Corporate and Business Laws

DMGT407

Edited By
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LOVELY PROFESSIONAL UNIVERSITY

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SYLLABUS

Corporate and Business Laws

Objectives: To develop knowledge and to gain ability to explain legal theories and concepts related to Indian Law with reference to overall legal framework.

Sr. No.	Description
1.	**Contract Act:** Offer and Acceptance, Consideration and Capacity of the Parties, Free Consent, Indemnity and Guarantee, Bailment and Agency.
2.	**The Negotiable Instruments Act:** Definition, Types of Negotiable Instruments, Negotiation, Endorsement and Crossing of Cheque, Dishonour of Cheques, Parties to Negotiable Instruments.
3.	**Contract of Sale of Goods:** Conditions and Warranties, Performance of Contract of Sale, Unpaid Seller and his Rights, Caveat Emptor.
4.	Partnership Act and Limited Liability Act.
5.	Concept of Company and its Characteristics. Formation of a company.
6.	Memorandum and Articles of Association.
7.	Prospectus, Shares and Share Capital.
8.	Management of Companies.
9.	Meeting of Directors and Shareholders.
10.	Winding up and Dissolution of a company.

Unit 1: Laws of the Contract

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Objectives

After studying this unit, you will be able to:

- Recognize the meaning of contract;
- Describe offer and acceptance of the contract;

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- Explain the consideration of a contract;
- Discuss the issue of capacity of the parties to contract.

Introduction

'Law' means any rule of conduct, standard or pattern, to which actions are required to conform; if not conformed, sanctions are imposed. When we speak of the law of a State, we use the term 'law' in a special and strict sense. In this sense, the term 'law' is defined in Oxford English Dictionary as "the body of rules whether proceeding from formal enactment or from custom, which a particular State or community recognises as binding on its subjects or members". These are rules which are recognised and acted on by courts of justice. Law may also be defined as rule of conduct of persons (both natural and artificial), imposed upon and enforced among the members of a given State.

We enter into contracts everyday. Some of these are made consciously, for example, purchase or sale of a share of a company or a plot of land. Contracts confer legal rights on one party and subject the other party to some legal obligation. In the case of people engaged in business, they carry on business by entering into contracts. Thus, the business executives, corporate counsels, entrepreneurs, and professionals in different fields deal frequently with contracts. At times, they have to draft one such contract or scrutinize it or provide inputs to its making or even interpret it. Therefore, it is necessary for them to know what constitutes a contract. The law relating to contracts is contained in the Indian Contract Act, 1872.

1.1 Meaning of the Contract

1. ***Contract:*** A contract is an agreement, enforceable by law, made between at least two parties by which rights are acquired by one and obligations are created on the part of another. If the party, which had agreed to do something, fails to do that, then the other party has a remedy.

   Example: D Airlines sells a ticket on 1 January to X for the journey from Mumbai to Bangalore on 10 January. The Airlines is under an obligation to take X from Mumbai to Bangalore on 10 January. In case the Airlines fails to fulfil its promise, X has a remedy against it.

   Thus, X has a right against the Airlines to be taken from Mumbai to Bangalore on 10 January. A corresponding duty is imposed on the Airlines. As there is a breach of promise by the promisor (the Airlines), the other party to the contract (i.e., X) has a legal remedy.

   Section 2(h) defines a contract as "an agreement enforceable by law". Thus, a contract essentially consists of two elements: (i) an agreement and (ii) its enforceability by law.

2. ***Agreement:*** Section 2(e) defines an agreement as "every promise and every set of promises forming consideration for each other". In a contract there are at least two parties. One of them makes a proposal (or an offer) to the other, to do something, with a view to obtaining the assent of that other to such act. When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. A proposal, when accepted becomes a promise [s.2(b)]. The person making the proposal is called 'promisor' and the person accepting the proposal is called the 'promisee' [s.2(c)].

3. ***Enforceability by law:*** The agreement must be such which is enforceable by law so as to become a contract. Thus, there are certain agreements which do not become contracts as this element of enforceability by law is absent. For example, an agreement to go for a stroll together or for a picnic does not become a contract, and therefore, neither rights nor

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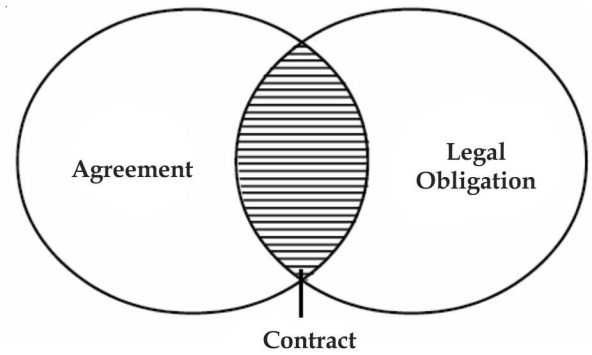
obligations are created on the part of the parties to the agreement. Thus, all agreements are not contracts; but all contracts are agreements. Further all legal obligations are not contractual. Only those legal obligations which have their source in an agreement are contractual. Thus, a legal obligation not to create a nuisance for others does not give rise to a contract; but nevertheless it is actionable by law.

Figure 1.1: Contract = Agreement + Legal Obligation



Examples:

1. A agrees to sell his motorcycle to B for ₹ 10,000. The agreement gives rise to a legal obligation on the part of A to deliver the motorcycle to B and on the part of B to pay ₹ 10,000 to A. The agreement is a contract. If A does not deliver the motorcycle, then B can go to a court of law and file a suit against A for non-performance of the promise on the part of A. On the other hand, if A has already given the delivery of the motorcycle and B refuses to pay the price, A can go to the court and file a suit against B for non-performance of promise.
2. A invites B for dinner in a restaurant. B accepts the invitation. On the appointed day, B goes to the restaurant. To his utter surprise A is not there or A is there but refuses to entertain B. B shall have no remedy against A. Similarly, in case A is present in the restaurant but B fails to turn up, then A shall have no remedy against B.

In example (2) above, the promises are not enforceable by law as there was no intention to create legal obligation. Such agreements are social agreements which do not give rise to legal consequences. In example (1) the obligation has it source in an agreement and the parties intend to be bound by the same and therefore it gives rise to a contract.

Notes **Ignorance of Law is no Excuse**

This is the literal translation of maxim *"ignorantia juris non excusat"*. Every member of the society is expected that his actions conform to a set pattern or standard as reflected in legal rules. For this purpose, he is presumed to know the legal rules. He cannot take the plea that he did not know them. No doubt, in practice, he cannot learn and understand all the laws of the land, but he can obtain expert guidance from those who possess legal knowledge. Thus, he has access to books on law and to those persons who are experts in legal matters. Therefore, the maxim *"ignorantia juris non excusat"* places a burden on every member of the society with the knowledge of law. In other words, "ignorance of law is not a good excuse".

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Self Assessment

Fill in the blanks:

1. A contract essentially consists of two elements which are ……..and its enforceability by law.
2. In a contract there are at least ……parties.

1.2 Indian Contract Act, 1872

For business executives, contract law is tremendously significant because it underlies or is related to all major areas of law affecting business. References to sections in this unit are to this Act, unless otherwise specified.

The general principles of the law of contracts are covered in 75 sections. Contract forms the basis of almost all the business law and you must know it thoroughly. The understanding of how a contract is made and ended and how the remedies for breach of the contract can be availed is essential to deal with laws.

That branch of law which determines the circumstances in which promises made by the parties to a contract shall be legally binding on them is governed by the Indian Contract Act, 1872. Also, it defines the remedies that are available through a court against a person who fails to perform his contract, and prescribes conditions under which the remedies are available.

The Indian Contract Act is concerned with the most important branch of business law as it affects all of us in one way or the other at one time or the other. However, it is of particular importance to business persons as bulk of their transactions are based on contracts. The Act imparts definiteness in business transactions as it ensures that what a person has been led to expect shall come to pass and what has been promised to him shall be performed. Thus the purpose of the law of contract is to ensure the realization of reasonable expectations of the parties who enter into a contract.

Self Assessment

Fill in the blanks:

3. The general principles of the law of contracts are covered in ……sections.
4. That branch of law which determines the circumstances in which promises made by the parties to a contract shall be legally binding on them is governed by the ……Act, 1872.

1.3 Essentials of the Contracts

Section-10 provides that all the agreements are contracts, if they are made by the free consent of parties, competent to contract, for lawful consideration and with a lawful object and are not expressly declared by law to be void. To constitute the contract:

1. There must be an agreement between the two or more than two parties. No one can enter into the contract with himself.
2. An agreement is composed of two elements – offer or proposal by one party and acceptance thereof by the other party. Party making the offer is known as offeror or proposer and the party to whom the offer is made is called as offeree.
3. When an offeree gives his assent to the offer, then he is known as acceptor.

