Indira Gandhi National Open University
School of Tourism and Hospitality
Services Management

# BTMC-132
# Fundamentals of Management

Block

# 2

## COMPANY FORMATION

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# BLOCK 2 COMPANY FORMATION

The company form of business organisation is the most appropriate and popular form in a complex modern day environment. In this form of organisation, money is invested by a large number of persons called shareholders who maybe scattered over different parts of the country or even the world.

For the formation of a company and the commencement of its business, a company has to prepare a number of documents, of these, the main documents are: (i) Memorandum of Association (ii) Articles of Association and (iii) Prospectus.

In this block comprising of five units, we have discussed the nature and types of companies, the role of promoters, the procedure of formation of a company as well as the importance, contents and legal implications of Memorandum of Association, Articles of Association and Prospectus . The five units are.

**Unit: 5** explains the nature of a company, the distinction between company and partnership and the various types of companies that can be formed.

**Unit: 6** describes the procedure for the formation and winding up of a company. It is divided into four stages: (i) Promotion; (ii) Filing of necessary documents; (iii) Incorporation/Registration; (iv) Commencement of business and winding up.

**Unit: 7** deals with Memorandum of Association and discusses the meaning, purpose, contents and the procedure for alteration of different clauses of Memorandum.

**Unit: 8** explains the meaning, purpose and contents of Articles of Association and describes the procedure for its alteration. It also discusses the effect of Memorandum and Articles and Doctrine of Constructive Notice as well as Doctrine of Indoor Management.

**Unit: 9** deals with Prospectus and explains its meaning, purpose and contents. It also discusses remedies available to an aggrieved party in case of misrepresentation in the prospectus.

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# UNIT 5 NATURE AND TYPES OF COMPANIES

**Structure**



## 5.0 OBJECTIVES

After studying this Unit, you should be able to:

- define a company;
- distinguish between company and body corporate;
- describe the characteristic features of a company;
- explain the concept of corporate veil,
- describe the various types of companies;
- understand associations not for profit; and
- describe an illegal association.

## 5.1 INTRODUCTION

The Companies Act, 2013 received the assent of the President on 29th August and was notified on 30th August, 2013. It has 470 sections and VII schedules, whereas the Companies Act 1956 had 658 sections and XV schedules. This Act provides detailed rules regarding formation, management and administration and winding up of companies by Tribunals. It has made changes in provisions relating to memorandum, definition of prospectus, appointment of auditors, and accounting standards and financial statements and investigations etc. In this Unit you will study the meaning and definition of a company, the main features of a company form of business organisation, and the various types of companies that can be formed in India.

## 5.2 MEANING AND DEFINITION OF A COMPANY

The term 'company' may be described to imply an association of persons formed for some common object or objects. The purposes for which people may wish to associate themselves are multifarious and include economic as well as non-economic objectives. However, the term 'company' is normally reserved for those associated for economic purpose, i.e., to carry on a business for gain. **This should, however, not give you an impression that a company under the companies Act cannot be created for non-economic or charitable purposes. In fact, Section 8 of the Companies Act, 2013 allows formation of non-profit associations as companies.**

Partnerships often describe themselves as 'A, B. C and Company'. But, this does not make the firm a company in the legal sense of the word; it only suggests that there are other persons also in the association.

In legal terminology a company means a company incorporated or registered under of the Companies Act, 2013 or under any of the earlier Companies Acts. Section 2(20) of the Companies Act, 2013 defines **a company to mean a company incorporated under this Act or under any previous company law.** This definition, however, is not exhaustive because it does not reveal the meaning and characteristics of a Company. Thus we have to see definition of a Company as given by famous Jurists.

***Lord Justice Lindley*** defines a Company as follows:

"A company is an association of many persons who contribute money or money worth to a common stock and employ it in some trade or business, and who share the profit and loss (as the case may be) arising therefrom. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it, or to whom it belongs, are called members. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted."

Another definition as given by ***Chief Justice Marshall*** reads as follows:-

"A company is a person, artificial, invisible, intangible and existing only in the eyes of law. Being a mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence."

According to ***Lard Haney***, "A company is an incorporated association which is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal."

From the above definitions, it is clear that a company has a corporate and legal personality. It is an artificial person and exists only in the eyes of law. It has an independent legal entity, a common seal and perpetual succession.

## 5.3 COMPANY VS. BODY CORPORATE

Body corporate means an association of persons which has been incorporated under some statute having perpetual succession, a common seal and having a legal entity different from the members constituting it. Section 2 (11) of the Companies Act, 2013 defines the expression 'body corporate' as follows:

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

i) a co-operative society registered under any law relating to co-operative societies; and

ii) any other body corporate (not being a company as defined in this Act), which the Central Government may, by notification, specify in this behalf".

A body corporate may be-

a) corporation sole, or

b) corporation aggregate.

A **'corporation sole'** is a body corporate constituted in a single person who, in right of some office or function, has corporate status. Examples of 'corporation sole' are to be found in perpetual offices such as the President, Governors, Crown, Ministers, and a public trustee. A corporation sole is not a "body corporate" for the purposes of the Companies Act, 2013. It is still a legal person and as such person it can be a member of a company- **Star Tile Works Ltd. v.N. Govindan (1956).**

A '**corporation aggregate'** consists of a group of persons contemporaneously associated so that they form a single person, e.g., a limited company, a trade union.

It may be of interest to note at this stage that because of inclusion of a company incorporated outside India within the definition of body corporate, a number of previsions of the Companies Act, 2013 apply to such companies; for example, Section 380 requires foreign companies carrying on business in India to deliver certain documents to the Registrar of Companies.

The expression 'corporation' or 'body corporate' is, thus, wider that the word 'company'. A company, as noted above, is a corporation aggregate.

## 5.4 IS COMPANY A CITIZEN

Although a company is regarded as a legal person (though artificial), it is not a citizen either under the Constitution of India or the Citizenship Act, 1955 **- Heavy Engineering Mazdoor Union V. State of Bihar (1969).** The Supreme Court of

India in **State Trading Corporation Ltd. v. CTO (1963)** held that a corporation including a company cannot have the status of a citizen under theConstitution of India. Thus, under the Constitution, a company has no fundamental rights which are expressly available to citizens only. It can, however, claim the protection of those fundamental rights which are available to all persons, whether citizens or not, for example, the right to own property.

In **Narasaraopeta Electric Corporation Ltd. v. State of Madras (1951),** the High Court observed that a company incorporated under the Indian Companies Act does not satisfy the requirements of the definition of 'citizen' in Article 5 of the Constitution and therefore is not a citizen.

A company is also not allowed to lay claim to fundamental rights on the basis of its being an aggregate of citizens. Once a company or a corporation is formed, the business of the company or the corporation is not the business of the citizens but that of the company or corporation formed as an incorporated body and the rights of the incorporated body must be judged on that footing and cannot be judged on the assumption that they are the rights attributable to the business of individual citizens- Supreme Court in **Telco Ltd. v. State of Bihar (1964).**

Although a company cannot be a citizen, yet it has a nationality, domicile and residence. A company is said to be resident and national of the place and country where it is incorporated.

## 5.5 MAIN FEATURES OF A COMPANY

On analysing the various legal and juristic definitions of the term 'company' you will observe that a company formed and registered under the Companies Act has certain special features which distinguish it from the other forms of organisations. The main characteristics features of a company are as follows.

1) **Creation of Law:** A company is an association of persons (except in case of 'One Person Company') registered under the Companies Act. It comes into existence only when it is so registered. Minimum number required for the purpose is 2, in case of a private company and 7, in case of a public company. Only one person can form a 'one person company' *(Section 3).*

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

3) **Separate Legal Entity:** Unlike partnership, company is distinct from the persons who constitute it. Section 9 says that on registration, the association of persons becomes a body corporate by the name contained in the memorandum.

   The legal status of a company has been aptly described by the Supreme Court of India in **Tata Engineering & Locomotive Co, Ltd. v. State of Bihar** as follows:

   "The corporation in law is equal to a natural person and has a legal entity of its own. The entity of the corporation is entirely separate from that of its

shareholders; it bears its own name and has a seal of its own; its assets are separate and distinct from those of its members; it can sue and be sued exclusively for its own purpose".

Even though the company lacks physical existence, for purposes of law it is regarded as an independent legal person who has a personality of its own and is different from the members constituting the company. Therefore, a company can enter into a contract with any of its members. A person can own its shares and also be its creditor. A shareholder of a company cannot be held liable for its acts and debts even though he virtually holds the entire share capital. No member can either individually or jointly claim any ownership rights in the assets of the company during its existence or on its winding up. Similarly, creditors of the company are creditors of the company alone and they cannot take action against the members of the company.

Even where a single shareholder virtually holds the entire share capital, a company is to be differentiated from such a shareholders. In the well known case of **Salomon v. Salomon & Co. Ltd. (1895-99),** Salomon was running a shoe business in England. He formed a company known as 'Salomon & Co. Ltd.' It consisted of Salomon himself, his wife, his four sons and a daughter. The shoe business of Mr. Salomon was sold to the company for £30,000. Mr. Salomon received from the company purchase price in the form of £20,000 fully paid shares of £1 each and £10,000 in debentures which carried a floating charge over the assets of the company and the balance in cash. One share of £1each was subscribed for in cash by each member of Salomon's family. Saloman was appointed the managing director of the company. During the course of business, the company became liable for some unsecured loan. The company in less than one year ran into financial difficulties and the liquidation proceedings started. On winding up, the assets realized £6,000. The company owed £10,000 to Mr. Salomon and £7,000 to unsecured creditors. Thus, after paying off the debenture holder (Mr. Salomon), nothing was left for unsecured creditors. Salomon and Salomon & Co. Ltd. was one and the same person. The company was only a façade to defraud the innocent creditors. Mr. Salomon should not be treated as a secured creditor, outside creditors should be paid first. The House of Lords held that the company had been validly constituted, and it is independent of its members. So Salomon is entitled to get his money first as he is a secured creditor. The business belonged to company and not to Salomon. Salomon was its agent; the company was not the agent of Salomon.

In **T.R. Pratt (Bombay) Ltd. Vs. E.D. Sasoon and Co. Ltd.,** it was observed that under the law, an incorporated company is a distinct entity, and although all the shares may be practically controlled by one person, in law a company is a distinct entity. Similarly in **Abdul Haq vs. Das Mal,** an employee sued a director of the company for the recovery of the amount of salary due to him. It was held that he could not succeed because the remedy lied against the company and not against the directors or members of the company.

As a consequence of separate legal entity, the company may enter into contracts with its members and vice-versa. Thus, a shareholder can be the creditor of the company.

4) **Limited Liability:** A major advantage enjoyed by a company is that the liability of its members is limited. The company being a separate person, its

members are not as such liable for its debts. You will later study that on the bases of liability, companies may be classified as (i) Companies limited by shares, (ii) Companies limited by guarantee, (iii) Companies limited by guarantee but having share capital, and (iv) Unlimited liability companies.

In case of a *company limited by shares,* the liability of members is limited to the nominal value of shares held by them. Thus, if the shares are fully paid up, their liability will be nil. In case of a *company limited by guarantee*, the liability of the members is limited up to the amount guaranteed by a member. But, in case of a *guarantee company having share capital,* the liability shall be limited to the aggregate of the amount remaining unpaid on the shares held by a member and the amount guaranteed by him.

You may note that, the Companies Act, 2013 allows companies to be formed with liability of members as unlimited. In case of an unlimited liability company, the liability of members shall not be limited to the nominal or face value of the shares held by them; they shall continue to be liable till each paisa of company's debts and liabilities has been paid off. However, the company being a separate legal entity, no suit can be filed by the creditors directly against the members.

5) **Separate Property:** Shareholders are not, in the eyes of the law, part owners of the undertaking. In India, this principle of separate property was best laid down by the Supreme Court in **Bacha F. Guzdar v. Commissioner of Income Tax, Bombay (supra).** The Supreme Court held that a shareholder is not the part owner of the company or its property, he is given only certain rights by law, e.g., to vote or attend meetings, to receive dividends.

In **Macaura v. Northern Assurance Co. Ltd. (1925),** it was held that a member does not even have an insurable interest in the properly of the company. In this case, Macaura held all except one share of a timber company. He insured the company's timber in his own name. On timber being destroyed by fire, his claim was rejected because he had no insurable interest in that timber. The Court observed: "No shareholder has any right to any item of property of the company for he has no legal or equitable interest therein".

6) **Perpetual Succession:** The term perpetual succession means the continued existence. The existence of the company is not affected by reasons such as the insolvency, death, unsoundness of mind of its members. The company has a perpetual succession. Members may come and members may go but the company goes on. It continues even if all its human members are dead. Even where during the war, all the members of a private company, while in general meeting were killed by a bomb, the company survived. Not even a hydrogen bomb could have destroyed it. In the aforesaid eventuality, the legal successors of the deceased shareholders will become the members. But this does not mean that a company can never come to an end. A company is creation of law it can be brought to an end by the process of law.

7) **Transferability of Shares:** One particular reason for the popularity of companies has been that their shares are capable of being easily transferred. The shares of a public company are freely transferable. A shareholder can transfer his shares to any person without the consent of other members. Articles of association, even of a public company can put certain restrictions

on the transfer of shares but it cannot altogether stop it. A shareholder of a public company possessing fully paid up shares is at liberty to transfer his shares to anyone he likes in accordance with the manner provided for in the articles of association of the company. **The Companies Act, 2013, vide Section 58(2) provides that without prejudice to sub-section (1), the securities or other interest of any member in a public company shall be freely transferable Provided that any contract or arrangement between two or more persons in respect of transfer of securities shall be enforceable as a contract. Thus, the present Act upholds shareholders' agreements providing for 'Right of first offer' and 'Right of first refusal' as valid even in case of a public company.**

However, a private company is required to put certain restrictions on transferability of its shares but the right to transfer is not taken away absolutely even in case of a private company.

8) **Common Seal:** A company being an artificial person is not bestowed with body of natural being. Therefore, it has to work through its directors, officers and other employees. But, it can be held bound by only those documents which bear its signatures. Common seal is the official signature of a company. A metallic seal should be used. Every company must have a common seal with its name engraved on the same.

As per Section 22(2), a company may, under its common seal, through general or special power of attorney empower any person to execute deeds on its behalf in any place either in or outside India. It further provides that a deed signed by such an attorney on behalf of the company and under his seal where sealing is required, shall bind the company and have the effect as if it were under its common seal. As per Companies (Amendment) Act, 2015, common seal is optional.

9) **Company may sue and be sued in its own name:** As juristic person, company can sue and be sued in its own name. This is so because a company has a separate legal existence. A company may enter into contracts and can enforce the contractual rights against others and it can be sued by others if it commits a beach of contract.

**Check Your Progress A**

1) Define a company.

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2) Enumerate the main features of a company.

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3) State, whether the following statements are true or false:

i) A computer is the creation of law.

ii) A company is an artificial person

iii) Since company is an artificial person, it can commit no wrong nor can it be sued in its own name.

iv) Like a partnership, a company comes to an end when any shareholder of the company dies

v) A company although is a corporate person yet it is not a citizen.

vi) The liability of a member is limited to the face value of the shares held by him.

## 5.6 LIFTING THE CORPORATE VEIL

Under Para 5.5, you learnt that a company has separate legal entity independent and different from its members. This principal of separate legal entity was well established in the famous case of **Salomon v. Salomon and Company Ltd**. On incorporation a line of demarcation or a veil is drawn between the company and its members. In fact, a company is an association of persons and such persons are the real beneficial owners of all the corporate property. Real persons behind the company are disregarded once they have formed a company and given the status of a legal entity.

As a consequence of this separate legal entity, the company enjoys several advantages which you have studied in foregoing para. But, the advantages of incorporation are allowed to be enjoyed only by those who want to make an honest use of the 'company'. In case of a dishonest and fraudulent use of the facility of incorporation, the law lifts the corporate veil and identifies the persons who are behind the scene and are responsible for the fraud. The corporate veil is said to be lifted when the court ignores the company and concerns itself directly with the officers or members of the company. Prof. Gower has observed, "When the law disregards the corporate entity and pays regard instead to the individual members behind the legal façade, it is known as lifting the veil of corporate personality".

You should, however, note that the power of the court to lift the corporate veil is purely discretionary. The court will lift the corporate veil when it is in the public interest to do so. In **Cotton Corporation of India Ltd. v. G.C. Odusumathd (1999),** the Karnataka High Court observed that lifting of the corporate veil of a company, as a rule is, not permissible in law unless otherwise provided by clear words of the statute or by very compelling reasons such as where fraud is intended to be prevented or trading with enemy company is sought to be defeated.

The circumstances under which the courts may lift the corporate veil may broadly be grouped under the following two heads:

A) Under statutory provisions

B) Under judicial interpretations

## 5.7 KINDS OF COMPANIES

Companies can be classified according to various bases. These are:

1) On the basis of incorporation
2) On the bases of liability
3) On the bases of control

See figure 5.1 to have an overall view of the different types of companies.

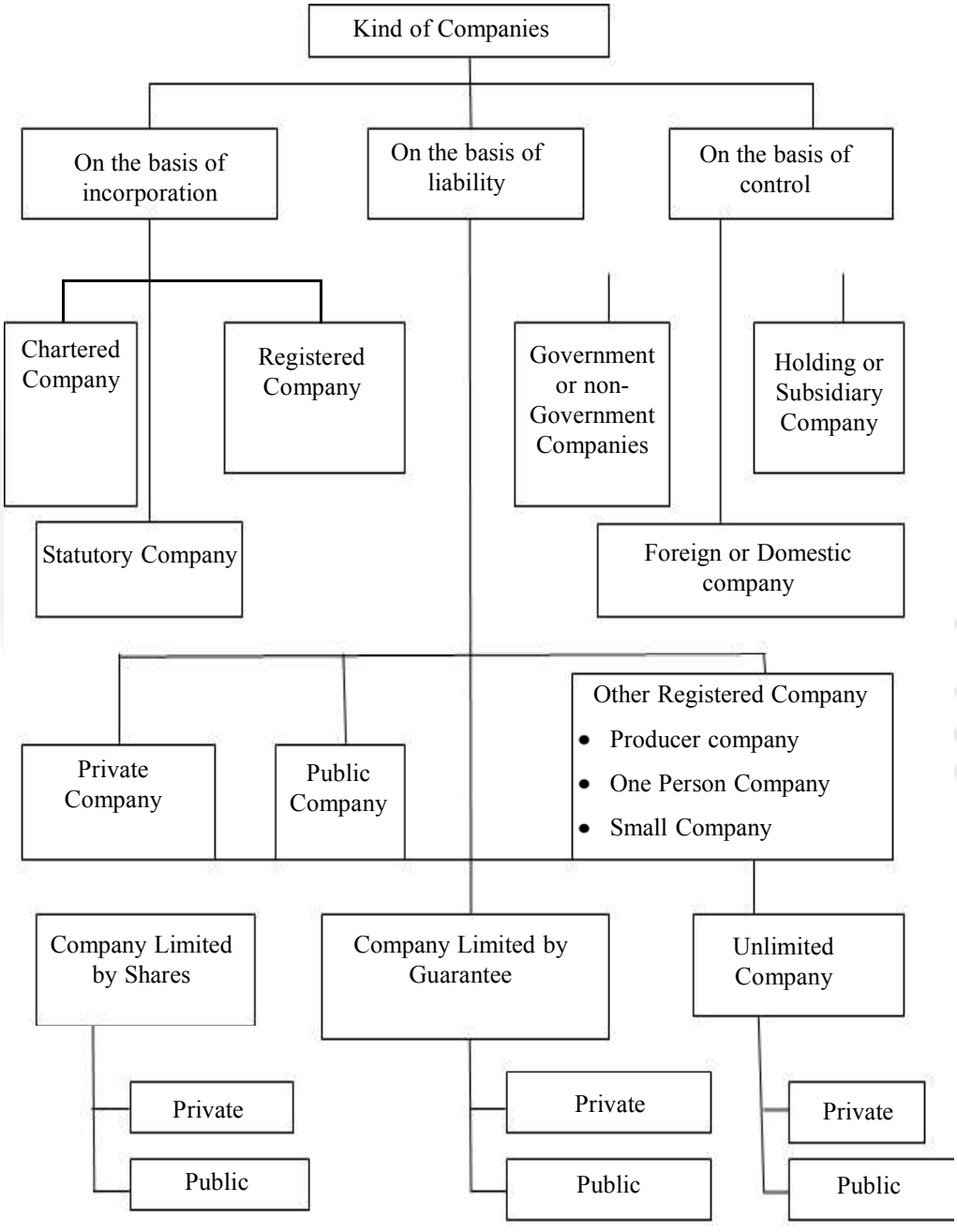


**Fig. 5.1: Kinds of Companies**

### 5.7.1 On the Basis of Incorporation

Depending upon the mode of incorporation, companies may be divided into the following three categories:

**i) Chartered Company:** A company incorporated under a special charter granted by the King or Queen of England is called 'chartered company'. A

charted company is regulated by its charter and the Companies Act does not apply to it. The charter also prescribes the nature of business and the powers of the company. The familiar examples of chartered companies are the East India Company and the Bank of England. *This type of company cannot now be formed in India.*

ii) **Statutory Company:** A statutory company is one which is created by a special Act of Parliament or a State Legislature. Such companies are usually formed for achieving a purpose related with public utilities. The nature and powers of such companies are laid down in the Special Act under which they are created. However, the provisions of the Companies Act are also applicable to them in so far as they are consistent with the provisions of the Special Act. A statutory company also has a separate legal entity and it is not required to use the word 'limited' after its name. The audit of such companies is conducted by the Controller and Auditor General of India (C&AG) and the annual report of working is required to be placed before the Parliament or State Legislature, as the case may be. Familiar examples of such companies are Reserve Bank of India, The Life Insurance Corporation of India, The Food Corporation of India, State Bank of India, etc.

iii) **Registered or Incorporated Company:** A registered company is one which is registered in accordance with the provisions of the Companies Act 2013 and also includes companies formed and registered under any of the previous Acts. A registered company comes into existence only when it receives the certificate of incorporation. Registered Companies are governed by the provisions of the Companies Act, 2013.

**A registered company may either be a private company or a public company.** A *private company* is one which by its articles of association (a) restricts the right of transfer of shares; (b) except in case of a one person company limits the number of its members to two hundred (not including members who are the present or past employees); (c) prohibits any invitation to the public to subscribe for any securities of the company [Section 2(68)].

*On the other hand, a* ***public company*** is one which is not a private company is a private company but subsidiary of a public company even where such subsidiary company continues to be a private company in its articles [Section 2 (71)].

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

1) ***Minimum Number of Members*** **[Section 3]:** In the case of a private company minimum number of persons to form a company is two while it is seven in the case of a public company.

2) ***Maximum Number of Members*****:** In case of private company the maximum number must not exceed two hundred whereas there is no such restriction on the maximum number of members in the case of a public company.

3) ***Transferability of Shares [Sections 44]:*** As per Section 44, the shares of any member in a public company shall be movable property transferable in the manner provided by the articles of the company. In a private company, by its very definition, articles of a private company have to contain restrictions on transferability of shares.

4) ***Prospectus [Section 2 (68)]:*** A private company cannot issue a prospectus, while a public company may, through prospectus; invite the general public to subscribe for its securities.

5) ***Minimum number of Directors [Section 149]:*** A private company must have at least two directors, whereas a public company must have at least three directors.

6) ***Retirement of Directors [Section 152]:*** Directors of a private company are not required to retire by rotation, but in case of a public company at least 2/ 3rd of the directors must be such whose period of office is subject to retirement by rotation.

7) ***Quorum for General Meetings [Section 103]:*** Unless the articles of the company provide for a larger number, ***in case of a public company***, the quorum shall be-

   i) Five numbers personally present if the number of members as on the date of meeting is not more than one thousand;

   ii) Fifteen members personally present if the number of members as on the date of meeting is more than one thousand but up to five thousand;

   iii) Thirty members personally present if the number of members as on the date of the meeting exceeds five thousand;

   **In the case of a private company, unless Articles provide for a higher number,** two members personally present, shall be the quorum for a meeting of the company.

*8)* ***Managerial Remuneration*** **[Section 197]:** In a private company, there are no restrictions on managerial remuneration, but in the case of a public company total managerial remuneration cannot exceed 11 per cent of the net profits. The remuneration payable to each managing/ whole time director or manager cannot exceed 5 per cent of the net profits unless approval of the Central Government has been taken. Likewise, there are restrictions on the remuneration payable to ordinary directors also.

