be subject to allotment of minimum number of specified securities.

**Exceptions:** The provisions of minimum subscription do not apply in the following cases:

(i) In case of offer for sale by existing members of the company.

(ii) In case of further issue of shares without a right to renounce the same in favour of others.

**Period of Receiving the Amount**

The Companies Act states that the minimum amount of subscription may be received within a period of 30 days from the date of issue of the prospectus or such other period as may be specified by the SEBI. SEBI Regulations prescribe that an issuer company shall receive the amount of minimum subscription (i.e., 90 per cent of issue price) on or before the date of closure of the issue. Since SEBI Regulations override the provisions of the Companies Act, the amount of minimum subscription must be received in accordance with the SEBI Regulations. According to the SEBI Regulations, public issue shall be kept open at least for three working days but not for more than ten working days. Hence, minimum subscription should be received by the date of closure of the issue fixed by the company.

**Consequences on Failure**

The following shall be the consequences if issuer company fails to receive the minimum amount of subscription:

1. **No Allotment:** If the minimum amount of subscription is not received within the specified time, the issuer company cannot allot the securities offered.
2. **Refund of Subscription:** If the issuer company fails to receive the minimum amount of subscription, it shall return the amount of subscription within specified time period.

**Penalty**

Sometimes, a company makes any default in complying with the above provisions (i.e., allots securities or does not refund the amount of subscription). In such a case, the company and its officer who is in default shall be liable to a penalty for each default of `1000 for each day during which such default continues or ` 1 lakh whichever is less [Sec. 39(5)].

**Personal Liability to Refund**

Sometimes, a company fails to receive the amount of minimum subscription and thereafter fails to refund it within the specified time, i.e., 15 days of the closure of the issue. In such a case the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at the rate of 15 per cent per annum.

### 7.2.6 PROVISIONS OR RESTRICTIONS ON ALLOTMENT OF SHARES

The provisions relating to allotment of shares may broadly be classified under the following two heads:

1. General provisions/restrictions.

2. Provisions/restrictions under the Companies Act.

**General Provisions/Restrictions**

The general provisions relating to allotment of shares are based on the law of contract. Since allotment is the acceptance by the company of the offer (i.e., application) for shares made by a person, the general principles as to offer and acceptance of the law of contract apply to the allotment of shares. Such provisions/restrictions are as follows:

**1. Proper Authority:** Allotment of shares must be made by proper authority. The Board of Directors is the proper authority to allot shares in a company. It can allot shares by a resolution at its valid meeting. However, if the articles provide, the committee of the Board of Directors may also allot the shares. But an allotment made by the Board without proper authority will be invalid. However, such allotment may be ratified by the company. It should be noted that allotment of shares will be valid even if there was some defect in the appointment of directors because of application of the doctrine of indoor management or Turquand rule. Even allotment by an irregularly constituted Board is held to be valid.

**2. Within Reasonable Time:** The allotment must be made within a reasonable period of time. An application to take shares lapses if allotment is delayed unreasonably. It has been held that the interval of about six months between application and allotment is not reasonable. Therefore, the applicant may refuse to accept such allotment.

But in the recent years, law and practice have undergone several changes. As per the latest SEBI guidelines, companies are, as far as possible, required to make allotment of shares within 15 days of the closure of the public issue. In case, a company fails to despatch the allotment letters/refund orders within 15 days from the date of the closure of the issue, the directors shall be liable to pay the money along with interest at the rate of 15 per cent per annum.

**3. Communication:** The allotment must be communicated to the applicant. Mere entry of the applicant's name in the register of shareholders is not sufficient to bind the applicant. It is said to be a proper allotment when the applicant has been informed about the allotment. However, a formal allotment letter is not necessary. It is enough if the applicant is made aware of the allotment.

The communication by post is complete and valid when a properly addressed and stamped letter of allotment is posted. Validity of communication is not affected even if the letter is delayed or lost in transit. An allotee cannot get rid of the allotment by showing that he did not receive the letter.

**4. Absolute and Unconditional:** The allotment must be absolute and unconditional. It must be in accordance with the terms and conditions of the application. Any allotment made without fulfilling conditions of the application (condition precedent) shall not be binding on the applicant.

**Example:** A person applied for 400 shares in a company on the condition that he would be appointed cashier of a new branch of the company. The Court held that he was not bound by the allotment unless he was so appointed [*Mutual Bank of India v. Sohan Singh*, AIR (1936) Lah 790].

If an applicant without rejecting the allotment pledges the shares allotted, he is bound by the allotment. Then he loses his right to reject the allotment. Sometimes, applicant applies with a condition that is to be fulfilled by the company subsequent to the allotment. In such a case, company is not bound by the condition and allotment would be valid.

**Example:** Anta made an application for shares subject to a condition that he would pay further sums for the shares only when the company paid dividends. The Court held that Anta was bound by the allotment even though the company had gone into liquidation below paying the dividends [*Motilal Chunilal v. Thakorea* (1912) 14 Bom LR 648}.

**5. Revocation:** Application for shares (i.e. offer to take shares) as well as the allotment (i.e. acceptance) can be revoked. According to the provisions of the Contract Act, an application can be revoked at any time before the communication of acceptance (i.e. allotment) is complete as against the applicant. Therefore, an applicant has the right to revoke his offer, that is, application for purchase of shares and ask the company to return the money paid any time before he is informed of the allotment.

It may be noted that a verbal withdrawal of application for allotment of shares is not enough. A company can also revoke allotment of shares at any time before the communication of allotment is complete as against the company, i.e. at any time before the applicant comes to know about the allotment.

**6. Consideration:** The allotment of shares may be made for valid consideration. A company limited by shares has no power to issue shares as a gift. If there is no payment in money's worth for the shares, the allotment would be ultra vires. Consequently allotment of shares as donation is not valid. It has also been held that directors should allot the shares in utmost good faith only in the best interests of the company. In one case, the shares of a company of high market value were allotted at a meagre price. It was held that the allotment was not in the best interests of the company.

**Provisions/Restrictions under the Companies Act**

The provisions regarding/restrictions on allotment of securities issued through prospectus are as follows:

**1. Registration of Prospectus:** When a public company wants to invite offers from the public for the purchase of its securities, it will have to register a prospectus with the Registrar and issue it to the public. It should contain all the matters and set out all the reports specified under this Act or by the SEBI. It must be signed by every director or proposed director of the company or by his agent authorized in writing. When a company submits a prospectus complying with all these provisions, the Registrar shall register the same. Thereafter, it should be issued within 90 days of its registration; otherwise it shall be treated as invalid prospectus [Sec. 26].

**2. Application to Stock Exchange before Making Public Offer:** Every company making a public offer shall before making such an offer (i.e. before opening of the issue) make an application to one or more recognized stock exchange or exchanges and obtain permission for the securities to be dealt with in such stock exchange or exchanges [Sec. 40(1)].

**3. Stating Name of Stock Exchange in Prospectus:** The prospectus shall state the name or names of one or more recognized stock exchange(s) in which the securities shall be dealt with [Sec. 40(2)].

**4. Issue of Application Form with Abridged Prospectus:** Any application for the purchase of any of the securities of a company shall be issued with an abridged prospectus. However, a copy of the prospectus shall also be issued on a request being made by any person [Sec. 33].

**5. Application Money:** The amount payable on application on every security shall not be less than 5 per cent of the nominal amount of the security or such other percentage or amount, as may be specified by the SEBI [Sec. 39(2)].

SEBI Regulations require that the minimum amount payable on application for each security shall not be less than 25 per cent of the issue price of the security. In case of offer for sale, full issue price of security shall be payable on application for each security [Regulation 49]. The application money shall be paid by cheque or other instrument.

**6. Keeping Application Money:** All monies received on application from the public for subscription to the securities shall be kept in a separate bank account in a scheduled bank [Sec. 40(3)].

**7. Minimum Amount/Subscription:** No allotment of securities offered to the public can be made unless the following conditions are satisfied:

(i) The amount stated in the prospectus as the amount of minimum subscription must have been subscribed; and

(ii) The sums payable on application (i.e. minimum amount payable on application) must have been paid to and actually received by the company by cheque or other instrument [Sec. 39(1)].

**8. Utilizing Application Money:** All monies received on application from the public shall not be utilized for any purpose other than the following:

**(a) For adjustment against allotment of securities or the allotment money.** Such utilization is allowed where the securities have been permitted to be dealt with in the stock exchange or stock exchanges specified in the prospectus.

**(b) For repayment of monies received from applicants.** Such utilization is allowed where the company, for any reason, is unable to allot securities [Sec. 40(3)].

**9. Punishment:** If a default is made in complying with the provisions contained in clauses 2, 3, 6 and 8 above (Section 40), the company shall be punishable with a fine, which shall not be less than ` 5 Iakh but which may extend to ` 50 Iakh. Moreover, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh or with both [Sec. 40(5)].

**10. Refund of Money if Minimum Amount is Not Subscribed:** Sometimes, the amount stated as the minimum amount in the prospectus is not subscribed and the sum payable on application is not received within a period of 30 days from the date of issue of the prospectus, or such other period as may be specified by the SEBI.

SEBI Regulations specify 15 days for refund of such money. Hence, the amount received as application money must be refunded within 15 days from the closure of the issue. The money to be refunded shall be credited only to the bank account from which the subscription was remitted [Sec. 39(3) and Rule PAS-II].

**11. Directors' Liability to Refund Money with Interest:** Sometimes, the money required to be refunded for non-receipt of minimum subscription is not refunded within 15 days from the closure of issue. In such a case, the directors of the company (who are officers in default) shall jointly and severally be liable to repay the money with interest at the rate of 15 per cent per annum.

**12. Penalty for Failure to Refund Application Money:** In case any default is made in returning the application money, the company and its officer who is in default shall be liable to a penalty for each default of ` 1,000 for each day during which such default continues or ` 1 lakh, whichever is less [Sec. 39(5)].

**13. Condition to Waive Compliance of Provisions Void:** Any condition purporting to require or bind any applicant for securities to waive compliance with any of the requirements stated in clauses 2, 3, 6 and 8 above (Section 40) shall be void [Sec. 40(4)].

**RETURN OF ALLOTMENT**

The Act requires that whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in such manner as may be prescribed [Sec. 39(4)]. The Rules notified by MCA prescribe that whenever a company makes any allotment of its securities, the company shall within 30 days thereafter file with the Registrar a return of allotment in Form No. PAS-3 along with the prescribed fee. In addition, the following documents shall be attached to Form No. PAS-3

**1. In case of Allotment of Shares for Cash:** A list of allottees shall be attached to Form No. PAS-3. The list shall be stating their names, address, occupation, if any and number of securities allotted to each of the allottees. The list shall be certified by the signatory of Form No. PAS-3 as being complete and correct as per the records of the company.

**2. In Case of Allotment of Shares (Not Being Bonus Shares) other than for Cash:** In the case of securities (not being bonus shares) allotted as fully or partly paid up for consideration other than cash, a copy of the contract shall be attached to the form. It shall be duly stamped, pursuant to which the securities have been allotted. In addition, any contract of sale if relating to a property or an asset, or a contract for services or other consideration shall be attached.

**3. In Case the Contract of Allotment, Sale or Service is not in Writing:** Where a contract referred to in clause 2 above is not reduced to writing, the company shall furnish complete particulars of the contract. It shall be stamped with the same stamp duty as would have been payable if the contract had been reduced to writing. Those particulars shall be deemed to be an instrument within the meaning of the Indian Stamp Act.

**4. Report of Valuer in Case the Consideration is other than Cash:** A report of a registered valuer (in respect of valuation of the consideration) shall also be attached along with the contract as mentioned in clauses 2 and 3 above.

**5. In case of Bonus Shares:** In case of issue of bonus shares, a copy of the resolution passed at the general meeting authorizing the issue of such shares shall be attached to the form.

**6. Report of the Valuer in case of Further Issue of Shares:** Sometimes, shares are issued under the provisions of further issue of shares by a company other than a listed company. In such a case, the company shall attach the valuation report of the registered valuer to Form No. PAS-3 [Rule PAS-12].

**Penalty:** A default is made in filing a return of allotment to the Registrar. In such a case, the company and its officer who is in default shall be liable to a penalty for each default of `1000 for each day during which such default continues or ` 1 lakh, whichever is less [Sec. 39(5)].

## 7.3 TRANSFER OF SECURITIES AND TRANSMISSION OF SECURITIES

Section 44 states that the shares or debentures or other interest of any member in a company shall be movable property transferable in the manner provided by the articles of the company. Section 56 of the Companies Act, 2013 deals with the transfer and transmission of securities or interest of a member in the company.

**Requirement for registering the transfer of securities:** According to the law, a company shall not register a transfer of securities of the company, or the interest of a member in the company in the case of a company having no share capital, unless a proper instrument of transfer, in such form as may be prescribed, duly stamped, dated and executed by or on behalf of the transferor and the transferee (except where the transfer is between persons both of whose names are entered as holders of beneficial interest in the records of a depository), specifying the name, address and occupation, if any, of the transferee, has been delivered to the company by the transferor or the transferee within a period of 60 days from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with the letter of allotment of securities.

**Instrument of transfer lost/ not delivered:** Where the instrument of transfer has been lost or the instrument of transfer has not been delivered within the prescribed period, the company may register the transfer on such terms as to indemnity as the Board may think fit.

**Power of company to Register**: Power of company to register shall not be effected by above provision (given under sub- section 1) on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted.

**Transmission of securities on an application of transferor alone:** Where an application is made by the transferor alone and relates to partly paid shares, the transfer shall not be registered, unless the company gives the notice of the application, in such manner as may be prescribed, to the transferee and the transferee gives no objection to the transfer within two weeks from the receipt of notice.

**Company delivering the certificate:** Every company shall, unless prohibited by any provision of law or any order of Court, Tribunal or other authority, deliver the certificates of all securities allotted, transferred or transmitted.

| **Different condition** | **Period of the delivering the certificates** |
|---|---|
| In the case of subscribers to the memorandum; | Within 2 months from the date of incorporation |
| In the case of any allotment of any of its shares | Within a period of two months from the date of allotment |

| | |
|---|---|
| In the case of a transfer or transmission of securities. | Within a period of one month from the date of receipt by the company of the instrument of transfer or the intimation of transmission |
| In the case of any allotment of debenture | Within a period of six months from the date of allotment |

Provided that where the securities are dealt with in a depository, the company shall intimate the details of allotment of securities to depository immediately on allotment of such securities.

**Transfer of security of the deceased:** The transfer of any security or other interest of a deceased person in a company made by his legal representative shall, even if the legal representative is not a holder thereof, be valid as if he had been the holder at the time of the execution of the instrument of transfer.