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4. At the time of entering into the contract parties must bethinking of the same thing in the same sense. It is called the consensus ad idem. Their minds must meet at the different facets of the subject matter of the contract.
5. There must be an intention on the part of the parties to create the legal relationships.
6. An agreement of a purely social or domestic nature is not a contract. In commercial agreements, the law presumes that the parties intended those agreements to have legal consequences.
7. The consent of the parties to the agreement must be free and genuine.
8. The parties to contract must be competent to the contract.
9. The contract must be supported by consideration on both sides. Each party to the contract must give or promise something and receive something or a promise in return.
10. The meaning of the agreement be certain or capable of being made certain.
11. The terms of the agreement should be capable of performance.

Did u know? **Privity of the Contract**

As a contract is entered into by two or more persons thereby creating rights and obligations for them, it is a party to the contract only who can enforce his rights as against the other party (i.e., the promisor). The basic principle underlying law of contracts is that a stranger to a contract cannot maintain a suit for a remedy. The law entitles only those who are parties to the contract to file suits for exercising their rights. This is known as 'privity of contract'. This rule can be traced to the fact that the law of contracts creates *jus in personam* as distinguished from *jus in rem*. Therefore, a stranger to a contract cannot maintain a suit.

Example: A is indebted to B. A sells certain goods to C. C gives a promise to A to pay off A's debt to B. In case C fails to pay, B has no right to sue C, being a stranger to the contract between C and A. In other words, C is not in privity with B. However, C is in privity with A.

Self Assessment

Fill in the blanks:

5. Party making the offer is known as offeror and the party to whom the offer is made is called as……...
6. When an offeree gives his assent to the offer, then he is known as ……..

1.4 Classification of the Contracts

Contracts can be classified in terms of their: (1) validity/enforceability (2) mode of formation and (3) performance.

1. ***Classification of contracts according to formation:*** A contract may be (a) Made in writing (b) By words spoken and (c) Inferred from the conduct of the parties or the circumstances of the case. Thus, s.9 provides that insofar as the proposal or acceptance of any promise is made in words, the promise is said to be express. Further, insofar as such proposal or acceptance is made otherwise than in words, the promise is said to be implied. Accordingly, contracts may be classified according to the mode of formation as express contracts and

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implied contracts. If the terms of a contract are expressly agreed upon (whether by words spoken or written) at the time of the formation of the contract, the contract is said to be an express contract. An implied contract is one which is inferred from the acts or conduct of the parties or the course of dealing between them.

(a) *Quasi-contract:* As soon as the offer intended to create legal relationship is accepted by the other party in absolute and unqualified terms, a contract is deemed to be formed or concluded. When the obligations are imposed on the party by the law and action is allowed to be brought by another party. Such obligations are known as quasi-contracts but the Act (Ss.68-72) describes them as "certain relations resembling those created by the contracts".

Example: A tradesman X leaves the goods at the Y's warehouse by mistake. Y treats the goods as his own. He is bound to pay to X for them.

A contract implied by the law is an obligation imposed by the court to do justice between the parties even though they never exchanged or intended to exchange promises. In this instance, a court implies a contract to prevent one party's unjust enrichment at the other's expense.

(b) *Formal and informal contracts:* This is another way of classifying contracts on the basis of their formation. A formal contract is one to which the law gives special effect because of the formalities or the special language used in creating it. The best example of formal contracts is negotiable instruments, such as cheques. A negotiable instrument has legal characteristic that differ from those of ordinary contracts. Informal contracts are those for which the law does not require a particular set of formalities or special language. The parties may use any style or language they please, as long as the usual requirements for contract (mutual assent, consideration, and so on) are met. The contract may be oral, or it may even be inferred from the parties' conduct in the absence of a statute requiring writing. Sometimes informal contracts are called 'simple' contracts.

2. ***Classification according to validity:*** Contracts may be classified according to their validity as (i) Valid, (ii) Voidable, (iii) Void, (iv) Unenforceable.

(a) A contract to constitute a valid contract must have all the essential elements of the contract. If one or more of these elements are missing, the contract is either voidable, void, illegal or unenforceable. As per s.2 (i) A voidable contract is one which may be repudiated (i.e., avoided) at the will of one or more of the parties, but not by others. Until it is so repudiated it remains valid and binding. It is affected by a flaw (e.g., misrepresentation, fraud, coercion, undue influence), and the presence of any of these defects enables the party aggrieved to take steps to repudiate the contract. It shows that the consent of the party, who has the discretion to repudiate, was not free.

Example: A, a man enfeebled by disease or age, is induced by B's influence over him, as his medical attendant to agree to pay B an unreasonable sum for his professional services. A can avoid the contract. A's consent is not free; it is affected by undue influence employed by B. A can take steps to set the contract aside.

(b) A voidable contract may be inferred as a valid and binding on both the parties till it is avoided by the aggrieved party. It can be avoided only by one party, and not by the other. The party at whose option the contract is voidable, is not bound to repudiate it. It may choose to affirm it, and thereby be bound by it as well as bind the

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other party. The party repudiating the contract is entitled to get damages for any loss that he may have suffered. In case he had received some benefit under the contract, he must restore it to the person, from whom it was received. Thus, the aggrieved party has twofold rights, i.e., (i) to repudiate the contract, and therefore not to be bound there under and (ii) to carry out the transaction as stipulated in spite of the flaw therein.

Example: A contracts to take indigo for B to a foreign port. A's government afterwards declares war against the country in which the port is situated. The contract becomes void when war is declared.

(c) An illegal agreement is one which transgresses some rule of basic public policy or which is criminal in nature or which is immoral. Such an agreement is a nullity and has a much wider import than a void agreement. All illegal agreements are void but all void agreements (or contracts) are not necessarily illegal.

Example: A, B and C enter into an agreement for the division among them of gains acquired or to be acquired, by them by fraud. The agreement is illegal as per s.23 of the Act.

An illegal agreement is not only void as between the immediate parties but has this further effect that even the collateral transactions to it become tainted with illegality.

Example: A borrows ₹ 15,000 from B, and enters into a contract with F, a foreigner, to import goods which are prohibited under the law. B has knowledge of the purpose of the loan. The agreement between A and B is collateral to the main agreement between A and F. Since the main agreement is illegal, therefore, the collateral agreement is also tainted with illegality.

3. ***Classification of contracts according to performance:*** On the basis of the extent to which they have been performed, contracts may be: (i) Executed and executory, or (ii) Unilateral and (iii) bilateral.

(a) An executed contract is one which has been wholly performed. Nothing remains to be done in terms of the contract.

Example: A buys a bicycle from a dealer. A pays cash. The dealer delivers the bicycle.

(b) An executory contract is one which remains wholly unperformed, or in which there remains something further to be done.

Example: On June 1, A enters into a contract with a dealer to buy a bicycle. The contract is to be performed on June 15.

(c) The executory contract becomes an executed one when it is completely performed.

Example: In the above example, if both - A and the dealer performs their obligations on June 15, the contract becomes executed. However, if in terms of the contract performance of promise by one party is to precede performance by another party, then the contract is still executory, though it has been performed by one party.

On June 1, A agrees to buy a bicycle from a dealer. The dealer has to deliver the bicycle on June 15 and A has to pay price on July 1. The dealer delivers the bicycle on June 15. The contract is executory as something remains to be done in terms of the contract.

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(d) A unilateral contract is one wherein at the time the contract is concluded there is an obligation to perform on the part of one party only.

Example: A makes payment for bus fare for his journey from Mumbai to Pune. He has performed his promise. It is now for the transport company to perform its promise.

(e) A bilateral contract is one wherein there is an obligation on the part of both to do or to refrain from doing a particular thing. In this sense, bilateral contracts are similar to executory contracts.

Self Assessment

Fill in the blanks:

7. Contracts may be classified according to their validity as Valid, Voidable, Void and……..

8. A ……contract is one wherein at the time the contract is concluded there is an obligation to perform on the part of one party only.

Caselet

Linc Renews Contract with Shahrukh

Linc Pen, a leading player in the branded pen industry, said it has renewed its brand endorsement contract with film star Shahrukh Khan. Shahrukh has been the brand ambassador for Linc Pen for the past one year.

"We have renewed the contract with him (Shahrukh Khan) for another year. His association with the brand has been very rewarding for us and has helped increase the brand visibility and boosted our sales figures as well," Linc Pen & Plastics Managing Director Mr Deepak Jalan said here.

The company's national sales have grown. This year sales are growing at 15 per cent as compared to 7 per cent last year, he said. "Over the years, Linc is one of the most trusted brands in the Indian writing pen industry and I am happy to be associated with the Linc family," the Bollywood actor said.

Source: thehindubusinessline.com

1.5 Proposal (or Offer) and Acceptance [Ss.3-9]

Offer is not only one of the essential elements of a contract but it is the basic building block also. An offer is synonymous with proposal. The offeror or proposer expresses his willingness "to do" or "not to do" (i.e., abstain from doing) something with a view to obtain acceptance of the other party to such act or abstinence [s.2(a)]. Thus, there may be 'positive' or 'negative' acts which the offeror is willing to do.

Examples:

1. Anna offers to sell her a book to Begum. Anna is making an offer to do something, i.e., to sell her a book. It is a positive act on the part of the offeror.