*9)* ***Public Deposits:*** A public company is free to accept deposits from the public (subject, however, to the provisions of sections 76). A private company cannot accept deposits from the public.

## 5.7.2 On the Basis of Liability

On the bases of liability, an incorporated company may either be (i) a company limited by shares, or (ii) a company limited by guarantee; or (iii) an unlimited company.

i) **Company Limited by Shares:** 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 is termed "a company limited by shares" [Section 2(22)]. Such a company is commonly called Limited Liability Company although the liability of the company is never limited; it is the liability of its members which is limited. The liability of members can be enforced at any time during the existence and also during the winding-up of the company.

Such a company must have share capital as the extent of liability is determined by the face value of shares. However, there is no liability to pay any balance amount due on the shares, except in pursuance of calls duly made in accordance with law and the articles, while the company is a going concern or of calls made in the event of winding of the company.

ii) **Company Limited by Guarantee:** A company limited by guarantee may be defined as a company having liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound-up **[Section 2 (21)].**

Such a company may or may not have share capital**.** If a company limited by a guarantee is formed without any share capital, then the members would be liable to pay only the guaranteed amount and that too when the company goes into liquidation. But if the company limited by guarantee is formed with share capital, then the members are also liable to pay the unpaid amount on their shares. But the guaranteed amount can be called up only at the time of winding-up of the company.

iii) **Unlimited Company:** A company having no limit on the liability of its members is an unlimited company [Section 2(92)]. Thus, in the case of an unlimited company, the liability of each member extends to the whole amount of the company's debts and liabilities. It may be seen that the liability of members of an unlimited company is similar to that of the partners but unlike the liability of partners, the members of the company cannot be directly proceeded against. Company being a separate legal entity, the claims can be enforced only against the company. Thus, creditors shall have to institute proceedings for winding-up of the company for their claims. But the official liquidator may call upon the members to discharge the debts and liabilities without limit.

An unlimited company may or may not have share capital.

Under Section 18, a company registered as an unlimited company may subsequently convert itself into a limited liability company. Any debt, liabilities, applications or contracts in regard to or entered into, by or on behalf of the unlimited company before such conversion shall not be affected by such conversion.

### 5.7.3 On the Basis of Control

Let us study the classification of companies on the basis of control, i.e., who effectively controls the affairs of the company. On this basis, the companies may be grouped as follows:

i) Holding and Subsidiary Companies

ii) Government Company

iii) Foreign Company

**i) Holding and Subsidiary Companies**

Generally speaking, if one company controls another company, the controlling company may be termed as the 'Holding company' and the company so controlled as a 'Subsidiary'.

According to Section 2 (87) "subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company-

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:

A company (let's call it Company 'S') shall be deemed to be the subsidiary of another company (let's call it Company 'H') only in the following cases:

a) When the company (Company 'H') controls the composition of Board of Directors of other company (Company 'S').

b) When the Company 'H' holds more than half of the total share capital of Company 'S'. Again, where Company 'H' together with Company 'S' holds more than half of the total share capital of company 'Z', then company 'Z' will be subsidiary of Company 'H'.

c) When Company 'S' is a subsidiary of a Company 'T' which itself is a subsidiary of Company 'H'.

*Only in any of the above cases, would the Company 'S' be deemed a subsidiary of Company 'H'.*

As you have just learnt from the above discussion, a holding company is usually a very major shareholder of its subsidiary but both continue to enjoy separate legal entities in the eyes of the law. Unless there is a specific contract between the two companies, one cannot be said to be the agent of another. A subsidiary company also cannot be said to be a part of the holding company.

**ii) Government Company**

Section 2 (45) of the Companies Act, 2013 defines a Government company to mean any company (registered under the Companies Act) in which not less than 51% of the paid- up share capital is held by:-

i) the Central Government; or

ii) any State Government or Governments; or

iii) partly by the Government and partly by one or more State Governments

*A subsidiary of a Government company shall also be treated as a Government company.*

Engineers India Ltd. (EIL), BHEL, and Hindustan Aeronautics Ltd. (HAL), are examples of Government companies. A statutory corporation formed under special Act of Parliament or State Legislature, like Life Insurance Corporation of India, is not a 'company' under the Companies Act, 2013 and as such is not a Government companies. These are corporations as distinguished from Government Companies and are incorporated as well as governed by respective separate Acts.

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* *As per Central Government Rules, "Total Share Capital", is defined to be aggregate of the paid-up equity share capital and paid-up preference share capital. (Rule No 1.2(1)(s)).*

A government company registered under this Act is not an agent of the government. It enjoys, like any other company registered under the Companies Act, an entity distinct from its members. Employees of such a company cannot be said to be the employees of the Government. Again, like any other company, it may be registered as a private company or a public company. Further, like any other company, it is governed by the provisions of the Companies Act 2013.

**iii) Foreign Company**

As per Section 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, *as per Section 386(C), having a share transfer office or share registration office will constitute a place of business*.

Section 380 requires the following documents to be filed with the Registrar of Companies within thirty days of the establishment of place of business in India by a foreign company:

a) a certified copy of the charter, statues or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company and, if the instrument is not in the English language, a certified translation thereof in the English language;

b) the full address of the registered or principal office of the company;

c) a list of the directors and secretary of the company containing such particulars as may be prescribed;

d) the name and address or the names and addresses of one or more persons resident in India authorised to accept on behalf of the company any notices or other documents required to be served on the company;

e) the full address of the office of the company in India which is deemed to be its principal place of business in India;

f) particulars of opening and closing of a place of business in India on earlier occasion or occasions;

g) declaration that none of the directors of the company or the authorised representative in India has ever been convicted or debarred from formation of companies and management in India or abroad; and

h) any other information as may be prescribed.

Where any alteration is made or occurs in the documents delivered to the Registrar under this section, the foreign company shall, within thirty days of such alteration, deliver to the Registrar for registration, a return containing the particulars of the alteration in the prescribed form.

Again, as per Section 382, a foreign company is obliged to conspicuously exhibit on the outside of every office or place, where it carries on business in India as well as in every prospectus issued by it:

i) the name of the company,

ii) the country in which it is incorporated,

iii) the fact that liability of its members is limited.

The aforesaid should also be stated on all business letters, bill heads, letter paper, all notices and other official publications of the company in legible English and also in a language in general use in the locality in which the office or place is situated.

Section 381 requires that every foreign company (except a foreign company or such class of foreign companies which have been exempted by the Central Government) shall, in every calendar year,

a) make out a balance sheet and profit and loss account in such form, containing such particulars and including or having annexed or attached thereto such documents as may be prescribed; and

b) deliver a copy of those documents to the Registrar.

Provisions of Section 92 of the Act relating to the filing of the annual return with the Registrar of Companies are also applicable to a foreign company.

**Check Your Progress B**

1) What is meant by corporate veil?

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2) What is a statutory company?

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3) What is meant by a registered company?

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4) What is meant by a company limited by guarantee having share capital?

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5) What is a Government Company?

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6) Fill in the blanks:

a) An incorporated company can come into existence as a chartered company, as a statutory company and as ……company.

b) In a company limited by guarantee, a member is required to pay the guaranteed sum only if the company is ……..

c) A government company is one in which not less than …….. per cent of the paid up share capital is held by the Central Government.

d) A foreign company which establishes a place of business in India after the commencement of the Companies Act, 2013, shall deliver to the Registrar of Companies, necessary documents for registration within …….. days of establishing the place of business in India.

7) State, whether the following statements are true or false:

i) Once a company has been registered as an unlimited company, it cannot be converted into a limited company without dissolving the company.

ii) A Government company is not governed by the provisions of the Companies Act, 2013.

iii) In a Government company, company's paid up share capital can be held partly by the Central Government and partly by one or more State Governments.

iv) A foreign company may carry on business in India and carries on its business in a foreign company.

v) A foreign company is a company registered in India and carries on its business in a foreign company.

vi) In case of holding company and a subsidiary company both companies continue to enjoy separate legal status.

vii) A private company which is a subsidiary of a public company is a public company.

8) State which of the following alternative is correct:

a) A private company

i) must have at least 7 members, ii) cannot have more than 50 members iii) must prohibit any invitation to public to subscribe for its shares, iv) must file a statement in lieu of prospectus

## 5.8 OTHER KINDS OF REGISTERED COMPANIES

Other kinds of registered companies include:

i) Producer Company

ii) One Person Company

iii) Small Company

### 5.8.1 Producer Company*

Based on the recommendations of Dr. Alagh Committee, the following is the summary of important provisions relating to Producer Companies:

1) **Meaning of Producer Company:** A producer company means a body corporate engaged in any activity connected with or related to any primary produce. 'Primary *produce*' means *(i)* produce of farmers, arising from agriculture (including animal husbandary, bee farming, etc.); *OR (ii)* from any other primary activity which promotes the interest of farmers or consumers; *OR (iii)* produce of persons engaged in handloom, handicraft and other cottage industries; *OR* (iv) by-products or ancillary of the aforesaid activities.

2) **Minimum and Maximum Number of Members:** Any ten or more producers** who are individuals or any two or more producer institutions*** or a combination of ten or more individuals and producer institutions may form and incorporate a company as a Producer Company. However, no person, who has any business interest which is in conflict with business of the Producer Company, shall become a member of that Company.

*There is no ceiling on maximum membership.*

* It may be noted that vide Section 465 of the Companies Act, 2013, producer companies shall continue to be governed by the existing provisions of the Companies Act, 1956 until a special Act is enacted.

** Producer means any person engaged in any activity connected with any primary produce.

***Producer Institution means a producer company or any other institution having only producer(s)/ producer company(ies) as its members whether incorporated or not having any of the objectives referred to in section 581B and which agreed to make use of the series of the producer company(ies) as provided in its articles.

3) **Share Capital:** The share capital of a producer company shall consist of equity shares only.

4) **Transferability and Transmission of Shares:** Shares of a member of a producer company shall not be transferable except to an active member with the previous approval of the Board. Shares, if allowed to be transferred, shall be at par value only.

   *However, in the event of death of a member, shares will be registered in the name of his nominee who must be a producer:*

5) **Liability of Members:** Liability of members of a Producer Company shall be limited to the amount, if any, unpaid on the shares held by them.

6) **Promoters' Remuneration:** The Producer Company may, with the approval of its members at its first general meeting, reimburse to its promoters all direct costs associated with the promotion and registration of the company including registration, legal fees, printing of a memorandum and articles.

7) **Status of a Private Company:** On registration, the Producer Company shall become a body corporate as if it is a private limited company without, however, any limit to the number of members thereof and without use of the word private as part of its name. As per Section 581F, name of a producer company shall end with the words 'Producer Company Limited'.

8) **Voting Rights of Members**

   a) Where the membership consists (i) solely of individual members; or (ii) of individuals and producer institutions, the voting rights shall be based on a single vote for every Member, irrespective of his shareholding or patronage of the Producer Company.

   b) In a case the membership consists of Producer institutions only, the voting rights of such Producer institutions shall be determined on the basis of their participation in the business of the Producer Company in the previous year, as may be specified by Articles. However, during the first year of registration of a Producer Company, the voting rights shall be determined on the basis of the shareholding by such Producer institutions.

9) **Cessation of Membership:** Whereas, no person, who has any business interest which is in conflict with business of the Producer Company, shall become a member of that company, a member, who acquires any business interest which is in conflict with the business of the Producer Company, shall, cease to be a member of that company and be removed as a Member in accordance with articles. Again, a person will cease to be a member, where he ceases to be a primary producer. He will, however, be paid par value of his shares or any other value that may be determined by the Board.

10) **Benefits to Members**

   a) Members shall not receive full value of the produce pooled or supplied. 'Withheld price' shall be paid later in cash or equity shares, as per the decision of the Boards.

b) Every member shall receive a limited return on the capital contributed by the members.

c) Members may be allotted bonus shares.

d) Surplus, if any, after making (i) provision for limited return and reserves (as required under Section 581(ZI) (ii) providing for the development of the business of the Producer Company; (iii) providing for common facilities; may be distributed to members as bonus in proportion to their respective participation in business. This may be given in cash or by way of equity shares.

**11) General Meetings:**

i) **First AGM:** The first annual general meeting (AGM) of a producer company shall be held within 90 days of incorporation to discuss appointment of directors; and adoption of articles of association. *No extension of time is permissible.*

ii) **Subsequent AGMs:** Gap between two AGMs must not be more than 15 months. ROC may extend this period for a maximum period of 3 months.

iii) **Time and Place of AGM:** Provisions in this regards are same as applicable to other companies. Thus, AGMs should be held at the registered office, on a day which is not a public holiday and during business hours.

iv) **EGM (Extraordinary general Meeting):** An EGM shall be called by the directors on a requisition duly signed by 1/3$^{rd}$ or more of the members who are entitled to vote there at.

v) **Notice:** Notice of every general meeting shall be sent to (a) every member; and (b) the auditor.

vi) **Quorum:** Quorum for AGM shall be 1/4$^{th}$ of total number of members. Articles may however fix higher quorum. No requirement for quorum has been prescribed for EGM.

## 5.8.2 One Person Company (OPC)

Section 2 (62) of the Companies Act, 2013 defines 'One Person Company' to mean a company with only one person as its members. Section 3(1)(c) provides that a company may be formed for any lawful purpose by one person, where the company to be formed is to be One Person Company, that is to say, a private company by subscribing his name to a memorandum and complying with the requirements of the Act in respect of registration.

**An OPC may be registered as 'limited by shares' or 'limited by guarantee'.**

However, the memorandum of One Person Company shall indicate the name of the other person, with his prior written consent in the prescribed form (Form No. INC.3), who shall, in the event of the subscriber's death or his incapacity 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 along with its memorandum and articles.

Such other person may withdraw his consent in such manner as may be prescribed. On the death of the promoter member of an OPC, the person nominated by such promoter member shall be the person recognised by the company as having title to all the shares of the member and shall be entitled to the same dividends and other rights and liabilities to which such sole promoter member of the company was entitled or liable.

The member of One Person Company may at any time change the name of such other person by giving notice and shall intimate the Registrar any such change within such time and in such manner as may be prescribed.

The works "One Person Company" shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

**Relaxations available to OPCs**

Relaxations given to an OPC include:

i) There is no need to prepare a cash-flow statement [Section 2(40)].

ii) The annual return can be signed by the Director and not necessarily a Company Secretary (Section 92).

iii) There is no necessity for an Annual General Meeting (AGM) to be held (Section 96).

iv) Specific provisions related to general meetings and extraordinary general meetings would not apply (Sections 100 to 111).

v) Compliance can be said to have been done if the resolutions are entered in the minutes' book of the company (Section 122).

vi) It would suffice if one director signs the audited financial statements (Section 134).

vii) Financial statements can be filed within six months from the close of the financial year as against 30 days (Section 137).

viii) An OPC needs to hold only one meeting of the Board of Directors in each half of a calendar year and the gap between the two meetings should not be less than ninety days (Section 173).

**Special Provisions applicable to OPCs**

Where the OPC limited by shares or by guarantee enters into a contract with the sole member of the company who is also the director of the company, the company shall, unless the contract is in writing, ensure that the terms of the contract or offer are contained in a memorandum or are recorded in the minutes of the first meeting of the Board of Directors of the company held next after entering into contract (Section 193). This will not apply to contracts entered into by Company in the ordinary course of its business.

***As per the Rules framed by the Central Government:***

1) Only a natural person who is an Indian citizen and resident in India shall be eligible to incorporate a One Person Company or be appointed as a nominee for the sole member of a One Person Company. The term "resident in India" means a person who has stayed in India for a period of not less than 182 days during the immediately preceding 1 financial year **(Rule No. 3.1)**

2) No person shall be eligible to incorporate more than a One Person Company or become nominee in more than one such company *(Rule No. 3.2).*

3) No minor shall become member or nominee of the One Person Company or can hold share with beneficial interest (*Rule No. 3.4*).

4) Such Company cannot be incorporated or converted into a company under section 8 of the Act (*Rule No 3.5*) or carry out Non-Banking Financial Investment activities including investment in securities of any body corporate (*Rule No 3.6*).

5) Where the paid up share capital of a One Person Company exceeds 50 lakh rupees and its average annual turnover during the relevant period exceeds 2 crore rupees, it shall cease to be entitled to continue as a One Person Company. ***(Rule No 3.7). It may convert itself into a private or public company within a period of 6 months from the date its paid up capital exceeds Rs. 50 lakh and* turnover exceeds Rs. 2 crore (Rule No. 6).***

6) **Conversion of One Person Company into a private company or a public company:** One Person company can get itself converted into a Private or Public company after increasing the minimum number of members and directors to 2 or minimum of 7 members and 3 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 i.e. Conversion of companies already registered ***(Rule No 6).*** **However, such a company cannot convert voluntarily into any kind of company unless two years is expired form the date of its incorporation** ***(Rule No 3.7).***

### 5.8.3 Small Company

The concept of Small Company has also been introduced for the first time in the Companies Act, 2013. According to Section 2 (85) of the Companies Act, 2013, "small company" means a company, other than a public company:

i) paid-up share capital of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than five crore rupees; and**

ii) turnover of which as per its last profit and loss account does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than twenty crore rupees:

However, the expression 'small company' small not include:

a) a holding company or a subsidiary company;

b) non-profit association (i.e., companies registered under Section 8 of the Companies Act, 2013);

c) a company or body corporate governed by any special Act.

* The Word 'or' has been substituted by the word 'and' vide the Companies (incorporation) Amendment Rules 2015 date 1.5.2015

In such company there is no need to prepare cash flow statement, annual return can be signed by the Director or Secretary and to hold only one meeting in one half of calendar year and gap between two meetings should not be more than 90 days.

## 5.9 ASSOCIATION NOT FOR PROFIT

An "Association not for profit" is an association which is formed not for making profits but for the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object (Section 8). Such an association may or may not be registered as a company under the Companies Act. When such an association is registered as a company with limited liability, it may be given a licence by the Central Government.

The Central Government may grant such a licence if it is proved to the satisfaction of the Central Government that a person** or an association of persons proposed to be registered under this Act as a limited company –

i) has in its objects the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object;

ii) intends to apply its profits, if any, or other income in promoting its objects; and

iii) intends to prohibit payment of any dividend to its members.

When the above conditions are fulfilled, the Central Government may, by licence, direct that the person or association may be registered as a company with limited liability without the addition to its name of the word "Limited' or the words "Private Limited".

*Examples of such companies are registered under Section 25 (now Section 8) include* Mohan Bagan Club, Gymkhana Club, Delhi District Cricket Association (D.D.C.A) etc.

## 5.10 ILLEGALASSOCIATIONS

### 5.10.1 Meaning

Section 464 of the Companies Act, 2013 read along with Rule 10 of the Companies (Miscellaneous) Rules, 2014 provides that no association or partnership consisting of more than 50 persons shall be formed for the purpose of carrying on any business that has for its object the acquisition of gain by the association or partnership or by the individual members thereof, unless it is registered as a company under this Act or is formed under any other law for the time being in force. Thus, if such an association is formed and not registered under either the Companies Act or any other law, it will be regarded as an 'Illegal Association' although none of the objects for which it may have been formed is illegal.

** You may note that under Section 8, the use of the word 'person' appears to allow even a single person to form a company for the objects specifies. However, Rule 3 (5) of the Companies (Incorporation) Rules, 2014 categorically provides that One Person Company cannot be incorporated or converted or converted into a company under section 8 of the Act.

### 5.10.2 Exceptions

a) **A Hindu undivided family (HUF) carrying on any business,** that is, a joint Hindu family may carry on any business, even for earning profits and with any number of members without being registered or formed in pursuance of any India Laws as required by Section 464 of the act, and yet it will not be illegal association. But, where two joint Hindu families join hands to carry on business, the provisions of Section 464 become applicable. However, in such a case, in reckoning the numbers of such an association, the minor members shall be excluded. As regards adult members, both male and female members shall be taken into account.

b) **An association or partnership, if it is formed by professionals who are governed by special Acts.**

### 5.10.3 Consequences

Following are the effects of an association being illegal:

1) Every member of such an association or partnership carrying on business shall be punishable with fine which may extend to one lakh rupees.

2) Every member is personally liable for all liabilities incurred in the business.

3) Such an association cannot enter into any contract.

4) Such an association cannot sue any of its members or any outsider, not even if the association is subsequently registered as a company.

5) It cannot be sued by a member or an outsider for any debts due to him because it cannot contract any debt.

6) It cannot be wound-up even under the provisions relating to winding-up of unregistered companies.

7) Can a member sue for partition or dissolution or accounts of an illegal association? The question was brought before the High Court of Allahabad in **Mewa Ram v. Ram Gopal (1926).** It was held that where an association was illegal and the business had been carried for some years, none of its members could sue for partition because partition would involve realisation of the assets of the company and payment of its debts, the very things which would be done in a suit for dissolution of partnership or winding-up of a company. It should be noted that while an unregistered firm can be dissolved, an illegal association cannot be dissolved because law does not recognise its very existence.

8) The illegality of an illegal association cannot be cured by subsequent reduction in the number of its members **(Kumar Swami Chettiar v. M.S.M. Chinnathambi Chettiar).**

9) The profits made by an illegal association are, however, liable to assessment to income-tax **(Gopalji Co. v. CITA).**

**Check Your Progress C**

1) What is the difference between One Person Company and a Small Company?

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2) What is 'Illegal Association'?

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3) Fill in the blanks:

a) An auditor for a government company is appointed by the ……..……..

b) Under Section …… Of the Act, any association created not for profit may be exempted by the Central Government and be registered with limited liability without using the work 'limited' as its last word.

4) State, whether the following statements are true or false:

i) A partnership firm can be a member of an association not for profit.

ii) An illegal association has no independent personality.

5) State which of the following alternative is correct:

b) An illegal association is

(i) A partnership formed for illegal activities, ii) a partnership with more than 100 partners, iii) a partnership dissolved by a court of law, iv) an HUF with more than 100 members.

## 5.11 LET US SUM-UP

A 'Company' implies an association of persons for some common object or objects. A 'company' under the Act is defined to mean a "company formed and registered under the Companies Act, 2013 or under any of the previous Company laws".

A company is characterised by the following features: (1) It is an incorporated association registered under the Act. (2) On registration, it becomes a body corporate and thus acquires an entity distinct from the members constituting it. (3) Although, a company is recognised as a person enjoying the rights and obligations thereof, it is an artificial person and exists only in contemplation of law. (4) The liability of members of a limited liability company is limited to the

extent of the amount unpaid on the shares held by him or the amount guaranteed by him. (5) A company being a distinct entity, the property of the company is also separate. Shareholders are not the part owners of the undertakings. A member does not even have an insurable interest in the property of the company (6) The shares of a company are movable property, transferable in the manner provided by the articles of the company. (7) A company being an artificial person cannot be incapacitate by illness or otherwise. Members may come and go but the company can go on forever. (8) A company has to work through the agency of human beings but it can be held bound by only those documents which bear its signatures – the common seal.

A company is an entity distinct from the members but is an artificial person. The persons who are engaged to manage its affairs may commit certain illegal acts or frauds in its name. It may, therefore, become necessary to identify and hold these individuals personally liable for their deeds. In other words, the veil of corporate personality may be pierced or lifted. The circumstances under which the corporate veil can be lifted are as follows:

a) Under Statutory Provisions

b) Under judiciary interpretation

A 'company' should, however, be distinguished from a 'body corporate'. The expression 'body corporate' is a wider expression than 'company'. 'Body corporate' includes, besides a 'company', a company incorporated outside India, public financial institutions, nationalised banks and any other association of persons declared as a body corporate by the Central Government.

A company is a person in the eyes of law. It also has a domicile and nationality. The courts have held that company is not a citizen and therefore cannot be said to have the fundamental rights expressly conferred upon citizens, only. However, those fundamental rights which are available to all persons, whether citizens or not, like the right to own property are available to the company.

**Kinds of Companies:** Companies may be classified into the following categories (i) Chartered companies; (ii) Statutory companies; and (iii) Registered Companies. A registered company may be either a company limited by shares or a company limited by guarantee or an unlimited company. Such company may, either be a private company or a public company. Foreign companies are those which are incorporated outside India, but have a place of business in India.

A company is deemed to be the holding company of another, if that other is its subsidiary. A company is deemed to be a subsidiary of another company only if:

i) the other company controls the composition of its board of directors;

ii) the other company holds more than half of the nominal value of its equity share capital; or

iii) it is subsidiary of any other company which, in turn, is the subsidiary of holding company

Producer companies are the companies in which any ten or more producers who are individuals or any two or more producer institutions may form and incorporate a company as a Producer Company.