**Default in compliance of the provisions:** Where any default is made in complying with the provisions of sub-sections (1) to (5), the company shall be punishable with fine varying from 25,000 rupees to 5 lakh rupees and every officer of the company who is in default shall be punishable with fine with the minimum of 10 thousand rupees extending to 1 one lakh rupees.

**Liability of depository:** Where any depository or depository participant, with an intention to defraud a person, has transferred shares, it shall be liable under section 447 of the Companies Act, 2013 with the liability mentioned under the Depositories Act, 1996.

**Punishment for personation of shareholder [Section 57]:** If any person deceitfully personates as

- an owner of any security or interest in a company, or
- of any share warrant or coupon issued in pursuance of this Act, and
- thereby obtains or attempts to obtain any such security or interest or any such share warrant or coupon, or λ
- receives or attempts to receive any money due to any such owner,

Such person shall be punishable with imprisonment for a term which shall not be less than one year but which may extend to three years and with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

**Refusal of registration and appeal against refusal [Section 58]:** Section 58 of the Companies Act, 2013, deals with process of the company to be followed by on refusal to register the transfer of securities.

**(i)** **If a private company limited by shares refuses, to register the transfer of, or the transmission of the right to any securities or interest of a member in the company,** then the company shall send notice of the refusal to the transferor and the transferee or to the person giving intimation of such transmission, within a period of thirty days from the date on which the instrument of transfer, or the intimation of such transmission, was delivered to the company. The securities or other interest of any member in a public company are freely transferable, subject to the contract/arrangement.

**(ii)** **The transferee may appeal to the Tribunal against the refusal** within a period of thirty days from the date of receipt of the notice or in case no notice has been sent by the company, within a period of sixty days from the date on which the instrument of transfer or the intimation of transmission, was delivered to the company.

**(iii)** **If a public company without sufficient cause refuses to register the transfer of securities** within a period of thirty days from the date on which the instrument of transfer or the intimation of transmission, is delivered to the company, the transferee may, within a period of sixty days of such refusal or where no intimation has been received from the company, within ninety days of the delivery of the instrument of transfer or intimation of transmission, appeal to the Tribunal.

**(iv)** The Tribunal, while dealing with an appeal may, after hearing the parties, either dismiss the appeal, or by order

(a) direct that the transfer or transmission shall be registered by the company and the company shall comply with such order within a period of ten days of the receipt of the order; or

(b) direct rectification of the register and also direct the company to pay damages, if any, sustained by any party aggrieved.

**(v)** If a person contravenes the order of the Tribunal he shall be punishable with imprisonment for a term not less than one year but may extend to three years and with fine not less than one lakh rupees which may extend to five lakh rupees.

**Rectification of register of member [Section 59]:** Section 59 of the Companies Act, 2013 provides the procedure for the rectification of register of members after the transfer of securities. The provision states that-

(i) **Remedy to the aggrieved for not carrying the changes in the register of members:** If the name of any person is, without sufficient cause, entered in the register of members of a company, or after having been entered in the register, is, omitted there from, or if a default is made, or unnecessary delay takes place in entering in the register, the fact of any person having become or ceased to be a member, the person aggrieved, or any member of the company, or the company may appeal in such form as may be prescribed, to the Tribunal, or to a competent court outside India, specified by the Central Government by notification, in respect of foreign members or debenture holders residing outside India, for rectification of the register.

(ii) **Order of the Tribunal:** The Tribunal may, after hearing the parties to the appeal by order, either dismiss the appeal or direct that the transfer or transmission shall be registered by the company within a period of ten days of the receipt of the order, or direct rectification of the records of the depository or the register and in the latter case, direct the company to pay damages, if any, sustained by the party aggrieved.

(iii) The provisions of this section shall not restrict the right of a holder of securities, to transfer such securities and any person acquiring such securities shall be entitled to voting rights unless the voting rights have been suspended by an order of the Tribunal.

(iv) **Where the transfer of securities is in contravention of any of the provisions of the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992** or this Act or any other law for the time being in force, there the Tribunal may, on an application made by the depository, company, depository participant, the holder of the securities or the Securities and Exchange Board, direct any company or a depository to set right the contravention and rectify its register or records concerned.

**(v)** **Default in complying with the order:** If any default is made in complying with the order of the Tribunal under this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

## TRANSMISSION OF SHARES

Transmission of securities has not been defined by the Companies Act. ‘Transmission by operation of law’ is not a transfer. It refers to those cases where a person acquires an interest in property by operation of any provision of law, such as by right of inheritance or succession or by reason of the insolvency or lunacy of the holder of securities or by purchase in a Court-sale.

Thus, transmission of securities takes place when the registered holder of securities dies or is adjudicated as an insolvent, or if the holder of securities is a company, it goes into liquidation. Because a deceased person cannot own anything, the ownership of all his property passes, after his death, to those who legally represent him. Similarly, when a person is declared insolvent, his entire property vests in the Official Assignee or Official Receiver. Upon the death of a sole registered holder of securities, so far as the company is concerned, the legal representatives of the deceased holder of securities are the only persons having title to the securities unless securities-holder had appointed a nominee, in which case he would be entitled to the exclusion of all others.

Section 56(1) of the Companies Act, 2013 states that the transfer of securities must be effected by a proper instrument of transfer and that a provision in the articles of an automatic transfer of securities of a deceased securities-holder is illegal and void. Such transfer does not amount to transmission which takes place by operation of law. Section 56(2) of the Act provides that nothing in the sub-section (1) shall prejudice the powers of the company to register, on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted. It follows that, for such transmission, instrument of transfer is not required, and, merely an application addressed to the company by the legal representative is sufficient.

Articles of companies generally provide for formalities to be observed for transmission of shares. In the absence of such provision in the articles of the company, Regulations 23 to 27 of Table F of Schedule I to the Act will govern the procedure for transmission. According to these regulations, the legal representatives are entitled to the shares held by deceased member and the company must accept the evidence of succession e.g., a succession certificate or letter of administrations or probate or any other evidence properly required by the Board of directors. He is, however, not a member of the company by reason only of being the legal owner of the shares. But he may apply to be registered as a member. On the contrary, instead of being registered himself as a member, he may make such transfer of the shares as the deceased or insolvent member could have made. The Board of directors also have the same right to decline registration as they would have had in the case of transfer of shares before death. But if the company unduly refuses to accept a transmission, the same remedies are available to the legal representative as in the case of a transfer namely, an appeal to the Tribunal under Section 58.

**DISTINCTION BETWEEN TRASFER AND TRANSMISSION OF SHARES**

| S. No. | Transfer of Securities | Transmission of securities |
|---|---|---|
| 1. | Transfer take place by a voluntary act of the transferor. | Transmission is the result of the operation of law. |
| 2. | An instrument of transfer is required in case of transfer. | No instrument of transfer is required in case of transmission. |
| 3. | Transfer is a normal course of transferring properly. | Transmission takes place on death of insolvency of a holder of securities. |
| 4. | Transfer of securities is generally made for some consideration. | Transmission of securities is generally made without any consideration. |
| 5. | Stamp duty is payable on transfer of securities by a holder of securities. | No stamp duty is payable on transmission of securities. |

# 7.4 SHARE CERTIFICATE AND SHARE WARRANT

## SHARE CERTIFICATE

A share Certificate refers to a document which is issued by a company evidencing that a person named in such certificate is the owner of the shares of Company as stated in the share certificate. The Indian Companies Act mandates companies for issuing share certificates post their incorporation.

**Details to be provided in a share certificate:** Every share certificate issued in India should contain the below mentioned:

1. Name of issuing Company
2. CIN no. (Corporate Identification Number) of such Company
3. Address of the company's registered office
4. Name of owners of such shares
5. Folio number of member
6. Number of shares which is represented by such share certificate

7. An amount which is paid on such shares
8. Distinct number of the shares

**The timeframe for issuing share certificates:** After the incorporation of the company, the company needs to issue the share certificates within two months from incorporation date. Where additional shares are allotted to the new or existing shareholders, the share certificates should be issued within two months from allotment date. In a case related to the share transfers, the share certificates should be issued to transferees within a period of one month of receipt of the instrument of transfer by such Company.

**Procedures for issuing share certificates**

**1. Board Meeting & Allotment of shares:** A board meeting is called for deciding about allotment of shares. The board of directors assigns a committee of directors known as allotment committee. The allotment committee would then decide about allotment of shares. Once allotment committee provides its report with respect to allotment of shares, the Board then approves such report and then passes the resolution for allotting shares to the respective applicants. Once shares are allotted by the allotment committee, the company secretary sends the letters of allotment to the respective members. The allotment letter refers to a letter that notifies the applicant that the company has allotted a certain number of shares to him. This letter of allotment is considered as the share certificate till issuance of the final certificate.

**2. Register of members:** The company secretary then prepares a Register of members from the lists of application received and allotment sheets. Register of member provides information about the shareholders and details of the shares which are allotted to them.

**3. Preparing and Printing Share Certificates:** The company secretary must arrange the form of the share certificate according to the form suggested by the Articles of Association. The secretary must get the form printed together with all the required details as per the provisions of the governing law. The secretary needs to fill all the details in share certificate with help of the application register and allotment sheets. The secretary also needs to ensure that the share certificate is signed by two directors of the company. The secretary needs to sign the share certificate. The secretary also needs to ensure that the company's seal and revenue stamp is affixed on each of the share certificates. Once certificates are in order, a board meeting is called for passing the resolution for issuing share certificates.

**4. Intimation and dispatch of share certificate:** The company secretary needs to inform all the shareholders that share certificates are ready and would be delivered in exchange of allotment letters and bankers receipt confirming payment of the allotment money. A public notice should be issued for the general information of the members. Members who surrender their allotment letters, share certificate are dispatched by the registered post to them. The local shareholders as per their preference can also collect the share certificates personally from company's registered office or from agency appointed for dispatching the share certificates.

5. **Penalty for breach:** Where a company makes any default in complying with provisions relating to issue of share certificates, such company would be punishable with a fine that wouldn't be less than Rs. 25,000 but could extend to Rs. 5,00,000 and every defaulting officer of such company would be punishable with a fine that wouldn't be less than Rs. 10,000 but could extend to Rs.1,00,000

**PROCEDURES FOR SHARE TRANSFER – PHYSICAL MODE**

One of the key features of a company is that its shares are transferable. Privileges of a shareholder include his/her rights to transfer shares. If a Company is limited by assurance and has no share capital, no transfer of share is involved as there are no shares to transfer.

The ownership of shares can be transferred by delivery of possession, but there is a contractual relationship between the members and the company. When shares are transferred the contractual relationship is assigned to the transferee which needs an instrument of transfer. Transferring a share involves a series of steps, first an agreement to sell (Share Transfer Deed), then execution of a deed of transfer and finally registration of the transfer. In this article, we look at the procedures for approval and registration involved in share transfer which is physical in mode.

**Transfer Deed**

Share transfer deed is an instrument of transfer that must be executed by both transferor and transferee. Share transfer deed must be duly stamped and delivered to the company along with certificate relating to shares transferred. Any instrument of transfer which is not in conformity with these provisions cannot be accepted by the company. Share transfer in physical mode is executed with the help of Form "SH-4″.

**Acknowledgement**

Some companies send a notice or acknowledgement of the instrument to the transferor who has lodged a transfer with the company before the documents are scrutinized. The notice of acknowledgement is usually in the form of a letter which holds a checklist for scrutiny of the transfer documents. Some companies follow a practice of issuing transfer receipt. If the transfer application is made by the transferor alone and he has partly paid for the shares; the company must not register the transfer unless the company acknowledges the transferee, and he does not have any objection in transferring the shares within 2 weeks from the receipt of the notice. There is no statutory obligation on the company to give notice to the transferor when the transfer documents are lodged by the transferee.

**Scrutiny**

On receipt of all the transfer documents, a scrutiny should be done to ensure that all the documents are in place. The scrutiny should be done within 3 to 5 days from the receipt of the transfer documents. In case the documents are not acceptable, the same should be returned to the transferee. In case the signature of the transferor in the transfer instrument differs from the specimen signature on the company's record, then the documents will be returned.

**Approval**

Every transfer of shares must be placed before the Board of Directors or committee for its approval. The registration takes place after approval. If everything is accepted after scrutiny, it should be approved by the right authority. Transfer of shares must be approved by the board. If articles of the company empower the board to delegate its power of approval of share transfer, then it may delegate it to a committee who might not be the company's directors.

**Registration**

Registration of share transfer is a requirement for the transferee obtaining the status of a member of the company. A transfer is incomplete without registration of share transfer. A share transfer form is a document through which the transferee agrees to accept the shares. This becomes a legal contract with the company. Once the company approves and registers the transfer, this leads to the entry of the transferee's name in the registry of the member and it qualifies his status as a member. The maintenance of the register of transfer is not a statutory requirement.

**Delivery of Share Certificate**

Transfer becomes effective only on registration of such shares by the company. The company shall deliver the share certificate within 1 month from the receipt by the company's instrument related to transfer. The instrument of transfer must be endorsed with the respective name of the transferee.

## SHARE WARRANT

A Share Warrant is a document issued by the company under its common seal, stating that its bearer is entitled to the shares or stock specified therein. Share warrants are negotiable instruments. They are transferable by mere delivery without registration of transfer.

**Conditions for issuing share warrants**

The following conditions should be satisfied for issuing share warrants.

1. Only a public company can issue share warrants.

2. It must be authorized by the Articles of Association.

3. The shares must be fully paid-up.

4. The approval of the Central Government is necessary.

On the issue of the share warrant, the company must strike off the name of the member in its Register of Members and must enter the following particulars:

1. The fact of the issue of the share warrant,

2. A statement of the shares included in the warrant, distinguishing each share by its number, and

3. The date of issue of the warrant.

It is a negotiable instrument and mere delivery transfers the ownership of the shares. Coupons are attached to each warrant, bearing the dates on which the dividend will be paid by the company as it cannot know who the shareholder or who is entitled to the dividends. The person who produces the appropriate coupon can receive payment of the dividend.

**Merits of Share Warrant**

1. The shares mentioned in it are transferable by mere delivery of the warrant. Registration is not necessary.

2. It is a negotiable instrument. So one who purchases the share warrant in good faith and without negligence gets a better title than that of the transferor.