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2. Amin offers not to file a suit against Bedi, if the latter pays Amin the amount of ₹ 10,000 outstanding. Here the act of Amin is a negative one i.e. he is offering to abstain from filing a suit.

An offer is made with a view to obtaining the assent of the offeree to the proposed act or abstinence. In Example (1) Anna is making an offer to sell a book with a view to obtaining the assent of Begum. Similarly, in Example (2), Amin is making an offer to Bedi with a view to obtaining Bedi's assent thereto.

1.5.1 Modes of Making an Offer

1. ***Specific and general offers:*** An offer can be made either to (i) A definite person or a group of persons, or to (ii) the public at large. An offer made either to a definite person or a group of persons is a specific offer. The specific offer can be accepted by that person to whom it has been made. Thus, if a real estate company offers to sell a flat to Amar at a certain price, then it is only Amar who can accept it. The offer made to the public at large is a general offer. A general offer may be accepted by any one by complying with the terms of the offer. The celebrated case of Carlill v Carbolic Smoke Ball Co. (1813) 1 Q.B. 256 is an excellent example of a general offer.

Example: A Patent Medicine company advertised that it would give a reward of £100 to anyone who contacted influenza after using smoke balls of the company for a certain period according to the printed directions. Mrs. Carlill purchased the advertised smoke ball and contacted influenza in spite of using the same according to the printed directions. She claimed the reward of £100. The company resisted the claim on the ground that advertisement was only an invitation to offer. They argued further that no offer was made to her, and that in any case she had not communicated her acceptance assuming the advertisement was an offer. She filed a suit for the recovery of the reward. Held that the advertisement in such type of cases amounted to general offers. She could recover the reward as she had accepted the offer by complying with the terms of the offer.

Philosophy underlying general offers: The general offer creates for the offeror a liability in favour of any person who happens to fulfil the conditions of the offer. It is not at all necessary for the offeree to be known to the offeror at the time. When the offer is made; he may be a stranger, but by complying with the conditions of the offer, he is deemed to have accepted the offer.

2. ***Implied offer:*** An offer, implied from the conduct of the parties or from the circumstances of the case, is known as implied offer.

   Some examples of different types of offers:

   (a) A real estate company proposes, by a letter, to sell a flat to Rajiv at a certain price. This is an offer by an act by written words (i.e., letter). This is also known as an express offer.

   (b) If the company proposes, over telephone, to sell the flat to Rajiv at a certain price then this is an offer by an act (by oral words). This is an express offer.

   (c) A company owns a fleet of motor boats for taking people from Mumbai to Goa. The boats are in the waters at the Gateway of India. This is an offer by conduct to take passengers from Mumbai to Goa. Even if the in charge of the boat does not speak or call the passengers, the very fact that the motor boat is in the waters near Gateway of India signifies company's willingness to do an act with a view to obtaining the assent of other(s) (i.e., would-be passengers). This is an example of an implied offer.

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(d) Akbar, a creditor, offers not to file a suit against Begum, a debtor, if the latter pays him the amount of ₹ 2000 outstanding. This is an offer by abstinence or omission to do something.

1.5.2 Difference between Offer and Invitation to Offer

An offer is to be distinguished from an invitation to offer. A prospective shareholder by filling up a share application form, usually attached to the prospectus, is making the offer. An auctioneer at the time of auction inviting offers from the bidders is not making an offer. The price lists, catalogues and inviting tenders and quotations are mere invitations to offer. Likewise a display of goods with a price tag on them in a shop window is construed an invitation to offer and not an offer to sell.

Example: In a departmental store, there is self-service. The customers pick up articles and take to the cashier's desk to pay. The customer's action in picking up a particular article is an offer to buy. As soon as the cashier accepts payment, a contract is entered into. However, there are certain exceptions to this. Thus, where a store advertises that it will give a free gift or a special discount to "the first 100 customers" or something like that, it may be anything that requires special effort on the part of the customer. If so, the store has made an offer which he may accept by being among the 100 customers. Similarly, sale promotion schemes requiring customers to do anything special are offers.

Caution **Essentials of a Valid Offer**

1. The terms of the offer must be definite, unambiguous and certain or capable of being made certain. If the terms of the offer are loose, vague, ambiguous or uncertain, it is not a valid offer.
2. An offeree must have knowledge of the offer before he can accept it. The offer must be communicated to the other party. The communication of offer is complete only when it comes to the knowledge of the offeree. If the offer is lost on the way in transit it is no offer. This is true of specific as well as general offers.
3. An offer cannot contain a term the non-compliance of which may be assumed to amount to acceptance. An offeror cannot say that if the offeree does not accept the offer within two days the offer would be deemed to have been accepted. Such a burden cannot be imposed on the offeree. It is for the offeree to accept the offer or not; and therefore, he may communicate his acceptance accordingly.
4. If a person makes a statement without any intention of creating a binding obligation this does not amount to an offer. It is only a mere declaration of intention to offer.

   For example, An auctioneer, L, advertised that a sale of office furniture would take place at a particular place on a stated day. H traveled down about 100 km. to attend the sale but found the furniture was withdrawn from the sale. He claimed compensation from the auctioneer. Held, that auctioneer was not liable.
5. Where two parties make identical offers to each other in ignorance of each other's offer this does not result in a contract. Such offers are known as cross offers and neither of the two can be called an acceptance of the other.
6. The offer must be made with a view to obtain acceptance thereto.

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7. The offer must be made with the intention of creating legal relationship. An offer of a purely social or domestic nature is not a valid offer.

8. The offer must be communicated to the offeree before it can be accepted. This is true of both specific and general offers.

   If no time is fixed by the offeror within which the offer is to be accepted, the offer does not remain open for an indefinite period. Where no time is specified, then the offer is to be accepted within a reasonable time. Thus, if no time is specified then the offer lapses after a reasonable time. What is a reasonable time is a question of fact and would depend upon the circumstances of each case.

9. An offer must be distinguished from a mere invitation to offer.

Did u know? ***Irrevocable offers.*** Generally, a proposer specifies a period within which the offeree must accept. Thus, if A makes an offer to B on 1st June, valid up to 6th June, but revokes it on 5th June, before its acceptance by B the revocation is effective, and the offeree has no remedy. However, the courts will bind an offeror to his promise to hold an offer open in exchange for a consideration given by the offeree. For instance, in the above case, if B had given some consideration to A to keep the offer open, then A could not revoke the same before the specified time. Sometimes such contracts are called "option contracts".

Counter-offer: When in place of accepting the terms of an offer as they are, the offeree accepts the same subject to certain conditions or qualifications, he is said to make a counter offer.

Example: An offer to sell rice was accepted by the offeree with an endorsement on the Sold and Bought Notes that yellow and wet grain will not be accepted [Ali Shain v. Moothia Chetti, 2 Bom L R 556]. Held, there was no contract.

1.5.3 Revocation of Offer

There are many reasons due to which the offer lapses or is revoked such as: (i) An offer is revoked by the death or insanity of the proposer, if the fact of his death or insanity comes to the knowledge of the acceptor before acceptance. Therefore, if the acceptance is made in ignorance of the death, or insanity of the offeror, there would be a valid contract, (ii) An offer lapses by the death or insanity of the offeree before acceptance, (iii) An offer terminates when rejected by the offeror, (iv) An offer terminates when revoked by the offeror before acceptance by the offeree, (v) An offer terminates by not being accepted in the mode prescribed, or if no mode is prescribed, in some usual and reasonable mode (or manner), (vi) A conditional offer terminates when the condition is not accepted by the offeree, (vii) An offer terminates by counter-offer by the offeree.

1.5.4 Special Terms in a Contract

Many times, there are certain special terms, which form part of the offer, but they are not duly brought to the notice of the offeree (i.e., consumer or a customer or a client), at the time the offer is made. If these special terms are not brought to the customer's notice, then there is no valid offer. In case the offer is accepted, and the contract is formed, the customer is not bound by the special terms. The terms may be brought to the customer's notice either (i) By drawing his attention to them specifically or (ii) By inferring that a man of ordinary prudence could find them by exercising ordinary diligence.

However, if the special conditions forming part of an offer are contained in a document which is delivered after the contract is complete, then the customer is not bound by them. Such a

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document is considered a non-contractual document as it is not supposed to contain the conditions of the contract.

1.5.5 Acceptance of an Offer

1. When the person to whom the offer is made signifies his assent thereto, the offer is said to be accepted [s.2(b)]. Thus, acceptance is the act of giving consent to the proposal. The offeree is deemed to have given his acceptance when he gives his assent to the proposal. The acceptance of an offer may be express or implied. It is express when the acceptance has been signified either in writing or by words of mouth or by performance of some required act of the offeree. The acceptance by performing the required act may be exemplified with reference to Carlill v. Carbolic Smoke Ball Co. case (supra).

Examples:

(a) A shopkeeper received an order from a customer - a household lady. He executed the order by sending the goods. The customer's order for goods constitutes the offer which was accepted by the shopkeeper by sending the goods. It is a case of acceptance by conduct. Here the shopkeeper is accepting the offer by the performance of the act (i.e., sending the goods).