One-person Company is a one shareholder corporate entity, where legal and financial liability is limited to the company only.

"Small Company" means a company, other than a public company (i) paid-up share capital of which does not exceed fifty lakh rupees; and (ii) turnover of which as per its last profit and loss account does not exceed two crore rupees.

An association or partnership which is formed with more than fifty persons according to Section 464, Companies Act 2013 must be regarded as an illegal association. However, a joint Hindu family carrying on a business, a stock exchange and associations not for profit-marking are not illegal associations. Every member of an illegal association shall be personally liable for all liabilities incurred in such business.

An association not for profit is an association which is formed not for making profit by for the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity protection environment or any such other object.

## 5.12 KEY WORDS

**Company:** An association of persons registered under the Companies Act. It is an artificial person created by law, with a distinctive name, a common seal and perpetual succession of its members.

**Chartered Company:** A company which is incorporated under a special Royal Charter granted by the King or Queen of England.

**Statutory Company:** A company which is created by a special Act of Parliament of State Legislature.

**Company limited by shares:** A company having the liability of its members limited to the value of share held by them.

**Company limited by guarantee:** A company having the liability of its members limited to such an amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound-up.

**Government Company:** A company in which not less than 51 per cent of the paid up capital is held by the Government.

**Private Company:** A Company in which (a) restricts the right of transfer of shares; (b) limits the number of its members to 200 (not including the present of past employee members); (c) prohibits any invitation to the public to subscribe for any shares or debentures of the company and (d) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives. The minimum number of members required to form a private company is 2.

**Public Company:** A public company is one which is not a private company and is a private company but subsidiary of a public company. The minimum number of members required to form a public company is seven.

**Unlimited company:** A company in which the liability of the members is unlimited.

**Perpetual Succession:** Continued existence irrespective of the life or sanity of its members.

**Foreign Company:** A company incorporated outside India but having a place of business in India.

**Corporate Veil:** A line of demarcation or a veil is drawn between the company and its members.

**Producer Company:** A company formed by any ten or more individuals, each of them being a producer or any two or more producer institutions or a combination of ten or more individuals and producer institutions.

**One person Company:** One-person Company is a one shareholder corporate entity, where legal and financial liability is limited to the company only.

**Small Company:** Small Company means a company, other than a public company,

i) paid-up share capital of which does not exceed fifty lakh rupees; and

ii) turnover of which as per its last profit and loss account does not exceed two crore rupees.

## 5.13 ANSWERS TO CHECK YOUR PROGRESS

**A)** 3) i) True, ii) True; iii) False, iv) False;
v) True; vi) True

**B)** 6) a) registered
b) wound up
c) fifty one
d) 8

7) i) False; ii) False; iii) True; iv) True;
v) False; vi)True vii) True; viii) True; ix) True

8) a) (iii)

**C)** 6) a) fifty one Comptroller and Auditor General of India
c) thirty

7) i) True; ii) True

8) a) (ii)

## 5.14 QUESTIONS FOR PRACTICE

1) Company is an artificial person by law with a perpetual succession and is different from the members constituting it. Comment.

2) Describe the main characteristics of a company.

3) Discuss the concept of corporate veil. Under what circumstances, can this veil be lifted?

4) Distinguish between a company and a partnership.

5) Distinguish between 'company' and 'body corporate'.

6) Write a note on Government Company.

7) Briefly discuss different types of companies.

8) What is a foreign company? Describe special provisions relating to foreign company.

9) Define a holding company and a subsidiary company. When can a company be called a subsidiary of another company? Explain.

10) What do you mean by an illegal association? What are the consequences of forming such an association?

11) Briefly discuss 'One Person Company' and 'Small Company'

**Note:** These questions will help you to understand the Unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

## REFERENCES

Avtar Singh, *Company law*, Eastern Book Company, Delhi Sixteenth edition.

Kucchal M.C., *Modern Indian Company Law*, Shri Mahavir Book Depot, Delhi

# UNIT 6 FORMATION OF A COMPANY

**Structure**



## 6.0 OBJECTIVES

After studying this Unit, you should be able to:

- describe the stages in the formation of a company;
- explain the meaning and importance of promoter
- describe the functions of a promoter
- enumerate the documents to the filed with the Registrar of Companies;
- discuss the effects of registration;
- explain the meaning of the certificate of incorporation;
- explain the meaning of company meeting.
- discuss the importance of company meeting.
- explain the various types of company meetings.
- explain the meaning of winding up a company;
- distinguish between winding up and dissolution; and
- list the grounds for compulsory winding up.

# 6.1 INTRODUCTION

In Unit 5 you learnt that a company is an artificial person created by law and has a distinct separate legal entity of its own. In this Unit, you will learn that before a company is actually formed, certain persons known as 'promoters' make a detailed investigation and, after satisfying themselves about the viability of the business, take certain steps to complete formalities and bring the company into existence; a process referred to as promotion. In this unit, you will also learn about the various stages involved in the formation of a company and the documents which are required to be filed with the Registrar of Companies. You will also learn about the importance of meetings, different types of meeting and as well about the winding up of a company.

# 6.3 STAGES IN THE FORMATION OF A COMPANY

The formation of a company is a lengthy process. It involves the following three stages:

1) Promotion
2) Registration or incorporation, and
3) Commencement of business

Each of the above stages comprises specific activities to be undertaken let us study each stage one by one.

# 6.3 PROMOTION

You learnt that a company is an artificial person created by law. A company is born only when it is duly incorporated. For incorporating a company various documents are to be prepared and other formalities are to be completed. All this work is done by promoters.

## 6.3.1 Promoter: Meaning and Importance

Gerstenberg has defined promotion *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.* After the idea is conceived, the promoters make detailed investigation to find out the weakness and strong points of the idea, determine the amount of capital required and estimate the operating expenses and probable income. On being satisfied about the economic viability of the idea, the promoters take all the necessary steps for incorporating the company.

According to **L. J. Bowen,** *the term promoter is a term not of law but of business, usefully summing up in a single word a number of business operations familiar to the commercial world by which a company is generally brought into existence.*

**Justice C. Cockburn** described a promoter as "one who undertakes to form company with reference to a given project and to set it going, and who takes the necessary steps to accomplish that purpose".

Section 2 (69) of the Companies Act, 2013 defines the term promoter as a person-

a) who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or

b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or

c) in accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act.

However, a person who is merely in a professional capacity shall not be treated as a promoter. The following description of promoter brings out the nature of activities that a promoter is usually associated with. These are:

1) He undertakes to from a company and see it going.

2) He undertakes a number of operations necessary to form a company

3) He advices, directs and instructs the Board of Directors.

4) He has a control over the affairs of the Company, directly or indirectly.

A Company may have more than one promoter. The promoter may be individual, firm, an association of persons or a body corporate. Even if a person has taken a very minor part in the promotion activities, he may still be a promoter. But a person cannot be held as promoter merely because he is a signatory to the memorandum or that he has provided money for the payment of formation expenses or has worked in a professional capacity, for example, in preparation of the documents to be filled for the registration of the company or even securing certificate of incorporation of the company. Thus, a solicitor who drafts the articles, or the accountant who values assets of a business to be purchased are merely giving professional assistance to the promoter. However, where he goes further than this, *for example,* by introducing his clients to a person who may be interested in purchasing shares in the proposed company, he would be regarded as promoter. A person cannot, however, become a promoter merely because he signs the memorandum as a subscriber for one or more shares **[Official Liquidator v. Velu Mudaliar].**

From the above, it should be clear that *a promoter is one who performs the preliminary duties necessary to bring a company into existence.* Thus the true test to describe a person as a promoter lies in finding out whether he is keen to form a company and takes steps to give it a concrete shape.

The promoters, in fact, render very useful services in the formation of a company. They render a very useful service to society and they play an important role in the industrial development of a country. A promoter has been described as a creator of wealth and an economic prophet. The promoters carry considerable risk because if the idea goes wrong then the time and money spent by them will be a waste.

### 6.3.2 Functions of a Promoter

You learnt that a promoter plays a very important role in the formation of a company. You have also noted that a promoter may be an individual, an association or a company. In their capacity as promoters, they perform the following functions in order to incorporate a company and to set it going:

i) **To originate the scheme for formation of the company:** Promoters are generally the first persons who conceive the idea of business. They carry out the necessary investigation to find out whether the formation of company is possible and profitable. Thereafter, they organise the resources to convert the idea into a reality by forming a company. In this sense, the promoters are the originators of the plan for the formation of a company.

ii) **To secure the co-operation of the required number of persons willing to associate themselves with the project:** The promoters, in accordance with whether they want to incorporate a private or public company, try to secure the co-operation of persons needed to from the company. Minimum number of members required to form a public company is seven and that for a private company the minimum number is two. Depending upon the form chosen, the promoters may decide upon the number of primary members.

iii) **To seek and obtain the consent of the persons willing to act as first directors of the company:** You have learnt that the company has a system of representative management and is managed by individuals appointed as directors. The first directors of the company however, are either the promoters themselves or are appointed by them. The promoters seek the consent of some individuals whom they consider appropriate so that they agree to be the first directors of the proposed company. Many a time promoters themselves become the first directors of the company.

iv) **To settle about the name of the company:** The promoters have to seek the permission of the Registrar of Companies for selecting the name of the company. The promoters usually give three to four names in order of preference. The promoters should ensure that the names selected are not identical with or too closely resemble the name of another existing company. They should also ensure that the suggested names also conform to the draft rules and other guidelines issued by the Ministry of Corporate Affairs in this regard. We shall discuss the provisions with respect to the name of the company in detail in Unit 7.

v) **To get the documents of the proposed company prepared:** You will study that certain documents like the Memorandum of Association and the Article of association are required to be filled with the Registrar of Companies before the company is registered and brought into existence. As the company itself does not exist before incorporation, this work of preparation of these documents has to be undertaken by the promoters. The promoters, on the advice of legal experts get the Memorandum and Articles of Association prepared and arrange for their printing. In case the proposed company is a public limited company, intending to issue shares to the public after incorporation, the promoters must also arrange to get the prospectus prepared and printed.

vi) **To appoint bankers, brokers and legal advisers for the company:** The incorporation of a company involves a lot of legal formalities. The promoters may need to consult the legal experts on several of these matters. They, therefore, appoint solicitors to assists them in the process of formation of the company. The company is formed for the purpose of formation of the company. The company is formed for the purpose of carrying on business and as such deals with funds and their management. The promoters must,

therefore, also appoint bankers for the company who will receive share application money. If the proposed company is a public limited company and proposes to raise funds from the public, the promoters must also ensure the success of the first capital issue made by the company by appointing underwriters and brokers.

vii) **To settle preliminary agreements for acquisition of assets:** The promoters may be required to acquire a suitable site for the factory, make arrangements for plant and machinery and may even make tentative arrangements for key personnel. Sometimes, in order to run the business, the company may be required to take over property of a running business. Promoters fulfill the function of seeing that such property and business is acquired by the proposed company on justifiable terms.

vii) **To enter into preliminary contracts with the vendors:** In respect of the properties and assets mentioned above, the promoters would need to settle the term of contracts with the third parties from whom these properties are to be bought. These contracts are called preliminary contracts.

ix) **To arrange for filing of the necessary documents with the Registrar:** The promoters are required to pay the stamp duty, filling fee and other charges for registration of the company. The promoters are to see that the various legal formalities for incorporating the company are duly complied with.

As mentioned above, many activities carried out by promoters to bring a company into existence. After discovery of the business idea and judging its soundness, the promoters organise the necessary resources for giving shape to their business idea. They negotiate for, and obtain the required property, the necessary plant and machinery and arrange for the capital necessary for the company. The promoters will also talk to persons who are willing to take the responsibility of becoming the first directors of the company.

It should be noted that a company can be formed only for a lawful purpose. The purpose of the company may be unlawful if it is:

a) Against any provisions of the company law, or

b) Against the provisions of any other law, applicable in India.

Promoters may form the company with limited liability or with unlimited liability. In case of a company with limited liability, the liability of members may be limited either by shares or by guarantee.

The promoters then obtain the approval of the proposed name from the Registrar of Companies. Application can now be made online also. Normally, the promoters are supposed to have about 3 to 4 proposed names, so that there is a possibility that at least one of these may be approved.

Section 4 of the Companies Act, 2013 provides that no company shall be registered by a name which is:

a) identical with or resemble too nearly to the name of an existing company registered under this Act or any previous company law; or

b) be such that its use by the company-

   i) will constitute an offence under any law for the time being in force; or

ii) is undesirable in the opinion of the Central Government.

*You will study in detail about this aspect in Unit 7 dealing with Memorandum of Association.*

Before an application for registration is filed with the Registrar of Companies, the promoters shall take the necessary steps for preparing the important documents such as 'memorandum of association' and 'articles of association'. For this the promoters may seek the help of a legal expert, a solicitor, chartered accountant, cost account, or a company secretary. These documents should be duly printed. The memorandum and articles have to be stamped and the value of the stamp differs from State to State as per the respective Study stamp laws.

Section 7 and the rules framed by the Central Government require that Memorandum and Articles of association of the company shall be signed by each subscriber to the memorandum, who shall add his name, address, description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any. The witness shall also verify his/their ID. However, it is not necessary that the promoters themselves should sign the memorandum and articles.

The written consent of directors to act as such is also to be filed. The directors are required to give a written undertaking to take up and pay for their qualification shares, if any, prescribed in the Articles.

Besides, there shall be filed 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.

A statutory declaration to the effect 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; is also to be field. The aforesaid declaration is to be signed by:

i) an advocate, a chartered accountant, cost accountant or company secretary in practice, who is engaged in the formation of the company, **and**

ii) a person named in the articles as a director, manager or secretary of the company

Besides these steps, depending upon the peculiar nature of the company and its objects, the promoters may be asked to comply with certain other requirements. These may include (i) obtaining the licence under the Industries (Development and Regulation) Act, 1951, (ii) obtaining clearance from the Ministry of Environment, (iii) entering into preliminary contracts, and (iv) preparing prospectus.

**Check Your Progress A**

1) What is meant by promotion of a Company?

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2) What are the functions of a Promoter?

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3) Fill in the blanks:

i) For formation of a company, the promoters have to pass through …… stages.

ii) The three stages for the formation of a company are promotion, …… and the commencement of the business.

iii) Promotion of a company begins with the …….

iv) A company may be formed only for a …….. purpose.

v) A company not having any limit on the liability of its members is known as an …….. company.

vi) In accordance with Section 5 of the Act, no company shall be registered by a name which is ……..... in the opinion of the …….

vii) The rules framed for the internal management of the affairs of the company are termed as ……

viii) Before delivering the memorandum and articles to the Registrar for registration of the company, these documents will be …….. by the ……. of the proposed company.

ix) The subscribers to the memorandum of association shall sign in the presence of at least one ……

## 6.4 DOCUMENTS TO BE FILED WITH THE REGISTRAR

After the promoters have got the necessary documents prepared, these are required to be filed with the Registrar of Companies. The documents that are necessary for the purpose of registration are as follows:

1) **Memorandum of Association:** The Memorandum of Association is the charter of the company. It needs to be originally prepared for every company. It defines the objectives for which the company is being formed. The memorandum by its clauses, describes the whole character of the company. This includes its objectives, its name, the nature of liability of its members, the State in which its registered office shall be located, the capital which the company is authorised to have. Besides, Memorandum must also state the names, addresses and other prescribed particulars of persons who subscribe their names to the memorandum of association.

   The memorandum defines the powers of a company and its relations with third parties.

   The memorandum of a company has to be in respective forms specified in Tables A,B, C,D, and E in Schedule 1 as may be applicable to such company.

   For purposes of registration, the promoters have to file with the Registrar of Companies, a duly signed and properly stamped printed Memorandum of Association.

   You should note that in case of a private company the memorandum of association should be signed by at least two persons in contrast to seven in case of a public company.

2) **Articles of Association:** The Articles of Association contain the rules and regulations for managing the internal affairs of the company and, therefore, govern the relationship between the company and its members. All companies are required to have articles of association. However, any company may adopt all or any of the regulations contained in the model articles applicable to the company. Model articles in relations to different kinds of companies are contained in Tables F, G, H, I and J in Schedule 1 to the Companies Act.

   In case of any company, which is registered under the Act, in so far as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall be deemed to be the regulations of that company.

   The articles of association should also be signed separately by subscribers and they should also be attested by a witness. Once again, note that in case of a private company the articles of association should be signed by at least two persons as against seven persons in case of a public company.

3) **Affidavit by subscribers to the memorandum and first directors:** There shall be filed 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 beach 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 (Section 7(1)(c).

4) **A list of persons who have agreed to become the first directors of the company should also be filed:** There shall be filed 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.

   Besides, the particulars of the interests of the persons mentioned in the articles as the first directors of the company in other firms or bodies corporate along with their consent to act as directors of the company in such form and manner as may be prescribed, must also be filed with the Registrar of Companies.

5) **Address for communication:** Address for communication till the company acquires its registered office shall also be supplied.

   However, company must, as per Section 12, acquire its registered office within 15 days of its incorporation for the purpose of receiving and acknowledging all communication and notices as may be addressed to it.

   Section 12 and the rules made in this regard also require the company to furnish to the Registrar verification of its registered office within a period of 30 days of its incorporation in the prescribed Form No. 2.25.

6) **Statutory declaration:** Lastly, the promoters must file a statutory declaration to the effect 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.

   The aforesaid declaration is to be signed by:

   i) an advocate, or

   ii) a chartered accountant, or

   iii) cost accountant, or

   iv) company secretary,

   In practice and engaged in the formation of the company; **And by** a person named in the articles as a director, manager or secretary of the company.

**Check Your Progress B**

1) List any three documents which are required to be filed with the Registrar for the purpose of incorporation of the company.

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2) State, whether the following statements are true or false:

   i) The memorandum of association of a company defines the objectives for which a company is formed.

   ii) The articles of association govern the relationship between the company and third parties.

   iii) The relations between the company and its members are regulated by its articles of association.

   iv) For the registration of a private company it is necessary that the articles of association are filed with the Registrar.

   v) The list of directors of a company along with their written consent to act as such must be filed with Registrar.

## 6.5 INCORPORATION

When the necessary documents have been delivered to the Registrar and the requisite fees paid, the Registrar shall scrutinize these documents and if he is satisfied that (a) all the documents are in order; (b) all the requirements of the Companies Act in respect of registration have been complied with, and (c) the object for which the company is to be formed are lawful; he shall enter the name of the company in the Register of Companies maintained by his office. He would then issue a Certificate in the prescribed form, under his signature, certifying that the company is incorporated. This certificate is called Certificate of Incorporation. The Certificate contains the name of the company, the date of its issue, and the signature of the Registrar with his seal. Certificate of Incorporation constitutes the company's birth Certificate and the company becomes a body corporate, with perpetual succession and a common seal. The company comes into existence on the date given in the Certificate of Incorporation.

If the Registrar is of the view that there are some minor defects in any document, he may require that the defects be rectified. But, if there are some material and substantial defects, the Registrar may refuse to register the company.

**Allotment of Corporate Identity Number (CIN):** As per Section 7(3), on and from the date mentioned in the certificate of incorporation, the Registrar shall allot to the company a corporate identity number (CIN), which shall be a distinct identity for the company and which shall also be included in the certificate.

### 6.5.1 Conclusiveness of Certificate of Incorporation

A Certificate of incorporation given by the Registrar of Companies in respect of any association shall be conclusive evidence that all the requirements of Companies Act have been complied with in respect of its registration as well as matters precedent and incidental thereto. This is also known as rule in *Peel's* case.

In this case, the memorandum was found materially altered after the signatories had signed but before registration. It was held that the corporate status remained

unaffected and the Certificate of incorporation was valid. Highlighting the necessity of this rule, Lord Cairns observed as follows:

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

As is clear from the above statement once the Registrar has issued the Certificate of incorporation, nothing further is to be inquired into and the validity of this Certificate cannot be disputed on any ground whatsoever. In ***Moosa Goolam Arif v. Ebrahim Goolam Arif,*** the memorandum of association of a public limited company was signed by two adult persons. Other five members of the company were minors. Their guardian made separate signatures for each of the minors. The Registrar registered the company and issued the Certificate of incorporation. The incorporation of the company was challenged and the plaintiff prayed that the Certificate of incorporation should be declared void. The Privy Council rejected the plea of the plaintiff and held that he Certificate of incorporation was valid.

The certificate of incorporation is also a conclusive proof of the fact that the company came into existence on the date mentioned in the Certificate. In the case of ***Jubilee Cotton Mills Ltd. V. Lewis,*** the company delivered the Registrar of Companies documents required for the registration of the company on 6th January. On 8th January, the Registrar registered the company and issued the Certificate of incorporation but dated it January 6. The company allotted few shares to Mr. Lewis on 6th January. The allotment was challenged and the court was requested to declare the allotment as void. The court held that the Certificate of incorporation is conclusive evidence of all that it contains. Hence, the company shall be deemed to have been formed on 6th January and allotment of shares was valid.

You should note that sub-sections (5), (6) and (7) of Section 7 make furnishing of any false or incorrect particulars of any information or suppression of any material information punishable with a minimum six months imprisonment which may extend up to ten years **and also** 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.

Besides the aforesaid penalty, the Tribunal may, on an application made to it, and 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 form 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.

However, before making any order, as aforesaid, -

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.

You should also note that the Certificate of incorporation is not the conclusive proof with respect to the legality of the objects of the company mentioned in the objects clause of the memorandum of association. As such, if a company has been registered whose objects are illegal, the incorporation does not validate the illegal objects. In such a case the only remedy available is to wind up the company.

### 6.5.2 Effects of Registration

You have just learnt that the Certificate issued by the Registrar of Companies is called the 'Certificate of incorporation'. This Certificate is a very important document for the company because the company begins its corporate life from the date of the Certificate.

On filling of documents like memorandum of association, articles of association, the declarations, etc., the Registrar shall issue a Certificate of Incorporation to the company. In this Certificate, he shall certify that the company has been incorporated. If the company is a limited company, the Registrar shall further certify that the company is a limited company.

From the date of incorporation i.e. the date mentioned in the Certificate of incorporation the company becomes a legal person distinct from its members. Section 9 describes the effects of registration in the following words:

"From the date of incorporation mentioned in the certificate of incorporation, such subscribes 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 and a common seal 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".

Thus, on incorporation, the following effects follow:

i) From the date of incorporation, the original subscribers to the memorandum as well as the other persons who may, from time to time, become members of the company, shall constitute a body corporate by the name contained in the memorandum of association. You would recall from Unit 5 that a company after incorporation becomes a body corporate distinct from its members. It becomes a legal person. The company's life starts from the date of its incorporation.

ii) The company acquires a perpetual succession. The consequences of it may be understood better by an example. If a company had ten shareholders and all of them die at the same time in a train accident, the company's existence will not be affected. In other words, we may say that the members may come and members may go, but the company goes on till it is wound up.

iii) The company can sue and be sued in its own name.

iv) Liability and debts of the company are not the liability of the shareholders/ members. They are, however, liable to contribute to the assets of the company, in the event of its being wound-up, to the extent of the amount remaining unpaid on the shares held by them or amount guaranteed, as the case may be.

v) The company will hold its property in its own name. The property of the company cannot be said to be the joint property of the shareholders.

vi) The memorandum and articles of association become binding on the members and the company. Articles are deemed to be a contract between the company and its members and would, after incorporation, govern the rights (a) of members against the company; (b) of company against the members, and (C) between members *inter se, i.e, amongst themselves*.

## 6.6 COMMENCEMENT OF BUSINESS

According to the Companies (Amendment) Act, 2015 w.e.f. 25.05.2015 all companies whether public or private can commence their business immediately after obtaining certificate of incorporation. Section 11 of the Companies Act 2013 has been omitted under which a company having share capital was required to obtain a certificate to commence business.

According to the Companies (Amendment) Act, 2017, a company may not commence business, unless it (i) files a declaration within 180 days of incorporation, confirming that every subscriber to the Memorandum of the company has paid the value of shares agreed to be taken by him, and (ii) files a verification of its registered office address with the Registrar of Companies within 30 days of incorporation. If a company fails to comply with these provisions and is found not to be carrying out any business, the name of the Company may be removed from the Register of Companies.

## 6.7 MEETINGS

The business of the company is carried on by the elected representatives, called as directors. The decisions are taken by the directors at the meeting of the Board. But they cannot take decision on all matters relating to the working of the company. There are certain matters which are to be decided by the general body of shareholders. For this purpose, the meetings of the shareholders are held wherein decisions are taken by shareholders by means of passing resolutions. The provisions of the Companies Act lay down the rules regarding the holding and conduct of such meetings.