3. Banks accept share warrants as a security for loans.

4. The company may provide for future dividend payments by attaching dividend coupons with the share warrants.

**Demerits of Share Warrant**

Share warrants are not very popular in India. It is due to the following disadvantages:

1. The bearer of the warrant is not a member of the company.

2. Since it is bearer instrument, the holder always faces the risk of losing the document.

3. The company should be very careful while printing and keeping them in safe custody.

4. The stamp duty on share warrant is very heavy.

5. Prior approval of the Central Government is essential.

6. The number of shares mentioned in it does not constitute a share qualification for directorship.

**Difference between share certificate and share warrant**

| Basis for Comparison | Share Certificate | Share Warrant |
|---|---|---|
| Meaning | A legal document that indicates the possession of the shareholder on the specified number of shares is known as share certificate. | A document which indicates that the bearer of the share warrant is entitled to the specified number of shares is share warrant. |
| Compulsory | Yes | No |
| Issued by | All the companies limited by shares irrespective of public or private. | Only public limited companies have the right to issue share warrant. |
| Negotiable Instrument | No | Yes |
| Transfer | The transfer of share certificate can be done by executing a valid transfer deed. | The transfer of share warrant can be done by mere hand delivery. |
| Original Issue | Yes | No |

| | | |
|---|---|---|
| Amount paid | Issued against fully or partly paid up share. | Issued only against fully paid up shares |
| Approval of Central Government for issue | Not Required at all | Prior approval of Central Government is required for issued Share Warrant. |
| Time Horizon for Issue | Within 3 months of the allotment of shares. | No time limit prescribed. |
| Provision in Articles of Association | Not Required | Required |

## 7.5 CHECK YOUR PROGRESS

Fill in the blanks

1. The minimum application money should be ……. of nominal value as per SEBI guidelines.
2. Share warrants can be issued with the prior approval of the ……… .
3. The company must deliver share certificate within …….. if the shares allotted by company.
4. ………. is voluntary passage of the rights and duties of member from a shareholder.
5. Transfer is effected by ………. .

## 7.6 SUMMARY

No public company inviting public for subscription of its securities can allot securities unless the amount stated in the prospectus as minimum amount has been subscribed. Whenever a company having share capital makes any allotment of securities, it shall file with the Registrar a return of allotment of securities. The transfer of securities means a transfer by sale by the registered holders of the securities. Every security holder of a company is entitled to transfer his securities subject to certain restrictions, when the securities are transferred from one person to another person by operation of law, it is transmission of shares. A share certificate is a document of title of share issued by a company.

## 7.7 KEYWORDS

**Allotment:** Appropriation of a certain number of shares to a certain person out of unappropriated share capital of the company.

**Minimum Subscription:** It is the amount which is stated as such in the prospectus.

**Transfer of Shares:** It is a transfer by sale by the registered holders of the Securities.

**Transmission of Securities:** When the securities are transferred to another person by operation of law, it is transmission of shares.

**Share Certificate:** It is a document of titles of shares issued by a company.

## 7.8 SELF ASSESSMENT TEST

1. Explain the procedure for transfer of securities.
2. What is the difference between transfer of shares and transmission of shares? Explain.
3. What is a share certificate? How does it differ from share warrant?
4. What is meant by minimum subscription? State the provisions of Company Act regarding the refund and deposits of minimum subscription.
5. What are the restricted on allotment of shares as per Company Act?

## 7.9 ANSWERS TO CHECK YOUR PROGRESS

1. 25%
2. Registrar
3. 3 Months
4. Transfer
5. Sales

## 7.10 REFERENCES/SUGGESTED READINGS


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# LESSON 8

# REDUCTION OF SHARE CAPITAL

## STRUCTURE



## 8.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Procedure for reduction of share capital.
- Concept of reorganization of capital.
- Explain in detail about the buy-back of shares.

## 8.1 INTRODUCTION

Share capital is used to mean the capital raised by the company through the issue of shares. The shares issued by a company The shares issued by a company can be either equity shares or preference shares. The memorandum of the company provides for the share capital clause. Companies limited by guarantee or unlimited companies need not have share capital.

# 8.2 REDUCTION OF SHARE CAPITAL AND REORGANISATION OF CAPITAL

**REDUCTION OF SHARE CAPITAL**

A company, limited by shares or a guarantee company with a share capital is permitted to reduce its share capital by section 66 in any of the following ways:

(i) By extinguishing or reducing the liability on any of its shares in respect of share capital not paid-up.

(ii) By cancelling any paid-up capital which is lost or unrepresented by available assets.

(iii) By paying off any paid-up capital which is in excess of the needs of the company.

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

**Reasons for Reduction of Share Capital**

1. The share capital of the company may be more than enough for its present and future 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 100 may represent assets worth ` 50. The company may wish to write off the lost capital.

Reduction under items (1) and (2) will reduce the funds available to the creditors. Reduction under item (3) affects the rights of different classes of shareholders.

**Procedure**

The procedure for reducing the share capital of a company is as follows:

1. **Special Resolution**

   A company shall pass a special resolution for reduction of share capital. Power to reduce share capital must be given in the Articles.

2. **Application to the Tribunal**

After having passed the special resolution for reducing the share capital, sanction of the Tribunal shall be obtained by the company. The petition under section 66 should be made in the prescribed form and accompanied by the documents, as prescribed.

**The object of requiring this sanction is three-fold:**

(1) To protect persons dealing with the company so that the fund available for satisfying their claim shall not be diminished except by ordinary business risks.

(2) To ensure that the reduction is equitable as between the shareholders of the company.

(3) To protect the interests of the public. The court must look after the interests of shareholders and creditors.

**Creditors consent**

If the reduction of share capital involves: (i) diminution of liability in respect of unpaid share capital; or (ii) payment to the shareholders of any paid-up share capital; and (iii) in any other case if the court so directs, every creditor of the company is entitled to object only with the consent of the court.

**Interest of Shareholders**

Before sanctioning the scheme of reduction of share capital, the Tribunal should see that the scheme for reduction of capital is fair and equitable to all kinds of shareholders.

**3. Order of the NCLT confirming the reduction**

The Tribunal may make an order, if it is satisfied that every creditor entitled to object has consented to the reduction.

**4. To add 'and reduced' word to the name of the company**

The Tribunal may also order the company to add the words and reduced to the name of the company for such period as may be specified in the order.

**5. Registration of the Order of NCLT and Minutes of reduction with Registrar**

The order of the NCLT confirming the reduction must be produced before the Registrar along with minutes for registration. On such registration by the Registrar, the resolution for reduction of share capital as confirmed by the tribunal takes place. Notice of the registration shall be published in such a manner as the Tribunal may direct.

The Registrar shall certify registration of the order and the minutes in hand. The Certificate of Registrar to this effect is conclusive evidence that all the requirements of the Act regarding the reduction of share capital have been complied with and that the share capital is such as is stated in the minutes.
[Sec. 66]

In consequence of reduction, the liability of a member of the company shall not exceed the difference between paid-up value of the share and the reduced value of the share.

6. The Tribunal may, if it is satisfied that the debt or claim of every creditor of the company has been discharged or determined or has been secured or his consent is obtained, make an order confirming the reduction of share capital on such terms and conditions as it deems fit.
7. No application for reduction for share capital shall be sanctioned by the Tribunal unless the accounting treatment, proposed by the company for such reduction is in conformity with the accounting standards specified in Section 133 or any other provision of this Act and a certificate to that effect by the company's auditor has been filed with the Tribunal.
8. The order of confirmation of the reduction of share capital by the Tribunal under Sub-section (3) shall be published by the company in such manner as the Tribunal may direct.
9. The company shall deliver to the Registrar certified copy of the order of the tribunal under Sub-section (2) and of a minute approved by the Tribunal showing –
   a) The amount of share capital;
   b) The number of shares into which it is to be divided;
   c) The amount of e
   d) ach share; and
   e) The amount, if any, at the date of registration deemed to be paid-up on each share.

Copy of the order as aforesaid shall be delivered to the Registrar within thirty days of the receipt of the copy of the order, who shall register the same and issue a certificate to that effect.

1. A member of the company, past or present, shall not be liable to any call or contribution in respect of any share held by him exceeding the amount of difference, if any, between the amount paid on

the share, or reduced amount, if any, which is to be deemed to have been paid thereon, as the case may be, and the amount of the share as fixed by the order of reduction.

2. Where the name of any creditor entitled to object to the reduction of share capital under this section is, by reason of his ignorance of the proceedings for reduction or of their nature and effect with respect to his debt or claim, not entered on the list of creditors, and after such reduction, the company is unable to pay the amount of his debt or claim, -
   a) Every person, who was a member of the company on the date of the registration of the order for reduction by the Registrar, shall be liable to contribute to the payment of that debt or claim, am amount not exceeding the amount which he would have been liable to contribute if the company had commenced winding up on the day immediately before the said date; and
   b) If the company is wound up, the Tribunal, may, on the application of any such creditor and proof of his ignorance as aforesaid, if it thinks fit, settle a list of persons so liable to contribute, and make and enforce calls and orders on the contributories settled on the list, as if they were ordinary contributories in a winding up.
   c) The rights of the contributories among themselves shall not be affected.
3. If any officer of the company –
   a) Knowingly conceals the name of any creditor entitled to object to the reduction;
   b) Knowingly misrepresents the nature or amount of the debt or claim of any creditor; or
   c) Abets or is privy to any such concealment or misrepresentation as aforesaid, he shall be liable under Section 447.
4. The company must publish the order of confirmation of the reduction of share capital may by the Tribunal in the manner as directed by the Tribunal failing which it shall be punishable with fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees.

**Reduction of Share Capital without the Sanction of the Tribunal**

There are some cases in which there is reduction of share capital and no confirmation by the Tribunal is necessary. These are:

i. *Buy-back of its shares by a company* under Section 68.
ii. *Forfeiture of shares* – A company may, in pursuance of its articles, forfeit shares for non-payment of calls.

iii. *Surrender of shares* – It is a short cut to forfeiture. It may be accepted by the company under circumstances where its forfeiture is justified. It has the effect of releasing the shareholder whose surrender is accepted from liability on shares.

iv. Diminution of capital – This has already been explained. Section 61 (2) clearly states that diminution of capital does not amount to reduction of capital.

v. *Redemption of redeemable preference shares* – This has already been explained as provided by Section 55.

vi. *Purchase of shares of a member by the company under Section 242* – The Tribunal may order the shares of any member by the company, under certain circumstances.

**Creditors ignorant of the proceedings**

If a creditor is ignorant of the proceedings for reduction and his name is not being entered on the list of creditors and after the reduction, the company is unable to pay his debt, the following procedure will be followed:

1. Every person, who was a member of the company at the date of the registration of the order for reduction and minute, shall be liable to contribute for the payment of that debt.
2. If the company is wound up, the creditor may by giving proof of his ignorance apply to the Tribunal.

**Penalty for concealing name of Creditors (Sec. 66)**

Any officer of the company who knowingly conceals the name of any creditor or misrepresents the nature of the debt shall be liable for action under Section 447.

**Reduction of Capital without Permission of NCLT**

In the following case Reduction of Capital is possible without permission of NCLT:

(i) Forfeiture of shares for non-payment of calls.

(ii) Surrender of partly paid shares.

(iii) Diminution of Capital by the cancellation of shares which have not been subscribed.

(iv) Purchase by the company of the share of any member under section 402 (b) on the orders of NCLT.

(v) Redemption of redeemable preference shares under section 80.

(vi) Buy-back of its own shares.

**Reduction of Capital vs. Diminution of Capital**

Reduction of capital involves, working off past losses against capital, cancellation of the uncalled capital or repayment of surplus capital. It may involve reduction of issued capital, subscribed or paid up share capital. Diminution of capital denotes cancellation of the authorized or issued capital (but not subscribed). Diminution of capital does not constitute a reduction of capital within the meaning of the Companies Act. The distinction between reduction and diminution of capital is as follows:

1. Diminution of capital is the reduction of the issued capital. Reduction of capital involves reduction of subscribed or paid-up capital; there is no reduction of issued capital.
2. Both require authorization by articles but whereas 'diminution' can be effected by an ordinary resolution (if so authorized by articles), reduction of capital cannot be effected without passing a special resolution.
3. 'Reduction' requires confirmation by court (Section 100) but 'diminution' needs no confirmation by the court (Section 94). In case of 'reduction', court may order the company to add the words 'and reduced' after its name [Section 102 (3) but no such order can be passed in case of 'diminution' Section 94].
4. In case of 'diminution', notice is to be given to Registrar within 30 days from the date of cancellation whereupon, the Registrar shall record the notice and make the necessary alteration in the memorandum and articles. In case of 'reduction', a more detailed procedure has been prescribed though there is no time limit as in case of 'diminution'.

**REORGANISATION OF CAPITAL**

The term reorganisation of the share capital includes consolidation of shares at different classes, or by division of shares into different classes, or by both these methods.

When a reorganisation of share capital of a company is:

(i) between a company and its creditors or any class of them, or

(ii) between a company and its members or any class of them, the NCLT may order a meeting of creditors or members of the company on an application by the company or by any creditor or members or by a liquidator in case the company is being wound up.

The reorganisation of share capital of a company shall be binding if the scheme is approved by a majority in number representing three-fourths in value of the creditors or members and the scheme is sanctioned by tribunal.

The companies limited by shares have to issue shares to raise the necessary capital for their operations. Issue of shares may be made in three ways:

1. By private placement of shares.

2. By allotting entire shares to an issue-house, which in turn, offers the shares for sale to the public.

3. By inviting the public to subscribe for shares in the company through a prospectus.

1. ***Private Placement of Shares:*** A private company limited by shares is prohibited by the Act and the articles from inviting the public to subscribe in shares or debentures. It also need not file statement in lieu of prospectus. Its shares are issued privately, to a small number of persons known to the promoters or related to them by family connections.

A public company can also raise its capital by placing the shares privately and, without inviting the public to subscribe to its shares or debentures. In this kind of arrangement, an underwriter or broker finds persons, normally his clients who wish to buy the shares. He acts merely as an agent and his function is simply to procure buyer for the shares, i.e., to place them. Since no public offer is made for shares, there is no need to issue any prospectus.

However, under s.70, such a company is required to file with the Registrar a statement in lieu of prospectus, at least 3 days before making allotment of any shares or debentures. As per the guidelines issued by SEBI in June, 1992, private placement of shares should not be made by subscription of shares from unrelated investors through any kind of market intermediaries. This means a promoters' share should not be contributed by subscription of those shares, by unrelated investors through brokers, merchant bankers, etc. However, subscription of such shares by friends, relatives and associates is allowed.

2. ***By an Offer for Sale:*** Under this arrangement, the company allots or agrees to allot shares or debentures at a price to a financial institution or an issue-house for sale to the public. The issue-house publishes a document called an offer for sale, with an application form attached, offering to the public shares or debentures for sale at a price higher than what is paid by it or at par. This document is deemed to be a prospectus [s.64(1)]. On receipt of applications from the public, the issue-house renounces the allotment

of the number of shares mentioned in the application in favour of the applicant purchaser who becomes a direct allottee of the shares.