(b) A loses his dog and announces a reward of ₹ 500 to anyone who brings his dog to him. B need not convey his acceptance of the offer, which is a general one. If he finds the dog and gives it to A, he is entitled to the reward as he accepted the offer by doing the required act.

2. ***Implied acceptance.*** Acceptance is implied when it is said to be gathered from the surrounding circumstances or the conduct of the parties.

Examples:

(a) A enters into a bus for going to his destination and takes a seat. From the very nature of the circumstance the law will imply acceptance on the part of A.

(b) A's scooter goes out of order and he is stranded on a lonely road. B, mechanic who observes this starts correcting the fault. A allows B to do the same. From the nature of the circumstances A has given his acceptance to the offer of B.

3. ***Who can accept an offer?*** We have mentioned earlier that a specific offer can be accepted only by the person to whom it is made. The rule of law is that if A wants to enter into a contract with B then C cannot substitute himself for B without A's consent. However in the case of a general offer it can be accepted by anyone by complying with the terms of the offer.

4. ***Essentials of a valid acceptance.*** The following are the essentials of a valid acceptance: (i) It must be absolute and unqualified and according to the exact terms of the offer (s.7), (ii) It must be communicated to the offeror, (iii) It must be according to the mode, if any, prescribed by the offeror (s.7), (iv) It must be given within the time specified, if any, otherwise it must be given within a reasonable time, (v) It must be made before the offer lapses or is terminated, revoked or withdrawn. If the offer has already lapsed then there is nothing to accept, (vi) It must be given by the person to whom the offer is made. However, in the case of a general offer, acceptance can be given by any member of the public.

5. ***A mere mental acceptance is no acceptance.*** Acceptance must be communicated to the offeror. The communication of acceptance may be express or implied. A mere mental

Notes

acceptance is no acceptance. A mere mental acceptance means that the offeree is assenting to an offer in his mind only and, therefore, there is no communication of acceptance to the offeror.

Example: A, a supplier, sent a draft agreement relating to the supply of coal and coke to the manager of a railway company for his acceptance. The manager wrote the word 'approved' on the same and put the draft in the drawer of his table intending to send it to the company's solicitors for a formal contract to be drawn up. By an oversight, the draft agreement remained in the drawer. Held, there was no contract as the manager had not communicated his acceptance to the proposer.

6. ***Effect of silence of the offeree or his failure to reply***. The acceptance of an offer cannot be implied from the silence of the offeree or his failure to reply.

Example: A offered by a letter to buy his nephew's T.V. set for ₹ 3,000, saying, "If I hear no more from you, I shall consider the T.V. set is mine at ₹ 3,000". The nephew did not reply at all, but he told an auctioneer who was selling his T.V. set, not to sell that particular T.V. set as he had sold it to his uncle. By mistake, the auctioneer sold the set. A sued the auctioneer for conversion. Held, A could not succeed as his nephew had not communicated acceptance and therefore there was no contract. However, if the offeree has by his previous conduct indicated that his silence means that he accepts then the acceptance of the offer can be implied from the silence of the offeree. Further, in the case of a general offer it is not necessary to communicate the acceptance if it is made by acting upon the terms of the offer.

7. ***Acceptance must be according to the mode prescribed [s.7].*** Where the offeror prescribes a particular mode of acceptance then the acceptor should follow that mode. In case no mode of acceptance is prescribed by the offeror, then the acceptance must be according to some usual and reasonable mode. If the offeror prescribes a manner in which the offer is to be accepted and the acceptance is not made in such manner, the offeror may, within a reasonable time, after the acceptance is communicated to him, insist that his offer shall be accepted in the prescribed mode and not otherwise, but if he fails to do so he is deemed to have agreed to the acceptance.

Example: A sends an offer to B through post in the usual course. B should make the acceptance in the "usual and reasonable manner" as no mode of acceptance is prescribed. He may accept the offer by sending a letter through post in the ordinary course within a reasonable time. However, if A had asked for an acceptance by telegram then B should accept the offer by telegram. In case B accepts the offer by a letter then A may insist that the acceptance should be in the prescribed mode. But if A (the offeror) does not insist within a reasonable time that the acceptance be in the prescribed mode, then he is bound by the acceptance though not made in the prescribed mode.

8. ***An agreement to agree in the future (futuristic agreements).*** Law does not allow making of an agreement to agree in the future. The parties must agree on terms of the agreement. The terms of the agreement must be either definite or capable of being made definite without further agreement of the parties.

Self Assessment

Fill in the blanks:

9. When in place of accepting the terms of an offer as they are, the offeree accepts the same subject to certain conditions or qualifications, he is said to make a …….offer.

Notes

10. If the terms of the offer are loose, vague, ambiguous or uncertain, it is not a ……offer.

11. When the person to whom the offer is made signifies his assent thereto, the offer is said to be…….

12. The acceptance of an offer cannot be implied from the ……..of the offeree or his failure to reply.

1.6 Completion of Communication of Offer and Acceptance [S.4]

It is necessary to communicate offer to the offeree and the acceptance to the offeror. When is it that the communication is considered to be completed? The communication of an offer is complete when it comes to the knowledge of the person to whom it is made. Where A proposes by a letter to sell his car to B at a certain price, the communication of the offer is complete when B receives the letter. The completion of communication of acceptance has two aspects, *viz.*; (i) As against the offeror and (ii) As against the acceptor. The communication of acceptance is complete (i) As against the offeror when it is put into a course of transmission to him so as to be out of the power of the acceptor; (ii) As against the acceptor, when it comes to the knowledge of the offeror. Thus, in the above example, if B accepts A's offer by sending a letter through post, then the communication of acceptance is complete (i) As against A when the letter is posted by B; and (ii) As against B when the letter is received by A.

Revocation of offer and acceptance [s.5]. It is possible for the offeror to revoke the offer before it is accepted by the offeree but not later. Similarly, the offeree may revoke acceptance, till the communication of acceptance is complete as against him but not later. Thus, in the above example A may revoke his offer at any time before or at the moment, when B posts his letter of acceptance, but not afterwards. B may revoke his acceptance at any time before or at the moment when the letter communicating it reaches A, but not afterwards. The communication of a revocation (of an offer or an acceptance) is complete (i) As against the person who makes it when it is put into a course of transmission to the person to whom it is made so as to be out of the power of the person who makes it; (ii) As against the person to whom it is made, when it comes to his knowledge. In the above example, A may revoke his offer by telegram. The revocation is complete (i) As against A when the telegram is dispatched; (ii) As against B when B receives it. B may revoke his acceptance by a telegram. B's revocation is complete as against B, when the telegram is dispatched, and as against A when it reaches him.

Contracts over telephone or through telex, fax/e-mail. One may enter into contracts either (i) when he is face to face with another person or (ii) over telephone or (iii) through telex or (iv) through post office. When one is face to face with another person, the contract comes into existence immediately after the negotiations are completed with the process of offer and acceptance. Contracts over telephone are just like contracts face to face. But the offeree must make it sure that his acceptance is received by the offeror otherwise there will be no contract, as communication of acceptance is not complete.

Self Assessment

Fill in the blanks:

13. It is possible for the offeror to revoke the offer before it is ……by the offeree but not later.

14. It is necessary to communicate offer to the offeree and the acceptance to the…….

Notes

1.7 Consideration [Ss.2(d), 23-25 and 185]

1.7.1 Meaning of Consideration

One of the essential elements of a valid contract is that it must be supported by consideration. In simple terms consideration is what a promisor demands as the price for his promise. The term consideration is used in the sense of quid pro que, i.e., "something in return". This something or consideration need not be in terms of money. This "something" may even be some benefit, right, interest or profit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other party. Also a promise by one party may be consideration for the promise of other party. Thus, a person who makes a promise to do something usually does so as a return of equivalent of some loss, damage or inconvenience that may have been occasioned to the other party in respect of the promise. The benefit so received, or the loss, damage or inconvenience so caused is regarded, in law, as the consideration for the promise.

Section 2(d) defines consideration as: "When at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such act or abstinence or promise is called a consideration for the promise".

Example: A agrees to sell his motorcycle to B for ₹ 20,000. Here B's promise to pay the sum of ₹ 20,000 is the consideration for A's promise to deliver the motorcycle, and A's promise to deliver the motorcycle is the consideration for B's promise to pay ₹ 20,000.

1.7.2 "No Consideration, No Contract" [Ss.10 and 25]

A promise without consideration cannot create a legal obligation. A person who makes a promise to do or abstain from doing something usually does so as a return of equivalent of some loss, damage, or inconvenience that may have or may have been occasioned to the other party in respect of the promise. The benefit so received or the loss, damage or inconvenience so caused is regarded in law as the consideration for the promise.