### 6.7.2 Meaning of Meeting and its Importance

'Meeting' may generally be defined as the gathering, assembly or coming together of two or more persons for transacting any lawful business. For proper working of the company, it is necessary that the shareholders meet as often as possible and discuss matters of mutual interest and take important decisions. Meetings provide a place for fruitful participation where free and frank discussion takes place. The decisions taken at the meetings generally become acceptable and are met with least resistance.

To constitute a valid meeting there must be at least two persons, because a meeting cannot be constituted by one person. But there are certain circumstances where one person can constitute a valid meeting, they are:

a) Where one person holds all the shares of particular class, he alone can constitute a meeting of that class;

b) Where the meeting is called by an order of the Tribunal, the Tribunal may direct that one member of the company present in person or by proxy shall constitute a valid meeting.

Company meetings play a significant role in decision making process. They provide an opportunity to shareholders to review the working of the company and take policy decisions, thereby controlling the Board of Directors. The directors are duty-bound to follow the decisions taken at the general meeting of shareholders. Meetings constitute a very important aspect in the management and administration in the company form of organisation.

### 6.7.3 Kinds of Meetings

Company meetings can broadly be classified as follows:

1) **Meetings of shareholders:** Such meetings are also known as genral meetings of the members which are held to exercise their collective rights. The meetings of the shareholders may again be of the following three types:
   a) Annual General Meeting;
   b) Extraordinary General meeting; and
   c) Class Meeting.

2) **Meetings of Directors:** The directors are to act collectively in the form of a Board, and the decisions are taken at the meetings of the Board of directors. These meetings may again be of two types:
   a) Meetings of the Board of directors; and
   b) Meetings of the committee of directors.

3) **Other Meetings:** These meetings may be any of the following:
   a) Meetings of debenture-holders;
   b) Meetings of creditors; and
   c) Meetings of creditors and contributories on the winding up of the Company.

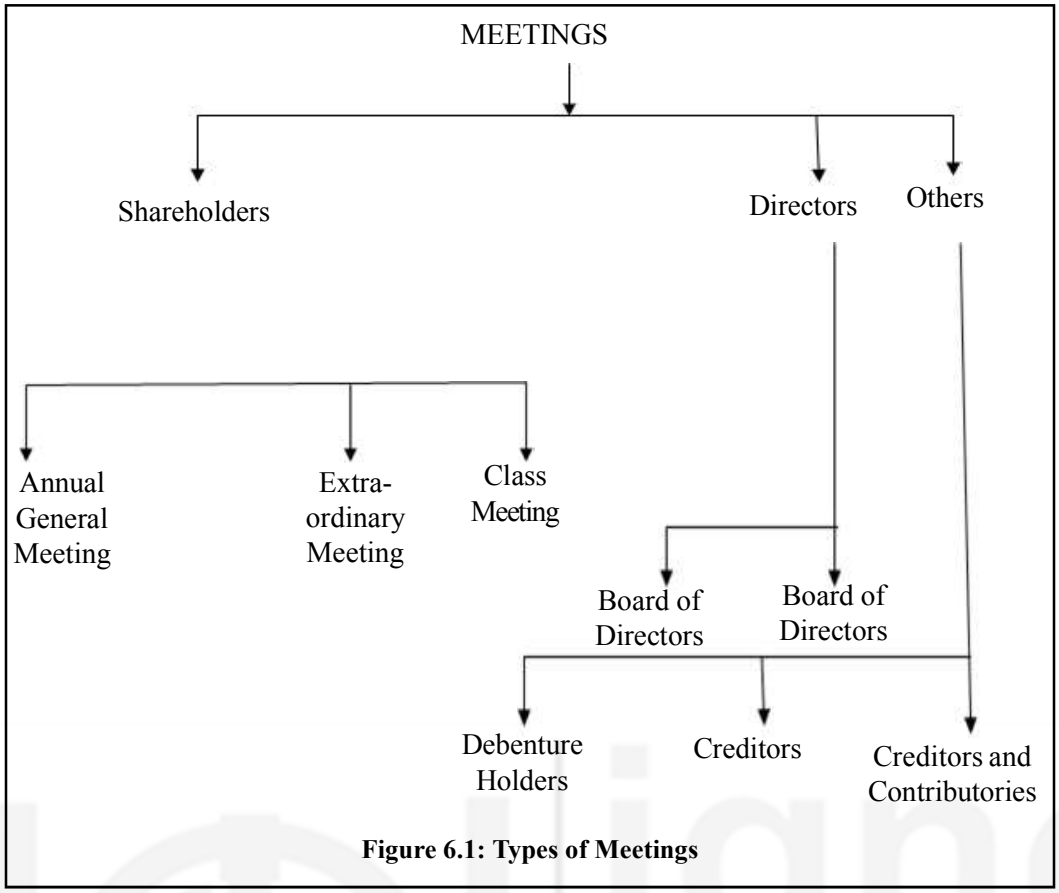


**Figure 6.1: Types of Meetings**

## 6.8 WINDING UP OF A COMPANY

A company is an artificial legal person created by law. Hence its life can be put to an end by the process of law.

The winding up is the process of putting an end to the life of the company. During this process the company ceases to carry on its normal business, the assets of the company are sold and the proceeds are utilised in paying off the debts and liabilities. If any surplus is left, it is paid back to the members in proportion to their contribution to the capital of the company. An administrator, called a liquidator, is appointed and he takes control of the company, collects its assets, pays its debts and distributes the surplus, if any, amount the members. Thus, with the winging up, a company ceases to be a going concern, all its operations come to a halt. You should note that the process of winding up begins only after the court passed the order for winding up, till such an order is passed there is no winding up.

Further, a company may be unable to pay its debts but it cannot be adjudicated insolvent as the law of insolvency does not apply to companies. Only individuals can be declared insolvent, not a body corporate. In such a case, a company can only be wound up.

**Winding Up and Dissolution**

Winding up and dissolution of the company are not the same thing. A company is not dissolved immediately on the commencement of winding up proceedings. Winding up is the prior stage and dissolution is the next, On dissolution, the name of the company is struck off by the Registrar from the Register of Companies i.e. it ceases to exist. While on winding up, the Company's name is not struck off

from the register. The legal entity of a company remains even after the commencement of winding up and it can be sued in a court of law. Dissolution is the final stage of the Company's winding up process. But a company can be dissolved without winding up under certain circumstances such as when it merges with another company.

The main points of difference between winding up and dissolution are as follows:

i) In winding up the assets of the company are sold and the proceeds are utilised in paying off the debts and other liabilities of the company. It is the first stage of terminating the life of a company. While the dissolution is the next stage and after this the company ceases to exist.

ii) The winding up proceedings are carried out by a liquidator of the company while in case of dissolution no such proceedings are carried out.

iii) Creditors can prove their debts in the winding up but not in the dissolution of the company.

iv) In the cases of winding up it is not always necessary to obtain an order of the court because voluntary winding up may take place, but for dissolution of the company, the order of the court is essential.

It is clear from the above discussion that winding up and dissolution of a company is not the same thing. A company may be wound up in any one of the following two ways (Sec. 270(1), namely-

i) By the Tribunal making a winding up order (compulsory winding up);

ii) By passing of an appropriate resolution for voluntary winding up at a general meeting of members (voluntary winding up).

**Check Your Progress C**

1) What is meant by Certificate of incorporation?

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2) What are the effects of incorporation?

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3) What is winding up of a company?

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4) State, whether the following statements are true or false:

i) A company comes into existence from the date of incorporation, mentioned on the Certificate of incorporation.

ii) The Registrar issues the Certificate of incorporation under his signature.

iii) A Certificate of incorporation issued by a Registrar is conclusive evidence of the fact that all the requirements of Companies Act have been complied with in respect of registration.

iv) Only a public company acquires perpetual succession, after incorporation.

v) A company is entitled to commence business immediately after obtaining the Certificate of incorporation.

## 6.9 LET US SUM-UP

The incorporation of a company consists of three stages, viz., promotion, incorporation and commencement of business. In the promotion stage, the promoters of the company conceive the business idea and organize all the resources needed for forming the company. They also get the necessary documents prepared, printed and file them in the office of the Registrar of Companies, along with the prescribed fee for registration. On scrutiny of these documents, if the Registrar is satisfied that all the formalities prescribed by the Companies Act have been complied with, he issues to the company, under his signatures, a Certificate of Incorporation. From this date the company begins its corporate existence. A company is an artificial legal person and can be wound up a) by Tribunal making a winding up order and b) by passing an appropriate resolution for voluntary winding up at a general meeting of members.

## 6.10 KEY WORDS

**Conclusive:** Final, which does not require any other evidence.

**Debenture:** A document or certificate signed by the officer of a company acknowledging indebtedness for money lent and a guaranteeing repayment with interest.

**Incorporated:** Constituted as a body corporate legally authorised to act as a person.

***Inter-se:*** Between or amongst themselves.

**Promoter:** Those who undertake the formation of a company.

**Statutory declaration:** A declaration made in compliance of a written law.

**Winding up:** A process by which the life of a company is put to an end

## 6.11 ANSWERS TO CHECK YOUR PROGRESS

**A)** 2) i) Three
ii) Incorporation
iii) Discovery of the business idea
iv) Lawful
v) Unlimited
vi) Undesirable, Central Government
vii) Articles of association
viii) Signed, subscribers or promoters
ix) Witness

**B)** 2) i) True ii) False iii)True iv)True v)True

**C)** 4) i) True ii)True iii)True iv)False v)True

## 6.12 QUESTIONS FOR PRACTICE

1) What are the different stages in the formation of a company? Discuss
2) List the documents that are required to be filed with the Registrar of Companies for the purposes of registration.
3) What do you mean by 'incorporation' of a company? What are the effects of registration of a company?
4) "The Certificate of incorporation is a conclusive proof that all the requirements of the Act in respect of formation of the company, have been complied with"? Explain.

**Note:** These questions will help you to understand the Unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

## REFERENCES

Avtar Singh, *Company law*, Eastern Book Company, Delhi Sixteenth edition.

Kucchal M.C., *Modern Indian Company Law*, Shri Mahavir Book Depot, Delhi

# UNIT 7 MEMORANDUM OF ASSOCIATION

**Structure**



## 7.0 OBJECTIVES

After studying this Unit, you should be able to:

- understand the meaning and purpose of Memorandum of Association;
- describe the different forms of Memorandum of Association relevant to different kinds of companies;
- list the different clauses of the Memorandum of Association;
- explain the doctrine of *ultra vires*; and
- describe the procedure for alteration of various clauses of Memorandum of Association.

## 7.1 INTRODUCTION

In the previous Units, you have learnt that company form of organisation offers certain distinctive advantages since limited liability and separation of management from ownership allows professionalism in handling large scale enterprises. Therefore, company form of organisation has become very popular particularly where huge funds are required. A company to be formed requires certain

documents to be filed with the Registrar of Companies. The most important document to be filed is the memorandum of association. In this Unit, you will learn the meaning and purpose of the memorandum of association. You will also learn the contents of this document, different clauses and how these clauses can be altered.

## 7.2 MEANING AND PURPOSE OF MEMORANDUM

According to Section 2(56) of the Companies Act, 2013 "Memorandum" means "Memorandum of association of a company as originally framed or altered from time to time in pursuance of any previous company law or of this Act". This definition neither states the nature of this document nor is indicative of its importance. Therefore we study the definition of Memorandum of Association given by Jurists. ***According to Palmer,*** the memorandum of association is a document of great importance in relation to the proposed company. It contains the objects for which the company is formed and therefore identifies the possible scope of its operations beyond which its actions cannot go. It defines as well as confines the powers of the company. If anything is done beyond those powers, that will be *ultra vires* (beyond powers of) the company and so void.

In the famous case of **Ashbury Railway Carriage & Iron Co. Ltd. v. Riche (1875),** Lord Cairns observed:

"The Memorandum of Association of a company defines the limitation on the powers of the company … it contains in it both: that which is affirmative and that which is negative. It states affirmatively the ambit and extent of vitality and power which by law are given to the corporation and it states, if it is necessary to state, negatively, the nothing shall be done beyond that ambit …."

Thus, Memorandum of Association enables shareholders, creditors and all those who deal with the company to know what its powers are and what is the range of its activities. An intending shareholder can find out the purposes for which his money is going to be used by the company and what risk he is taking in making the investment. Likewise, anyone dealing with the company, say, the supplier of goods or money will know that the transaction he intends to make with the company is within the objects of the company and not *ultra vires* its objects. In short, Memorandum of Association is the constitution of a company. It is the edifice on which the structure of the company stands.

## 7.3 MEMORANDUM OF ASSOCIATION – WHETHER AN UNALTERABLE CHARTER

You have noted under **Para 7.2** that the Memorandum of Association not only defines the powers of the company but also confines them. A company cannot act beyond the powers given to it by the Memorandum. Any action outside the scope of Memorandum shall be void and inoperative. The purpose of the Memorandum is to enable the shareholders, creditors and those who deal with the company to know what its permitted range of activities is. It tells the shareholders the purposes for which their money is likely to be used.

Memorandum of Association is a document on the basis of which a company is formed. Therefore, it is but desirable that the clauses of this document should not be allowed to be changed frequently. It is for this purpose that the Companies Act has laid down elaborate rules for making alterations in the Memorandum, Section 13 of the Act provides that except the capital clause (which may be altered by passing an ordinary resolution), a company may, by a special resolution and after complying with the procedure specified in this section, alter the provisions of its memorandum, The provisions referred in section 13 relate to the name, registered office, objects, and liability clauses. These are deemed to be the conditions contained in the Memorandum. For making alterations in the name clause or shifting of the registered office from on State to another, it is necessary to obtain the approval of the Central Government. Again, for alteration of objects by 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 the dissenting shareholders have been 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 (SEBI)

Thus, we can state that though Memorandum of Association is the charter of the company, but it is not unalterable. The different clauses of this document can be altered by following the procedure laid down in the Act in this respect.

## 7.4 FORM OF MEMORANDUM

Section 4 (6) requires that the memorandum of a company shall be drawn up in such a form as is given in Tables A,B,C,D & E in Schedule 1 to the Act as may be applicable in the case of the company.

Sections 3 and 4 read with section 7 and the rules made thereunder require the memorandum to be signed by at least seven persons in case of a 'public company' (two in the case of 'private company' and only one person, in case of 'one person company') in the presence of at least one witness, who will attest the signature(s). Each of the subscribers must write opposite his name the number of shares he takes. The signatories to the Memorandum shall add their address, description and occupation. Similar particulars of the witness (es) should also be entered. Tables prescribe are:

Table A = Company Limited by Shares

Table B = Company Limited by Guarantee not having share capital

Table C = Company Limited by Guarantee having share capital

Table D = Unlimited Company and not having share capital

Table E = Unlimited Company and having share capital

You may note that the rules framed by the Central Government, in this regard further provide that the witness shall state that "I witness to subscriber/ subscriber(s) who has/have subscribed and signed in my presence (date and place to be given). Further I have verified his/their ID for their identification and satisfied myself of his/her/their identification particulars as filled in".

Where a subscriber to the memorandum is illiterate, he shall affix his thumb impression or mark which shall be describe as such by the person, writing for him, who shall place the name of the subscriber against or below the mark and authenticate it by his own signature. He shall also write against the name of the subscriber, the number of shares taken by him. Such person shall also read and explain the contents of the memorandum and articles of association to the subscriber and make an endorsement to that effect on the memorandum and articles of association.

Where the subscriber to the memorandum is a body corporate, the memorandum and articles of association shall be signed by directors, officer or employee of the body corporate duly authorised in this behalf by a resolution of the board of directors of the body corporate. Where the subscriber is a Limited Liability Partnership, it shall be signed by a partner of the Limited Liability Partnership, duly authorised by a resolution approved by all the partners of the Limited Liability Partnership, provided that in either case, the person so authorised shall not, at the same time, be a subscriber to the memorandum and Articles of Association.

For the first time detailed procedure has been provided in the rules for signing of the memorandum where subscriber to the memorandum is a foreign national residing outside India.

## 7.5 CONTENTS OF MEMORANDUM

Section 4 requires the memorandum of a company to contain the following:

a) the name of the company, with 'limited' or 'private limited' as the last word(s) of the name in the case of a public company or a private company, as the case may be. In case of one person company, Section 12 requires that the words 'One Person Company' must be mentioned in brackets below the name of the company; This does not apply to companies registered under section 8 (companies with charitable objects).

b) the name of the State, in which the registered office of the company is to be situated;

c) the objects for which the company is proposed to be incorporate and any matter considered necessary in furtherance thereof;

d) the liability of members of the company, whether limited or unlimited, 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 up to 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;

e) in the case of a company having a share capital-

   i) 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;

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

It may be noted that the memorandum of association of a company cannot contain anything contrary to the provisions of the Companies Act. If it does, the same shall be devoid of any legal effect (Section 6).

Now, let us discuss in detail, the various clauses of Memorandum of Association.

### 7.5.1 Name Clause [Sec. 4(1)(a)]

A company being a distinct legal entity must have a name of its own to establish its separate identity. The promoters are free to choose any suitable name for the company provided:

1) The last words(s) in the name of the company, if limited by shares or by guarantee is 'limited' or 'private limited', as the case may be. However, an "association not for profit", incorporated as a company and licensed by the Central Government, may not use the word 'limited' or 'private limited' as part of its name, even though the liability of its members is limited (Section 8).

2) The name stated in the memorandum is not-

   a) identical with or resembles too nearly to the name of an existing company registered under this Act or any previous company law; or

   b) such that its use by the company-

      i) will constitute an offence under any law for the time being in force; or

      ii) is undesirable in the opinion of the Central Government.

Further, a company shall not be registered with a name which contains-

a) any word or expression which is likely to give the impression that the company is in any way connected with, or having the patronage of, the Central Government, any State Government, or any local authority, corporation or body constitute by the Central Government or any State Government under any law for the time being in force. Thus, words like President, Prime Minister, Central, Municipal, Panchayat may not be allowed; or

b) such word or expression, as may be prescribed; unless the previous approval of the Central Government has been obtained from the use of any such word or expression.

## Undesirable Names

Rule 2.4 framed by the Central Government under the Companies Act, 2013, in this regard, provides as follows:

- In determining whether a proposed name is identical with another, the differences on account of the following shall be disregarded. In other words, the proposed name cannot be merely different with respect to *inter alia*, the following:
  - the type and case of letters, spacing between letters and punctuation marks;
  - joining words together or separating the words;
  - using different phonetic spellings or spelling variations, for example, P.Q. Industries limited is existing then P and Q Industries or Pee Que Industries or P n Q Industries or P & Q Industries will not be allowed. Similarly if a name contains numeric character like 3, resemblance shall be checked with 'Three' also;
  - the addition of an internet related designation, such as .com, .net, .edu, .gov, .org, .in;
  - the addition of words like New, Modern, Nav, Shri, Sri, Shree, Sree, Om, Jai, Sai, The, etc;
  - different combination of the same words, e.g., if there is a company in existence by the name of "Builders and Contractors Limited", the name "Contractors and Builders Limited" will not be allowed unless it is change of name of existing company;
  - if the proposed name is the Hindi or English translation or transliteration of the name of an existing company or limited liability partnership in English or Hindi, as the case may be.
- Again, a name shall be considered undesirable if:-
  - it attracts the provisions of section 3 of the Emblems and Names (Prevention and Improper Use) Act, 1950;
  - it includes the name of a registered trade mark or a trade mark which is subject of an application for registration, unless the consent of the owner or applicant of registration, of the trade mark, as the case may be, has been obtained and produced by the promoters;
  - it includes any word or words which are offensive to any section of the people;
- A name shall also generally be considered undesirable if:-
  - the proposed name is identical with or too nearly resembles the name of a limited liability partnership;
  - the name reflects objects of the company and is not in consonance with the principal objects of the company as set out in the memorandum of association;
  - the company's main business is financing, leasing, chit fund, investments, securities or combination thereof, such name shall not be allowed unless the name is indicative of such related financial activities, viz., Chit Fund/Investment/Loan, etc.;

- it resembles closely the popular or abbreviated description of an existing company or limited liability partnership;
- the proposed name is identical with or too nearly resembles the name of a company or limited liability partnership incorporated outside India and reserved by such company or limited liability partnership with the Registrar:

But, if a foreign company is incorporating its subsidiary company in India, then the original name of the holding company as it is may be allowed with the addition of word India or name of any Indian state or city, if otherwise available;

- the proposed name implies association or connection with embassy or consulate or a foreign government;
- the proposed name includes or implies association or connection with or patronage of a national hero or any person held in high esteem or important personages who occupied or are occupying important positions in Government;
- the proposed name is vague or an abbreviated name such as 'ABC limited' or '23K limited' or 'DJMO' Ltd: abbreviated name based on the name of the promoters will not be allowed. For example:- BMCD Limited representing first alphabet of the names of the promoters like Bharat, Mahesh, Chandan and David.

An existing company may, however, use its abbreviated name as part of the name for formation of a new company as subsidiary or joint venture or associate company;

- the proposed name is identical to the name of a company dissolved as a result of liquidation proceeding and a period of two years have not elapsed from the date of such dissolution (since the dissolution of the company could be declared void within the period aforesaid by an order of the Tribunal under section 356 of the Act);
- it is identical with or too nearly resembles the name of a limited liability partnership in liquidation or the name of a limited liability partnership which is struck off up to a period of five years;
- the proposed name includes words such as 'Insurance', 'Bank', Stock Exchange', 'Venture Capital', 'Asset Management', 'Nidhi', Mutual fund' etc., unless a declaration is submitted by the applicant that the requirements mandated by the respective regulator, such as IRDA, RBI, SEBI, MCA, etc. have been complied with by the applicant;
- the proposed name includes the word "State", the same shall be allowed only in case the company is a government company;
- the proposed name is containing only the name of a continent, country, state, city such as Asia limited, Germany Limited, Haryana Limited, Mysore Limited;
- the name is only a general one, like Cotton Textile Mills Ltd, or Silk Manufacturing Ltd., and not Lakshmi Silk Manufacturing Co. Ltd;
- it is intended or likely to produce a misleading impression regarding the scope or scale of its activities which would be beyond the resources at its disposal:

- In case the key word used in the name proposed is the name of a person other than the name(s) of the promoters or their close blood relatives, 'No objection' from such other (s) shall be attached with the application for name.

**Too similar names** – In case of too similar names, the resemblance between the names must be such as is likely to deceive. A name is likely to deceive where it suggests some connection or association with an existing company.

**Examples**

In **Ewing v. Buttercup Margarine Co. Ltd. [1917]** the plaintiff who carried on business under the name of Butter Cup Dairy Co. succeeded in obtaining an injunction against the defendant on the ground that the public might think that the two businesses were connected since the word 'Buttercup' was an unnecessary and fancy one.

However, merely that few words are common may not render the name too identical and thus undesirable. Thus, in **Society of Motor Manufactures & Traders Limited v. Motor Manufactures & Traders Mutual Assurance Limited [1925],** the plaintiff company brought an action to restrain the defendant company from using the said name. But, Lawrence, J., held "anyone who took the trouble to think about the matter, would see that the defendant company was an Insurance company and that the plaintiff society was a trade protection society and I do not think that the defendant company is liable to have its business stopped unless it changes its name simply because a thoughtless person might unwarrantedly jump to the conclusion that it is connected with the plaintiff society".

Similarly, in **Asiatic Government Security Life Assurance Company Ltd. v. New Asiatic Insurance Company Limited [1939]**, the Court held the two names were not too identical and therefore, did not restrain the respondents.

*Thus, whether a name is too similar or not and therefore it shall be allowed or not is question in each case, one of fact.*

**Publication of name (Sec. 12)**

Sub-section (3) of Section 12 provides that 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 in the language in general use in the locality. The words 'outside of every office' do not mean outside the premises in which the office is situated **– Dr. H. L. Batliwalla Sons & Company Ltd. v. Emperor [1941].** Where office is situated within a compound, the display outside the office room though inside the building is sufficient;

b) have its name engraved in legible characters on its seal;

c) get its name, address of its registered office and the Corporate Identity Number along with telephone number, fax number if any, e-mail and website addresses, if any, printed in 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.

However, 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, along with its name, the former name or names so changed during the last two years as required under clauses (a) and (c).