3. ***By Inviting Public through Prospectus:*** This is the most common method by which a company seeks to raise capital from the public. The company invites offer from members of the public to subscribe for the shares or debentures through prospectus. An investor is expected to study the prospectus and if convinced about the prospects of the company, apply for shares.

**Issue of Shares to existing Shareholders**

The capital is also raised by issue of rights shares to the existing shareholders (Section 81). In this case the shares are allotted to the existing equity shareholders in proportion to their original shareholding, e.g., one share against every two shares held by a member.

**Public Issue of Shares**

Public issue of shares means the selling or marketing of shares for subscription by the public by issue of prospectus. For raising capital from the public by the issue of shares or debentures, a public company has to comply with the provisions of the Companies Act, the Securities Contracts (Regulations) Act including the Rules made thereunder and the Guidelines and instructions issued by the concerned Government authorities, the Stock Exchange and SEBI, etc. Management of public issue involves coordination of activities and cooperation of a number of agencies such as managers to the issue, underwriters, brokers, registrars to the issue, solicitors/legal advisors, printers, publicity and advertising agents, financial institutions, auditors and other Government/ Statutory agencies such as Registrar of Companies, Reserve Bank of India, stock exchange, SEBI, etc.

It is advisable to keep in mind the guidelines issued by SEBI with regard to issue of shares termed as “Guidelines for Disclosure and Investor Protection” before issuing shares to the public. Share application form to seek permanent account number. In respect of applications for value of 50,000 or more, the applicant or in case of applications in joint names, each of the applicant, shall mention his/her permanent account number/GIR number and income-tax circle, ward, district or the fact of non-allotment of PAN/GIR number, as the case may be and applications not complying with the provisions are liable to be rejected.

## 8.3 BUY-BACK OF SHARES

Buy-back is a procedure which enables a company to go back to the shareholders of its shares and offer to purchase from them the shares that they hold. The rationale for buy-back is that when the company has an excess capital, it should reduce its share capital through buy-back and hence improve upon its earnings per share. It is a strategy of re-structuring its capital by which excess paid up share capital can be extinguished. The buy-back provisions are contained in Section 68 of the Companies Act, 2013.

1. **Sources of Buy-back**

According to Section 68, a company may purchase its own shares or other specified securities out of the following:

(i) Free reserves; or

(ii) Securities premium account; or

(iii) Proceeds of an earlier issue other than fresh issue made specifically for buy-back purposes.

In case shares are bought back out of free reserves then Section 69 stipulates that a sum equal to the nominal value of shares bought back shall be transferred to a reserve account to be called the 'Capital Redemption Reserve Account' and details of such transfer shall be disclosed in the balance-sheet. This account may be applied by the company for issue of fully paid bonus shares.

2. **Conditions of Buyback**

No company shall purchase its own shares or other specified securities unless:

**(i) Power in Articles:** The buy-back is authorised by its articles;

**(ii) Special Resolution:** A special resolution has been passed in general meeting of the company authorising the buy-back. However, special resolution is not required where the buy-back is less than 10% of the total paid up equity capital' and free reserves of the company.

**(iii) Limitations on Buy Back:** The buy-back of equity shares in any financial year shall not exceed 25%, of its total Paid-up equity capital + Free Reserves in that financial year;

**(iv) Debt-Equity Ratio:** The Debt equity ratio should not be more than 2 : 1 after the buy-back.

**(v) Shares must be fully paid-up:** All the shares or other specified securities for buy-back are frilly paid-up; that all the shares are not subject to any lock in period [19(5) of SEBI Regulations].

**3. Explanatory Statement to the notice**

According to section 102, the notice of the meeting, at which special resolution is proposed to be passed, shall be accompanied by an explanatory statement stating the following, viz,

(a) a full and complete disclosure of all material facts;

(b) the necessity for the buy-back;

(c) the class of security intended to be purchased under the buy- back;

(d) the amount to be invested under the buy-back; and

(e) the time limit for completion of buy-back.

**4. Time for Buy-back**

Every buy-back shall be completed within twelve months from the date of passing the special resolution or a resolution passed by Board.

**5. Buy-back from whom**

The buy-back may be:

(a) from the existing security-holders on a proportionate basis; or

(b) from the open market (through stock exchange or book building process); or

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity declaration.

**6. Declaration of Solvency**

The Board before making such buy-back should file with the Registrar and the SEBI a declaration of solvency in Form No. SH. 9 and verified by an Affidavit to the effect that the Board of Directors has made a full enquiry into the affairs of the company and the company will not be rendered insolvent within a period of 1 year from the date of declaration by the Board.

However, no declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

**1. Physical Destruction of Securities**

Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within 7 days of the last date of completion of buy-back.

**2. Further Issue after Buy-back**

Where a company completes a buy-back of its shares, it shall not make further issue of the same kind of shares including right shares or other specified securities within a period of six months except by way of bonus issue.

**3. Maintenance of Register**

Company shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

**4. Return to be filed with the Registrar and SEBI**

A company shall, after the completion of the buy-back file with the Registrar and SEBI (in case of listed companies), a return containing such particulars relating to the buy-back within 30 days of such completion.

**Rule 17(14) of the Companies (Share Capital and Debentures) Rules, 2014** states that a certificate in Form No. SH. 15 signed by 2 directors of the company including 1 managing director, must certify that the buy-back of the securities is made in compliance with the provisions of this Act. This certificate must be annexed to the return filed with the Registrar in Form. No. SH. 11.

5. **Transfer to Capital Redemption Reserve** (Section 69)

Where a company purchases its own shares out of free reserves, then a sum equal to nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve. The said amount can be used only for the payment of fully paid up bonus shares.

**6. Penalty**

Where any company fails to comply with the provisions of section 53, such company and every officer who is in default shall be liable to a penalty which may extend to an amount equal to the amount raised through the issue of shares at a discount or five lakh rupees, whichever is less, and the company shall also be liable to refund all monies received with interest at the rate of twelve per cent, per annum from the date of issue of such shares to the persons to whom such shares have been issued.

**Prohibition on buy-back in certain Circumstances** **[Section 70]**

No company shall directly or indirectly purchase it own shares or other specified securities:

(a) through any subsidiary company including its own subsidiary companies; or

(b) through any investment company or group of investment companies; or

(c) if a default, by the company,

(i) in repayment of deposit or interest payable thereon,

(ii) redemption of debentures or preference shares or

(iii) payment of dividend to any shareholder or

(iv) repayment of any term loan or interest payable there onto any financial institution or bank is subsisting.

## 8.4 CHECK YOUR PROGRESS

Fill in the blanks

1. …………. used for reducing the share capital of a company.
2. ………….. means consolidation of shares at different classes, or by division of shares into different classes, or by both these methods.
3. The buy-back of share provisions are contained in section …….. of the Companies Act, 2013.
4. ………… is the reduction of the issued capital.
5. When a company purchases its own shares out of free reserves, then a sum equal to nominal value of shares so purchased shall be transferred to the ………. .

## 8.5 SUMMARY

Sections 100-105 of Companies Act provide for the reduction of share capital. A company limited by shares, if so authorized by its articles, may, by special resolution, which is to be confirmed by the court reduce its share capital. There are some cases in which there is reduction of share capital and no confirmation by the court is necessary. Reduction of capital involves, working off past losses against capital, cancellation of the uncalled capital or repayment of surplus capital. Diminution of capital does not constitute a reduction of capital within the meaning of the Companies Act. The rationale for buy-back is that when the company has an excess capital, it should reduce its share capital through buy-back and hence improve upon its earnings per share.

## 8.6 KEYWORDS

**Reduction of Share Capital:** It involves, working off past losses against capital, cancellation of the uncalled capital or repayment of surplus capital.

**Reorganization of Share Capital:** This includes consolidation of shares at different classes, or by division of shares into different classes, or by both these methods.

**Buy-back of Shares:** It is a procedure which enables a company to go back to the shareholders of its shares and offer to purchase from them the shares that they hold.

## 8.7 SELF ASSESSMENT TEST

1. What is the procedure for reduction of share capital as per Companies Act? Explain.
2. Describe the concept of buy-back of shares. State the procedure of buy-back of shares by Indian corporates.
3. Distinction between reduction of share capital and reorganization of share capital.

## 8.8 ANSWERS TO CHECK YOUR PROGRESS

1. Special Resolution
2. Reorganization of Share Capital
3. Section 68
4. Diminution of Capital
5. Capital Redemption Reserve

## 8.9 REFERENCES/SUGGESTED READINGS

1. M.C. Shukla A Manual of Mercantile Laws; Sultan Chand & Company, New Delhi.
2. N.D. Kapoor Mercantile Law; Sultan Chand & Co., New Delhi.
3. N.D. Kapoor & Dinkar Pagare, Business Laws and Management; Sultan Chand & Sons.
4. M.C. Kuchhal Mercantile Law; Vikas Publishing House, New Delhi.
5. P. P. S. Gogna A Textbook of Business Law; Sultan Chand & Company, New Delhi.

# LESSON 9

# DEPOSITORY SYSTEM

## STRUCTURE



## 9.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Explain the objectives and salient features of Depositories Act, 1996.
- Describe the participants in a depository system.
- Procedure for dealing of securities through depository system.

## 9.1 INTRODUCTION

The traditional paper-based system of dealing in securities involves a long and complex process with enormous paper work. It is time consuming and expensive process. It is full of inefficiencies and problems including the problems of bad deliveries, forged and fake security certificates, mutilated or torn security certificates, loss or theft of security certificates and delayed registry of transfer of security certificates. To get rid of such myriads of problems, the depository system for dealing in securities was introduced. It is almost paperless system. This system is regulated by the Depositories Act, 1996.

In depository system, the depository company holds securities in trust on behalf of its clients. It records the names of its clients as beneficial owner of securities in electronic form. Whenever a client deals in securities, the depository records the facts in its electronic record system.

## 9.2 MEANING OF DEPPOSITORY SYSTEM

It is a system whereby the transfer and settlement of scrips take place not through the traditional method of transfer deeds and physical delivery of scrips but through the modern system of effecting transfer of ownership of securities by means of book entry on the ledgers or the depository without the physical movement of scrips. The new system, thus, eliminates paper work, facilitates automatic and transparent trading in scrips, shortens the settlement period and ultimately contributes to the liquidity of investment in securities. This system is also known as 'scripless trading system'. **At present there are two depositories in India:** (a) National Securities Depository Ltd. (NSDL), and (b) Central Depository Services (India) Ltd. (CDSL). National Securities Depository Limited which commenced operations during November 1996 was promoted by IDBI, UTI and National Stock Exchange (NSE). Central Depository Services (India) Limited commenced operations during February 1999. It was promoted by Mumbai Stock Exchange in association with Bank of Baroda, Bank of India, State Bank of India and HDFC Bank.

### 9.2.1 OBJECTIVES AND SALIENT FEATURES OF DEPOSITORIES ACT, 1996

**Objectives**

The Depositories Act, 1996, aims at providing for:

a) A legal basis for establishment of depositories to conduct the task of maintenance of ownership records of securities and effect changes in ownership records throughout by book entry;

b) Dematerialisation of securities in the depositories mode as well as giving option to an investor to choose between holding securities as at present or holding securities in a dematerialised form in a depository;
c) Making the securities fungible;
d) Making the shares, debentures and any interest thereon of a public limited company freely transferable; and
e) Exempting all transfers of shares within a depository from stamp duty.

**Salient Features of Depositories Act**

The Depositories Act, 1996 extends to the whole of India.

It contains 31 Sections grouped into six Chapters. The salient features of the Depositories Act, 1996 are:

- The Act makes a provision for setting up of multiple Depositories in India.
- Every Depository shall be required to be registered with SEBI and shall obtain from it the certificate to commence business.
- The investors shall have the option to retain their shareholdings in the physical mode or convert it in dematerialised from (Demat).
- Investors who opt for Demat shall have to register themselves with one or more participants.
- The securities held in Demat mode shall be fungible, i.e., they shall cease to have any distinctive folio or certificate number.
- The Depository would only be the registered owner. Investors shall be the beneficial owners and their names will appear in the records of the Depository. All rights, benefits and liabilities will be with the investors only.
- Ownership changes in the Depository system will be made automatically on the basis of delivery versus payment. There will be regular, mandatory flow of information about the details of ownership in the Depository’s record to the company concerned.
- No stamp duty shall be charged on shares transferred in the Demat mode.
- Securities held in Demat mode may be pledged.

### 9.2.2 DEPOSITORY SYSTEM PARTICIPANTS/CONSTITUENTS

The following parties are the constituents of a depository system:

1. Depository.

2. Depository participant.

3. Investor or beneficial owner of securities.

4. The security issuer company or its Registrar and Transfer Agent.

**1. Depository:** According to the Depositories Act, 'Depository' means a company formed and registered under the Companies Act and which has been granted a certificate of registration under the Securities and Exchange Board of India (SEBI) Act, 1992.

The Depositories Act, 1996 defines "Depository" as "an organization where securities of a shareholder are held in the form of electronic accounts in the same way as bank holds money". The Depositories Act, 1996 requires a depository to be a company registered under the Companies Act and with SEBI under the SEBI (Depository and Participants) Regulations, 1996. So far only two Depositories have been allowed by SEBI to function, viz., National Securities Depository Limited (NSDL) and Central Depository Services (India) Ltd. (CDSL).

A Depository acts through the medium of his agent called 'Depository Participant'. According to SEBI (Depositories and Participants) Regulations, financial institutions, banks, custodians, stock brokers, etc., can become depository participants. A Depository Participant (DP) acts as a service provider to the investors by acting as a custodian of the electronic accounts of the clients and taking care of trading and settlement thereof. DP acts as an interface between Investor and Depository.

Simply stated, a depository is a company incorporated under the Companies Act and registered with the SEBI having a certificate of commencement of business from the SEBI. It holds securities, like shares, debentures, bonds, Government securities, mutual fund units etc. on behalf of its client investors in electronic form through its authorised depository participants. It also provides services related to transactions in securities.

A depository is deemed to be the registered owner of securities only for the purpose of effecting transfer of ownership of securities on behalf of the beneficial owner.

At present there are only two depositories in India: (i) National Securities Depository Limited (NSDL), and (ii) Central Depository Services (India) Limited (CDSL). These are registered with the SEBI.

