Indira Gandhi National Open University
School of Management Studies

BCOC-135
Company Law

Block

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PROGRAMME DESIGN COMMITTEE B.COM (CBCS)

Prof. Madhu Tyagi
Director, School Management Studies, IGNOU, New Delhi

Prof. R.P. Hooda
Former Vice-Chancellor
MD University, Rohtak

Prof. B. R. Ananthan
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Darjeeling

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School of Management Studies IGNOU

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Dr. Anupriya Pandey

COURSE DESIGN COMMITTEE

Prof. Madhu Tyagi
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IMI, Qutub Institutional Area
New Delhi

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Shaheed Bhagat Singh College
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University of Delhi, Delhi

Faculty Members
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Prof. N.V. Narasimham
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Prof. M.S.S. Raju
Dr. Sunil Kumar
Dr. Subodh Kesharwani
Dr. Rashmi Bansal
Dr. Madhulika P Sarkar
Dr. Anupriya Pandey

COURSE PREPARATION TEAM

Mr. Vinod Prakash
Motilal Nehru College, University of Delhi, Delhi

Dr. S.S Gulshan
Collage of Business studies University of Delhi, Delhi

Prof. G.K. Kapoor
IMI, Qutub Institutional Area
New Delhi

Prof. G.K. Kapoor (Editior)
IMI, Qutub Institutional Area
New Delhi

Prof. Madhu Tyagi
SOMS, IGNOU, New Delhi
(Course Coordinator)

PRINT PRODUCTION

Sh. Y. N. Sharma
Assistant Registrar (Pub.)
MPDD, IGNOU, New Delhi

Sh. Sudhir Kumar
Section Officer (Pub.)
MPDD, IGNOU, New Delhi

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BLOCK 2 PRINCIPAL DOCUMENTS

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.

The Memorandum of Association defines the relation of the company with the outside world and the scope of its activities beyond which its actions cannot go. The Articles of Association of a company contain the rules relating to the management of its internal affairs. The purpose of Prospectus is to provide the required information about the company and invite as well as induce the prospective investors to subscribe to the shares and debentures of the company.

In this Block comprising of units 6, 7 and 8, you will study in detail about the importance, contents and legal implications of these three documents.

Unit 6 deals with Memorandum of Association and discusses the meaning, the purpose, the contents and the procedure for alteration of different clauses of Memorandum.

Unit 7 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 8 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 6 MEMORANDUM OF ASSOCIATION

Structure

6.0 Objectives

6.1 Introduction

6.2 Meaning and Purpose of Memorandum

6.3 Memorandum of Association – Whether an Unalterable Charter

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6.0 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.

6.1 INTRODUCTION

In the previous Block, you have learnt that company form of organization offers certain distinctive advantages over partnerships. Limited liability and separation of management from ownership allows professionalism in handling large scale enterprises. Therefore, company form of organization 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 the 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 and how the different clauses of the memorandum can be altered.

6.2 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 these 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, that 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.

6.3 MEMORANDUM OF ASSOCIATION – WHETHER AN UNALTERABLE CHARTER

You have noted under **Para 6.2** 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 one 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.

6.4 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 I 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.

Table A = Company Limited by Shares

Table B = A Company Limited by Guarantee not having share capital

Table C = A Company Limited by Guarantee having share capital

Table D = An Unlimited Company and not having share capital

Table E = An 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 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 authorized in this behalf by a resolution of the board of directors of the body corporate and where the subscriber is a Limited Liability Partnership, it shall be signed by a partner of the Limited Liability Partnership, duly authorized by a resolution approved by all the partners of the Limited Liability Partnership, provided that in either case, the person so authorized 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.

6.5 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. This does not apply to companies registered under section 8 (companies with charitable objects. 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.

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 incorporated 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 the 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.