In case of 'one person company', the words "One Person Company" shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

***Penalty:***

If a company does not paint or affix its name and the address of its registered office in the prescribed manner and if any default is made in complying with the requirements of this section, the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every day during which the default continues but not exceeding one lakh rupees. [Section 12 (8))

## 7.5.2 Registered Office Clause {Sec. 4(1) (b)]

This clause states the name of the State in which the registered office of the company will be situated. Every company must have a registered office which establishes its domicile and is also the address at which the company's statutory books must normally be kept and to which notices and other communications can be sent. The Registrar of Companies, within 15 days from the date of incorporation (Section 12) (1).

The company must furnish to the Registrar verification of its registered office within a period of thirty days of its incorporation by filing any of the prescribed documents.

## 7.5.3 Objects Clause [Section 4(1) (c)]

The objects clause defines the objects of the company and indicates the sphere of its activities. As per Section 4 (1) (c ), in this clause must be stated the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof.

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

The objects of the company must not be illegal, immoral or opposed to public policy or in contravention of the Act. For example, a public limited company cannot finance purchase of its own shares (Section 67 (2)).

## 7.5.4 Liability Clause [Sec. 4(1) (d)]

This clause states the nature of liability of the members **In the case of a limited liability company having share capital,** it must state that liability of members is limited to the amount unpaid on the shares. Thus, where a shareholder holding

a 10 rupee share has paid of Rs.5 on it, he can be called upon to pay the balance of Rs.5. But if he has paid the full value of Rs. 10, he cannot be required to pay anything more even if the company owes huge debts to its creditors.

**In the case of companies limited by guarantee,** this clause will state the amount which every member undertakes to contribute to the assets of the company in the event of its being wound up.

**In the case of unlimited liability company** whether having share capital or not, this clause shall state that the liability of its members is unlimited.

### 7.5.5 Capital Clause [Sec. 4 (1) (e)]

This clause must indicate the amount of capital with which the company is registered and is known as Registered or Authorised or Nominal capital.

As per Sec. 4 (1) (e), in the case of a company having a share capital, the memorandum must state the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share.

In the case of a public company having a share capital, a share may be either a Preference Share or an Equity share. Thus, a company's capital may be Preference share capital and Equity share capital. This clause shall state the number and value of shares into which the capital of the company is divided.

These shares are of a certain fixed or amount. This fixed value is known as the "Par" or "nominal" value of a share. Thus, the nominal value of an equity share may be, say, Rs. 10, and that of a preference share, say, Rs. 100.

The effect of this clause is that the company cannot issue more shares than stated under this clause without altering the Memorandum as per Section 61 of the Companies Act, 2013.

### 7.5.6 Association Clause of Subscription Clause [Sec. 4 (1) (e)]

At the end of the Memorandum of every company there is an association or subscription clause in which the subscribers to the Memorandum of Association make the following declaration:

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

In case of 'one person company', the declaration made shall be as follows:

"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."

According to Section 3 of the Act, the Memorandum shall be signed by at least seven subscribers in case of a public company, at least two subscribers in case of a private company and one subscriber where the company to be formed is one person company.

**The statutory requirements regarding subscription of memorandum are:**

a) the memorandum must be signed by each subscriber in the presence of at least one witness who must attest the signature;

b) each subscribe must take at least one share;

c) each subscriber must write opposite his name the number of share he takes [Section 4 (1) (e)]

## 7.6 DOCTRINE OF *ULTRA VIRES*

The term '*Ultra*' means '*beyond*' and the term '*Vires*' means the '*powers*'. Thus, *ultra vires* a company means *'beyond the powers of a company*'. You have learnt that the objects clause of the Memorandum states the objects of the company, therefore, any act which is beyond the stated purposes in *ultra vires* the company and, therefore, null and void. The company shall not be bound by such acts which are *ultra vires* the company. The purpose of the doctrine of *ultra vires* is to protect the interest of members, outsiders and creditors. They are:

i) The members of the company know the purposes for which their money can be used by the company.

ii) The third parties dealing with the company know the purposes for which the company has been brought into existence and, therefore, restrict their transactions with the company to those purposes only. Similarly, the creditors are assured that the assets of the company shall not be risked in unauthorised business.

Thus, in order to protect the interests of the shareholders and the third parties which enter into contracts with the company, the company's activities are confined to the objects given in the Memorandum of Association. It cannot do anything beyond the objects clause and if it does, it will be considered *ultra vires* (beyond capacity) and void *ab-initio*.

*Ultra vires* acts can be divided into the following three categories:

1) *Ultra vires* the Companies Act,

2) *Ultra vires* the Memorandum of Association, and

3) *Ultra vires* the Articles of Association.

**1) *Ultra vires* the Companies Act:** Any act done contrary to or in excess of the scope of Companies Act will be *ultra vires* the Act. Such an act shall be void and cannot be ratified even by a unanimous resolution of all the shareholders. A few examples of such acts are as follows:

a) Payments of dividend out of capital;

b) Issue of bonus shares in lieu of dividend;

c) Issuance of unauthorised capital;

d) Reducing the share capital without complying with legal formalities.

**2) *Ultra vires* the Memorandum of Association:** The Memorandum defines and confines the powers of company. The object of the company is determined by the Memorandum. A company cannot do anything which is beyond the purview of the objects clause. Any act done in contravention of

the object clause shall be *ultra vires* the Memorandum and shall be void and it cannot be ratified even by an unanimous resolution of all the shareholders. The doctrine of *ultra vires* was first applied in the famous case of **Ashbury Railway carriage and Iron Co. v. Riche.** In this case the company was incorporated to make, and sell, or lend on hire, railway carriages and wagons and to carry on the business of mechanical engineers and general contractors. The directors of the company entered into a contract with Riche, a firm of railway contractors to finance the construction of a railway line in Belgium. The contract was ratified by the company by passing a special resolution at a general meeting. Later, the contract was repudiated by the company on grounds of its being *ultra vires* and it was sued for breach of contract. The House of Lords held the contract was *ultra vires* the Memorandum and therefore void. It could not be ratified by the shareholders, as the contract was *ultra vires* the object clause.

The doctrine of *ultra vires* has been recognised in India as well. The doctrine has been affirmed by the Supreme Court in *A. L. Mudalir v. LIC of India.*

3) ***Ultra vires* the Articles of Association:** Acts which are *ultra vires* the articles of associations but are within the powers of the company are termed as *ultra vires* the articles. For example, payment of interest on 'advance calls' at a rate higher than allowed by the articles. Such act shall also be void, but the company in general meeting may alter the articles by a special resolution and ratify unauthorised acts

**Effects of Ultra vires transactions:**

1) **Void ab-initio**: An act which is *ultra vires* the company shall be null and void and it cannot be enforced against the company.

2) **No ratification:** An *ultra vires* the company transaction cannot be ratified even by the whole body of shareholders.

3) **Not enforceable:** Not only outsiders cannot enforce *ultra vires* transactions against the company, the company can also not enforce such transactions against third parties.

4) **Injunction:** Whenever an *ultra vires* act has been or its about to be done, any member of the company can approach the Court and get an injunction restraining the company from proceeding with the *ultra vires* acts.

5) **Personal liability of Directors:** The directors of the company can be held personally liable for any loss caused by an *ultra vires* transaction.

From the above it should be clear to you that if an act is *ultra vires* the company, then such act shall be null and void. Thus, if a company borrows money beyond its limit, it is *ultra vires* and the lender has no right in respect of the loan against the company.

You should note that if an act is *ultra vires* the directors, but it is within the powers of the company then such an act is not altogether void. It can be ratified by the shareholders in their general meeting and when it is so ratified, the company becomes liable for such acts. Now, if the company has power to borrow, but it restricts the authority of the directors to borrow upto a certain sum [Section 179

(4)], if the directors exceed their authority and borrow more than what they are authorised to borrow then the company may, if it wishes, ratify the directors' act, in which case the loan binds both the lender and the company as if it had been made with the company's authority in the first place.

**Check Your Progress A**

1) Mention the type of company against the Table in which its model form of Memorandum is given:

   Table A .....

   Table B .....

   Table C .....

   Table D .....

   Table E .....

2) Fill in the blanks.

   i) Memorandum of Association is to be signed by at least …….. persons in the case of a public company and by …… persons in the case of a private company.

   ii) Every subscriber to the Memorandum has to take at least ……. share.

   iii) The purpose of the Memorandum of Association is to protect the interest of …….. as well as outsiders.

3) State whether the following statements are True or False.

   i) Memorandum of Association limits the area of operation of a company.

   ii) The signatures of subscribers to the memorandum need not be witnessed.

   iii) Every company is not required to prepare and file its own Memorandum of Association at the time of incorporation.

   iv) Any act done by a company beyond its objects clause is ultra vires.

   v) In the case of a company limited by shares, a member is liable to pay only the unpaid amount on his shares.

   vi) In the case of a company limited by guarantee, a member can be called upon to pay the 'guarantee amount' at any time during the life time of the company.

## 7.7 ALTERATION OF DIFFERENT CLAUSES IN THE MEMORANDUM

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

### 7.7.1 Change of Name

A) **Change of name at the instance of the company:** Section 13 provides that the name of a company may be changed at any time *by passing a special resolution* at a general meeting of the company and with the written approval of the Central Government. However, no approval of the Central Government is necessary if the change of name involves only the addition or deletion of the word "private" (i.e., when public company is converted into a private company or *vice versa*).

The company shall file with the Registrar:

a) The special resolution passed by the company; and

b) The approval of the Central Government.

When any change in the name of a company is made, as aforesaid, 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 in Form 2.27 with the new name and the change in the name shall be complete and effective only on the issue of such a certificate.

B) **Change of name on a direction from the Central Government:** If through inadvertence or otherwise, a company on its first registration or on its registration by a new name has been registered with a name which, in the opinion of the Central Government, is identical with or too closely resembles the name of an existing company, the company may change its name within a period of *three months* from the issue of such direction by passing an ordinary resolution and by obtaining the approval of the Central Government in writing [Sec. 16].

Again, the company may change its name by following the aforesaid procedure, where an application has been made to the Central Government by a registered proprietor of a trade mark within three years of incorporation or registration or change of name of the company and, in the opinion of the Central Government, the name is identical with or too nearly resembles a registered trade mark of such proprietor under the trade Marks Act, 1999. Where such a direction is made by the Central Government, the company shall change its name or new name, as the case may be, within a period of *six months* from the issue of such direction.

**In cGMP Pharmaphan (P.) Ltd. v. Regional Director, Ministry of Corporate Affairs, [2011],** NNE Pharmaplan (P) Ltd., filed a representation before Regional Director under section 22 (now Section 14) seeking a direction that petitioner-company incorporated on a later date with name cGMP Pharmaplan (P.) Ltd. should change its name. Regional Director concluded that use by petitioner of word "Pharmaplan" in its name would have a misleading effect in mind of general public and as such, it was a fit case for issue of direction under section 22(1) (b) [now Section 14] and directed petitioner to delete word 'Pharmaplan' from its existing name and change its name to some other name. The Delhi High Court held that since names of both companies structurally and phonetically too nearly resembled each other, Regional Director was right in directing petitioner to change its name.

**As per Rule 2.25 framed by the Central Government,** change of name shall not be allowed to a company which has defaulted in filing its Annual Returns or Financial Statements or any document due for filing with the Registrar or which has defaulted in repayment of matured deposits or debentures or interest on deposits or debentures.

You would have noted that the direction of the Central Government is required to be complied within a period of three or six months, as the case may be, from the date thereof.

If a company makes default in complying with any direction given under section 16 (1), the company shall be punishable with fine of one thousand rupees for every day during which the default continues and every officer who is in default shall be punishable with fine which shall not be less than five thousand rupees but which may extend to one lakh rupees [Section 16 (3)].

Where a company changes its name or obtains a new name under Section 16 (1), it shall within a period of *fifteen days* from the date of such change, give notice of the change to the Registrar along with the order of the Central Government, who shall carry out necessary changes in the certificate of incorporation and the memorandum.

The change of name becomes effective on the issue of fresh certificate of incorporation. The Registrar will also make the necessary alteration in the memorandum of association of the company.

Section 15 further requires that 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.

In case of any default in this regard will make the company and every officer who is in default liable to a penalty of one thousand rupees for every copy of the memorandum or articles issued without such alteration.

**C) Effect of change of name**

i) The change of name shall not affect any rights/obligations of the company or render the same defective in legal proceedings by or against it. Moreover, any legal proceedings which might have been continued or commenced by or against the company by its former name may be continued by or against the company by its new name.

ii) However, if any legal proceeding is commenced, after change of name, against the company, in its old name, it is a case of mere misdescription and not a case of proceeding against a person not in existence. It is not an incurable defect and plaint can be amended to substitute the new name – **Pioneer Protective Glass Fibre (P.) Ltd. v. Fibre Glass Pilkington Ltd. [1986].**

iii) By change of name constitution of company does not change: **In Economic Investment Corporation Ltd. v. CIT [1970].** It was held that by change of name, the constitution of the company is not changed. The only thing that changes is its name; all the rights and obligations

under the law of the old company pass to the new company. It is not similar to the reconstitution of a partnership, which in law means creation of a new legal entity altogether.

### 7.7.2 Change of Registered Office

This may include:

a) **Change of registered office from one premises to another premises in the same city, town or village [Sec. 12]** – 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 passing a resolution of the Board of directors. However the company should inform the Registrar the new address within 15 days of the change who shall record the same.

b) **Change of Registered Office from one town or city or village to another town or city or village in the same State [Section 12]** – In this case the following procedure is to be followed:

   i) **Special resolution** – A special resolution is required to be passed at a general meeting of the shareholders.

   ii) **Confirmation of Regional Director –** Confirmation of the Regional Director is to be obtained where the change is from jurisdiction of one Registrar of Companies to the jurisdiction of another Registrar of Companies. The application to the Regional Director shall be made in Form INC – 23. The Regional Director shall communicate the confirmation within a period of thirty days from the date of receipt of application to the company.

   **As per Rule 28** the shifting of registered office shall not be allowed if any inquiry, inspection or investigation has been initiated against the company or any prosecution is pending against the company under the Act.

   iii) **Copy of special resolution and confirmation by Regional Director to be filed with ROC –** A copy of the special resolution, as aforesaid, is to be filed with the Registrar within 30 days (Section 117). Copy of the confirmation by Regional Director shall be filed with the Registrar of Companies within 60 days of confirmation. The Registrar is required to register the same and certify the registration within 30 days from the date of filing of such confirmation (Section 12).

   The certificate issued by the Registrar shall be conclusive evidence that all the requirements of this Act with respect to change of registered office have been complied with and the change shall take effect from the date of the certificate.

   If any default is made in complying with any of the aforesaid requirements, the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every day during which the default continues but not exceeding one lakh rupees.

c) **Change of Registered Office from on State to another State** – Section 13 contains provisions with respect to the shift of registered office from one

State to another, You should note that shift of registered office from one premises to another within the same city/town/village or even from one city to another but within the same State does not involve alteration of memorandum. It's because, in the memorandum only the name of the State where registered office shall be located is mentioned. Shift of registered office from one State to another will involve alteration of memorandum and, therefore, requires a more elaborate procedure to be followed. Registered office of a company can be shifted from one State to another by:

1) Passing special resolution;
2) Settlement of the list of creditors including debenture holders;
3) Obtaining the consent of the creditors and in case any creditor or creditors object, his debt or claim should be discharge or determined or secured to the satisfaction of the Central Government.
4) Obtaining confirmation from the Central Government.

**Obtaining confirmation from the Central Government**

For obtaining confirmation from the Central Government, Rule 30 of the Companies (Incorporation) Rules, 2014 provides that an application shall be filed with the Central Government in Form No. INC-23 along with the prescribed fee and specified documents.

The aforesaid information must, by way of an affidavit, be signed by the Company Secretary of the company, if any, and not less than two directors of the company, one of whom shall be a managing director.

Again, there shall also be attached to the application an affidavit from the directors of the company that no employee shall be retrenched as a consequence of shifting of the registered office from one State to another State.

There shall also be attached to the application a copy of the acknowledgment of service of a copy of the application with complete annexure to the Registrar and Chief Secretary of the State where the registered office is situated at time of filing the application.

The company must also keep a duly authenticated copy of the list of creditors at the registered office.

Where any objection of any person whose interest is likely to be affected by the proposed application has been received by the applicant, it shall serve a copy there of to the Central Government on or before the date of hearing.

Where no objection has been received from any of the parties, who have been duly served, the application may be put up for orders without hearing.

***Order of Confirmation***

Rule 30, read along with Section 13 (5) provides that before confirming the alteration, the Central Government shall ensure that, with respect to every creditor and debenture holder who, in the opinion of the Central government, is entitled to object to the alteration, and who signifies his objection in the manner directed by the Central government, either his consent to the alteration has been obtained

or his debt or claim has been discharged or has determined, or has been secured to the satisfaction of the Central Government.

The Central Government may make an order confirming the alteration on such terms and conditions, if any, as it thinks fit, and may make such order as to costs as it thinks proper.

You may note that the shifting of registered office shall not be allowed if any inquiry, inspection or investigation has been initiated against the company or any prosecution is pending against the company under the Act.

Sub-section (5) of Section 13 provides that the Central Government shall dispose of the application under sub-section (4) within a period of sixty days.

***Filling of order of the Central Government with the Registrar***

Section 13 (7) read along with Rule 30 of **the Companies (Incorporation) Rules, 2014** requires a certified copy of the order of the Central Government approving the alteration to be filed by the company with the Registrar of each of the States within a period of 30 days, 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.

### 7.7.3 Change in Objects Clause

Discussion on alteration of objects may be divided into:

1) Alteration of objects by a company which has not issued a prospectus
2) Alteration of objects by a company which has issued a prospectus

**1) Alteration of objects by a company which has not issued a prospectus**

A company which has not issued a prospectus may change its objects by passing a special resolution (Section 13 (1)).

**2) Alteration of objects by a company which has issued a prospectus**

Section 13 (8) read along with Rule 32 of the **Companies (Incorporation) Rules, 2014** provides that 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 through postal ballot is passed by the company.

**Besides,**

i) The notice in respect of the resolution for altering the objects shall contain the prescribe particulars including the unutilised amount out of the money so raised through prospectus, justification for the alteration/change in the objects, amount proposed to be utilised for the new objects.

ii) The advertisement giving details of each resolution to be passed for change in objects shall be published in the newspapers (one in English and one in vernacular language) which are in circulation at the place where the registered office of the company is situated.

iii) The advertisement shall be published simultaneously with the dispatch of postal ballot notices to shareholders.

iv) The notice shall also be placed on the website of the company, if any, indicating therein the justification for such change.

v) 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.

vi) The Registrar shall register the alteration of the memorandum with respect to the objects of the company and certify the registration within a period of thirty days from the date of filing of the special resolution.

### 7.7.4 Change in Liability Clause

The Companies Act, 2013 or the Rules made there under do not contain any provisions with respect to the alteration of liability clause. However, since the relationship between a member and the company is a contractual relationship, the liability of a member of a company cannot be increased unless the member agrees in writing. The consent of the member may, however, be given either before or after the alteration. Increase in liability may be by way of subscribing for more shares than the number held by him at the date on which the alteration is made or in any other manner.

*In case of unlimited liability company*, the liability may be made limited or reduced by re-registration of the company (Section 18). The alteration will, however, not affect any debts, liabilities, obligations or contracts entered into by or with the company before the registration of the unlimited company as a limited company [Sec. 18 (3)].

### 7.7.5 Change in Capital Clause

Section 61 provides that, if the articles authorise, a company limited by share capital may, by an ordinary resolution passed in general meeting, alter the conditions of its memorandum in regard to capital so as:

1) to increase its authorised share capital by such amount as it thinks expedient;

2) to consolidate and divide all or any of its share capital into shares of larger amount than its existing shares e.g., 10 shares of Rs. 10 each may be consolidated into one share of Rs. 100 each;

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

4) to sub-divide its shares, or any of them, into shares of smaller amount than fixed by the memorandum, but the proportion of paid and unpaid on each share must remain the same;

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

**Check Your Progress B**

1) Fill in the-blanks.

   i) A company can shift its Registered Office to another State by passing a special resolution and with the permission of the ……

   ii) The capital clause of Memorandum points out the …… capital of a company.

   iii) Capital clause can be altered by …….

   iv) Object clause can be altered by……..

2) Which of the following is correct:

   a) i) Memorandum of association is an unalterable charter.

      ii) Memorandum of association is an alterable charter.

      iii) Memorandum of association is not a charter.

   b) i) Authorised share capital of a company cannot be changed.

      ii) Authorised share capital of a company may be increased by passing an ordinary resolution.

      iii) Authorised share capital of a company may be increased by passing a special resolution.

      iv) Authorised share capital of a company may be increased by passing a special resolution and approval of the Central Government.

## 7.8 LET US SUM-UP

Memorandum of association of a company is a document of great importance. It defines as well as confines the powers of the company. Any act beyond the scope of the memorandum is *ultra vires* the company and thus unenforceable. Section 4 of the Companies Act, 2013 requires that the memorandum of a company must be drawn up in the form as given in Tables A,B,C,D & E in Schedule 1, as may be applicable in the case of a company. Further, Section 4 requires the memorandum of a limited company to contain information about its name (with 'limited' or 'private limited' as the last word(s), as the case may be); the name of the State in which registered office is to be situated; the objects with which the company is being registered; the liability being limited or unlimited; the amount of authorised share capital and its division into shares of fixed amounts. Memorandum of association has following clauses:

**Name Clause:** Promoters are free to choose any suitable name for the company provided: i) the last word/(s) is/are 'limited' or 'private limited', as the case may be (except in case of 'associations not for profit' if licensed by the Central Govt.); (ii) the name chosen is not undesirable. Central Govt. has framed certain rules in determining as to when a name may be considered undesirable.

Every company is required to paint or affix its name and address of its registered office outside of every office or place of business in a conspicuous position and in letters which are easily legible and in the language in general use in the locality.

**Registered office clause:** This clause sates the name of the State in which the registered office of the company will be situated. Registered office of a company establishes its domicile.

**The Objects Clause**: In this clause must be stated the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof.

Any act beyond the objects stated in the memorandum is *ultra vires* the company and thus void.

**Liability clause:** This clause states the nature of liability of the members. In the case of a limited company, it must state that the liability of its members is limited by the amount remaining unpaid on the shares held by a member and in case of a guarantee company, by the amount guaranteed by him.

**Association or Subscription Clause:** At the end of the memorandum of every company there is an association or subscription clause. Each subscriber must write opposite his name the number of shares he undertakes to subscribe for.

**Alteration of Memorandum:** The contents of a memorandum can be altered only in the manner and to the extent provided in the Act.

Name of a company can be changed by passing a special resolution and obtaining the approval of the Central Government. However, approval of the Central Government is not necessary where in consequence of conversion of a private company into a public company or vice versa; the only change sought is deletion or addition of the word 'private'.

Where a company has been registered by an undesirable name, the Central Government may direct it to alter its name. In such a case, the company may change its name by passing an ordinary resolution and then obtaining confirmation of the Central Government for the new name.

Registered office of a company may be shifted from one premises to another premises by passing a resolution of the Board of directors and intimating the change to ROC within 15 days thereof. But, where the registered office is proposed to be shifted from one city to another city within the same state, special resolution at a general meeting of shareholders must be passed. However, if shift of registered office from one city/town, etc. to another but within the same state results in change of jurisdiction of one ROC to the other, approval of the Regional Director shall also be necessary. Copy of the confirmation by Regional Director shall be filed with the Registrar of Companies within 60 days of the date of confirmation. The registrar is required to register the same and certify the registration within 30 days from the date of filing of such confirmation. But, shifting of registered office from one state to another state requires passing of special resolution of shareholders as well as the approval of Central Government.

Alteration of objects by a company which has not issued a prospectus, may change its objects of passing a special resolution. But, if company has raised money through issue of 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 through postal ballot is passed by the company.

Liability of a member cannot be increased unless the member agrees in writing.

Alteration of capital clause may involve increase of authorised capital of the company, or sub-division or consolidation of shares or cancellation of shares not taken or agreed to be taken by any person. Any of these changes can be done, as per Section 61, by passing an ordinary resolution in general meeting of shareholders.

## 7.9 KEY WORDS

**Memorandum of Association:** It is a fundamental document containing conditions on the bases of which a company is incorporated.

**Limited Liability:** It denotes that the liability of the members is limited by the amount remaining unpaid on their shares. In the case of a guarantee company, this phrase denotes the maximum amount up to which a member of a company can be called upon to pay at the time of winding up.

**Par Value:** A company limited by shares has a share capital which is divided into shares of a certain fixed value or amount. This fixed value amount is known as "Par Value".

**Registered Office:** The Registered Office of a company determines its domicile. Also, this is the office to which notices are served and communications are sent to the company.