Exceptions to the rule "no consideration, no contract". There are some cases where contracts, even though not supported by consideration, are enforceable. Firstly, an agreement made without consideration is valid if it is expressed in writing and is registered under the law relating to registration of documents and is made an account of natural love and affection between parties standing in a near relation to each other. Secondly, a promise without consideration is valid if it is a promise to compensate wholly or in part a person who has already voluntarily done something for the promisor or something the promisor was legally compellable to do. Thus, where A finds B's purse and gives it to him, and B promises to give A ₹ 100, this a valid contract. Thirdly, a promise to pay wholly or in part a debt which is barred by the Limitation Act can be enforced if it is in writing and is signed by the debtor or his authorised agent. A debt barred by limitation cannot be recovered. Therefore, a promise to pay such a debt is, strictly speaking, without any consideration. But if a written promise to pay is made by the debtor then the same is enforceable by the creditor. Fourthly, the rule 'no consideration, no contract' does not apply to completed gifts. Fifthly, no consideration is required in the case of an agreement between a principal and an agent (s.185).

Notes

Example: An elder brother, on account of natural love and affection, promised to pay the debts of his younger brother. The agreement was put to writing and was registered. This was held to be a valid agreement, even though there was no consideration for the promise.

1.7.3 Rules regarding Consideration

The following rules as regards consideration emerge from the definition given in s.2(d):

1. ***Consideration must move at the desire of the promisor*** and therefore an act done by the promise at the desire of a third party is not a consideration.

2. ***Consideration may move either from the promisee or any other person:*** It is not necessary that the consideration must move from the promisee. It may move from any other person. In such a situation, the promisee can maintain a suit even if he is a stranger to the consideration. But he must not be a stranger to the contract.

   Capacity of a stranger to consideration to file a suit. We have seen earlier that a stranger to a contract cannot maintain a suit. However, a stranger to consideration can maintain a suit. Consideration may be supplied either by promisee or any other person.

Example: A, a lady, by a deed of gift, transferred certain property to her daughter with a direction that the daughter should pay an annuity to A's brother as had been done by A. On the same day, the daughter executed a writing in favour of A's brother agreeing to pay the annuity. Afterwards, she declined to fulfil her promise saying that no consideration had moved from A's brother to her. A's brother was held entitled to recover the money (Chinnayya v. Ramayya, 4 Mad 137).

3. ***Consideration need not be adequate:*** How much consideration or payment must there be for a contract to be valid, is always the lookout of the promisor. Courts do not see whether a person making the promise has recovered full return for the promise. Thus, if A promises to sell his pen worth ₹ 80 for ₹ 20 only the inadequacy of the price in itself shall not render the contract void. But where A pleads coercion, undue influence or fraud, then the inadequacy of consideration will also be a piece of evidence to be looked into.

4. ***Consideration must be real and competent:*** A consideration for a contract must be real and not illusory. Also, the consideration must be competent, i.e., it must be something to which law attaches some value.

Example: A promises to discover treasure by magic. The agreement is void, being illusory.

5. ***Consideration must be legal:*** Illegal consideration renders a contract void.

6. ***A consideration may be present, past or future:*** A consideration which moves simultaneously with the promise is called present (or executed) consideration. 'Cash Sales' provides an excellent example of the present consideration. Where the consideration is to move at a future date it is called future or executory consideration. It takes the form of a promise to be performed in the future.

Example: A, a shopkeeper, promises B, a household lady, to deliver certain items of grocery after three days. B promises to pay for it on delivery.

   A past consideration is something wholly done, forborne or suffered before the making of the contract.

Notes

Example: A saves B's life. B promises to pay A ₹ 10,000 out of gratitude. The consideration for B's promise is a past consideration, something done before making of the promise.

1.7.4 Unlawful Consideration and Object [Ss.23-24]

There are certain cases in which the consideration and the object of an agreement are unlawful, thereby making it unenforceable. Section 23 defines an illegal agreement as one the consideration or object of which-

1. is forbidden by law
2. defeats the provisions of any law
3. is fraudulent
4. involves or implies injury to the person or property of another
5. the court regards it as immoral or opposed to public policy.

1. ***Where it is forbidden by law.*** A loan granted to the guardian of a minor to enable him to celebrate the minor's marriage in contravention of the Child Marriage Restraint Act is illegal and cannot be recovered (Srinivas v. Raja Ram Mohan (1951) 2. M.L.J. 264). A promises to drop a prosecution which he has instituted against B for robbery and B promises to restore the value of the things taken. The agreement is void as its object is unlawful.
2. ***Where it is of such a nature that if permitted it would defeat the provisions of any law.*** A let a flat to B at a rent of ₹ 12,000 a month. With a view to reduce the municipal tax, A made two agreements with B. One by which the rent was stated to be ₹ 4,500 only and the other by which B agreed to pay ₹ 7,500 for services in connection with the flat. Held, A could not recover ₹ 7,500 since the agreement was made to defraud the municipal authority and thus void [Alexander v. Rayson (1939) IK.B.169].
3. ***Where it is fraudulent.*** A, being an agent for a landed proprietor, agrees for money without the knowledge of his principal to obtain for B, a lease of land belonging to his principal. The agreement between A and B is void as it implied a fraud by concealment by A, on his principal.
4. ***Where it involves or implies injury to the person or property of another.*** An agreement between some persons to purchase shares in a company, with a view to induce other persons to believe contrary to the fact that there is a bona fide market for the shares, is void.
5. ***Where the court regards it as immoral or opposed to public policy.*** A who is B's power of attorney promises to exercise his influence as such with B in favour of C, and C promises to pay ₹ 5,000 to A. The agreement is void being against public policy.

Examples:

1. X agrees to buy from a jeweller certain jewellery to be delivered to him after two months. In the meantime, the government enacts a law on gold control and prohibits dealings in gold. When the time for delivery of the jewellery comes the jeweller refuses to deliver the same. What can X do? He has no cause of action. The contract becomes void when the law is enacted. Thus, the contract was originally valid but becomes void later on by subsequent (supervening) illegality.

Notes

2. A dealer enters into a contract to sell a smuggled item to X. The import of such type of goods is illegal under the laws of the country. A refuses to deliver the item as promised. What are the rights of X? The contract is void.

Self Assessment

Fill in the blanks:

15. The term ……...is used in the sense of quid pro que.

16. Consideration must move at the desire of the ……

1.8 Capacity to Contract [Ss.10-12]

1.8.1 Persons who are Competent to Contract

Any one cannot enter into a contract; he must be competent to contract according to the law. Every person is competent to contract if he (i) is of the age of majority, (ii) is of sound mind, and (iii) is not disqualified from contracting by any law to which he is subject (s.11). Thus, there may be a flaw in the capacity of parties to the contract. The flaw in capacity may be due to minority, lunacy, idiocy, drunkenness, drug addiction or status. If a party to a contract suffers from any of these flaws the contract may not be a valid one. If the contract would have been allowed to be a valid one then it would result in one party being at a disadvantage in the bargaining process.

1.8.2 Capacity of a Minor to Enter into a Contract

Age of a person determines enough maturity to make a contract. The contract law defines maturity as the age of majority. That usually is 18 years. Does this mean that a minor is not competent to contract? No, a minor may make a contract, but he is not bound by the contract; however the minor can make the other party bound by the contract. Thus, a minor is not bound on a mortgage or a promissory note, but he can be a mortgagee, a payee, or an endorsee. He can derive benefit under the contract. However, an agreement with a minor cannot be ratified by him on his attaining majority so as to make himself bound by the same. Further, if he has received any benefit under the contract, the minor cannot be asked to refund the same. In fact he is always allowed to plead minority and is not estopped to do so even where he had procured a loan or entered into some other contract by falsely representing that he was of full age. It is to be noted that if money lent to him or an item sold to him could be traced then the court may, on equitable grounds, ask the minor to return the same to the lender or the seller, as the case may be as a minor does not have the liberty to cheat. In the case of a fraudulent misrepresentation of his age by the minor, inducing the other party to enter into a contract, the court may award compensation to the other party under Ss.30 and 33 of the Specific Relief Act, 1963.

Further, a minor cannot be a partner in a partnership firm. However, he may with the consent of all the partners for the time being, be admitted to the benefits of partnership (s.36, the Indian Partnership Act, 1932). Also, a minor can act as an agent and bind his principal by his acts without incurring any personal liability.

Section 68 provides that a minor's estate is liable to a person who supplies necessaries of life to a minor, or to one whom the minor is legally bound to support, according to his station in life, not on the basis of any contract, but on the basis of an obligation resembling a contract. However, there is no personal liability of a minor for the necessaries of life supplied. The definition of a "necessary of life" depends entirely on the person and the situation. It probably will always include food and probably will never include a car. In order to entitle the supplier to be reimbursed

Notes

from the minor's estate, the following must be satisfied: (i) The goods are 'necessaries', for that particular minor having regard to his conditions in life (or status or standard of living) and that purchase or hire of a car may be 'necessary' for a particular minor; (ii) The minor needs the goods both at the time of sale and delivery. What is necessary to see is the minor's actual requirements at the time of sale and at the time of delivery, where these are different.