**2. Depository participant:** A depository participant (DP) is an intermediary or agent of the depository who provides depository services to its registered clients/security-holders. A depository may register as many DPs as is deemed necessary by it. They are appointed under an agreement. My person may choose any DP of a depository and open dematerialization account or popularly known as the demat account with it. The account-holder/client may deposit his securities already held by him or newly allotted to him or fresh bought by him.

**3. Investor or beneficial owner of securities:** Investor is the person whose name is recorded in the records of the depository as the beneficial owner of securities held or bought by him. My investor or intending investor in securities can open an account with any DP of the depository. For this purpose, the investor has to execute an agreement with the depository through its any of the DPs.

**4. Security issuer company or its Registrar and Transfer Agent:** The security issuer company or its 'Registrar and Transfer Agent' (R & T Agent) is another most significant constituent of a depository system. Issuer company usually assigns its role relating to issue and transfer of securities to such agent.

**RIGHTS AND OBLIGATIONS OF DEPOSITORIES AND ITS CONSTITUENTS**

This Regulations deal with rights and obligations of depositories and every depository has to state in its byelaws the eligible securities for dematerialisation which include shares, scrips, stock, bonds, debentures stock, Indian Depository Receipts or other marketable securities of a like nature, etc., and include units of mutual funds, rights under collective investment schemes and venture capital funds, commercial paper, certificate of deposit, securitised debt, money market instruments Government Securities and even unlisted securities. Every depository is required to enter into an agreement with the issuer in respect of securities disclosed as eligible to be held in demat form. No agreement is required to be entered into where the depository itself is an issuer of securities. The depository is also required to enter into a tripartite agreement with the issuer, its transfer agent and itself where company has appointed a transfer agent. Every depository is required to maintain continuous connectivity with issuers, registrars and transfer agents, participants and clearing house or clearing corporations. Depositories should take adequate measures including insurance to protect the interest of the beneficial owners. Every depository is required to maintain the following records and documents namely:

– records of securities dematerialised and rematerialised;

– the names of the transferor, transferee, and the dates of transfer of securities;

– a register and an index of beneficial owners;

– details of holding of the securities of the beneficial owners as at the end of the each day;

– records of instruction(s) received from and sent to participants, issuers' agents and beneficial owners;

– records of approval, notice, entry and cancellation of pledge or hypothecation, as the case may be;

– details of participants;

– details of securities declared to be eligible for dematerialisation in the depository; and

– such other records as may be specified by SEBI for carrying on the activities as a depository.

Every depository has to intimate SEBI the place where the records and documents are maintained. Subject to the provisions of any other law, the depository shall preserve records and documents for a minimum period of five years. Participants are required to enter into an agreement with beneficial owners. It is required that separate accounts are to be opened by every participant in the name of each of the beneficial owner and the securities of each beneficial owner are to be segregated and shall not be mixed up with the securities of other beneficial owners or with the participant's own securities. The participants are obliged to reconcile the records with every depository on a daily basis. Participants are required to maintain the following records for a period of five years–

– records of all the transactions entered into with a depository and with a beneficial owner;

– details of security dematerialised, rematerialized on behalf of beneficial owners with whom it has entered into an agreement;

– records of instructions received from beneficial owners

– and statements of account provided to beneficial owners; and – records of approval, notice, entry and cancellation of pledge or hypothecation as the case may be.

**Difference between Depository and Custodian**

Both depository and custodial services are responsible for safe keeping of securities but they are different in the sense that the Depository can legally transfer beneficial ownership, which a custodian cannot. The main objective of a Depository is to minimize the paper work involved with the ownership, trading and transfer of securities.

### 9.2.3 DEALING OF SECURITIES THROUGH DEPOSITORY SYSTEM

Dealing of securities through depository involves certain steps. The steps are as follows:

**1. Account Opening:** Every security-holder or a person who intends to become a security- holder may open an account with a DP of a depository for deposit of his holding of securities in the account. This account is called the dematerialization account or popularly known as the demat account.

In order to open a de mat account with a DP, the investor has to fill up an application form and execute an agreement with the depository through its DR by this agreement, the investor empowers the depository to transfer ownership of securities on his behalf to any other person in accordance with his instructions.

On opening of the account, the investor shall get an identification number called 'Client ID.' It serves as a reference for all the transactions with the DP. Thereafter, he can hold the shares in the electronic form. He can get a statement of holdings after each transaction from his DR

**2. Dematerialization of Existing Securities:** My person who is having securities in physical form may at any time apply to the issuer company or its R & T Agent through the DP (where he has a demat account) for dematerialization of his holding of securities. For this purpose, the security-holder, will have to fill up a dematerialization request form (DRF) and submit the same along with the original security certificates to. the DR The DP then confirms the details of the DRF and sends these documents to the concerned company or to its R & T Agent. The company shall cancel the security certificates and record in the. register of members the name of the depository as the registered owner of those securities and inform the DP. The DP shall credit the account of the beneficial owner or investor with the number of shares so dematerialized.

The beneficial owner shall continue to enjoy all his rights on those securities except the right to transfer ownership of securities. Thus, right to receive bonus shares, right shares, dividend, to attend and vote on resolutions at meetings remains with the beneficial owner but the right to transfer ownership of the securities on behalf of the beneficial owner remains with the depository.

It may be noted that every security-holder is required to fill up a separate DRF for dematerialization of securities of each company.

**3. Allotment in Demat Form:** Every listed company and every company seeking listing of its securities in any recognized stock exchange is required to allot all the securities in demat form. Hence, wherever a company allots securities to any investor, it intimates the concerned depository about the allotment of securities. Depository makes a credit entry of allotted securities in the account of the concerned beneficial owner.

It may be noted that besides the above stated companies, any other company may opt for depository system and request its security-holders to receive securities in demat account. But the subscribers of securities of such a company should always be given the option either to receive the security certificates in physical form or to hold the securities with a depository.

**4. Buying and Selling/Transfer of Dematerialized Securities:** Every beneficial owner of securities may buy and sell the dematerialized securities. The procedure for buying and selling dematerialised securities is similar to the procedure for buying and selling physical securities. The difference lies in the process of delivery (in case of sale of securities) and receipt of delivery (in case of purchase of securities) of securities.

Whenever, a beneficial owner buys securities, the broker will receive the securities in his account on the payout day. Then the broker will send the delivery instruction slip (DIS) to its DP to debit his account and credit buyer's (beneficial owner) account.

Any person who is having a balance of securities in his demat account can sell the securities through a broker, who is a clearing member (CM) of a clearing house. When broker sells securities of a beneficial owner, the beneficial owner is required to give the delivery of securities out of the securities lying to the credit of his demat account in the DP. For this purpose, the seller issues a duly filled in and signed delivery instrument slip (DIS) to his DP to debit his account and credit his broker's account.

It may be noted that a DIS contains the name of the DP, DP-ID number, demat account number, name of the transfer or, CM-ID number and name of broker (seller 's)/CM number, name of (broker's) DR Buyer's Client-ID, demat account number, settlement number etc. are filled in by the issuer of DIS. The transfor also fills in the scrip (security) code number, name of the company and number of shares (in figures or words) to be transferred and date of execution of the slip. Before delivering, the transfer or also puts his signature on the slip. Then, it is handed over to the DP which in turn transfers the shares to the transferee's DP account. The transferee's account may be in the same DP or any in other DP.

**Who can render Depository Services?**

Anybody to be eligible to provide depository services must –

a) Be formed and registered as a company under the Companies Act, 2013,
b) Be registered with SEBI as a depository under the SEBI Act, 1992,
c) Have framed by-laws with the previous approval of SEBI,
d) Have obtained a certificate of commencement of business from SEBI,
e) Have one or more participants to render depository services on its behalf, and
f) Have adequate systems and safeguard to prevent manipulation of records and transactions to the satisfaction of SEBI,
g) Have been established by one or more of the following (i) public financial institution (ii) a bank (iii) a foreign bank (iv) recognized stock exchange (v) a body corporate engaged in providing financial services (vi) a body corporate constituted or recognized in foreign country for providing custodial, clearing or settlement services in securities market and approved by the Central Government (vii) an institution engaged in providing financial services established outside India and approved by the Central Government.

**Are all eligible securities required to be in the Depository mode?**

It is not necessary that all eligible securities must be in the depository mode. In the scheme of the depository legislation, the investor has been given supremacy. If the wishes to avail of the depository services in respect of any eligible security, whether existing or to be issued, the issuer who has entered into an agreement with one or more depositories has to give him the facility. The investor has the choice of holding physical securities or opting for a depository based ownership record. At the time of fresh issue, the issuer who has entered into an agreement with the depository is under obligation to give the option to the investors wither to receive the security certificates under the paper based system (non-depository mode) or opt to hold securities with a depository (depository mode). The decision on whether or not to hold securities within the depository mode and if in the depository mode with which depository or participant, would be entirely with the investor. Such freedom can be exercised either at the time of the initial offer of the security by indicating his choice in the application form or at any subsequent time. He will also have the freedom to switch from depository mode to non-depository mode and vice versa. Under Section 29, companies making public offer of any security shall issue the same only in dematerialised form by complying with the provisions of the Depositories Act, 1996 and regulations made.

## 9.2.4 BENEFITS OF DEPOSITORY SYSTEM

In the depository system, the ownership and transfer of securities takes place by means of electronic book entries. Depository system offers numerous direct and indirect benefits. Some of them are as follows:

**1. Elimination of Bad Deliveries:** In the depository system, once holdings of an investor are dematerialized, the question of bad delivery of securities does not arise i.e. they cannot be held "under objection". In the physical delivery system, buyer is exposed to the risk of bad delivery of securities.

**2. Elimination of Risks Associated with Physical Certificates:** Dealing in physical securities is associated with the risks of theft of securities certificates, mutilation of certificates, loss of certificates during the transit through and from the registrars. This problem does not arise in case of depository system of dealing in securities.

**3. No. Stamp Duty:** No stamp duty for transfer of any kind of securities is required to be paid in the depository system.

**4. Immediate Transfer of Securities:** In the depository system, once the securities are credited to the investors account on pay out day, he becomes the beneficial owner of the securities. On the other hand, in case of physical delivery system, the investor has to send it to the company's registrar for registration of transfer of securities. This process usually takes much more time than the time fixed under statutory provisions. Thus, it exposes the investors to the risk price fluctuations and to the risk of loss of security certificate in transit.

**5. Faster Settlement Cycle:** The settlement cycle follows rolling settlement on T+2 basis. It means the settlement of trades takes place on the 2nd working day from the trade day. Hence, this enables faster turnover of securities and more liquidity with the investor.

**6. Faster Disbursement of Non-Cash Corporate Benefits like:** Depository system provides direct credit of non-cash corporate entitlements such as rights and bonus shares, etc. to an investors' account. Thus, it ensures faster disbursement of benefits and avoids the risk of loss of certificates in transit.

**7. Reduced Brokerage:** Many brokers charge reduced rate of brokerage for trading securities in demat form. Since, the system reduces their back office cost and risk of bad deliveries, the brokers usually charge less brokerage.

**8. Easy to Change of Investors Address:** In case of change of address, holders of securities in physical form have to undergo a long change procedure with each company. Under the depository system, the investors have to only inform their DP with all relevant documents and the required changes are effected in the. database of all the companies, where the investor is a registered beneficial owner of securities.

**9. Easy to Transmission of Securities:** In case of dematerialized holdings, the process of transmission is more convenient. The transmission formalities for all securities held in a demat account can be completed by submitting documents the DP. Whereas, in case of physical securities, the surviving joint holder(s)/legal heirs/nominee has to correspond independently with each company in which shares are held.

**10. Easy to Sell Securities on Behalf of a Minor:** A natural guardian is not required to take Court approval for selling demat securities on behalf of a minor.

**11. Ease in Portfolio Monitoring:** Since statement of account gives a consolidated position of investments in all securities, it simplifies the portfolio management.

## 9.3 PROVISIONS OF DEPOSITORIES ACT

The Depositories Act, 1996 is deemed to have come into force on 20th September, 1995 because it was enacted after promulgation of ordinance by the President. The main provisions of the Depositories Act are as follows:

**1. Certificate of Commencement of Business:** Every depository shall act as a depository only after obtaining a certificate of commencement of business from the SEBI [Sec. 3].

**2. Agreement Between Depository and Participant:** A depository shall enter into an agreement with one or more participants as its agent [Sec. 4].

**3. Services of Depository:** Any person may enter into an agreement with any depository through its any DP for availing its services [Sec. 5].

**4. Surrender of Certificate of Security:** Any person who has entered into an agreement with depository shall surrender the certificates of securities to the issuer company for which he seeks to avail the services of a depository.

The issuer company, on receipt of certificate of security shall cancel the certificate of security and substitute in its records the name of the depository as a registered owner in respect of that security and inform the depository accordingly.

A depository shall on receipt of information enter the name of the person who surrendered the security certificates as the beneficial owner [Sec. 6].

**5. Registration of Transfer of Securities with Depository:** Every depository shall on receipt of intimation from a participant registers the transfer of security in the name of the transferee.

If a beneficial owner or a transferee of any security seeks to have custody of such security, the depository shall inform the issuer accordingly [Sec. 7].

**6. Options to Receive Security Certificate or Hold Securities with Depository:** Every person subscribing to securities offered by an issuer shall have the option either to receive the security certificates or hold securities with a depository.

Where a person opts to hold a security with a depository, the issuer shall intimate such depository the details of allotment of the security. On receipt of such information the depository shall enter in its records the name of the allot tee as the beneficial owner of that security [Sec. 8].

**7. Securities in Depositories to be in Fungible Form:** All securities held by a depository shall be dematerialized and shall be in a fungible form. Hence, securities held in depository shall not have distinctive numbers.

**8. Rights of Depositories and Beneficial Owner:** These are as follows:

(i) A depository shall be deemed to be the registered owner for the purposes of effecting transfer of ownership of security on behalf of beneficial owner.

(ii) The depository as a registered owner shal1t have any voting rights or any other rights in respect of securities held by it. Such rights shall remain with the beneficial owner.

(iii) The beneficial owner shall be entitled to all the rights and benefits and be subjected to all the liabilities in respect of his securities held by a depository [Sec. 10].

**9. Register of Beneficial Owner:** Every depository shall maintain a register and an index of beneficial owners in the manner provided for register of members in the Companies Act [Sec. 11].

**10. Pledge or Hypothecation of Securities held in a Depository:** This shall be done in accordance with the following provisions:

(i) A beneficial owner may with the previous approval of the depository create a pledge or hypothecation in respect of a security owned by him through a depository.

(ii) Every beneficial owner shall give intimation of such pledge or hypothecation to the depository and such depository shall thereupon make entries of the pledge or hypothecation in its records accordingly.