***Ultra-Vires*:** Something which is beyond the powers of a company to do.

**Unlimited Liability:** The liability of the members of a company is termed as unlimited when their personal assets can be called to pay the liabilities of the company.

## 7.10 ANSWERS TO CHECK YOUR PROGRESS

**A**) 1) A A company limited by shares.

B) A company limited by guarantee and not having a share capital.

C) A company limited by guarantee and having a share capital.

D) An unlimited company and not having share capital.

E) An unlimited company and having share capital.

2) i) 7;2 ii)One iii)Members

3) i) True ii)False iii)False iv)True v)True vi)False

**B)** 1) i) Central Government

ii) Authorised/Registered/Nominal

iii) Passing an ordinary resolution at a general body meeting

iv) Passing a special resolution through postal ballot

2) a) (i) b) (ii)

## 7.11 QUESTIONS FOR PRACTICE

1) What do you understand by Memorandum of Association?

2) What is the purpose of Memorandum of Association?

3) Enumerate the different clauses which are included in the Memorandum of Association, and explain each of them.

4) Explain the Doctrine of *ultra vires* with suitable examples.

5) Describe the procedure for alteration of the objects clause of a company.

**Note:** These questions will help you to understand the Unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

# UNIT 8 ARTICLES OF ASSOCIATION

**Structure**



## 8.0 OBJECTIVES

After studying this Unit, you should be able to:

- explain the meaning and purpose of articles of association;
- describe the contents of articles of association;
- explain the procedure for alteration of articles of association;
- know the limitations on the power of the company to alter articles of associations;
- explain the relationship of and distinction between articles of association and memorandum;
- explain the legal effects of the memorandum and articles; and
- understand the doctrines of constructive notice and indoor management.

## 8.1 INTRODUCTION

You have learnt in earlier units that a company is an incorporated body. Therefore, rules have to be framed for the management of its internal affairs and the conduct of its business. The relationship between the company and the members constituting it is to be defined. The rights and duties of members vis-à-vis the company is to be described. All such rules and regulations are given in the articles of association. The Articles is the second important document which has to be filed with the Registrar of Companies.

\The Companies Act, 2013, in Tables F, G, H, I and J in Schedule I has given model regulations for the management of respective companies that may be formed under the Companies Act. As per the Companies Act, 2013, every company must have Articles of Association. However, a company has the freedom to adopt the applicable model Articles in whole or any of the regulations applicable to such company. In this Unit, you will learn about the significance of the Articles and its contents. You will also note the distinction between the Memorandum and the Articles. The procedure of altering the Articles has also been explained. You will also study the legal effects of these documents. The doctrines of Constructive Notice and Indoor Management have been explained in detail.

## 8.2 MEANING AND PURPOSE OF ARTICLES

The articles of association of a company are its bye-laws or rules and regulations that govern the management of its internal affairs and the conduct of its business.

According to Section 2(5) of the Companies Act, 2013 'Articles' means the articles 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".

The Articles regulate the internal management of the company. They define the powers of its officers. They also establish a contract between the company and the members and between the members *inter se*. This contract governs the ordinary rights and obligations incidental to membership in the company ***[Naresh Chandra Sanyal v. Calcutta Stock Exchange Association Ltd. (1971)]***.

Articles are like the partnership deed in a partnership. They set out provisions for the manner in which the company is to be administered. In particular, they provide for matters like the making of calls; forfeiture of shares; directors' qualifications; procedure for transfer and transmission of shares and debentures.

## 8.3 REGISTRATION OF ARTICLES

Documents to be filed for registration of a company include Articles of Association of the company. As per Section 5 of the Companies Act, 2013, the articles of a company shall be in respective forms specified in Tables, F,G,H,I and J in Schedule 1 as may be applicable to such company. You may note that Table F contains model articles for a company limited by shares. Table G, H, I and J contain model articles for a company limited by guarantee and not having a share capital, an unlimited company and having a share capital and an unlimited company but not having a share capital respectively.

A company may adopt all or any of the regulations contained in the model articles applicable to such company.

In case of any company, which is registered under the Companies Act, 2013, in so far as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall, so far as applicable, be the regulations of that company in the same manner and to the extent as if they were contained in the duly registered articles of the company. With respect to companies registered under any previous law, the existing articles may continue unless the company decides to change the

same as per the model articles contained in the respective applicable table, as aforesaid.

**Signing of the Articles of Association**

**As per Rule 13 of the Companies (Incorporation) Rules, 2014**, the Memorandum and Articles of Association of the company shall be signed in the following manner.

- **Memorandum and articles of association of the company shall be signed by each subscriber to the memorandum,** who shall add his name, address description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any.

  The witness shall state that "I witness to subscriber/subscriber(s) who has/ have subscribed and signed in my presence (date and place to be given). Further I have verified his/their ID for their identification and satisfied myself of his/her their identification particulars as filled in.

- ***Where a subscriber to the memorandum is illiterate*,** he shall affix his thumb impression or mark which shall be described as such by the person, writing for him, who shall place the name of the subscriber against or below the mark and authenticate it by his own signature. He shall also write against the name of the subscriber, the number of shares taken by him. Such person shall also read and explain the contents of the memorandum and articles of association to the subscriber and make an endorsement to that effect on the memorandum and articles of association.

- ***Where the subscriber to the memorandum is a body corporate,*** the memorandum and articles of association shall be signed by director, officer or employee of the body corporate duly authorised in this behalf by a resolution of the board of directors of the body corporate.

- ***Where the subscriber is a Limited Liability Partnership,*** it shall be signed by a partner of the Limited Liability Partnership, duly authorised by a resolution approved by all the partners of the Limited Liability Partnership.

- ***Where subscriber to the memorandum is a foreign national residing outside India,*** memorandum and articles of association shall be signed in the manner prescribe in the rules.

## 8.4 CONTENTS OF ARTICLES

You have learnt that the Articles of Association of a company contains the rules and regulations for the internal management of the company. As per Section 5 of the Companies Act, 2013, the articles shall also contain such matters, as may be prescribed. However, company may include such additional matters in its articles as may be considered necessary for its management.

**Provisions for Entrenchment**

For the first time Companies Act, 2013 contains provisions relating to entrenchment from Articles. Sub-section (3) of Section 5 provides that the articles

may contain provisions for entrenchment. What it means is that Articles may provide that certain provisions of the Articles will not be alterable merely by passing a special resolution; they will require a more elaborate prescribed procedure to be followed.

The provisions for entrenchment referred to above shall only be made either on formation of a company, or by an amendment in the articles agreed to by all the members of the company in the case of a private company and by a special resolution in the case of a public company.

Where the articles contain provisions for entrenchment, whether made on formation or by amendment, the company shall give notice to the Registrar of such provisions in such form and manner as may be prescribed.

The Articles of Association of a company usually contain rules and regulations relating to the following matters:

i) The exclusion, wholly or in part, of the model articles as contained in respective Tables.

ii) Share capital- shares and their value and their division into equity and preference shares, if any.

iii) Rights of each class of shareholders and procedure for variation of their rights.

iv) Procedure relating to the allotment of shares, making of calls and forfeiture of shares.

v) Increase, alteration and reduction of share capital.

vi) Rules relating to transfer or transmission of shares and the procedure to be followed for the same.

vii) Lien of the company on shares allotted to the members for the amount unpaid in respect of such shares and the procedure in respect thereof.

viii) Appointment, remuneration, powers, duties etc. of the directors and officers of the company.

ix) Constitution and composition of Audit committee, Remuneration Committee, CRS Committee.

x) Procedure for conversion of shares into stock and vice versa.

xi) Notice of the meetings, voting rights of members, proxy, quorum, poll, etc.

xii) Audit of accounts, transfer of amount to reserves, declaration of dividend, etc.

xiii) Borrowing powers of the company and the mode of exercise of those powers.

xiv) Issue of share certificate including procedure for issue of duplicate shares.

xv) Issue of share certificate including procedure for issue of duplicate shares.

xvi) Winding up of the company.

The Articles of Association must be prepared carefully and it must contain rules in regards to all such matters which are required to be contained therein and which are necessary for the smooth functioning of the company.

But you must remember that the Articles must not contain anything which is against the provisions of the Companies Act or the Memorandum of Association. For example, Articles must not contain a rule permitting the payment of dividend out of example; Articles must not contain a rule permitting the payment of dividend out of capital, because according to Section 123, dividend can be paid only out of profits.

**Regulations required in case of unlimited company, company limited by guarantee and private company limited by shares**

Table G, H, I and J appended to Schedule 1 require the Articles of Association of a guarantee company having share capital and an unlimited liability company having share capital to mention the number of members with which the company proposes to be registered and in case of a guarantee company not having share capital and an unlimited liability company not having share capital, the Articles of Association should also state that the subscribers to the memorandum and such other persons as the Board shall admit to membership shall be members of the company.

A private company having a share capital must provide in the articles, the three restrictions specified in sub-clauses *(i), (ii)* and *(iii)* of sub-section (68) of Section 2, viz., *(i)* as to the right to transfer shares *(ii)* limit as to number of its members *(iii)* invitation to public to subscribe for any securities of the company. Any other private company (i.e., not having share capital) must provide in its articles, restrictions as given under *(i)* and *(ii)* as mentioned above.

## 8.5 ALTERATION OF ARTICLES

Section 14 provides that subject to the provisions of the Act and to the conditions contained in its memorandum; a company may, by 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.

Where 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, that is, restrictions contained in Section 2 (68), the company shall, as from the date of such alteration, cease to be a private company.

In other words, a private company may convert itself into a public company by omitting the three restrictive clauses of Section 2 (68) [*Already discussed under definition of a private company in Unit 5*].

But, where alteration of the Articles shall have the effect of conversion of a public company into a private company, the same shall not take effect unless the approval of the Tribunal has been obtained. In other words, if a public company wants to convert itself into a private company by introducing the three restrictive clauses of Section 2 (68), merely passing of special resolution will not be sufficient; it will have to obtain the approval of the Tribunal also.

A copy of special resolution altering the articles must be filed with the Registrar within 30 days of the passing of the special resolution as required by section 117. The right to alter articles just by passing special resolution is so important that a company cannot, in any manner, deprive itself of this power – **Walker vs. London Tramway Company [1879].**

Sub-section (2) of Section 14 requires every alteration of the articles and a copy of the order of the Tribunal approving the alteration, where applicable, 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 and the Registrar shall register the same.

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.

### 8.5.1 Limitation on Power to Alter Articles

You have noted that Section 14 of the Companies Act, 2013 allows companies to alter the articles of association of a company by passing special resolution and where alteration is to have the effect of converting a public company into a private company; the company shall have to obtain the approval of the Tribunal also besides passing special resolution. However, this right of the company to alter Articles is subject to certain limitation. These limitations include:

1) **Not to be inconsistent with Memorandum:** The alteration must not exceed the powers given by the memorandum or be in conflict with any provisions of the memorandum. In the event of conflict between the memorandum and the articles, it is the memorandum that will prevail.

2) **Not to be inconsistent with Companies Act or any other law:** The alteration must not be inconsistent with any provisions of the Companies Act or any other statute – for example, no public company can finance purchase of its own shares (Section 67) and if the articles of such a company are altered so as to have such a power then such power will be void.

   Similarly, where a resolution was passed expelling a member and authorising the director to register the transfer of his shares without an instrument of transfer, the resolution was held to be invalid as being against the provisions of the Act **[Madhava Ramachandra Kamath vs. Canara Banking Corporation [1941]]**

3) **Not be inconsistent with any alteration made by the Tribunal:** Where under Section 242, the Tribunal makes an order with respect to any alteration in the memorandum or articles of a company, then the company shall not have the power to make any alteration which is inconsistent with its orders except with approval of the Tribunal [Sec. 242 (5)].

4) **The altered articles must not include anything which is illegal or opposed to public policy or unlawful.**

5) **The alteration must be bonafide for the benefit of the company as a whole:** *It should not constitute a fraud on or oppress the minority.* The alteration will not, however, be bad merely because it inflicts hardship on an individual shareholder. In **Allen vs. Gold Reefs of West Africa Limited**

**[1900],** a company had a lien on all shares 'not fully paid-up' for calls due to the company. There was only one shareholder 'A', who owned fully paid-up shares. He also held partly paid shares in the company'. 'A' died. The company altered its articles by striking the words "fully paid up" and thus giving itself a lien on all shares – whether fully paid up or not. The legal representative of 'A' challenged the alteration on the ground that the alteration had retrospective effect. *Held that*, the alteration was good, as it was done *bona fide* for the benefit of the company as a whole, even though the alteration had a retrospective effect.

*Again*, in **Side Bottom vs. Kershaw Leese & Co. [1920],** a company was empowered by an alteration in the articles, to expropriate shares held by any member who was in business in competition with the company. At the time of alteration, there was only one member doing business in competition with the company. He challenged the alteration. *Held*, the alteration was valid being *bona fide* for the benefit of the company

6) **An alteration of articles of effect a conversion of a public company into a private company cannot be made without the approval of the Tribunal (Section 14).**

7) **A company cannot justify breach of contract with third parties or avoid a contractual liability by altering articles: In British Murac Syndicate Ltd. vs. Alperton Rubber Co. [1915],** an agreement provided that so long as the plaintiff syndicate should hold 5,000 shares in the defendant company, it should have the right of nominating two directors on the Board of the defendant company. A provision to the same effect was contained in 'Article 88' of the defendant company's articles. The plaintiff syndicate nominated two directors whom the defendant company refused to accept. An attempt was then made to cancel Article 88, but an injunction was granted to restrain it. The learned judge observed that the contract involved, as one of its terms that Article 88 was not to be altered.

   However, where the damage is capable of being measured in terms of money, the company may alter its articles, subject to payment of damages for breach.

8) **Retrospective operation of Articles:** The amended regulation in the articles of association cannot operate retrospectively, but only from the date of amendment **[Pyare Lal Sharma vs. Managing Director, J & K Industries Ltd. (1989)].**

## 8.5.2 Effect of Altered Articles

Alteration binds members in the same way as original articles. The provision of Section 10 providing that the articles shall bind the company and the members to the same extent as if they had been signed by the company and by each member, means the articles as originally framed, or as the may from time to time stand after they have been altered are valid under the provision of the Act. There is clear power to alter the articles, and as altered, they bind members just in the same way as did the original articles**.** ***(Malleson vs. National Insurance & Guarantee Corpn. [1894])*.**

Right of a shareholder to transfer his shares is always subject to provision in articles of association as well as Section 14. A transferee, therefore, cannot have

a better right than the transferor. The rights of a transferee, until the transfer becomes effective, as against the company will again be subject to the provisions of the articles of association and the relevant provisions of the Act. The alteration affecting the articles of association in exercise of the said power cannot, therefore, be challenged by the transferee on the ground of being *mala fide* – **Mathrubumi Printing & Co. Ltd. v. Vardhaman Publishers Lt. [1992].**

## 8.6 RELATIONSHIP BETWEEN MEMORANDUM AND ARTICLES

The memorandum defines the company's objects and various powers it possesses; the articles determine how those objects shall be achieved and those powers exercised.

The articles of a company are subordinate and controlled by the memorandum of association which is the dominant instrument and constrains the general constitution of the company. The memorandum is fundamental and can be altered only under certain circumstances provided by the Act. But the articles are only internal regulations, over which the members of the company have full control and may alter them according to what they think fit. Care has to be taken to see that regulations provided for in the articles do not exceed the powers of the company as laid down by its memorandum – **Ashbury vs. Watson [1885]**. Articles going beyond the Memorandum are *ultra vires* – **Shyam Chand vs. Calcutta Stock Exchange [1947].**

Subject to the rule that the memorandum prevails in the event of a conflict, the memorandum and the articles are contemporaneous documents, must be read together, and ambiguity or uncertainty in the one may be removed by reference to the other. Thus, where the memorandum was silent as to whether the company's shares were to be all of one class or might be of different classes, it was held that a power given by the articles to issue shares of different classes resolved the uncertainty and enabled the company to do so **[Re, South Durham Brewery Company (1885)].** Where the memorandum of a trading company empowered to do all things incidental to achieving the object, it was held that provision in the articles empowering the company to lend money merely exemplifies the general words of the memorandum, and the company was, therefore, entitled to lend money to its employees **[Rainford vs. James Keith and Blackman Company Ltd. (1905)].** Again, where the memorandum empowered the company to borrow on the security of its assists or credit and the articles provided that it might mortgage its uncalled capital, it was held that the articles merely made specific the general words of the memorandum so that the company could have power to mortgage its uncalled capital **[Re Pyle Words (No. 2) (1891)].**

The relationship between memorandum and articles has been aptly summed up by Lord Cairns, L.C. in **Ashbury Railway Carriage & Iron Co. Ltd. vs. Riche [1875]** as follows:

"The articles play a part subsidiary to a memorandum of association. They accept the memorandum of association as a charter of incorporation of the company, and so accepting it, the articles proceed to define the duties, rights and powers of governing body as between themselves and the company at large, and the mode and form in which business of the company is to be carried on, and the mode and

form in which changes in the internal regulations of the company may from time to time be made …. The memorandum is as it were …. The area beyond which the actions of the company cannot go; inside that area, the shareholders may make such regulations for their own government as they think fit."

## 8.7 DISTINCTION BETWEEN MEMORANDUM AND ARTICLES

The main points of distinction between memorandum and articles are following:

1) The memorandum contains the fundamental conditions upon which alone the company is allowed to be incorporate. They are conditions introduced for the benefit of the creditors, and the outside public, as well as the shareholders. The articles of association are the internal regulations of the company; they only regulate the relationship between company and the shareholders/members and amongst the members themselves.

2) Memorandum lays down the area beyond which the activities of the company cannot go. Articles provide for regulations inside that area. Thus, memorandum lays down the parameters for the articles.

3) Memorandum of association can be altered only under certain circumstances and in the manner provided in the Act. In most of the cases permission of the Central Government or Tribunal is required, besides the approval of the shareholders in a general body meeting either by way of an ordinary resolution or special resolution. Generally, articles can be altered by the members by passing a special resolution only.

4) Memorandum of association cannot include any clause contrary to the provisions of the Companies Act. The articles of association are subsidiary both to the Companies Act and the memorandum of association.

5) Acts done by a company beyond the scope of the memorandum are *ultra vires* and, thus, absolutely void. They cannot be ratified even by unanimous vote by all the shareholders. But the acts beyond the articles can be ratified by the shareholders provided the relevant provisions are not beyond the memorandum.

**Check Your Progress A**

1) Fill in the blanks.
   i) Articles of Associations are subsidiary to …….
   ii) Articles of Association are the rules and regulations for the management of …… …… of the company.
2) State whether the following statements are True or False.
   i) Articles of Association regulate the relationship of the company with members.
   ii) Articles are the Charter of a company.
   iii) Every company is required to frame its own Articles of Association.
   iv) Articles of Association must be signed by subscribers to the Memorandum.

v) Articles of a company can contain matters inconsistent with the provisions of the Companies Act, 2013.

vi) Articles of Association are not required to be registered in case of a private company limited by shares.

## 8.8 BINDING EFFECT OF MEMORANDUM AND ARTICLES

Section 10 provides that the Memorandum and Articles, when registered, bind the company and its members to the same extent as if they had been signed by the company and by each member and contain covenants on its and his part to observe all the provisions of the Memorandum and of the Articles. Thus, the company is bound to the members; the members are bound to the company; and the members are bound to the other members by whatever is contained in these documents. But, in relation to Articles, neither a company nor its members are bound to outsiders.

The discussion on legal effect of the Memorandum and Articles may be made under the following heads:

a) Members bound to the company;

b) Company bound to the members;

c) Members bound to members;

**a) Members Bound to the Company**

Each member must observe the provisions of the Memorandum and Articles. Every member is bound by whatever is contained in the Memorandum and Articles.

In **Borland's Trustee vs. Steel Bros. Co. Ltd. [1901]** the articles of a company contained a clause that on the bankruptcy of a member, his shares should be sold to other person and at a price fixed by the directors. 'B', a shareholder was adjudicated bankrupt. His trustee in bankruptcy claimed that he was not bound by these provisions and should be at liberty to sell the shares at the market value. Held, that the trustee was bound by the articles, as a share was purchased by 'B' in terms of the articles.

Each member is not only bound by the covenants of memorandum and articles as originally framed but as altered from time to time in accordance with the provisions of the Companies Act.

**b) Company Bound to Members**

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

In **Wood vs. Odessa Waterworks [1889],** the directors proposed to pay dividend in kind by issuing debentures. The articles provided for payment of dividends. The Court held that payment means payment in cash and therefore the company could be compelled to pay dividend in terms of the Articles.

**c) Members Bound to Members**

The Articles bind the members *inter se*, i.e., one to another as far as rights and duties arising out of the Articles are concerned.

It is well settled that the Articles of Association will have a contractual force between the company and its members as also between members *inter se* in relation to their rights as such members - **Ramakrishna Industries (P.) Ltd. vs. P.R. Ramakrishnan [1988].**

After the articles are registered, they not only constitute a contract between the association or company on the one hand and its constituent members on the other, but they also constitute a contract between the members *inter se*- **Shiv Omkar Maheshwari vs. Bansidhar Jagannath [1957].**

The Articles of a company provided that whenever any member wished to transfer his shares, he was under an obligation to inform the directors of his intention and the directors were under an obligation to take the said shares equally between them at a fair value. The directors refused to take shares of a particular member on the ground that the articles did not impose an enforceable liability upon them. *Held*, the directors were under an obligation to purchase the shares, as members of the company, in terms of the provision of the Articles. There was a personal liability of members *inter se* **[Rayfield v. Hand (1960)].**

However, Articles do not create an express contract among the members of the company. A member of a company has no right to bring a suit to enforce the Articles in his own name against any other member or members. It is the company alone which can sue the offender so as to protect the aggrieved member. It is in this way that the rights of members *inter se* are regulated.

A shareholder may, however, sue in his own name to restrain another, or others from doing fraudulent or *ultra vires* act. In **Jahangir R. Modi vs. Shamji Ladha [1866-67],** the Bombay High Court held: "a shareholder can maintain an action against the directors to compel them to restore to the company the funds of the company that have (by them) been employed in a transaction that they have no authority to enter into, without making the company a party to the suit".

**Whether Company or Members Bound to the Outsiders**

The Memorandum or Articles do not confer any contractual rights upon outsiders against the company or its members, even though the name of the outsider is mentioned in the Articles. An outsider (i.e., a non-member) cannot rely on Articles of Association for his action against the company.

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

the Articles of Association. His case was dismissed on the ground that, he as a solicitor, was no party to the Article. He must prove a contract independent of the Articles. There was no infringement of his right as a member **[Eley vs. Positive Government Security Life Assurance Co. (1876)].**

**Whether Directors are Bound by whatever is Contained in the Articles**

The directors of a company derive their powers from the Articles and are subject to limitation, if any, applied on their powers by the Articles. If they contravene any provision of Articles, they render themselves liable to an action at the instance of the members. However, members may ratify the act of directors, if they so desire. But, if as a result of breach of duty, any loss has resulted to the company, the directors are liable to reimburse the company any loss so suffered.

## 8.9 CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES

Section 399 provides that the Memorandum and Articles when registered with Registrar of Companies 'become public documents' and then they can be inspected by anyone by electronic means on payment of the prescribed fee. Again, Section 17 read along with **Rule 34 of the Company (Incorporation) Rules, 2014** provides that a company shall on payment of the prescribed fee send a copy of each of the following documents to a member within seven days of the request being made by him-

1) the memorandum;
2) the articles, if any;
3) every agreement and every resolution referred to in sub-section (1) of section 117, if and so far as they have not been embodied in the memorandum and articles.

Failure to supply the copy (ies), as above, will make the company as well as every officer in default liable to a fine @ Rs. 1,000 per day for each day of the default or Rs. 1,00,000, whichever is less.

Therefore, any person who contemplates entering into a contract with the company has the means of ascertaining and is thus presumed to know the powers of the company and the extent to which they have been delegated to the directors. *In other words*, every person dealing with the company is presumed to have read these documents and understood them in their true perspective. This type of presumed knowledge of these documents is termed as **"constructive notice of Memorandum and Articles of Association"**. Even if the party dealing with the company does not have actual notice of the contents of these documents it is presumed that he has an implied (constructive) notice of them. Where any charge or any property or assets of a company or any of its undertaking is registered under Section 77, any person acquiring such property, asset or undertaking or part thereof any share or interest therein shall be deemed to have notice of the charge from the date of such registration (section 80)

**Example**

One of the articles of a company provides that bill of exchange to be effective must be signed by two directors. A bill of exchange is signed only by one of the directors. The payee will not have a right to claim under the bill.