6.5.1 The 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 word(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 resemble 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 constituted 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 8 of the Companies (Incorporation) Rules, 2014, as amended by Companies (Incorporation) Rule, 2019 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 (12 of 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 for 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 name of the promoter 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 include 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 name - 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. vs. 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 a question in each case.

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, if any;

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.

If a company does not paint or affix its name and the address of its registered office in the prescribed manner, 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)]

6.5.2 The 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 notice of the exact situation (address) of the registered office shall be given to the Registrar of Companies, within 30 days from the date of incorporation (Section 12).

Verification of the Registered Office

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.

6.5.3 The 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— ***Attorney General*** v. ***G.E. Rly. Co.***[1880]. 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)).

6.5.4 The 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 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 and costs, charges and expenses of winding up of the company.

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.

6.5.5 The 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 value 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.

6.5.6 The Association or 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 subscriber must take at least one share;

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

6.6 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 is 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 unauthorized 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* he 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) Payment of dividend out of capital (Sec. 123);

   b) Issue of bonus shares in lieu of dividend (Sec. 63);

   c) Issuance of unauthorized capital (Sec. 62);

   d) Reducing the share capital without complying with legal formalities (Sec. 66).

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 contractor to finance 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 that 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 recognized in India as well. The doctrine has been affirmed by the Supreme Court in **A.L. Mudaliar 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 can 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 with in 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 authorized 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.

6.7 ALTERATION OF DIFFERENT CLAUSES IN THE MEMORANDUM

Section 13 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.

6.7.1 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.

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 regis-tered 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 eGMP Pharmaplan (P.) Ltd. vs. 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 eGMP 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 29 of the Companies (Incorporation) Rule, 2014 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 can be amended to substitute the new name - **Pioneer Protective Glass Fibre (P.) Ltd. vs. Fibre Glass Pilkington Ltd. [1986]**.

iii) By change of name constitution of company does not change: In **Economic Investment Corporation Ltd. vs. 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.

6.7.2 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 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 (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 one State to another State*** - Section 13 contains provisions with respect to the shift of the 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 discharged or determined or secured to the satisfaction of the Central Government;

4. Obtaining confirmation from the Central Government.
5. Giving notice of the change of registered office in the manner prescribed to be given to registrar of companies within 30 days of the change.

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 the 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 thereof 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.

Filing 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.

6.7.3 Change in Objects Clause

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 have not issued a prospectus may change its object by passing a special resolutions.

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. Requirement of passing of special resolution through postal ballet is not applicable where the number of members is upto 200. (companies management and administration rules 2014).

Besides, the notice in respect of the resolution for altering the objects shall contain the prescribed particulars including the unutilized amount out of the money so raised through prospectus, justification for the alteration/change in the objects, amount proposed to be utilized for the new objects.

6.7.4 Change in Liability Clause

The Companies Act, 2013 or the Rules made thereunder 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)].

6.7.5 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 paid-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 of a company having issued prospectus and part of the funds so raised being unutilized can be altered …… ……

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.

6.8 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 I, 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 the 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 Government); (ii) the name chosen is not undesirable. Central Government 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 states 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.

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 Compa-nies within 60 days of the date of confirmation. The Registrar is required to register the same and certify the regis-tration 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, if Articles are silent, the company may at any time alter its objects by passing a Board of Directors' 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.

6.9 KEY WORDS

Memorandum of Association: It is a fundamental document containing conditions on the basis 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.

6.10 ANSWERS TO CHECK YOUR PROGRESS

A. 1.

Table A	A company limited by shares.
Table B	A company limited by guarantee and not having a share capital.
Table C	A company limited by guarantee and having a share capital.
Table D	An unlimited company and not having share capital.
Table 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)

6.11 TERMINAL QUESTIONS

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.
4. Illustrate the Doctrine of *ultra vires* with suitable examples.
5. Describe the procedure for alteration of the objects clause of a company.
6. A company has its registered office in Delhi. The Board of Directors wants to shift its registered office from Delhi to Chandigarh, advise.
7. A Company was registered with name 'Pyare Lal and Sons' Pvt. Ltd. on Ist July, 2019 with registrar of companies in Delhi. Another company got registered with name 'Pyaray Lal and Sons Pvt Ltd. at Jaipur with registrar of Company as 20th September, 2019. Discuss.
8. A Company has the business of manufacturing shirts for men. It wants to now add a new business of manufacturing "Trausers for men'. Its main object clause contains' Manufacturing readymade garments for men'. Discuss the 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.