(iii) Any entry in the records of a depository shall be evidence of a pledge or hypothecation [Sec. 12].

**11. Furnishing of Information and Records by Depository and Issuer:** Every depository shall furnish to the issuer company information about the transfer of securities in the name of beneficial owners at such intervals and in such manner as may be specified by the bye-laws.

Every issuer company shall make available to the depository copies of the relevant records in respect of securities held by such depository [Sec. 13].

**12. Option to Opt Out in Respect of any Security:** If a beneficial owner seeks to opt out of a depository in respect of any security he shall inform the depository accordingly. The depository shall on receipt of intimation make appropriate entries in its records and shall inform the issuer. Every issuer shall, within thirty days of the receipt of intimation from the depository and on fulfilment of such conditions and on payment of such fees as may be specified by the regulations, issue the certificate of securities to the beneficial owner or the transferee, as the case may be [Sec. 14].

**13. Depositories to Indemnify Loss in Certain Cases:** Any loss caused to the beneficial owner due to the negligence of the depository or the DP, the depository shall indemnify such beneficial owner.

Where the loss due to the negligence of the DP is indemnified by the depository, the depository shall have the right to recover the same from such DP [Sec. 16].

**14. Rights and Obligations of Depositories:** The rights and obligations of the depositories, DPs and the issuer companies (whose securities are dealt with by a depository) shall be specified by the regulations. The eligibility criteria for admission of securities into the depository shall be specified by the regulations.

**15. Powers of SEBI:** The SEBI has been granted the following powers under the Depositories Act:

**(a) To call for information and Enquiry:** The SEBI may call upon any issuer company, depository, DP or beneficial owner to furnish in writing such information relating to the securities held in a depository as it may require [Sec. 18 (1)].

**(b) To make Enquiry or Inspection:** The SEBI may authorize any person to make an enquiry into or inspection of the affairs of the issuer company, beneficial owner, depository or DP. He shall submit a report of such enquiry or inspection to it within such period as may be specified in the order [Sec. 18 (2)].

**(c) To give Directions:** If after making or causing to be made an enquiry or inspection, the SEBI may issue any of the following directions in the interest of investors or the securities market:

(i) To any depository or DP or any person associated with the securities market.

(ii) To any issuer company [Sec 19].

In addition, the Depositories Act also provides for penalty in case of contravention of the provisions of it and for non compliance of the orders of the SEBI.

## 9.4 CHECK YOUR PROGRESS

Fill in the blanks

1. ……….. an organization where securities of a shareholder are held in the form of electronic accounts in the same way as bank holds money.

2. ……… and ……… two depositories which are registered with SEBI.

3. Every security-holder or a person who intends to become a security- holder may open an account with a DP of a depository for deposit of his holding of securities in the account is known as ………… .

4. ……… is an intermediary or agent of the depository who provides depository services to its registered clients/security-holders.

5. On the basis of ……….. settlement cycle of trade follows.

## 9.5 SUMMARY

The legal framework for depository system in the Depositories Act, 1996 provides for the establishment of single or multiple depositories. All the securities held by a depository are dematerialized and are in a fungible form. In the depository system, the ownership and transfer of securities takes place by means of electronic book entries. A Depository Participant (DP) is the representative (agent) of the investor in the depository system providing the link between the Company and investor through the Depository. The Depository Act, 1996 and SEBI (Depositories and Participants) Regulations, 1996 regulates the function of Depositories and participants. Regulation 55A of SEBI (Depositories and Participants) Regulations, 1996 provides that every issuer shall submit audit report on a quarterly basis to the concerned stock exchanges audited by a practicing Company Secretary or a qualified Chartered Accountant, for the purposes of reconciliation of the total issued capital, listed capital and capital held by depositories in dematerialized form, the details of changes in share capital during the quarter and the in-principle approval obtained by the issuer from all the stock exchanges where it is listed in respect of such further issued capital. Both the Depositories in India have allowed Practising Company Secretaries to undertake internal audit of the operations of Depository Participants (DPs). –Depository Participants are subject to concurrent audit by a Practising Company Secretary or qualified Chartered Accountant. Concurrent Audit includes audit of process of demat account opening, control and verification of delivery instruction slips.

## 9.6 KEYWORDS

**Depository:** It means a company formed and registered under the Companies Act and which has been granted a certificate of registration under the Securities and Exchange Board of India (SEBI) Act, 1992.

**Settlement on T+2 basis:** It means the settlement of trades takes place on the 2nd working day from the trade day.

**Depository Participant:** Depository Participant (DP) is an intermediary or agent of the depository who provides depository services to its registered clients/security-holders.

## 9.7 SELF ASSESSMENT TEST

1. Explain the objectives and salient features of Depositories Act.
2. Who are the participants of depository system? Explain in detail.
3. State the procedure of dealing of securities through depository system.

4. What are the benefits of depository system? Discuss.

## 9.8 ANSWERS TO CHECK YOUR PROGRESS

1. Depository
2. NSDL and CDSL
3. DEMAT
4. Depository Participant
5. T + 2

## 9.9 REFERENCES/SUGGESTED READINGS

1. N.D. Kapoor & Dinkar Pagare, Business Laws and Management; Sultan Chand & Sons.
2. M.C. Kuchhal, Mercantile Law; Vikas Publishing House, New Delhi.
3. P. P. S. Gogna, A Textbook of Business Law; Sultan Chand & Company, New Delhi.
4. D. Chandra Bose, Business Laws; PHI Learning Pvt. Ltd.

# LESSON 10

# BORROWING POWERS AND MANAGERIAL REMUNERATION

## STRUCTURE



## 10.0 LEARNING OBJECTIVES

After reading this lesson, you should be able to:

- Outline the provisions relating to borrowing powers of a company.
- Explain the consequences of ultra vires borrowings.
- Define charges and compare between fixed and flexible charge.
- Identify the charges whose registration is mandatory.

- Describe the provisions regarding managerial remuneration.

# 10.1 INTRODUCTION

It is a general commercial practice to borrow funds for the purpose of conducting business. Every company borrows money for its long-term, short-term, or medium-term requirements from various sources. Every sources have different ways to borrow funds for successful running of operations.

# 10.2 MEANING OF BORROWING

Borrowing or loan is a comprehensive term. It includes borrowings by issuing debentures or bonds or other securities or raising loans in any other way whether with or without security. But the term does not include the temporary borrowings or, loans repayable on demand, or within a period of 6 months from the date of borrowing or loan.

### 10.2.1 Provisions Regarding Power of Borrowing

Companies borrow funds or take loans. The provisions of law regarding borrowing powers of companies are summarized as follows:

**1. Implied Power of Trading Company:** A trading or commercial company has implied power to borrow even though there is no express power conferred on it by its memorandum. Therefore, a trading company can borrow for the purposes of its business unless it is prohibited by its memorandum. But the usual practice is that every trading company includes in its memorandum the express power to borrow monies for its business purposes. The articles of the company may prescribe the limit and manner in which the power to borrow may be exercised or delegated. A trading company means a company whose objective is to earn profit and distribute it among its members.

**2. No Implied Power of Non-trading Company:** A non-trading company has no implied power to borrow for any purpose. It can borrow only when its memorandum gives it an express power to borrow. It can borrow to the extent of the limit set by the memorandum. Here, non-trading company means a not-for-profit company (e.g, a building society, a literary, scientific institution, or an educational institution).

**3. Statutory Limit on Borrowings:** Board of directors of any company cannot borrow money (including the money already borrowed by the company) exceeding the aggregate of the paid-up capital of the company and its free reserves apart from the temporary loans obtained from bankers subject to the consent of the company by a special resolution [Sec. 180(1)].

**4. Limits set by Memorandum:** The memorandum or the articles may set a limit on borrowings by a company. But this limit cannot exceed the statutory limit or higher limit fixed by the general meeting.

**5. Borrowing Beyond Limits:** If a company borrows in excess of the statutory limit, the debt shall not be valid and effectual. However, if the lender proves that he advanced the loan in good faith and without knowledge that the limit imposed had been exceeded, he can reclaim the amount so advanced [Sec. 180(5)].

**6. Temporary Loans not Included:** While calculating the amount of borrowing under the statutory limit, the 'temporary loans' shall not be considered. The expression 'temporary loans' means loans repayable on demand or within 6 months from the date of the loan. It includes loans such as short-term cash credit arrangements, the discounting of bills, and the issue of other short-term loans of a seasonal character but does not include loans raised for the purpose of financing expenditure of capital nature [Sec. 180(1)].

**7. Time to Exercise Power:** A company can exercise its borrowing power only after it is entitled to commence its business. If any default is made in complying with this provision, the company shall be liable to a penalty, which may extend to ` 5,000. Moreover, every officer who is in default shall also be punishable with a fine, which may extend to ` 1,000 for every day during which the default continues [Sec. 11].

**8. Person Authorized to Borrow:** The Board of directors of a company has the power to borrow on behalf of the company. It can exercise the power to borrow by means of resolution passed at the meeting of the Board. However, the Board may delegate the power to borrow monies by a resolution passed at a meeting. It can delegate to any committee of directors, the managing director, the manager or any other principal officer of the company or in case of a branch office of the company the principal officer of the branch office [Sec. 179].

**9. Powers to Mortgage or Charge Assets:** The power to borrow naturally implies the power to mortgage or charge the property of the company. Usually, title deeds of property, book debts, goodwill, patent rights, or copyrights can be mortgaged or charged.

**10. Certain Assets cannot be Mortgaged or Charged:** The following assets of a company cannot be charged or mortgaged:

(i) Uncalled capital of the company

(ii) Reserve capital

(iii) Amount guaranteed by the members of a company limited by guarantee

(iv) Books of accounts.

## 10.2.2 CONSEQUENCES OF ULTRA VIRES BORROWINGS

Borrowing without or beyond express or implied powers are known as ultra vires borrowings.

These may be of two kinds:

I. Borrowings ultra vires the company.

II. Borrowings ultra vires the directors.

**I. Borrowings *Ultra Vires* the Company**

If a company borrows money without or beyond its express or implied powers, the borrowing is ultra vires. The following are the consequences of such borrowings:

(i) Borrowings ultra vires the company are void. Therefore, no relation of creditor and debtor arises between the parties.

(ii) The mortgage or charge created for the security of the loan shall be void and inoperative.

(iii) Borrowings ultra vires the company cannot be ratified even by a unanimous resolution passed in the company's general meeting.

(iv) Even no suit against the company can be filed under the general law of the land. It is because ultra vires lender has no legal or equitable debt against the company.

**Remedies Available to Lender**

Although the borrowings ultra vires the company are void but at equity, the lender has the following remedies:

**1. Injunction:** When a lender comes to know of the lending beyond the power of the company, he may obtain an injunction from the Court and restrain the company from parting with the money. But this remedy can be availed of only if the money lent has not been spent by the company.

**2. Recovery or Restitution:** The lender can recover the money from the company if he can trace and identify the money lent. If the money has been spent for the purchase of any property, he can claim possession of such property as its true owner. If the money lent cannot be traced but it can be proved that the company has been benefited thereby (e.g. by increase in assets), the lender can claim repayment of his money out of that benefit.

**3. Subrogation:** If the company has used the money borrowed in paying off its lawful creditors, the lender may be subrogated to the rights of the creditors. Consequently, the lender will be entitled to rank as a creditor of the company up to the amount so used. Thus, the lender steps into the shoes of the old creditors of the company who were so paid off.

**4. Suit against Directors:** If the directors exceed their power in borrowing the money, the lender may sue them personally for breach of warranty of authority.

**II. Borrowings ultra vires the Directors**

Sometimes, a borrowing is intra vires the company but ultra vires of those managing the company (i.e., directors of the company). Directors cannot borrow beyond the paid-up capital and free reserves of the company without the consent of the company by a special resolution. Any loan incurred by a company in excess of this limit shall not be valid unless the lender proves that he advanced the loan in good faith and without knowledge that the limit imposed on the power has been exceeded [Sec. 180(5)].

Where the directors of a company borrow money beyond their limit to borrow without the consent of the company in general meeting, ordinarily, the company is not bound to repay. However, if the money borrowed beyond the limit has been used for the benefit of the company either in paying its debts or for its legitimate business purpose, the company cannot escape its liability on the ground that the directors had no authority to borrow.

But sometimes, a managing director of a company who is not authorized to borrow money which is not necessary. It is neither bona fide nor for the benefit of the company. Hence, the company is not liable for the amount borrowed.

## 10.3 MEANING CHARGE AND MORTGAGE

The power to borrow naturally implies the power to charge or mortgage the property of the company. Therefore, when a company borrows money on the security of property of the company, it can charge or mortgage its property in favour of its creditors (i.e., lenders or debenture-holders).

**Meaning of Charge and Mortgage**

According to Section 2(16), "Charge means an interest or lien created on the property or assets of a company or any of its undertakings or both as security and includes a mortgage." In one case, charge has been defined in the following words:

"Where in a transaction for value, both the parties agree that the existing and future property shall be made available as security for the payment of a debt and that the creditors shall present right to have it made available, there is charge."

It may be noted that there is charge even though the present legal right of the creditor can only be enforced at some future date and though the creditor gets no legal right to property (either absolute or special or any legal right to possession), but only gets the right to have the security made available by an order of the Court.

Charge also includes a lien and an equitable charge whether created or evidenced by an instrument in writing or by deposit of title deeds or by an agreement to deposit.

**Mortgage:** A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future or the performance of an agreement which may give rise to a pecuniary liability [Section 58, The Transfer of Property Act, 1882].

**Characteristics of Charge**

Following are the characteristics of a charge:

1. Charge is an interest or lien created on an asset/property in favour of creditors.
2. Charge can be created:
   (a) On any asset or property.
   (b) On any undertaking.

(c) On any movable or immovable property.

(d) On any present or future assets.

3. Charge can be created on any tangible or intangible property or on both.
4. It can be created on any property situated in or outside India.
5. Charge is evidenced by an instrument in writing.
6 Charge may also be created by deposit of title deeds of the property or by an agreement to deposit the same.
7. The purpose of creating a charge is to provide security for payment of a debt.
8. Every charge created by a company needs to be registered with the Registrar.

**Kinds of Charges**

Charges created on the property of a company may be of any of the two kinds:

1. Fixed or specific charge.

2. Floating charge.

**1. Fixed or Specific Charge:** A charge is said to be fixed or specific when it is created on some specific, ascertained, and definite property of a permanent nature such as land or building. Thus, such a charge covers the existing ascertained or capable of being ascertained and defined property. In case of such a charge, the company creating the charge can only deal with the property subject to the prior rights created by the charge. In other words, the company cannot dispose of the property without the consent of the charge-holder.