## 8.10 DOCTRINE OF INDOOR MANAGEMENT

The rule of constructive notice proved too inconvenient for business transactions, particularly where the directors or other officers of the company were empowered under the articles to exercise certain powers subject only to certain prior approvals or sanctions of the shareholders. Whether those sanctions and approvals had actually been obtained or not could not be ascertained because the investors, vendors, creditors and other outsiders could not dare ask the directors in so many words about those sanctions having been obtained or to produce the relevant resolutions. Quite naturally, suppose if you desire to buy a 'bond' or 'debenture' issued by company, you are not going to ask directors of the company to provide shareholders' resolutions authorising them to issue such bonds before you subscribe the same. Likewise, if a director approaches you to buy certain goods worth, say, a few thousands of rupees, you will not ask him for a power of attorney or other relevant document authorising him to make those purchases on behalf of the company.

And if you do, may be, you will lose a good customer once for all. Since there are no means to ascertain whether necessary sanctions and approvals have been obtained before a certain officer exercises his powers which, as per articles, can only be exercised subject to certain approvals, those dealing with the company can assume that if the directors or other officers are entering into those transactions, they would have obtained the necessary sanctions. This is known as the 'doctrine of indoor management' and was first laid down in the case of **Royal British Bank vs. Turquand [1856].**

The facts of ***Turquand's* case** were as follows:

The directors of a company were authorised by the articles to borrow on bonds such sums of money as authorised from time to time, by a resolution of the company in general meeting. The directors gave a bond to T without the authority of any such resolution. The question arose whether the company was liable on the bond. *Held*, the company was liable on the bond, as T was entitled to assume that the resolution of the company in general meeting had been passed.

You should note that the position would have been different if the sanction of general body of shareholders required was by way of special resolution. It's because all special resolutions are required to be registered with the ROC as per Section 117 and all those dealing with the company are deemed have knowledge of documents registered with ROC.

Thus, you would have observed from the foregoing discussion that the 'doctrine of constructive notice' throws a burden on people entering into contracts with a company by making a presumption that they would have read the company's memorandum and the articles even though they might not have actually read them. The 'doctrine of indoor management', on the other hand allows all those who deal with the company to assume that the provisions of the articles have been observed by the officers of the company. *In other words*, the persons dealing with the company are not bound to inquire into the regularity of internal proceedings.

***Exceptions to the Doctrine of Indoor Management***

The above noted 'doctrine of indoor management' is, however, subject to certain exceptions based on cases. In other words, relief on the ground of 'indoor

management' cannot be claimed by an outsider dealing with the company in the following circumstances:

1) **Where the outsider had knowledge of irregularity** – The rule does not protect any person who has actual or even an implied notice of the lack of authority of the person acting on behalf of the company. Thus, a person knowing fully well that the directors do not have the authority to make the transaction but still enters into it cannot seek protection under the rule of indoor management.

   In **Howard vs. Patent Ivory Co**., the articles of a company empowered the directors to borrow up to one thousand pounds with the consent of the company in general meeting. Without such consent having been obtained, they borrowed 3,500 pounds from one of the directors who took debentures. The company refused to pay the amount. *Held*, the debentures were good to the extent of one thousand pounds only because the director had notice or was deemed to have the notice of the internal irregularity. Therefore the company was liable to them for £1000 only

2) **No knowledge of Articles** – Again, the rule cannot be invoked in favour of a person who did not consult the memorandum and articles and thus did not rely on them. In **Rama Corporation vs. Proved Tin & General Investment Co. [1952],** T was a director in the investment company. He, purporting to act on behalf of the company, entered into a contract with the Rama Corporation and took a cheque from the latter. The articles of the company (Proved Tin & General Investment) did provide that the directors could delegate their powers to one of them. But Rama Corporation people had never read the articles. Later, it was found that the directors of the company did not delegate their powers to T. Plaintiff (Rama Corporation) relied on the rule of indoor management. *Held*, they (Rama Corporation) could not, because they even did not know that power could be delegated.

3) ***Forgery* –** The rule of indoor management does not extend to transactions involving forgery or otherwise void or illegal *ab initio*. In the case of forgery it is not that there is absence of free consent but there is not consent at all. The person whose signatures have been forged is not even aware of the transaction and the question of his consent being free or otherwise does not arise. Since there is no consent at all there is no transaction. Consequently, it is not that the title of the person is defective but there is no title at all. Therefore, howsoever clever the forgery might be the person gets no rights at all. Thus, where the secretary of a company forged signatures of two of the directors required under the articles on a share certificate and issued certificate without authority, the applicants were refused registration as members of the company. The certificate was held to be a nullity and the holder of the certificate was not allowed to take advantage of the doctrine of indoor management – **Ruben vs. Great Fingal Consolidated [1906].**

4) ***Negligence* –** The 'doctrine of indoor management', in no way, rewards those who behave negligently. Thus, where an officer of a company does something which shall not ordinarily be within his powers, the person dealing with him must make proper enquiries and satisfy himself as to the officer's authority. If he fails to make an enquiry, he is stopped from relying on the Rule. In **Al Underwood vs. Bank of Liverpool [1924],** a person who was a

sole director and principal shareholder of a company paid into his own account cheques drawn in favour of the company. *Held*, that, the bank should have made inquiries as to the power of the director. The bank was put upon an enquiry and was accordingly not entitled to rely upon the ostensible authority of director.

Similarly, in **B. Anand Behari Lal vs. Dinshaw & Co. (Bankers) Ltd. [1942],** an accountant of a company transferred some property of a company in favour of Anand Behari. On an action brought by him for breach of contract, the Court held the transfer to be void. It was observed that the power of transferring immovable property of the company could not be considered within the apparent authority of an accountant.

**5)** ***Others –*** *Doctrine is also not applicable where a pre-condition is required to be fulfilled before company itself can exercise a particular power*. *In other words*, the act done is not merely *ultra vires* the directors/officers but *ultra vires* the company itself – **Pacific Coast Coal Mines vs. Arbuthnot [1917]**

**Check Your Progress B**

1) Fill in the blanks.

   i) Memorandum and Articles, when registered, bind a company and its …….

   ii) Every person dealing with a company is presumed to have notice of the contents of ……

   iii) Any one dealing with the company is ……. to assume that whatever was required to be done in the internal management of the company has been done.

2) State whether the following statements are True or False.

   i) Articles may explain any ambiguity included in the Memorandum.

   ii) Memorandum and Articles are deemed to contain terms upon which shares are sold by the company.

   iii) Any one dealing with the company is not entitled to assume that whatever was required to be done as regards internal management of the company has been done.

   iv) Articles of Association regulate the relations of company with its members.

   v) A person who could discover irregularity while dealing with a company cannot claim benefit of the doctrine of indoor management.

3) State which of the alternatives is correct in the following cases:

   i) Table F contains a model form of

      a) Regulations for management of a company limited by shares.

      b) Memorandum of a company limited by shares.

      c) Memorandum and Articles of Association of a company limited by guarantee and not having a share capital.

   ii) If the Articles conflict with the Memorandum

a) the Articles shall prevail.

b) the Memorandum shall prevail.

c) the directors will resolve the conflict.

d) the court will resolve the conflict

iii) The Articles of a company may be altered by

a) the directors.

b) any official of the company.

c) shareholders by passing an ordinary resolution.

d) shareholders by passing a special resolution.

## 8.11 LET US SUM-UP

The articles of association of a company are its bye-laws or rules and regulations that govern the management of its internal affairs and the conduct of its business. Articles define the powers of its officers. They also establish a contract between the company and the members and between members *inter se.*

In relation to 'memorandum', articles' occupy a position subordinate to 'Memorandum'. It is the memorandum that prevails in the event of a conflict between the two.

Articles contain provisions relating to matters like share capital of the company; rights of various shareholders; share certificates; lien on shares; calls on shares; transfer of shares; transmission of shares; conversion of shares into stock and *vice versa*; general meetings and proceedings thereat; directors including first directors, their appointment, qualifications, powers and proceedings of Board of directors' meetings.

Tables F, G, H, I and J to Schedule 1 give the model form of articles for various types of companies. A company may straightway adopt relevant model Articles.

As per Rule 13 of the Companies (Incorporation) Rules, 2014, the Articles of Association of the company shall be signed by each subscriber to the memorandum, who shall add his name, address, description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation, if any.

Articles may be altered by passing a special resolution of the shareholders. This power is, however, subject to certain limitations, namely, alteration must not be inconsistent with the provisions of the Companies Act, or any other statute; it must not include anything illegal or opposed to public policy, must be *bona fide* in the interest of the company as a whole; must not have the effect of converting a public company into a private company unless approval of the Tribunal has been obtained; should not result in breach of contract with third parties; the amendment should, generally, not be operative retrospectively. A valid alteration of articles binds members in the same way as original articles.

As per section 399, the memorandum and articles when registered with the Registrar become public documents and then they can be inspected by any one

by electronic means on the payment of the prescribed fee. Since this facility of inspection has been made available to all those who deal with company, law presumes that they not only have knowledge of their contents but have also understood them. Thus, even if the party dealing with the company does not have actual notice of the contents of these documents, it is presumed that he has an implied notice of them. This is known as 'doctrine of constructive notice'.

However, the aforesaid rule of constructive notice has been held to be subject to the rule of indoor management. The 'rule of indoor management' was first laid down in the case of *Royal British Bank v. Turquand*. The 'rule of indoor management' offers protection to those dealing with the company through its officers who fail to follow the procedures prescribed under the articles before exercising those powers.

The persons dealing with the company are not bound to inquire into the regularity of internal proceedings.

However, the relief under 'indoor management' cannot be availed of by the directors who have the means of verifying the truth or those who did not read articles at all. Again, it is not available in case of forgery or even negligence.

## 8.12 KEY WORDS

**Constructive Notice:** Knowledge of the contents of documents on the part of those who are dealing with the company is presumed by law.

***Inter se:*** Amongst themselves.

**Public Document:** Any document which is in possession of an officer of the government, and is open to inspection is known as a public document.

## 8.13 ANSWERS TO CHECK YOUR PROGRESS

**A)** 1) i) Memorandum of Association; ii) Internal Affairs

2) i) True; ii) False; iii) True; iv) True; v) False; vi) False;

**B)** 1) i) members ii) Memorandum and Articles of Association iii) entitled

2) i) True, ii) True, iii) False, iv) True, v) True

3) i) a; ii) b; iii) d

## 8.14 QUESTIONS FOR PRACTICE

1) What are Articles of Association" How can they altered?
2) "The power of altering Articles of Association is wide, yet it is subject to a large number of limitations." Explain.
3) What are the usual contents of the Articles?
4) Explain the legal effect of the Articles of Association. How far they are binding on outsiders?
5) Explain briefly the relation between Memorandum and Articles of Association?

6) What is the distinction between a Memorandum and Articles of Association?

7) Explain the 'doctrine of indoor management'. Are there any exceptions to this doctrine?

8) Answer the following problems given reasons:

   i) The authorised signatory of a company issued a share certificate in favour of X, which apparently complied with the company's articles as it was purported to be signed by two directors and the secretary and it had the company's common seal affixed to it. In fact, the secretary had forged the signatures of the directors and affixed the seal without any authority. Will the certificate be binding upon the company?

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

   iii) Company 'A' lends money to Company 'B' on a mortgage of its assets and the procedure laid down in the articles was not complied with and the directors of the two companies were the same. Is the mortgage binding upon Company B?

   iv) A limited Company is formed with its Articles stating that one Mr. Anil shall be the solicitor for the company, and that he shall not be removed except on the ground of misconduct. Can the company remove Mr. Anil from the position even though he is not guilty of misconduct?

   v) A company, in which the directors hold majority of the shares, altered its Articles so as to give power to directors to require any shareholder, who competed with the company's business, to transfer his shares, at their full value, to any nominee of the directors. S had some shares in the company, and he was in competition with the company. Is S bound by the alteration?

**Hints:**

i) No; Forgery confers no protection, it is a nullity. Therefore, certificate is not binding on the company *(Refer to Ruben v. Great Final Consolidated Co. case).*

ii) No; the company is not liable. Once again, protection under indoor management cannot be claimed by those who have no knowledge of the Articles *(Refer to Rama Corporation v. Proved Tin and Investment Co. case)*

iii) No; the mortgage is not binding on company B. The directors had knowledge of the irregularity.

iv) Yes; the company can remove Mr. Anil because Articles of Association constitute no contract between the company and the outsiders (*Refer to Eley v. Positive Government Life Assurance Co. Ltd. case).*

v) Yes; S is bound by the alteration being in the interest of company as a whole *(Refer to the case of Side Bottom v. Kershaw Leese & Co.).*

**Note:** These questions will help you to understand the Unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

# UNIT 9 PROSPECTUS

**Structure**



## 9.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and importance of prospectus;
- describe the contents of prospectus;
- explain the meanings of the deemed prospectus, shelf prospectus and information memorandum;
- understand the concept of minimum subscription;
- discuss the consequences of allotment of shares in fictitious name;
- describe the golden rule for framing of a prospectus; and
- explain the effects of misstatements in a prospectus and the remedies available.

## 9.1 INTRODUCTION

After incorporation of the company, the next step is to raise the necessary resources for carrying the business of the company. You have learnt that a private company is prohibited from inviting public to subscribe to its share capital. Thus, the need of inviting public to subscribe to the share capital arises only in the case of a public company. Even in case of a public company, if the directors are confident of arranging the required capital privately, they need not issue a prospectus. Generally, a public company raises its capital by issuing a prospectus. Besides, inviting the investors, the objective of issuing a prospectus is to inform them about the company's business, financial position, capital structure, future prospects, management, etc. In this unit; you will learn the meaning, need and importance of issuing a prospectus. You will also note contents of a prospectus, meaning of deemed prospectus, shelf prospectus and information memorandum. At the end, you will also know about golden rule for framing of a prospectus and allotment of shares in a fictitious name and also the various remedies available to an aggrieved investor in case prospectus contained misrepresentation.

## 9.2 MEANING AND IMPORTANCE OF A PROSPECTUS

A prospectus, as per Section 2(70), means any document described or issued as a prospectus and includes a red herring prospectus or shelf prospectus 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.

Thus, a prospectus is not merely an advertisement; it may be a circular or even a notice. A document shall be called a prospectus if it satisfies two things:

a) It invites subscription to, or purchase of, shares or debentures or any other security of a body corporate;

b) The aforesaid invitation is made to the public.

***What constitutes an offer to the public?***

As per Section 42 (4), an offer or invitation shall be deemed to be invitation to public, if it cannot be considered as private placement under sub-section (2) of Section 42. Explanation I to Section 42 (2) along with the rules framed thereunder provide that if a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than 200 persons in a financial year, whether the payment for the securities has been received or not or whether the company intends to list its securities or not on any recognised stock exchange in or outside India, the same shall be deemed to be an offer to the public. Thus, we may say that if any company invites subscription or allots any security to 200 or more persons *in a financial year*, it will be said to have made a public offer. However, while counting the aforesaid figure of 200 persons, the following shall not be taken into account:

1) Qualified institutional buyers;

2) Employees, who are offered securities under a scheme of employees stock option as per provisions of section 62 (1) (b).

To be a prospectus, it must be 'issued to the public'. Single private communication does not amount to issue to the public **[Nash v. Lynde (1929)].** In this case, several copies of a document marked "strictly confidential" and containing particulars of a proposed issue of shares, were sent by the managing director of a company to a co-director, who in turn sent a copy to a solicitor, who gave it to a client who, in turn, passed it on to a relation. Thus, a document was passed on privately through a small circle of friends of the directors. The House of Lords held that there had been no issue to the public.

Further, it may be noted that, as per the general law of contracts, an invitation shall not be an invitation to the public if it cannot be calculated to result, directly or indirectly, in the securities becoming available for subscription or purchase by persons other that those receiving the invitation, Thus, it will not be an invitation to public where 'B', a friend of 'A' who receives the invitation, also desires to subscribe, but his offer is refused because he was not invited to make the offer. On the other hand, it will become an invitation to public where his (B's) offer shall also be considered.

Again, the offering of shares to kith and kin of a director is not an invitation to the public to buy shares – **Rattan Singh vs. Managing Director, Moga Transport Co. Ltd. [1959].**

You must remember that a prospectus is not an offer by the company but it is only an invitation to offer. A company, by issuing a prospectus to the public, invites applications for the purchase of its shares, debentures or other securities. The persons who want to purchase share in the company would fill up the share application form and submit the same along with the share application money. This act of applicants amounts to making offers to the company to buy as many shares in the company as are mentioned in the share application forms. The Board of directors of the company will then make the allotment of shares in response to those share application forms. This act of Board of directors amounts to acceptance of the offer of the applicant to purchase shares. Thus, a contract between the applicant and the company is made with all the contractual rights and obligations.

Section 33 reads "(1) No form of application for the purchase of any of the securities of a Company shall be issued unless such form is accompanied by an ABRIDGED PROSPECTUS. However, abridged prospectus need not accompany an application form, if it is shown that the application form was issued:

a) in connection with a *bona fide* invitation to a person to enter into a contract of underwriting agreement with respect to such securities; or

b) in relation to securities which were not offered to the public.

2) A copy of the prospectus shall, on request being made by any person before closing of the subscription list and the offer, be furnished to him.

3) If a company makes any default in complying with the provisions of this section, it shall be liable to a penalty of fifty thousand rupees for each default.

According to Section 2 (1) an 'abridged prospectus' means a memorandum containing such salient features of a prospectus as may be prescribed by Securities and Exchange Board by making regulations in this behalf.

**Note:** The word memorandum here means a note, report or detailed statement and not memorandum of association.

## 9.3 CONTENTS OF A PROSPECTUS

As per the requirement of Section 26 of the Companies Act, 2013, contents of a prospectus shall comprise of:

i) Information to be given in a Prospectus

ii) Reports to be set out in Prospectus

iii) Declaration

iv) Other matters

### 9.3.1 Information to be Given in a Prospectus

Section 26 of the Companies Act, 2013 along with **Rule 3 of the Companies (Prospectus and Allotment of Securities) Rule, 2014** require a prospectus to state the following information namely:

i) names and addresses of the registered office of the company, company secretary, Chief Financial Officer, auditors, legal advisers, trustees, if any, the names, addresses and contact details of the corporate office of the issuer company, compliance officer of the issuer company, merchant bankers and co – managers to the issue, registrar to the issue, bankers to the issue, stock brokers to the issue, underwriters, credit rating agency for the issue, arrangers, if any, of the instrument, names and addresses of such other persons as may be specified by the Securities and Exchange Board in its regulations;

ii) dates of the opening and closing of the issue, and a declaration which shall be made by the Board or the Committee authorised by the Board in the prospectus that the allotment letters shall be issued or application money shall be refunded within fifteen days from the closure of the issue or such lesser time as may be specified by Securities and Exchange Board or else the application money shall be refunded to the applicants forthwith, failing which interest shall be due to be paid to the applicants at the rate of fifteen per cent annum for the delayed period;

iii) a statement by the Board of Directors about the separate bank account where all monies received out of the issue are to be transferred;

iv) disclosure of details of all monies including utilised and unutilised monies out of the previous issue in the prescribe manner;

v) details about underwriting of the issue including the names, addresses, telephone numbers, fax numbers and e-mail addresses of the underwriters and the amount underwritten by them;

vi) consent of the directors, auditors, bankers to the issue, trustees, solicitors or advocates, merchant bankers to the issue, registrar to the issue, lenders and experts;

vii) the authority for the issue and the details of the resolution passed therefor;

viii) procedure and time schedule for allotment and issue of securities;

ix) the capital structure of the company shall be presented in the following manner, namely:

i) a) the authorised, issued, subscribed and paid up capital (number of securities, description and aggregate nominal value);

b) the size of the present issue;

c) the paid up capital-

A) after the issue;

B) after conversion of convertible instruments (if applicable);

d) the share premium account (before and after the issue).

ii) the details of the existing share capital of the issuer company in a tabular form, indicating therein with regard to each allotment, the date of allotment, the number of shares allotted, the face value of the shares allotted, the price and the form of consideration.

x) The prospectus to be issued shall contain the following particulars, namely:-

a) main objects and present business of the company and its location;

b) the objects of the issue;

c) the purpose for which there is a requirement of funds;

d) the funding plan (means of finance);

e) the summary of the project appraisal report (if any);

f) the schedule of implementation of the project;

g) the interim use of funds, if any;

xi) particulars relating to:

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; and

e) any litigation or legal action pending or taken by a Government Department or a statutory body during the last five years immediately preceding the year of the issue of prospectus against the promoter of the company;

xii) minimum subscription, amount payable by way of premium, issue of shares otherwise than on cash;

xiii) details of directors including their appointments and remuneration, and such particulars of the nature and extent of their interests in the company, as may be prescribed; and

xiv) disclosures in such manner as may be prescribed about sources of promoter's contribution.

### 9.3.2 Reports to be Set out in the Prospectus

The prospectus shall set out the following reports for the purposes of the financial information, namely;

i) reports by the auditors of the company with respect to its profits and losses and assets and liabilities, amounts or rates of dividends, if any, paid by the issuer company in respect of each class of shares for each of the five financial years immediately preceding the year of issue of the prospects and such other matters as may be prescribed;

ii) reports made in the prescribed manner by the auditors upon the profits and losses for each of the five financial years immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries and in such manner as may be prescribed.

However, in case of a company with respect to which a period of five years has not elapsed from the date of incorporation, the prospectus shall set out in such manner as may be prescribed, the reports relating to profits and losses for each of the financial year immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries;

iii) reports made in the prescribed manner by the auditors upon the profits and losses of the business of the company for each of the five financial years immediately preceding the issue and assets and liabilities of the business on the last date to which the accounts of the business were made up, being a date not more that one hundred and eighty days before the issues of the prospectus:

Again, in case of a company with respect to which a period of five years has not elapsed from the date of incorporation, the prospectus shall set out in the prescribed manner, the reports made by the auditors upon the profits and losses of the business of the company for all financial years from the date of its incorporation, and assets and liabilities of its business on the last date before the issues of prospectus; and

iv) reports about the business or transactions to which the proceeds of the securities are to be applied directly or indirectly;

### 9.3.3 Declaration

There shall be included a declaration about the compliance of the provisions of this Act and a statement to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 and the rules and regulations made there under.

### 9.3.4 Other Matters

Prospectus shall also such other matters and set out such other reports, as may be prescribed.

Further, SEBI Regulations, 2009 stipulate very elaborate disclosure requirements in relation to offer documents. Companies are required to comply with the same.

**Statement of an Expert included in a Prospectus**

A prospectus may contain a statement purporting to be made by an expert. The term "expert" includes an engineer, a valuer, a chartered accountant, a company secretary, a cost accountant and any other person who has the power to issue a

certificate in pursuance of any law. The reports from and expert will be included in a prospectus if

i) such an expert is a person who is not and has not been engaged or interested in the formation or promotion or management of the company,

ii) he gives his written consent to the issue of the prospectus and had not withdrawn the consent until the prospectus is delivered to the Registrar for registration,

iii) a statement that he has given and not withdrawn his consent thereto is included in the prospectus.

**Exemptions**

The aforesaid requirements of Section 26, that is, with respect to the contents do not apply to:

**a)** ***Rights Issue, i.e.***, the issue to existing members or debenture-holders of a company, of a prospectus or form of application relating to shares in or debentures of the company, whether an applicant has a right to renounce the shares in favour of any other person or not.

**b)** ***Shares/Debentures Uniform in all respects:*** The provisions of Section 26 do not apply to the issue of a prospectus or form of application relating to share 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.

**Variation in terms of contract or objects in prospectus (Section 27)**

If, at any time, the company wants to vary the terms of a contract referred to in the prospectus or objects for which for which the prospectus was issued, it shall not be allowed to do so except by way of special resolution. The notice of the special resolution must clearly indicate the justification for such variation and the same should be published in the newspapers (one in English and one in vernacular language) in the city where the registered office of the company is situated.

***Again, it may be noted that a company cannot use any amount raised by it through prospectus for buying, trading or otherwise dealing in equity shares of any other listed company.***

***Exit Option***

The Companies Act, 2013 has for the first time given an exit option to shareholders who do not agree to the proposal to vary the terms of contracts or objects referred to in the prospectus. The exit option shall be given by promoters or controlling shareholders at such exit price and in such manner and conditions as may be specified by the Securities and Exchange Board by making regulations in this behalf.