A minor's estate is liable not only for the necessary goods but also for the necessary services rendered to him. The lending of money to a minor for the purpose of defending a suit on behalf of a minor in which his property is in jeopardy, or for defending him in prosecution, or for saving his property from sale in execution of a decree is deemed to be a service rendered to the minor. Other examples of necessary services rendered to a minor are: provision of education, medical and legal advice, provision of a house on rent to a minor for the purpose of living and continuing his studies.

A minor's parents/guardians are not liable to his creditors for the breach of a contract by him whether the contract is for necessaries of life or not. However, the parents would be liable where the minor is acting as their agent.

1.8.3 Mental Incompetence Prohibits a Valid Contract

A person who is not of sound mind may not enter into a contract; he must be of sound mind so as to be competent to contract. A test of soundness of mind has been laid down by law. A person is said to be of unsound mind for the purpose of making a contract if at the time he makes it he is incapable of understanding it and of forming a rational judgement as to its effect upon his interests. A person who is usually of unsound mind but occasionally of sound mind may make a contract when he is of sound mind (s.12).

1.8.4 Alien Enemy (Political Status)

An alien is a person who is a citizen of a foreign country. Thus, in the Indian context, an alien is a person who is not a citizen of India. An alien may be (i) an alien friend or (ii) an alien enemy. An alien friend whose country is at peace with the Republic of India, has usually the full contractual capacity of a natural born subject. In case of contracts with an alien enemy (i.e., an alien whose country is at war with India) the position may be studied under two heads; (a) contracts during the war; and (b) contracts made before the war. During the subsistence of the war an alien can neither contract with an Indian subject nor can he sue in an Indian court except by licence from the Central Government. As regards contracts which are against the public policy or are such which would benefit the enemy stand dissolved. Other contracts (i.e. not against public policy) are merely suspended for the duration of the war, and are revived after the war is over provided they have not already become time-barred under the law of limitation. Further an Indian, who resides voluntarily or who is carrying on business in a hostile territory, would be treated as an alien enemy.

However, an alien friend, whose country is at peace with the Republic of India, has usually, the full contractual capacity of a natural born Indian subject. But he cannot acquire property on any Indian Ship, and also cannot be employed a Master or any other Chief Officer of such a ship.

1.8.5 Foreign Sovereigns and Ambassadors (Political Status)

Foreign sovereigns and accredited representatives of a foreign state or Ambassadors can enter into contracts and enforce those contracts in our courts. However, they enjoy some special privileges. They cannot be sued in our courts unless they choose to submit themselves to the jurisdiction of our courts. In fact they cannot be proceeded against in Indian courts without the sanction of the Central Government.

Notes

A company incorporated under the Companies Act, 1956, or a statutory corporation brought into existence by passing a Special Act of Parliament (corporate status). A company cannot go beyond its objects mentioned in its memorandum of association. The company's activities are confined strictly to the objects mentioned in its memorandum, and if they go beyond these objects, then such activities are ultra vires and void, and cannot be ratified even by the assent of the whole body of shareholders.

Also, a statutory corporation cannot go beyond the objects mentioned in the Special Act of Parliament. Similarly, Municipal Corporations (local bodies) are disqualified from entering into contracts which are not within their statutory powers.

Insolvent persons (legal status). A person adjudicated as insolvent is incompetent to contract until he obtains a certificate of discharge from the court.

Task Discuss the statement 'Freedom to contract is a myth or an illusion' in the light of day-to-day transactions in the market and the essentials of the law.

Self Assessment

Fill in the blanks:

17. Every person is competent to contract if he is of the age of……..
18. Section ……provides that a minor's estate is liable to a person who supplies necessaries of life to a minor.

Case Study

Cut Your Teeth on Law

Communication of acceptance of an offer is complete as against the acceptor the moment it comes to the knowledge of the offeror.

Correct: According to Section 4 of the Indian Contract Act, communication of acceptance is complete as against an offeror when it is put into a course of transmission to him so as to be out of the power of the acceptor and as against the acceptor when it comes to the knowledge of the offeror.

The Indian Contract Act differs from the English law in this regard. Owing to this provision, it is possible for the acceptor to withdraw the acceptance before the communication of acceptance comes to the knowledge of the offeror.

In order to constitute a valid contract, consideration between two parties must be adequate.

Incorrect: According to the explanation to Section 25, an agreement to which consent is freely given is not void merely because the consideration is inadequate; but the inadequacy of consideration may be considered by the court to determine the question whether the consent of the promise is freely given or not.

A threat to lodge criminal prosecution on a false charge amounts to coercion.

Correct: Coercion is committing, or threatening to commit, an offence with the intention of causing any person to enter into an agreement. Here a threat to lodge criminal

Contd...

Notes

prosecution by itself will not amount to coercion; but if this done on the basis of false charge, it will amount to coercion as it is criminal in nature.

In the absence of any provision in the contract of guarantee in the contract, forbearance on the part of creditor to sue the principal debtor does not discharge the surety.

Correct: According to Section 137, in the absence of any contract to the contrary, mere forbearance on the part of the creditor to sue the principal debtor does not discharge the surety. If there is a positive agreement by the creditor with the principal debtor not to sue, then the surety will be discharged if he has not consented to such an arrangement.

A 'contract of indemnity' is not a 'contingent contract'.

Incorrect: In the case of a contract of indemnity, the indemnifier promises to save the indemnity holder from the loss caused to him by the conduct of the promisor himself or by the conduct of any other person. This promise is contingent in nature, as it has to be performed only when the loss is incurred.

Ratification of agency is valid even if knowledge of the principal is materially defective.

Incorrect: According to Section 198, no valid ratification can be made by a person whose knowledge of the facts of the case is materially defective.

A seller of goods shall be called an 'unpaid seller' even when a part payment of the price of goods sold has been made to him by a buyer.

Correct: As per Section 45(1) of the Sale of Goods Act, the seller is deemed to be an unpaid seller if the whole of the price has not been paid or tendered.

'Goods' means every kind of property other than actionable claims and money.

Incorrect: Only moveable property is included in the definition of goods. So it is incorrect to say that goods will mean every kind of property.

An unregistered firm may institute a suit if the value of the suit does not exceed ₹ 100.

Incorrect: An unregistered firm cannot institute any suit against a third party. It can, however, avail of the right of set off to an amount not exceeding ₹ 100.

A partner making advance of money to the firm, beyond the amount of his agreed capital is entitled to interest on such advanced money.

Correct: As per Section 13(c) of the Partnership Act, a partner is entitled to interest at the rate of 6 per cent on the advance of money to the firm beyond the amount of his agreed capital.

Contract Matters

Based on the extent to which the contracts have been performed, one may classify them as executed or executory. Executed contract is one where both the parties to the contract have fulfilled their respective obligations under the contract. Suppose a book is purchased from a bookshop on payment of cash, the contract is called executed. On the other hand, executory contract is one where both the parties and at least one of the parties are yet to perform the respective obligations.

No consideration, no contract: According to Section 10 of the Indian Contract Act, one of the essentials of a valid contract is lawful consideration. An agreement without consideration is not a contract.

Contd...

Notes

Consideration means something in return. It is the price for which the promise of the other is bought. It may be in the form of benefit, right, interest or profit that may accrue to one party, or it may be some forbearance, detriment, loss or responsibility suffered by the other.

Section 25 of the Contract Act makes it clear that an agreement without consideration is invalid. However, the same section provides certain exceptions to the rule 'no consideration, no contract'. An agreement without consideration is valid under following circumstances:

- It is expressed in writing and duly registered and made on account of natural love and affection between parties standing in near relations to each other;
- It is a promise to compensate a person who has already done something, which the promisor is legally compellable to do;
- It is a promise in writing signed by the debtor or his agent to pay a time-barred debt;
- It is a completed gift;
- It is a contract of bailment or contract of agency.

Question

"No consideration, no contract". Analyse.

Source: thehindubusinessline.com

1.9 Summary

- Law is defined as a rule of conduct of persons, imposed upon and enforced among the members of a given state. Ignorance of law is no excuse.
- A contract is an agreement enforceable by law.
- All agreements are not contracts, but all contracts are agreements.
- All agreements are contracts, if they are made by free consent of parties, competent to contract, for a lawful consideration, and with a lawful object, and are not expressly declared by law to be void.
- Contracts may be classified in terms by their (a) validity or enforceability (b) mode of formation and (c) performance.
- Offer or proposal is the basic building block of a contract. It is made with a view to obtaining the assent of the offeree.
- When the person to whom the offer is made signifies his assent thereto, the offer is said to be accepted.
- It is necessary to communicate offer to the offeree and the acceptance to the offeror.
- A contract with a minor is void as he is not competent to contract.
- Consideration is what a promisor demands as the price for his promise.

1.10 Keywords

Consideration: When at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstain from doing, something, such actor abstinence or promise is called consideration for the promise.

Notes

Express Contract: It is that contract the terms of which are expressly agreed upon (whether by words spoken or written) at the time of its formation.

General Offer: It is that offer which is made to the public at large.