**2. Floating Charge:** A floating charge is an equitable charge on the floating assets of the company. It is a charge on the class of floating assets and not on any specific and definite assets. It is a charge on present as well future assets of the company, which goes on changing from time to time in the ordinary course of business.

The company is free to deal with the assets charged until the charge-holder takes steps to enforce the security or the company goes into liquidation. Thus, such a charge remains dormant until the company ceases to be a going concern or until the charge-holder enforces the security.

When the floating charge crystallizes, it becomes fixed charge and assets covered therein are subject to the same restrictions as in case of a fixed charge.

**Characteristics:** The main characteristics or the features of floating charge are as follows:

1. Floating charge can be created on all or any class of assets excluding the assets on which charge cannot be created.
2. It is a charge on present as well as future assets which in the ordinary course of business would be changing from time to time
3. The company is free to deal with assets charged until the charge-holder takes steps to enforce the security or the company goes into liquidation.
4. Such a charge remains dormant until the company ceases to be a going concern or until the charge-holders enforces the security.
5. When the floating charge crystallizes, it becomes a fixed charge.
6. When the company makes a breach of any condition of charge, the charge- holder can enforce the charge.
7. No particular words are necessary to create a floating charge. Any words which show the intention of the parties that the company shall continue to deal with the assets charged in ordinary course of business will create a floating charge.

**Consequences and Advantages of Floating Charge**

Following are the main advantages or consequences of floating charge till the charge crystallizes:

**1. Use the Property:** A company may continue to use the property on which a floating charge has been created.

**2. Recharge or Mortgage:** A company is entitled to create a further charge on the same assets to secure another debt provided it is not prohibited by the terms of the earlier charge. Every subsequent charge is deemed to have notice of all the earlier charges which have been registered (Sec. 80).

**3. Fixed Charge after Floating Charge:** A company may not only create a further floating charge on the assets already charged but can also create fixed charge on the same assets.

**4. Sell, Transfer or Lease the Property:** A company can sell or lease the property charged in the ordinary course of business if it is authorized by its memorandum. Even a company can transfer its whole of the undertaking to another under a scheme of amalgamation within the objects of the company.

## 8.3.1 DISTINCTION BETWEEN FIXED AND FLOATING CHARGE

Distinction between fixed and floating charges has been enumerated in Table 8.1

**Table 10.1 Distinction between Fixed and Floating Charges**

| **Basis of Distinction** | **Fixed Charge** | **Floating Charge** |
|---|---|---|
| 1. Nature of assets | Fixed charge may be created on specific and definite assets of permanent nature (e.g., land or building) | Floating charge may be created on any assets or class of floating assets. |
| 2. Dealing in property | Property charged cannot be transferred. It an be used by the company. | Property charged can be used, sold, transferred, or mortgaged by the company. |
| 3. Existing or future property | Fixed charge can be created only on existing ascertained property. | Floating charge can be created on existing as well as future assets of the company. |
| 4. Change | Fixed charge cannot become floating charge | A floating charge may become fixed charge |
| 5. Effect | Fixed charge has its effect from the day, it is created | Floating charge remains dormant till any event specified in the deed of the charge happens |
| 6. Suspension | Right of fixed charge-holder cannot be suspended. | Rights of floating charge-holder can be suspended by an agreement. |

**Crystallization of Floating Charge**

Crystallization is the process of conversion of floating charge into a fixed charge. Floating charge crystallizes in any of the following cases:

1. When the company ceases to carry on its business.
2. When the company goes into liquidation.
3. When the creditors or debenture-holders take steps to enforce the security.
4. When the creditor or debenture-holder gets a receiver appointed by the Court.
5. When the creditor/debenture-holder does any other act which affects the company's power of disposition over assets charged.
6. When any of the events specified in the charge deed happens.

**Effect of Crystallization:** When a floating charge crystallizes, it is said to become fixed. The charge-holder gets priority over the subsequent charge and other unsecured creditors. But the creditors who are entitled to preferential payment in the event of winding up of a company (under Section 327) shall get priority over the creditors holding a floating charge even if the company is not at that time in the course of winding up [Sec. 123].

**Effect of Winding up on Validity of Floating Charge**

A floating charge on the undertaking or property of the company created within 12 months immediately preceding the commencement of the winding up shall be invalid unless it is proved that the company immediately after the creation of the charge was solvent except in the following cases:

(i) Where the amount of any cash paid to the company at the time of or subsequent to the creation of the charge.

(ii) Where the amount of any cash paid to the company was the consideration for the charge together with interest on that amount. However, the amount of interest shall be at the rate of 5 per cent per annum or such other rate as may be notified by the Central Government in this behalf [Sec. 332].

The object of the above provision is to prohibit companies which are in insolvent condition from creating any floating charges on their assets, with a view to securing past liabilities. It also empowers the Central Government to prescribe by rules regarding the rate of floating charge.

**Charges Whose Registration is Compulsory**

It shall be the duty of every company to register the particulars of charge created on the following:

1. A charge created on the property or assets of the company.
2. A charge created on any of the undertakings of the company.
3. A charge created on any tangible or otherwise property or assets of the company.
4. A charge created on property or asset or undertaking situated in or outside India [Sec.77(1)].
5. A property acquired subject to charge.
6. Any modification in the terms or conditions of any charge already registered.
7. Any modification in the extent or operation of any charge already registered.
8. Any charge created in or outside India [Sec. 79].

**Charges whose Registration is not Required**

The charges which are not created by the parties to any agreement are not required to be registered. Following are some of such charges whose registration is not required:

1. Charges created by an order or decree of Court
2. Charges created by liquidator.

## 10.3.2 REGISTRATION OF CHARGE

The major provisions with respect to registration of charges are as follows:

**1. Duty to Register Charges:** It shall be the duty of every company to register every charge created on its property or assets or any of its undertakings. Charge created within or outside India needs to be registered. The registration of charge is essential even if the charged property is situated in or outside India and is either tangible or otherwise.

**2. Filing Particulars and Instrument of Charge:** For registration, every company shall file the particulars of charge with the Registrar. The particulars shall be signed by the company and the charge-holder.

The particulars of charge shall be filed along with a copy of the instrument creating the charge. The copy of every such instrument shall be verified as follows:

(a) Where the instrument or deed relates solely to the property situated outside India, the copy shall be verified by a certificate issued either under the seal if any, of the company or under the hand of any director or company secretary of the company. Alternatively, it may be verified by a certificate issued by an authorized officer of the charge-holder or under the hand of some person other than the company who is interested in the mortgage or charge.

(b) Where the instrument or deed relates (whether wholly or partly) to the property situated in India, the copy shall be verified by a certificate issued under the hand of any director or company secretary of the company or an authorized officer of the charge-holder [Sec. 77(1) and Rule CHG-3].

**3. Time Limit for Registration:** Every charge created shall be registered within 30 days of its creation [Sec. 77(1)].

**4. Condonation of Delay by The Registrar:** Sometimes, a company fails to register the charge within 30 days of its creation. In such a case, the company can apply to the Registrar for condonation of the delay. Such application shall be in Form No. CHG-1. This application shall be supported by a declaration from the company signed by its secretary or director. The declaration shall be to the effect that such belated filing shall not adversely affect rights of any other intervening creditors of the company.

If the Registrar is satisfied with the cause for not filing the particulars and instrument of charge within a period of 30 days of the date of its creation, he may allow the registration of the same after 30 days. But the company shall be required to register the charge within 300 days of the date of its creation or its modification on payment of additional fee [Sec. 77(1) and Rule CHG-4].

**5. Extension of Time Limit by the Central Government:** Sometimes, a company even fails to register a charge within 300 days of its creation. In such a case, the company may seek extension of time from the Central Government. The Registrar shall not register the charge unless the delay is condoned by the Central Government.

The Central Government is empowered to condone the delay and extend the time limit for registration of a charge even after 300 days of its creation. A company may make an application to the Central Government in Form No. CHG-8 along with the fee for seeking extension of time. The Central Government may issue an order for condonation of the delay and extension of time for registration of the charge in any of the following cases:

(i) Where such delay or omission was accidental or due to inadvertence.

(ii) When the delay or omission was due to some other sufficient cause.

(iii) Where the delay or omission is not of a nature to prejudice the position of creditors or shareholder of the company.

**6. Registration by Registrar:** On receipt of the order of the Central Government extending the time for registration of charge, the company shall file a copy of the order to the Registrar in Form No. INC-28 along with the fee. While filing the form, the company shall comply with the conditions stipulated in the order. The Registrar shall register the charge. While registering the charge, the Registrar shall ensure that such registration of charge shall not prejudice any right acquired in respect of the property before the charge is actually registered.

**Certificate of Registration**

Where a charge is registered with the Registrar, he shall issue a certificate of registration of such charge. The certificate shall be issued to the company and to the person in whose favour the charge is created (i.e., charge-holder). The certificate shall be in prescribed form and manner Sec. 77(2)).

**Certificate Conclusive Evidence:** The certificate of registration of charge issued by the Registrar shall be conclusive evidence of the fact that the requirements of registration of charge (under Chapter VI of the Act and the Rules made thereunder) have been complied with.

**Deemed or Constructive Notice of Charge**

Where any charge on any property or assets of a company or any of its undertakings is registered, any person acquiring such property, assets, or undertakings (or part thereof or any or interest therein) shall be deemed to have notice of the charge from the date of such registration [Sec. 80].

**Provisions of Charge Applicable in Certain Matters**

The provisions of charge [Sec. 77] shall apply to the following matters:

1. When a company acquires a property which is subject to a charge.

2. When the terms or conditions of any registered charge are modified.

3. When the extent or operation of any registered charge is modified [Sec. 79].

**Unregistered Charge Not Taken into Account**

No charge created by a company shall be taken into account by the liquidator or any other creditor unless it is duly registered and a certificate of registration of such charge is given by the Registrar [Sec. 77(3)]. But this provision shall prejudice any contract or obligation for the repayment of the money secured by a charge [Sec. 77(4)].

## 10.3.3 MANAGERIAL REMUNERATION

Managerial remuneration means the remuneration payable to managerial personnel of a company. For the purpose of calculation and payment of managerial remuneration, managerial personnel mean the following personnel:

(a) Managing director or manager.

(b) Whole-time director.

(c) Other directors.

The main provisions regarding managerial remuneration, that is, remuneration payable to Managing Director (MD), Whole-time Director (WD) or manager are as follows:

**Maximum Limit of Remuneration**

The maximum remuneration payable by a public company to its directors (MD, WD, and part-time directors) and manager in respect of a financial year cannot exceed 11 percent of the net profits of the company [Sec. 197(1)]. The net profits for the above purposes shall be computed in the manner referred to in Section 198. However, the remuneration of the directors shall not be deducted from the gross profits [Sec. 197(1) and 197(8)]. 1t should be noted that remuneration paid for services rendered other than of professional nature shall be inclusive of remuneration payable to directors [Sec 197(4)].

**Exclusions from remuneration**

The remuneration paid in any of the following ways shall be exclusive of maximum limit of remuneration:

**1. Sifting Fee Payable to Directors:** The limit of 11 per cent of net profits shall be exclusive of any fee payable to directors for attending meetings (i.e. sitting fee) of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board [Sec. 197(5)].

**2. Remuneration for Services of Professional Nature:** Any remuneration for services rendered by any director in other capacity shall not be included in the maximum amount of remuneration in the following cases:

(i) If the services rendered are of professional nature.

(ii) If in the opinion of the 'Nomination and Remuneration Committee' [if the company is a listed company or a company belonging to a prescribed class, i.e. covered under Section 178(1)], or the Board of directors in other cases, the director possesses the requisite qualification for the practice of the profession [Sec. 197(4)].

**3. Insurance Premium Paid for Indemnifying Against Liability for Negligence etc.:** Sometimes, insurance is taken by a company on behalf of its MD, WD, manager, CEO, CFO or company secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company. In such a case, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel. However, if such person is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration [Sec. 197(13)].

**Higher Payment with Approval of Central Government**

A company in a general meeting may authorize the payment of remuneration exceeding 11 per cent of the net profits of the company, subject to the provisions of Schedule V. However, such resolution of general meeting for higher remuneration shall require the approval of the Central Government [Sec. 197(1)].

**Ceiling on Individual and Overall Remuneration**

The remuneration payable to any one MD or WD or manager shall not exceed 5 per cent of the net profits of the company. If there is more than one such director, remuneration shall not exceed 10 per cent of the net profits to all such directors and manager taken together [Sec. 197(1)].

**Remuneration in Case of No Profits or Inadequate Profits**

Sometimes, a company has no profits or inadequate profits and cannot pay remuneration in accordance with the above provisions. In such a case, the company shall not pay to its directors (including any managing or whole-time director or manager), by way of remuneration any sum (exclusive of any fees payable to directors for attending meetings and for their professional services) except in accordance with the provisions of Schedule V. If the company is not able to comply with provisions of Schedule V, it shall pay the remuneration only with the previous approval of the Central Government [Sec. 197(3)].

**Increase in Remuneration in Case of No Profits or Inadequate Profits**

This is the case where Schedule V is applicable on the grounds of no profits or inadequate profits. In such cases, any provision for increase in remuneration (in the company's articles, or in an agreement entered into by it or in any resolution passed by the company in general meeting or its Board relating to the remuneration of any director which purports to increase or has the effect of increasing the amount thereof), shall not have any effect unless such increase is in accordance with the conditions specified in that Schedule. If such conditions are not being complied with, such increase shall be effective only when the approval of the Central Government is obtained [Sec. 197(11)].

**Remuneration from Holding or Subsidiary Company**

Any director who is in receipt of any commission from the company and who is a MD or WD of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company. However, the company shall be required to disclose such fact in the Board's report [Sec. 197(14)].

**DETERMINATION AND PAYMENT OF REMUNERATION**

**1. Determination of Remuneration:** The remuneration payable to the directors of a company (including any MD or WD or manager), shall be determined by any of the following:

(i) By the articles of the company.

(ii) By a resolution passed by the company in general meeting.

(ii) By a special resolution passed by the company in general meeting, if the articles so require.

It may be noted that the remuneration shall be determined in accordance with and subject to the provisions of this Section (i.e. Section 197). It should be noted that the remuneration payable to a director determined aforesaid shall be inclusive of the remuneration payable to him for the services rendered by him in any other capacity except for the services of professional nature rendered in the professional capacity [Sec. 197(4)].

**2. Mode of Payment:** A director or manager may be paid remuneration in any of the following ways:

(i) By way of monthly payment.

(ii) By way of a specified percentage of the net profits of the company.

(iii) Partly by way of monthly payments and partly by way of a specified percentage of the net profits [Sec. 197(6)].