**Offer of sale of shares by certain members of company (Section 28)**

You may note that, the Companies Act, 2013, for the first time, has incorporated provisions with respect to offer of sale of shares by certain members of company to be effected by the company on their behalf.

It provides that where certain members of a company (whether individuals or body corporate) propose, in consultation with the Board of Directors to offer whole or part of their holding of shares to the public, they shall collectively authorise the company to take all actions in respect of offer of sale for and on their behalf. They shall reimburse the company all expenses incurred by it on this matter.

Section 28, in this regard provides that any document by which the offer of sale to the public is made shall, for all purposes, be deemed to be a prospectus issued by the company and all laws and rules made thereunder as to the contents of the prospectus and as to liability in respect of misstatements in and omission from prospectus or otherwise relating the prospectus shall apply as if this is a prospectus issued by the company.

## 9.4 STATUTORY REQUIREMENTS IN RELATION TO A PROSPECTUS

1) ***Dating of Prospectus*** – As per section 26, a prospectus issued by or on behalf of a company or in relation to an intended company must be dated. The Section further provides that ***the date on the prospectus shall be deemed to be the date of the publication of the prospectus.***

2) ***Registration of Prospectus*** – Section 26 (1) requires the delivery of a copy of the prospectus to the Registrar on or before the date of its publication. The copy of the prospectus so delivered, should be signed by all the persons named there in as director or proposed director or by his duly authorised attorney. Every prospectus issued under sub-section (1) shall, on the face of it :

   a) state that a copy has been delivered for registration to the Registrar as required under sub-section (4); and

   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.

The Registrar **shall not register a prospectus** unless the requirements of this section with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus.

The aforesaid requirements apply to existing company or any intended company.

***No prospectus shall be issued after ninety days from the date on which a copy of it was delivered to the Registrar.***

**Refusal to Register the Prospectus**

Section 26 (7) provides that the Registrar shall not register a prospectus unless the requirements of Section 26 with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus. Thus, the Registrar will refuse to register a prospectus if:

a) It is not dated;

b) It does not contain matters, reports and declaration to be set out in it;

c) It contains statements or reports of experts engaged or interested or in the formation or promotion or management of the company;

d) It includes a statement purported to be made by an expert without a statement that 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;

e) A copy delivered to the Registrar is not signed by every person who is named therein as a director or proposed director of the company or by his duly authorised attorney.

**Penalty for non compliance**

If a prospectus is issued in contravention of the aforesaid provision of Section 26, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees and 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 three years or with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees, or with both [Section 26 (9)].

**Prospectus in the form of Advertisement (Section 30)**

Where an advertisement of any prospectus of a company is published in any manner, it shall be necessary to specify therein the contents of its memorandum as regards the objects, the liability of members and the amount of share capital of the company, and the names of the signatories to the memorandum and the number of shares subscribed for by them, and its capital structure.

## 9.5 WHEN PROSPECTUS IS NOT REQUIRED TO BE ISSUED

Issue of a prospectus by a company is not compulsory in the following cases:

1) A private company is not required to issue a prospectus.

2) Even a public company need not issue a prospectus if the promoters or directors feel that they can mobilize resources through personal relationships and contacts, and, therefore, the shares or debentures are not offered to the public.

3) Where the shares or the debentures are offered to existing holders of shares or debentures by way of right (*i.e.,* rights issue) with or without the right of renunciation in favour of other person [Section 26 (2) (a)].

4) Where the issue relates to shares or debentures which are, or to be, uniform in all respects with shares or debentures previously issued and dealt in and quoted on a recognised stock exchange [Section 26(2) (b)].

**Check Your Progress A**

1) Choose the correct alternative(s):

   i) Registrar of Companies shall refuse to register a prospectus:

      a) If it is not dated.

b) contains statement of an expert who has not signed it.

c) contains information which is six months old.

d) in all the aforesaid cases.

ii) A prospectus issued in the form of advertisement must state:

a) the objects for which the company has been formed.

b) the liability of members.

c) the amount of share capital of the company.

d) its capital structure.

e) all of the above

iii) The date of issue of the prospectus is:

a) the date appearing on the prospectus.

b) the date when the prospectus is actually published

c) the date of registration of the prospectus with the Registrar of companies.

iv) A public company need not issue a prospectus:

a) in case of rights issue of shares or debentures:

b) shares or debentures being offered are uniform in all respects with shares or debentures previously issued and dealt in and quoted on a recognised stock exchange.

c) where invitation is made by way of advertisement.

d) only in (a) and (b) above

e) in (a), (b) and (c) above

## 9.6 PROSPECTUS BY IMPLICATION/DEEMED PROSPECTUS

In general, the provisions of the Companies Act relating to prospectus are restricted to cases where the invitation is made by or on behalf of a company for subscription of its shares or debentures. As such it was possible at one time for a company to avoid the statutory provisions relating to prospectus by allotting shares or debentures to the public through the medium of Issue House. The shares or debentures will be allotted to these Issue Houses which will in turn invite subscription from the public through their own offer documents. Thus, the company could indirectly raise subscriptions from the members of the public without issuing an offer document or prospectus.

Section 25 covers documents issued by the Issue Houses. Accordingly, such an offer document is treated as a prospectus issued by the company. Section 25 has been essentially designed to check the by-passing of the provisions of Section 26 (Section 26 requires certain information to be disclosed and certain reports to be set out in the prospectus) by making an offer of sale of shares or debentures through the medium of Issue Houses.

Section 25(1) provides that where a company allots or agrees to allot any shares or debentures with a view to these being offered for sale to the public, any document by which the offer of sale to the public is made, shall for all purposes be deemed to be a prospectus issued by the company.

Further, sub-section (2) of Section 25 provides that unless the contrary is proved, an allotment of, or an agreement to allot, shares or debentures shall be deemed to have been made with a view to the shares or debentures being offered for sale to the public, if it is shown:

a) that the offer of the shares or debentures for sale to the public was made within six months after the allotment or agreement to allot; or

b) that at the date when the offer was made, the whole consideration to be received by the company in respect of the shares or debentures had not been received by it.

**Additional Requirements Relating to Deemed Prospectus**

In respect of a document deemed as a prospectus, section 25(3) requires that it must contain certain information in addition to the information required to be stated in a prospectus under Section 26. Additional information requirements are as under:

a) the net amount of consideration received or to be received by the company in respect of the shares or debentures to which the offer relates; and

b) the place and time at which the contract under which the said shares or debentures have been or are to be allotted may be inspected. Section 26, dealing with registration of prospectus applies to the deemed prospectus in terms of Section 25(3) (ii) and accordingly it renders the persons making the offer of sale to the public as deemed directors of the company.

Where the person making the offer is a company or a firm, the document (*i.e.*, deemed prospectus) must be signed by at least two directors or one-half of the partners, as the case may be [Section 26 (4)].

## 9.7 SHELF PROSPECTUS AND RED HERRING PROSPECTUS

### 9.7.1 Shelf Prospectus (Section 31)

"Shelf prospectus" means a prospectus in respect of which the securities or class of securities included there in are issued for subscription in one or more issues over a certain period without the issue of a further prospectus – Explanation to Section 31.

Sub section (1) of Section 31 provides that a 'shelf prospectus' may be issued by any class or classes of companies as the Securities and Exchange Board (SEBI) may provide by regulations in this behalf. Raising finance from the public by means of various securities is a time consuming process. Every time any such issue comes, a fresh prospectus is required to be filed. Although it is a repetitive matter, the procedural aspects take a lot of time. In order to minimise the burden on such institutions, 'shelf prospectus' has been introduced. The validity period of a 'shelf prospectus' cannot exceed one year from the date of opening of the

first offering of securities under that prospectus. For subsequent offerings, information memorandum updating the information under the various heads will have to be filed and entire set comprising of shelf prospectus and the information memorandum shall constitute the prospectus and have to be circulated to the general public. *The provisions of Section 31, in this regard, are as follows:*

i) A shelf prospectus may be issued by any class or classes of companies as the Securities and Exchange Board of India (SEBI) may provide by regulations in this behalf.

ii) A company filing a shelf prospectus with the Registrar shall not be required to file prospectus afresh at every stage of offer of securities by it within the period of its validity which cannot be more than one year.

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

iv) An Information Memorandum shall be issued to the public alongwith shelf prospectus filed at the stage of the first offer of securities. Information memorandum together with the shelf prospectus shall be deemed to be a prospectus.

**Note:** The word memorandum here means a report, or detailed note or summary and not Memorandum of Association.

### 9.7.2 Red Herring Prospectus [Section 32]

Section 32 of the Companies Act, 2013 contains the following provisions with respect to 'red herring prospectus':

1) A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus.

   "Red herring prospectus" means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

2) 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.

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

4) Any variation between the red herring prospectus and a prospectus shall be highlighted as variations in the prospectus.

5) Upon the closing of the offer of securities, the prospectus stating therein:

   a) the total capital raised, whether by way of debt or share capital,

   b) the closing price of the securities, and

   c) any other details as are not included in the red herring prospectus shall be filed with the Registrar and the Securities and Exchange Board of India.

## 9.8 MINIMUM SUBSCRIPTION

No allotment of any securities of a company offered to the public for subscription shall be made unless the amount stated in the prospectus as the minimum amount has been subscribed and the sums payable on application for the amount so stated have been paid to and received by the company by cheque or other instrument (Section 39).

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.

**As per Rule 11 of the Companies (Prospectus and Allotment of Securities) Rules, 2014** the application money shall be repaid within a period of 15 days from the closure of the issue. In case of failure to repay, 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 fifteen per cent per annum.

The application money to be refunded shall be credited only to the bank account from which the subscription was remitted.

In case of company's failure to return the amount, 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 [Section 39(5)].

## 9.9 MISSTATEMENT IN A PROSPECTUS AND ITS CONSEQUENCES

The prospective shareholders are entitled to true and faithful disclosures in the prospectus. The persons issuing the prospectus are bound to state everything accurately and not to omit material facts.

### 9.9.1 What is an Untrue Statement/Misstatement?

According to section 34(1) of the Act, a statement included in a prospectus shall be deemed to be untrue:

a) if the statement is misleading in the form or context in which it is included; or

b) where any inclusion or omission from a prospectus of any matter is likely to mislead.

Thus, in regard to considering a prospectus as fraudulent, it is not necessary that there should be false representation in it; even if every word included in the prospectus is true, the suppression of material facts may render it fraudulent. To judge its effect, it should be read as a whole.

In ***Rex v. Kylsant*** [1932], all the statements included in the prospectus issued by the company were literally true. One of the statements disclosed the rates of dividends paid for a number of years. But, dividends had been paid not out of

trading profits but out of realised capital profits. This material fact was not disclosed. *Held*, that the prospectus was false in material particular and Lord Kylsant, the managing director and chairman, who knew that it was false, was held guilty of fraud.

*A mere silence* cannot be a sufficient foundation of setting aside the allotment of shares. The withholding of facts should be such that if not stated it makes that which is stated absolutely false. In ***Peek v. Gurney*** **[1873],** the prospectus issued did not mention about certain liabilities. This created a false impression about the company being very prosperous. The prospectus was held to be untrue.

## 9.9.2 Liability and Defences

An allottee of shares, who had applied for shares, on faith of a prospectus (i) containing untrue statement; or (ii) including or omitting material facts which have the effect of what is stated as false has remedies against the company, its promoters and directors and experts.

It should be noted carefully that the right to claim compensation for any loss or damage is available only to a person who has 'subscribed' for shares, debentures or any other security on the faith of the prospectus containing untrue statements. Thus, a subsequent buyer of shares in the open market has no remedy against the company or the directors or promoters. If there is any misrepresentation of material fact in a prospectus, there may arise (i) civil liability, and (ii) criminal liability.

**Civil Liability**

Section 35 (1) provides that 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, besides punishment under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

You should note that Section 36 provides for Punishment for fraudulently inducing persons to invest money. We shall discuss the provisions of Section 36 a little later.

***Defences available to avoid Civil Liability***

No person shall be liable under Section 35 (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, or

b) that it was issued without his authority or consent; or

c) 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.

However, 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 (Section 35 (3).

**Criminal Liability**

According to Section 34, where a prospectus, issued, circulated or distributed 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 punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and 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.

**Defences available to avoid Criminal Liability**

The aforesaid criminal liability will not be attracted if the person proves that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

**Punishment for fraudulently inducing persons to invest money**

Section 36 provides that any person who,

i) either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or

ii) deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into specified agreements, shall be punishable with imprisonment for a term with shall not be less than six month but which may extend to ten years and 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.

Agreements covered under Section 36 include:

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.

**Action by Affected Persons (Section 37)**

A suit may be filed or any other action may be taken under section 34 or section 35 or section 36 by any person, group of persons or any association of persons

affected by any misleading statement or the inclusion or omission of any matter in the prospectus.

Thus, Section 37, not only provides for individual action but also for class action.

## 9.10 GOLDEN RULE FOR FRAMING OF PROSPECTUS

The 'Golden Rule' for framing of a prospectus was laid down by Justice Kindersely in *New Brunswick & Canada Rly. & Land Co. v. Muggeridge (1860).* Briefly, the rule is:

Those who issue a prospectus hold out to the public great advantages which will accrue to the persons who will take shares in the proposed undertaking. Public is invited to take share on the faith of the representations contained in the prospectus. The public is at the mercy of company promoters. Everything must, therefore, be stated with strict and scrupulous accuracy, nothing should be stated as fact which is not so, and no fact should be omitted the existence of which might in any degree affect the nature of quality of the principles and advantages which the prospectus holds out as inducement to take shares. In a word, the true nature of the company's venture should be disclosed.

In ***Rex v. Kylsant*** *(1932),* the prospectus stated that dividends of 5 to 8 per cent had been regularly paid over a long period. The truth was that the company had been incurring substantial losses during the seven years preceding the date of the prospectus and dividends had been paid out of the realised capital profits. *Held*, the prospectus was false and misleading. The statement though true in itself was rendered false in the context in which it was stated.

A half truth, for instance, represented as a whole truth may tantamount to a false statement [Lord Halsbury in ***Aarons Reefs v. Twisa***].

Thus, the persons issuing the prospectus must not only include in the prospectus all the relevant particulars specified in Section 26 of the Act, which are required to be stated compulsorily but should also voluntarily disclose any other information within their knowledge which might in any way affect the decision of the prospective investor to invest in the company.

## 9.11 ALLOTMENT OF SHARES IN FICTITIOUS NAMES

Section 38 provides that 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 punishable with imprisonment for a term which shall not be less

than six months but which may extend to ten years and shall also be liable to fine which shall not be less that the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

The aforesaid penal provisions must be prominently reproduced in every prospectus issued by a company and in every form of application for securities.

Further, 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 (Subsection (3)).

The amount received through disgorgement or disposal of securities shall be credited to the Investor Education and Protection Fund.

## 9.12 ANNOUNCEMENT REGARDING PROPOSED ISSUE OF CAPITAL

It is very common for companies to get an announcement regarding proposed issue of share/debentures inserted in the leading newspapers. It is not required by company law to do so. But it is done in order to invite the attention of the public to the proposed issue. On the top of the insertion it is given that, "It is only an announcement and not a prospectus", in order to avoid penal provisions under Sections 34 and 35 for publishing an incomplete prospectus.

Section 30, in this regard, provides that where an advertisement of any prospectus of a company is published in any manner, it shall be necessary to specify therein:

i) the objects as stated in the Memorandum;

ii) the liability of members;

iii) the amount of authorised share capital of the company;

iv) the name of the signatories to the memorandum and the number of shares subscribed for by them; and

v) the capital structure of the company.

**Check Your Progress B**

1) Fill in the blanks.

   i) A company should not issue a prospectus to the public unless a copy thereof has been delivered to the .....

   ii) Shelf Prospectus remains valid up to .....

   iii) A prospectus containing statement by experts, must contain .....

   iv) A prospectus must be issued within ..... of its registration.

2) State whether the following statements are True or False.

   i) A public company may allot shares without issuing a prospectus.

   ii) A document is not a prospectus unless it is an invitation to the public to subscribe for shares in, or debentures of, or any other security with a body corporate.

iii) A prospectus must be dated.

iv) A public company issuing shares among friends and relatives need not issue a prospectus.

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

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

vii) A director can avoid criminal liability for misstatements in the prospectus if proves that he had reasonable ground to believe that the statement alleged to be untrue is true.

viii) Where a prospectus contains untrue statements, the persons who authorised its issue are punishable with fine upto Rs. 50,000.

ix) Red herring prospectus is a prospectus filed with RoC after the filing of the Prospectus.

## 9.13 LET US SUM-UP

Unlike a private company which arranges its share capital primarily, from friends and relatives, a public company normally invites public to subscribe to its share capital. In such a case the public company issues a prospectus inviting subscription. In fact, before the prospectus is issued, the company is required to take certain steps which include the appointment of bankers, auditors, underwriters, brokers, making arrangements for listing of shares on stock exchanges, drafting the prospectus, etc.

Thereafter, the Board of directors has to decide about the time of issue of prospectus. For this purpose, the Board considers the condition of the capital market, the investors' mood, fiscal and monetary policies of the Government and the state of business conditions.

Meaning and definition of a prospectus: Prospectus means any document described or issued as a prospectus and includes a red herring prospectus or shelf prospectus or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchases of any securities of a body corporate.

As to what constitutes an offer to the public, Section 42 (4) states that an offer or invitation shall be deemed to be invitation to public, if it cannot be considered as private placement. Explanation I to Section 42 (2) along with the rules framed thereunder provide that if a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than 200 persons in a financial year, the same shall be deemed to be an offer to the public.

Contents of a prospectus: As per the requirement of Section 26 of the Companies Act, 2013, contents of a prospectus shall comprise of:

1) Information to be given in a Prospectus
2) Reports to be set out in the Prospectus
3) Declaration to be made
4) Other matters

Although most of the public companies do issue a prospectus to meet their financial requirements, the issue of a prospectus by a company is not compulsory. In the following cases, a company is not required to issue a prospectus:

1) In the case of a public company where the promoters or directors propose to mobilise resources through personal relationships and contacts and, therefore, do not propose to approach public for subscription.
2) Where the shares or debentures are offered to existing holders of shares or debentures by way of right.
3) Where the issue relates to shares or debentures which are uniform in all respects with shares or debentures previously issued and dealt in and quoted on a recognised stock exchange.
4) Where invitation is made by way of advertisement.

If, at any time, the company wants to vary the terms of a contract referred to in the prospectus or objects for which the prospectus was issued, it shall not be allowed to do so except by way of special resolution. Besides, the company must give exit option to those shareholders who do not approve of the variations.

Statutory requirements in relation to prospectus: As per section 26, a prospectus issued by or on behalf of a company or in relation to an intended company must be dated. The Section further provides that *the date on the prospectus shall be deemed to be the date of the publication of the prospectus.*

Further, Section 26 requires the delivery of a copy of the prospectus to the Registrar on or before the date of its publication.

The Registrar will not register a prospectus unless the requirements of this section with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons names in the prospectus.

*No prospectus shall be issued after ninety days from the date on which a copy of it was delivered to the Registrar.*

Deemed prospectus: In order to check the by-passing of the provisions relating to prospectus, section 25 declares that all documents containing offer of shares or debentures for sale shall be included within the definition of the term prospectus. Therefore, offer of shares or debentures through the medium of Issue Houses shall require the provisions relating to prospectus to be duly complied with if certain conditions are satisfied.

Besides, any company proposing a public issue may issue a red-herring prospectus before it issues prospectus. A 'red-herring prospectus' is prospectus which does not have complete particulars on the price of securities offered and quantum of securities offered.

Misstatement in a prospectus: In order to ensure that the prospective investors are not subjected to frauds by making certain positive misrepresentation in the

prospectus or by deliberately omitting certain material information, certain remedies have been provided to the aggrieved parties who may subscribe on the faith of any misrepresentation or omissions calculated to deceive. The remedies proved for the right to rescind, a claim for damages and also prosecution of the company and the guilty officers in terms of imprisonment for a term which shall not be less than six months but which may extend to ten years and 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.

Prohibition of allotment of shares in fictitious name: Section 38 prohibits making of an application for acquiring shares of a company under a fictitious name. The section makes the act punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and the person guilty of such fraud 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.

## 9.14 KEY WORDS

**Minimum Subscription:** It is an amount so mentioned in the prospectus and, as per SEBI regulations, 2009, can in no case be less than 90% of the Issue. In the event of company's failure to raise minimum subscription, the entire application money has to be refunded back.

**Prospectus:** It is a document issued by a company inviting members of the public to subscribe to its share capital.

**Abridged Prospectus:** It means a memorandum containing such salient features of a prospectus as may be prescribed by SEBI

**Shelf Prospectus:** A company which proposes to make more than one public issue of securities in a period of one year, may file 'shelf prospectus' which will remain valid up to one year. Such a company need not issue a prospectus every time it offers securities to public; it shall only need to file an 'information memorandum' with respect to changes in the financial position, new charges created, etc.

**Red-Herring Prospectus:** It is a prospectus which does not have complete particulars on the price of securities offered and quantum of securities offered.

**Deemed Prospectus:** The document that offers shares or debentures of a company through the medium of Issues Houses

**Issue Houses:** An investment banking firm whose business is to underwrite share or debenture issue and offer the securities to the public.

**Information Memorandum:** It is issued along with self prospectus and contains all material fact relating to new charge created, changes in financial position between various offers of securities and other changes as may be prescribed.

## 9.15 ANSWERS TO CHECK YOUR PROGRESS

A) 1) i) (d); ii) (e); iii) (a); iv) (d)

B) 1) i) Registrar of Companies;
ii) one year;
iii) a statement about the consent of the expert;
iv) 90 days.

2) i) True; ii) True; iii) True; iv) True; v) False;
vi) True; vii) True; viii) False; ix) False

## 9.16 QUESTIONS FOR PRACTICE

1) Explain the provisions of the Companies Act, 2013, with regard to the registration of prospectus of a public company going for public issue of equity shares. What are the documents required to be submitted by the company to the Registrar of Companies for the above purpose?'

2) When and by whom can the allotment of shares be rescinded on the ground of a false and misleading prospectus under the Companies Act, 1956?

3) When is a company not required to issue prospectus in connection with issue of shares or debentures? When can the invitation for offer to subscribe for shares be treated as not having been made to the public?

4) Who is an 'Expert'? Explain his liability, relating to publication of prospectus, for any misstatement in the report given by him?

5) Define 'Prospectus'. Discuss briefly the contents of 'Prospectus'.

6) State the liability of the company and the directors with respect to misstatements included in a prospectus. When a director of a company is not liable to an aggrieved party for the issue of a prospectus containing a 'misstatement'?

7) Write a note on:
   i) 'Shelf Prospectus'.
   ii) Red herring Prospectus.

8) What is a 'Deemed Prospectus'? State the provisions of the Companies Act, 2013 with respect to 'Deemed Prospectus'.

9) Answer the following problems giving reasons:
   i) X Co. Ltd., intended to buy a rubber estate in Peru. Its prospectus contained extracts from an experts report giving the number of rubber trees in the estate. The report was inaccurate. Will any shareholder buying the shares of the company on the basis of the above representation have any remedy against the company? Can the persons authorising the issue of the prospectus escape from their liability?

ii) A prospectus issued by a company contained a promise of subscription of a substantial amount by some persons so as to induce the public to subscribe. The plaintiff who was allotted 10 shares alleged material misrepresentation. Decide?

iii) 'A' purchased from 'B' 1000 shares of a company on the basis of prospectus containing wrong statement. What remedies are available to 'A' against the company?

iv) A company issued a prospectus. All the statements contained therein were literally true. It also stated that the company had paid dividends for a number of years, but did not disclose the fact that the dividends were not paid out of trading profits, but out of capital profits. An allottee of shares wants to avoid the contract on the ground that the prospectus was false in material particulars. Decide.

**Hints:**

i) The allottee shall have the right to claim damages from the company. Persons authorising the issue of prospectus shall not be liable since they made the statement on the basis of report of an expert. However, expert can be proceeded against.

ii) The allottee shall be entitled to return back shares and claim refund of price as well as damages. Company as well as persons responsible for issue of prospectus can be charge with criminal liability.

iii) 'A' shall have no remedy against the company since shares were not purchased from the company.

iv) Yes, the allottee will succeed. See *Rex v. Kylsant* case.

**Note:** These questions will help you to understand the Unit better. Try to write answers for them. But do not submit your answers to the University. These are for your practice only.

## SUGGESTED READINGS

Avtar Singh, Company Law, Eastern book book Company, 2016 Edition

MC Kucchal Modern India Companies Law. Delhi, Shri Mahavir Book, 2015 edition.