Implied Contract: It is that contract which is inferred from the acts or conduct of the parties or the course of dealing between them.

Ownership: It is described as a bundle of rights in rem, having certain characteristics, namely the right of unspecified duration, and use, and generally being inheritable and transferable.

Specific Offer: It is that offer which is made to a definite person or a group of persons.

Voidable Contract: It is that contract which may be repudiated at the will of one or more of the parties, but not by others.

1.11 Review Questions

1. Analyse the practical importance of the Indian Contract Act to business persons.
2. "All agreements are not contracts but all contracts are agreements". Comment.
3. "There are some contracts and documents which are required to be not only in writing and signed by the parties, but in addition, required to be registered with some competent authority or the other". Do you agree? Justify.
4. Suppose A gives a promise to B to give a sum of ₹ 250/- every month for the tuition of English. In case, A refuses to give the promised amount, B has no remedy against A. Do you agree? Justify.
5. "A contract is a contract from the time it is made and not from the time its performance is due." Justify.
6. "Every illegal agreement is void but every void agreement may not amount to illegal agreement." Justify.
7. Do you agree with the statement: "Ignorance of law is no excuse"? Justify giving the repercussion which the person may has to face if he is ignorant about the laws.
8. X promises Y to obtain for Y an employment in the public service for a consideration, say ₹ 10,000. Is the agreement legal? Justify.
9. "A minor's estate is liable for necessaries of life supplied". Comment.
10. "Insufficiency of consideration is immaterial but an agreement without consideration is void". Do you agree? Justify.
11. Consideration may be present, past or future. Illustrate.
12. "A stranger to a contract cannot maintain a suit but a stranger to consideration can do so". Discuss the importance of this statement with reference to the Indian Contract Act, 1857.
13. The term consideration is used in the sense of *'quid pro quo'* or 'something in return'. What does this 'something' relates to? Illustrate your answer.
14. Ram's son absconded from the home. He sent his servant in search of the boy. When the servant has left ram, by handbills offered to pay ₹ 500 to anybody discovering the boy. The servant cam to know of this offer only when he had already traced the missing child. He however brought an action to recover the reward. Will he succeed in his attempt? Justify.

Notes

15. A enters into a contract with B for the supply of 800 tonnes of iron ore within 4 months. A fails to make the delivery in time owing to difficulty in transport. But he admitted the availability of iron-ore in the market at a higher price. Can A take the plea of the impossibility of the performance? Justify.

Answers: Self Assessment

1.	an agreement	2.	two
3.	75	4.	Indian Contract
5.	offeree	6.	acceptor
7.	Unenforceable	8.	unilateral
9.	counter	10.	valid
11.	accepted	12.	silence
13.	accepted	14.	offeror.
15.	consideration	16.	promisor
17.	majority	18.	68

1.12 Further Reading

Book

S.S. Gulshan, *Business Law,* Excel Books, New Delhi, 2006.

Online links

bizlaw0.tripod.com/id4.html

www.netlawman.co.in

Unit 2: Consent, Indemnity and Guarantee Acts

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Objectives

After studying this unit, you will be able to:

- Describe the connotation of consent and coercion;
- Discuss the impression of mistakes;
- Recognize the purpose and meaning of guarantee;
- Explain the meaning of indemnity.

Introduction

Whenever the parties enter into the contract, it is essential that it should be from free and at the will of the parties on either side. There should be no undue influence or misrepresentation on part of both parties while entering into the contract.

When a company needs some money for its business it approaches a bank. The bank requires that the managing director M promises to repay the loan personally should the company default. When the directors of the company including M execute the promissory note on behalf of the company, they sign as company's officials. M, the managing director signs again as an individual. The relationship between M and the bank is called a guarantee or suretyship. It is a contractual relationship resulting from the unconditional promise of M (known as the surety or guarantor) to repay the loan to the creditor (the bank) for the obligation of the principal debtor (the company) should it default. If the company fails to repay the loan, the bank can approach M for the payment.

Sometimes the banks (lenders) ask for more security for the loans in addition to the personal guarantee of an official of the borrowing company. The company may agree that a particular machinery in its factory would serve as collateral security for the loan. If the company defaults, the bank now has three options: to compel the principal debtor to pay, demand payment from the surety, or obtain a court order to either claim or sell the collateral. The bank need not look to the collateral first. But if M pays the money to the bank, then the right of the bank on the collateral gets transferred to him. The bank has yet another alternative for securing its loan to the company. It could ask that all the three directors (including M) sign the promissory note as co-sureties. If they do so and the company defaults, the bank may seek payment from any one or any two of them or all of them. The law relating to the contracts of guarantee is given in the Indian Contract Act, 1872.

2.1 Consent and Free Consent

2.1.1 Meaning of Consent

While an offer made by one party is accepted by the other party, the consent of the offeree to the offer by the offeror is necessary. It is essential to the creation of a contract that both parties agree to the same thing in the same sense. When two or more persons agree upon the same thing in the same sense they are said to consent.

Example: A agrees to sell his Maruti car deluxe model for ₹ 1.20 lakhs. B agrees to buy the same. There is a valid contract since A and B has consented to contract on the same subject matter.

Notes

2.1.2 Free Consent

For a contract to be valid it is not only necessary that the parties consent but also that they consent freely. Where there is a consent but no free consent the contract is voidable at the option of the party whose consent was not free. Thus, free consent is one of the essentials of a valid contract. A consent is said to be free when it is not caused by: (i) coercion, (ii) undue influence, (iii) fraud, (iv) misrepresentation or (v) mistake.

Self Assessment

Fill in the blanks:

1. When two or more persons agree upon the same thing in the same sense they are said to…….
2. For a contract to be valid it is not only necessary that the parties consent but also that they consent …….....

2.2 Meaning of Coercion (Ss.15 and 72)

Coercion is (i) the committing or threatening to commit any act forbidden by the Indian Penal Code or (ii) the unlawful detaining or threatening to detain any property to the prejudice of any person whatever with the intention of causing any person to enter into an agreement. [s.15].

Example: A threatens to kill B (C's son) if C does not let his house to A and thereupon C gives his consent. This consent is no consent in the eye of law as the agreement is caused by coercion.

Threat to commit suicide - Is it coercion? The doubt arises because suicide, though forbidden by the Indian Penal Code, is for obvious reasons not punishable. A dead person cannot be punished. But, since s.15 declares that committing or threatening to commit any act forbidden by the Indian Penal Code is coercion, a threat to commit suicide should obviously be so regarded (suicide being forbidden).

Example: A obtained a release deed from his wife and son under a threat of committing suicide. The transaction was set aside on the ground of coercion [Ammiraju v. Seshamma (1917) 41 Mad. 33].

Effect of coercion on the validity of contract (s.19A). When consent to an agreement is caused by coercion the agreement is voidable at the option of the party whose consent was so obtained. Thus, the aggrieved party can have the contract set aside if he so desires otherwise the contract is a valid one. However, a person, to whom money has been paid or anything delivered under coercion, must repay or return it to the other party (s. 72).

Example: A railway company refused to deliver certain goods to the consignee except upon the payment of an illegal charge for carriage, and he paid the sum charged in order to obtain the goods. He is entitled to recover so much of the charge as was illegally excessive.

Notes

Self Assessment

Fill in the blanks:

3. Coercion is the committing or threatening to commit any act forbidden by the …….
4. When consent to an agreement is caused by coercion the agreement is ……..at the option of the party whose consent was so obtained.

2.3 Meaning of Undue Influence (S.16)

Undue influence consists in the improper exercise of power over the mind of one of the contracting parties by the other. A contract is said to be induced by undue influence where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other.

Example: A, a man enfeebled by disease or age, is induced by B's influence over him as his medical attendant to agree to pay B an unreasonable sum for his professional services, B employs undue influence.

Presumption of undue influence as regards persons in particular relationships. After reciting the general principle of undue influence, s.16 lays down rules of presumption as regards persons in particular relations. It reads: A person is deemed to be in a position to dominate the will of another: (i) where he holds a real or apparent authority over the other or where he stands in a fiduciary relation to the other or (ii) where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness or mental or bodily stress.

Some of the relationships which raise a presumption of undue influence are: (a) parent and child; (b) guardian and ward; (c) doctor and patient; (d) spiritual guru and disciple; (e) lawyer and client; (f) trustee and beneficiary. However, the presumption of undue influence can be rebutted by showing that the party said to have been influenced had independent legal advice of one who had full knowledge of the relevant facts.

Example: A Hindu, well advanced in age, with the object of securing benefits to his soul in the next world, gave away his whole property to his spiritual guru. Undue influence was presumed.

There is no presumption of undue influence in the relationships between (i) husband and wife; (ii) master and servant; (iii) creditor and debtor; (iv) landlord and tenant.

Party on whom lies the burden of proving that the contract (i) was or (ii) was not induced by undue influence [s.16(3)]. The burden of proving that the contract is not induced by undue influence lies on the party who is in a position to dominate the will of the other. Thus, in cases (above given) where undue influence is presumed the onus of proof lies on parent, guardian, doctor, spiritual guru, lawyer, trustee. On the other hand, in relationships where undue influence is not presumed the party alleging undue influence must prove that it existed.