UNIT 7 ARTICLES OF ASSOCIATION

Structure

7.0 Objectives

7.1 Introduction

7.2 Meaning and Purpose of Articles

7.3 Registration of Articles

7.4 Contents of Articles

7.5 Alteration of Articles

7.5.1 Limitation on Power to Alter Articles

7.5.2 Effect of Altered Articles

7.6 Relationship between Memorandum and Articles

7.7 Distinction between Memorandum and Articles

7.8 Binding Effect of Memorandum and Articles

7.9 Doctrine of Constructive Notice

7.10 Doctrine of Indoor Management

7.11 Let Us Sum Up

7.12 Key Words

7.13 Answers to Check Your Progress

7.14 Terminal Questions

7.0 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.

7.1 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.

7.2 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", *i.e.*, the Act of 2013".

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.

7.3 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. Tables G, H, I and J contain model articles for a company limited by guarantee and having a share capital, 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 authorized 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 authorized 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 prescribed in the rules.

7.4 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, CSR 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 certificates including procedure for issue of duplicate shares.

xv) Winding up of the company.

The Articles of Association must be prepared carefully and it must contain rules in regard 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 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

Tables G, H, I and J appended to Schedule I 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 securites 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.

7.5 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, the 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*].

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 Central Government has been obtained. In other words, if a public company wants to convert itself into a public 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 Central Government 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 Central Government 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.

7.5.1 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 Central Government 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 the 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 bona fide 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 to effect a conversion of a public company into a private company cannot be made without the approval of the** Central Government ***(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 clearly 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)**].

7.5.2 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 they may from time to time stand after they have been altered are valid under the provisions 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 provisions 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 Ltd. [1992]**.

7.6 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 contains 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 assets 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 Works (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."

7.7 DISTINCTION BETWEEN MEMORANDUM AND ARTICLES

The main points of distinction between memorandum and articles may be noted as follows:

1. The memorandum contains the fundamental conditions upon which alone the company is allowed to be incorporated. They are conditions introduced for the benefit of the creditors, and the outside public, as well as 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.

7.8 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 fulfil 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 provisions 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 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 out-sider (*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 Articles. 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.

7.9 DOCTRINE OF CONSTRUCTIVE NOTICE

Section 399 provides that the Memorandum and Articles when registered with Registrar of Companies 'become public documents' and then they can be inspected by any one 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 of 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 is known as **"doctrine of constructive notice".** 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 a 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.

7.10 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 a company, you are not going to ask directors

of the company to produce shareholders' resolution 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 only. They could, however, exceed the limit of 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 pounds 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 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 relied on the rule of indoor management. *Held*, they 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 no 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 estopped 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.

7.11 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 I 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 Central Government 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 payment of the prescribed fee. Since this facility of inspection has been made available to all those who deal with the 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.

7.12 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.

7.13 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

7.14 TERMINAL QUESTIONS

1. What are Articles of Associations" 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 giving 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 busi-ness, 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 8 PROSPECTUS

Structure

8.0 Objectives

8.1 Introduction

8.2 Meaning and Importance of Prospectus

8.3 Contents of a Prospectus

8.4 Statutory Requirements in Relation to a Prospectus

8.5 When Prospectus is not Required to be Issued

8.6 Prospectus by Implication/Deemed Prospectus

8.7 Shelf Prospectus and Red herring Prospectus

8.7.1 Shelf Prospectus

8.7.2 Red herring Prospectus

8.8 Minimum Subscription

8.9 Misstatement in a Prospectus and its Consequences

8.10 Golden Rule for Framing of Prospectus

8.11 Allotment of Shares in a Fictitious Name

8.12 Announcement Regarding Proposed Issue of Capital

8.13 Let Us Sum Up

8.14 Key Words

8.15 Answers to Check Your Progress

8.16 Terminal Questions

8.0 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 and shelf prospectus;
- 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.