**Sitting Fee**

A director may receive remuneration by way of fee for attending meetings (sitting fee) of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board. However, the amount of such fees shall not exceed the amount as may be prescribed. Moreover, different fees for different classes of companies and fees in respect of independent director may be such as may be prescribed [Sec. 197(5)].

The Rules notified by the MCA have prescribed that a company may pay a sitting fee to a director for attending meetings of the Board or committees thereof, such sum as may be decided by the Board of directors of the company. However, such fee shall not exceed ` one lakh per such meeting. It should be noted that the sitting fee for independent directors and women directors shall not be less than the sitting fee payable to other directors.

**Remuneration to Non-executive (part-time) Directors**

The remuneration payable to non-executive directors (who are neither managing directors nor whole-time directors) shall not exceed the following limits:

(i) One per cent of the net profits of the company, if there is a managing or whole- time director or manager.

(ii) 3 per cent of the net profits in any other case [Sec. 197(1)].

It may be pointed out that the percentages aforesaid shall be exclusive of any sitting fees payable to directors [Sec. 197(2)].

**Remuneration to Independent Directors**

An independent director shall not be entitled to any stock option. But he may receive remuneration by the following ways:

(i) Fees for attending meetings of the Board or the Committees thereof.

(ii) Reimbursement of expenses for participation in the Board and other meetings.

(iii) Profit related commission as may be approved by the members [Sec. 197(7)].

His right to remuneration and commission is subject to the provisions of Sections 197 and 198 [Sec. 149(9)].

**OTHER PROVISIONS AS TO REMUNERATION**

**1. Refund of Excess Sums Drawn:** Sometimes, a director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed or without prior sanction of the Central Government, if required. In such a case, he shall refund such sums to the company. Until such sums are refunded, the director shall hold them in trust for the company [Sec. 197(9)]. It should be noted that the company shall not waive the recovery of any sum refundable to it unless permitted by the Central Government [Sec. 197(10)].

**2. Disclosure of Ratio of Remuneration in the Board's Report:** Every listed company shall disclose in the Board's report, the ratio of the remuneration of each director to the median employee's remuneration. The Board's report shall contain such other details as may be prescribed [Sec. 197(12)].

**3. Punishment:** If any person contravenes the provisions of this Section, he shall be punishable with fine which shall not be less than ₹ one lakh but which may extend to ` 5 Iakh [Sec. 197(15)].

**4. Recovery of Remuneration in Certain Cases:** Sometimes, a company is required to re-state its financial statements due to fraud or non-compliance with any requirement under this Act and the Rules made thereunder. In such a case, the company shall recover from any past or present managing director or whole-time director or manager or Chief Executive Officer (by whatever name called) who, during the period for which the financial statements are required to be re-stated, received the remuneration (including stock option) in excess of what would have been payable to him as per restatement of financial statements [Sec. 199].

**5. Central Government or Company to Fix Limit of Remuneration:** The Central Government or a company may, (while giving its approval under Sec. 196, to any appointment or to any remuneration under Section 197 in respect of cases where the company has inadequate or no profits) fix the remuneration within the limits specified in this Act at such amount or percentage of profits of the company, as it may deem fit. While fixing the remuneration, the Central Government or the company shall have regard to the following:

(a) The financial position of the company.

(b) The remuneration or commission drawn by the individual concerned in any other capacity.

(c) The remuneration or commission drawn by him from any other company.

(d) Professional qualifications and experience of the individual concerned.

(e) Such other matters as may be prescribed [Sec. 200].

Moreover, the Rules notified by the MCA also require that the Central Government or the company shall have regard to the following matters while fixing remuneration:

(a) The financial and operating performance of the company during the 3 preceding financial years.

(b) The relationship between remuneration and performance.

(c) The principle of proportionality of remuneration within the company, ideally by a rating methodology which compares the remuneration of directors to that of other directors on the Board who receive remuneration and employees or executives of the company.

(d) Whether remuneration policy for directors differs from remuneration policy for other employees and if so, an explanation for the difference.

(e) The securities held by the director, including options and details of the shares pledged as at the end of the preceding financial year.

**6. Forms of and Procedure as to Certain Applications:** Every application made to the Central Government in relation to appointment and remuneration of managerial personnel shall be in Form No. MR-2 and shall be accompanied by prescribed fee.

Before any such application is made, there shall be issued by or on behalf of the company a general notice to the members of the company, indicating the nature of the application proposed to be made. Such notice shall be published at least once in a newspaper in the principal language of the district of the registered office of the company and circulating in that district and at least once in English in an English newspaper circulating in that district. The copies of the notices, together with a certificate by the company as to the due publication thereof, shall be attached to the application [Sec. 20 1(2) and (3) and Rule MR-6 and 7].

**COMPUTATION OF PROFITS**

The net profits for the purposes of managerial remuneration (Section 197) shall be computed in the manner referred to in Section 198. According to Section 198, the manner of computation consists of the following stages:

(a) Credit shall be given for the sums specified in Sub-Section (2).

(b) Credit shall not be given for those specified in Sub-Section (3)

(c) The sums specified in Sub-Section (4) shall be deducted.

(d) The sums specified in Sub-Section (5) shall not be deducted [Sec. 198(1)].

These stages (Sub-Sections) are explained in the ensuing paragraphs.

**1. Credit for Bounties and Subsidies:** In computing the net profits for the purpose of payment of managerial remuneration, credit shall be given for the bounties and subsidies received from any Government, or any public authority (constituted or authorized in this behalf, by any Government) unless and except in so far as the Central Government otherwise directs [Sec. 198(1) and (2)].

**2. Credit not to be given:** In making the computation of profits, credit shall not be given for the following sums:

(a) Profits, by way of premium on shares or debentures of the company which are issued or sold by the company.

(b) Profits on sales by the company of forfeited shares.

(c) Profits of capital nature including profits from the sale of undertaking or any of the undertakings of the company or of any part of it.

(d) Profits from the sale of any immovable property or fixed assets of capital nature comprised in the undertaking or any of the undertakings of the company. Such profits shall not be considered where the business of the company consists, whether wholly or partly, of buying and selling any such property or assets. However, where the amount for which any fixed asset is sold exceeds its written-down value, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value.

(e) Any change in carrying amount of an asset or of a liability recognized in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value [Sec. 198(3)].

**3. Sums to be Deducted:** In making the computation of profits, the following sums shall be deducted:

(a) All the usual working charges.

(b) Directors' remuneration.

(c) Bonus or commission paid or payable to any member of the company's staff or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis.

(d) Any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits.

(e) Any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf.

(f) Interest on debentures issued by the company.

(g) Interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets.

(h) Interest on unsecured loans and advances.

(i) Expenses on repairs to immovable or to movable property provided the repairs are not of a capital nature.

(j) Outgoings inclusive of contributions made (under Section 181) to bona fide and charitable funds.

(k) Depreciation to the extent specified in Section 123.

(l) The excess of expenditure over income, which had arisen in computing the net profits in accordance with this Section in any year in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained.

(m) Any compensation or damages to be paid by virtue of any legal liability including a liability arising from a breach of contract.

(n) Any sum paid by way of insurance against the risk of meeting any liability such as referred to in the above clause.

(o) Debts considered bad and written off or adjusted during the year of account [Sec.198(4)]

**4. Sums not to be Deducted:** In making the above computation, the following sums shall not be deducted:

(a) Income tax and super tax payable by the company under the Income Tax Act or any other tax on the income of the company not falling under Section 198(4) (d) and (e) above.

(b) Any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in Section 198(4) (m) above.

(c) Loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value.

(d) Any change in carrying amount of an asset or of a liability recognized in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value [Sec. 198(5)].

**PROVISIONS OF PART II AND IN OF SCHEDULE V**

**Remuneration payable without approval of the Central Government:** Parts II and III of Schedule V contain the limits of remuneration payable to managerial persons without approval of the Central Government. These may be described under the following heads:

I. Remuneration payable by companies having profits: Section I of the Schedule V.

II. Remuneration payable by companies having no profits or inadequate profits without Central Governments' approval: Section II of the Schedule V.

III. Remuneration payable by companies having no profits or inadequate profits without Central Government's approval in certain special circumstances: Section III of the Schedule V.

IV. Perquisites not included in managerial remuneration: Section IV of the Schedule V.

V: Remuneration payable to a managerial person in two companies: Section V of the Schedule V.

**Remuneration Payable by Companies having Profits:** Subject to the provisions of Sections 197, a company having profits in a financial year may pay any remuneration to a managerial person or persons not exceeding the limits specified in such Section.

**Remuneration Payable by Companies Having No Profits or Inadequate Profits without Central Government's Approval:** Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government's approval, pay remuneration to the managerial person not exceeding the higher of the limits prescribed under Scheme (A) and B) given below: The Scheme (A) is as follows:

| **Where the Effective Capital is** | **Limit of Yearly Remuneration Payable shall not Exceed (`)** |
|---|---|
| (i) Negative or less than 5 crore | 30 lakh |
| (ii) 5 crore and above but less than 100 crore | 42 lakh |
| (iii) 100 crore and above but less than 250 crore | 60 lakh |
| (iv) 250 crore and above | 60 lakh plus 0.01 per cent of the effective capital in excess of ` 250 crore. |

However, the above limits shall be doubled if the resolution passed by the shareholders is a special resolution.

**Explanation:** It is hereby clarified that for a period less than one year, the limits shall be prorated. .

**Scheme (B):** In case of a managerial person who was not a security holder, holding securities of the company of nominal value of ` 5 lakh or more or an employee or a director of the company or not related to any director or promoter at any time during 2 years prior to his appointment as a managerial person (2.5 per cent of the current relevant profit).

However, if the resolution passed by the shareholders is a special resolution, this limit shall be doubled. The limits specified under this Section shall apply to the companies other than listed companies and their subsidiaries in the following cases:

(a) The payment of remuneration is approved by a resolution passed by the Board and, in the case of a company covered under Section 178(1) also by the Nomination and Remuneration Committee.

(b) The company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in the preceding financial year before the date of appointment of such managerial person.

(c) A special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding 3 years.

(d) A statement along with a notice calling the general meeting referred to in clause (iii) is given to the shareholders containing the information specified in Section II of Part II of the Schedule V including reasons and justification for payment of remuneration beyond the said limit.

**Remuneration Payable by Companies having no Profit or Inadequate Profit without Central Government's Approval in Certain Special Circumstances:** In the following circumstances a company may, without the Central Government's approval, pay remuneration to a managerial person in excess of the amounts provided in Section II above:

(a) Where the remuneration in excess of the limits specified in Section I or II is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in general meeting to make such payment, and treats this amount as managerial remuneration for the purpose of Section 197 and the total managerial remuneration payable by such other company to its managerial persons including such amount or amounts is within permissible limits under Section 197.

(b) A company may pay remuneration up to two times the amount permissible under Section II in the following cases:

   (i) Where the company is a newly incorporated company, for a period of 7 years from the date of its incorporation.

(ii) Where the company is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction or National Company Law Tribunal, for a period of 5 years from the date of sanction of scheme of revival.

(c) Where remuneration of a managerial person exceeds the limits in Section II but the remuneration has been fixed by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal.

(d) A company in a Special Economic Zone as notified by the Department of Commerce from time to time which has not raised any money by public issue of shares or debentures in India and has not made any default in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in any financial year, may pay remuneration up to ` 2.40 crore per annum.

**Perquisites Not Included in Managerial Remuneration**

1. A managerial person shall be eligible for the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II and Section III

(a) Contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income Tax Act, 1961.

(b) Gratuity payable at a rate not exceeding half a month's salary for each completed year of service

(c) Encashment of leave at the end of the tenure

2. In addition to the perquisites specified, above an expatriate managerial person (including a non-resident Indian) shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II or Section III:

**(a) Children's Education Allowance:** In case of children studying in or outside India, an allowance limited to a maximum of ₹ 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.

**(b) Holiday Package for Children Studying Outside India or Family Staying abroad:** Return holiday package once in a year by economy class or once in two years by first class to children and to the members of the family from the place of their study or stay abroad India if they are not residing in India, with the managerial person.

**(c) Leave Travel Concession:** Return package for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

For the purposes of this Schedule, ‘family’ means the spouse, dependent children and dependent parents of the managerial person.

## 10.4 CHECK YOUR PROGRESS

Fill in the blanks

1. ……… is an equitable charge on the floating assets of the company.
2. The maximum remuneration payable by a public company to its directors and manager in respect of a financial year cannot exceed ………. .
3. …….. charge may be created on specific and definite assets of permanent nature.
4. Every charge created shall be registered within ……….. of its creation.
5. ………… is a transfer of interest in immovable property for securing payment of a debt.

## 10.5 SUMMARY

The power to borrow in the case of a company is generally specified in the Memorandum or in the Articles of a company. A public company having share capital cannot exercise borrowing power unless certificate of commencement of business is obtained. A company cannot borrow in excess of its paid up capital and free reserves. Again, a company cannot borrow without or beyond its express or implied powers, otherwise such a borrowing is ultra vires and is void. If the borrowing is ultra vires, the lender in equity has the rights of injunction, recovery, subrogation and suit against directors. Companies Act requires charges to be registered with the Registrar of Companies. The debt in respect of which the charge is created remains valid and can be recovered as an insecured debt. A charge created on specific property of permanent nature is called as fixed charge. Overall, managerial remuneration payable by a public company shall not exceed 11% of the net profit of the company for that financial year. However, company in general body meeting with the approval of Central Government may pay higher remuneration subject to regulations.

## 10.6 KEYWORDS

**Mortgage:** It is a transfer of interest in immovable property for securing payment of a debt.

**Charge:** It is a means of providing security for repayment of debt in the form of present or future title to movable or immovable property.

**Floating Charge:** It is an equitable charge on the floating assets of the company.

**Managerial Remuneration:** It is the remuneration payable to managerial personnel of a company.

## 10.7 SELF ASSESSMENT TEST

1. Explain the provisions of Companies Act regarding payment of managerial remuneration.
2. Explain the limits of remuneration of managing director mentioned in Schedule V of the Companies Act.
3. State the legal provisions as to borrowing powers of a company and discuss the consequences of ultra vires borrowings.
4. Define charge. Distinguish between fixed and floating charge and state the circumstances when the floating charge becomes fixed charge.
5. What are the charges whose registration is compulsory? What are the consequences of non-registration of charges?

## 10.8 ANSWERS TOCHECK YOUR PROGRESS

1. Floating Charge
2. 11% of the net profits of company
3. Fixed
4. 30 Days
5. Mortgage

## 10.9 REFERENCES/SUGGESTED READINGS


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