8.1 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 and shelf prospectus. At the end, you will also know about the various remedies available to an aggrieved investor in case prospectus contains misstatement.

8.2 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 conditions:

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 III to Section 42 (3) 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 than those receiving the invitation. Thus, it will not be an invitation to public where 'B', a friend of 'A' who receives the invitation, also desires to subscribe, but his offer is refused because he was not invited to make the offer. On the other hand, it will become an invitation to public where his (B's) offer shall also be considered.

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 shares 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 form. 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.

8.3 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 the Prospectus

iii) Declaration to be made

iv) Other matters

Information to be given in a Prospectus

Section 26(1) of the Companies Act, as amended by the Companies (Amendment) Act, 2017, requires a prospectus to be dated and signed and state such information as may be specified by Securities and Exchange Board of India in consultation with Central Government.

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 thereunder.

Other Matters

Prospectus shall also state such other matters and set out such other reports, as may be prescribed.

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 an expert must not be included in a prospectus unless:

i) such 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 gave 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 shares or debentures which are, or are to be, in all respects uniform with shares or debentures previously issued and for the time being dealt in or quoted on a recognized stock exchange.

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 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 to prospectus shall apply as if this is a prospectus issued by the company.

8.4 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 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 authorized attorney;

Penalty

If a prospectus is issued in contravention of the aforesaid provisions 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.

8.5 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)].
5. 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 recognized 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

8.6 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 Houses. 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 the document (*i.e.*, deemed prospectus) must be signed by at least two directors.

8.7 SHELF PROSPECTUS AND RED HERRING PROSPECTUS

8.7.1 Shelf Prospectus (Section 31)

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

8.7.2 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.

8.8 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)].

8.9 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.

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 particulars 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 for 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.

Liability and Defences

An allottee of shares, who had applied for shares, on the 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 a 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.

d) that with respect to every misleading statement purported to have been made by an expert or copy or extract from a report or valuation, he had reasonable ground to believe and did up to the time of issue of prospectus believe that person was competent to make it and had no knowledge before allotment thereunder.

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 authorizes 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 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.

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/Class Action Suit (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.

8.10 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 shares 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 or 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 vs. 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.

8.11 ALLOTMENT OF SHARES IN FICTITIOUS NAMES PROHIBITED

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 than 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.

8.12 ANNOUNCEMENT REGARDING PROPOSED ISSUE OF CAPITAL

It is very common for companies to get an announcement regarding proposed issue of shares/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 authorized share capital of the company;

iv) the names 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 authorized 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.

8.13 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.

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 purchase 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 III to Section 42 (3) 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:

i) Information to be given in a Prospectus

ii) Reports to be set out in the Prospectus

iii) Declaration to be made

iv) 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.

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 **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.

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 a 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 provide 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.

8.14 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.

Issues House: 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 facts relating to new charge created, changes in financial position between various offers of securities and other changes as may be prescribed.

8.15 ANSWERS TO CHECK YOUR PROGRESS

A) 1. i) (d); ii) (e); iii) (a); iv) (d)

B) 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.

8.16 TERMINAL QUESTIONS

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, 2013?
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. 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'?
6. Write a note on:
   i) 'Shelf Prospectus'.
   ii) Red herring Prospectus.
7. What is a 'Deemed Prospectus'? State the provisions of the Companies Act, 2013 with respect to 'Deemed Prospectus'.
8. 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 avail-able 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 charged 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.

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