Consequences of undue influence (s.19A). An agreement caused by undue influence is voidable at the option of the party whose consent was obtained by undue influence. However, any such contract may be set aside either absolutely or if the party who was entitled to avoid it has received any benefit thereunder then upon such terms and condition as the court deems fit.

Notes

Example: A, a money lender, advanced ₹ 1,000 to B, a household lady, and by undue influence induced B to execute a bond with interest at 8 per cent per month then the court may set the bond aside ordering B to repay ₹ 1,000 with such interest as the court may deem just.

Extra precautions to be taken while entering into contract with a pardanashin woman. A pardanashin woman is one, who according to the custom of her community, observes complete seclusion. The courts in India regard such women as being especially open to undue influence. When therefore an illiterate pardanashin woman is alleged to have dealt with her property and to have executed a deed, the burden of proving that there was no undue influence was on the party setting up the deed. The law demands that the person who deals with a pardanashin lady must show affirmatively and conclusively that the deed was not only executed by, but was explained to and was really understood by the lady.

Money lending transactions. In money lending transactions the rate of interest being high, or that the borrower is in urgent need of money is not an evidence of undue influence. These two facts do not by themselves show that there is undue influence. However, if the rate of interest is so high that the court considers it unconscionable, then the burden of proving that there was no undue influence lies on the creditor.

Example: A, being in debt to B, the money lender, contracts for a fresh loan at compound interest of 25 per cent the transaction may be held to be unconscionable and a reduced rate of simple interest may be awarded.

Self Assessment

Fill in the blanks:

5. Undue influence consists in the improper exercise of ……..over the mind of one of the contracting parties by the other.
6. The presumption of undue influence can be rebutted by showing that the party said to have been influenced had independent legal advice of one who had …….of the relevant facts.

2.4 Meaning of Fraud [Ss. 17 and 19]

Fraud means and includes any of the following acts committed by a party to a contract with an intent to deceive the other party thereto or to induce him to enter into a contract: (i) the suggestion as a fact of that which is not true by one who does not believe it to be true; (ii) active concealment of a fact by one having knowledge or belief of the fact; (iii) promise made without any intention of performing it; (iv) any other act fitted to deceive; (v) any such act or omission as the law specifically declares to be fraudulent.

2.4.1 Essential Elements or Conditions for a Fraud to Exist

For a fraud to exist the following are the essential elements:

(i) There must be a representation or assertion and it must be false. To constitute fraud there must be an assertion of something false within the knowledge of the party asserting it. Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud. To constitute fraud ordinarily there must be active misstatement of fact as the withholding of that which is not stated makes that is stated absolutely false.

Notes

(ii) The representation or assertion alleged to be false must be of a fact. A mere expression of opinion, puffery or flourishing description does not constitute fraud.

(iii) The representation or statement must have been made (a) knowingly or (b) without belief in its truth or (c) recklessly, carelessly whether it be true or false. In (a) and (b) there seems to be no difficulty since fraud is proved when it is shown that a false representation has been made knowingly or without belief in its truth. However, with regard to reckless misstatement it may appear difficult to say whether it amounts to fraud because the person making such statement does not himself definitely know that the statement is false. But if we carefully look into it we find that it does amount to fraud. Though the person making it is not sure of the truth of the statement yet he represents to the other party as if he is absolutely certain about its truth.

(iv) The representation, statement, or assertion must have been made with the intention of inducing the other party to act upon it. For fraud to exist the intention of misstating the facts must be to cause the other party to enter into an agreement.

(v) The representation must in fact deceive. It has been said that a deceit which does not deceive is not a fraud. A fraud or misrepresentation, which does not cause the consent to a contract of the party on whom such fraud is practiced or to whom such misrepresentation was made, does not render a contract voidable.

(vi) The party subjected to fraud must have suffered some loss. It is a common rule of law that there is no fraud without damages. As such a fraud without damage does not give rise to an action of deceit.

Example: A informs B fraudulently that A's estate is free from encumbrance. B therefore buys the estate. The estate in fact is subject to a mortgage. B may either avoid the contract or may insist on its being carried out and the mortgage deed redeemed.

Self Assessment

Fill in the blanks:

7. For a fraud to exist there must be a representation or assertion and it must be…….

8. It is a common rule of law that there is no fraud without……..

2.5 Meaning of Misrepresentation (Ss.18-19)

Misrepresentation is also known as simple misrepresentation whereas fraud is known as fraudulent misrepresentation. Like fraud, misrepresentation is an incorrect or false statement but the falsity or inaccuracy is not due to any desire to deceive or defraud the other party. Such a statement is made innocently. The party making it believes it to be true. In this way, fraud is different from misrepresentation. The case of misrepresentation may be classified into the following three groups: (i) the positive assertion in a manner not warranted by the information of the person making it, of that which is not true though he believes it to be true. (ii) Any breach of duty which without an intent to deceive gives an advantage to the person committing it (or anyone claiming under him) by misleading another to his prejudice or to the prejudice of anyone claiming under him. (iii) Causing however innocently a party to an agreement to make a mistake as to the substance of a thing which is the subject of the agreement.

Notes

Examples:

1. A chartered a ship to B which was described in the 'Charter Party' and was represented to him as being not more than 2,800 tonnage registered. It turned out that the registered tonnage was 3,045 tons. A refused to accept the ship in fulfillment of the charter party. He would be entitled to avoid the charter party by reason of the erroneous statement as to tonnage.
2. H sold W with all faults certain animals which were suffering from some fever, the fact of which was known to him but he did not disclose to W, it was held that there was no fraud (Ward v. Hobbs (1878) A C 13).

Silence may in itself be equivalent to speech. Silence may in itself amount to fraud where the circumstances are such that "silence is in itself equivalent to speech".

Example: Where B says to A, "if you do not deny it I shall assume that the car does not overheat" A says nothing. Here A's silence is equivalent to speech.

However, a mere expression of opinion, puffery or flourishing description does not amount to a fraud.

Example: A, a seller of a vintage car says that the car is a 'beauty'. It is merely A's opinion. But in case he says that the car is worth ₹ 5 lakhs whereas he paid only ₹ 2 lakhs for it, then he has misstated a fact which may amount to fraud or simple misrepresentation.

Notes **Fraud and Misrepresentation**

The following are the points of difference between the two:

1. In case of fraud, the party making false or untrue representation makes it with the intention to induce the other party to enter into a contract. Misrepresentation, on the other hand, is innocent i.e., without any intention to deceive or to gain an advantage.
2. Both fraud and misrepresentation make a contract voidable at the option of the party wronged. But in case of fraud, the party defrauded gets the additional remedy of suing for damages caused by such fraud. In case of misrepresentation generally the only remedies are rescission and restitution.
3. In case of fraud, the defendant cannot take the plea that the plaintiff had the means of discovering the truth or could have done so with ordinary diligence. In case of misrepresentation it could be a good defense.

   Cases of fraud or misrepresentation in which the contract is not voidable. There are two exceptions to the principle that the party aggrieved or wronged can avoid the contract. Firstly, where the party whose consent was caused by fraud or misrepresentation had the means of discovering the truth with ordinary diligence. Secondly, where the party after becoming aware of the fraud or misrepresentation takes a benefit under the contract or in some way affirms it.

Consequences of fraud and misrepresentation [s.19]. The party aggrieved or wronged has two remedies viz, (i) he can avoid the performance of the contract (ii) he can insist that the contract

Notes

shall be performed and that he shall be put in the position in which he would have been if the representation made had been true. In case of fraud he has an additional remedy, i.e., he can sue for damages.

Exceptions to the principle that the party aggrieved or wronged by misrepresentation cannot claim damages. The directors of a company are liable in damages under s.62 of the Companies Act, 1956, even for misstatements, i.e., misrepresentation in the prospectus issued by the company inviting public for subscription. Also where there exists a confidential relationship between the parties (such as solicitor and client), and negligent representation is made by one to the other then the aggrieved party may claim damages.

Task Peter by way of misrepresentation leads Deepak erroneously to believe that 100 quintals of indigo are made annually at Peter's factory, Deepak examines the accounts of the factory and finds that only 50 quintals of indigo have been made. Afterwards, Deepak buys the factory. Now, he wants to avoid the contract on the ground of misrepresentation. Advise him giving reasons.

Self Assessment

Fill in the blanks:

9. Silence may in itself amount to ……..where the circumstances are such that "silence is in itself equivalent to speech".
10. The case of misrepresentation is classified into …….groups.

2.6 Meaning of 'Mistake' [Ss.20-21]

Mistake may be defined as an erroneous belief on the part of the parties to the contract concerning something pertaining to the contract. For example, A agrees to buy from B a certain house. It turns out that the house had been destroyed by fire before the time of the bargain though neither party was aware of the fact. The agreement is void. A cannot insist for possession of the house. The agreement is void as there is a mistake on the part of both the parties about the existence of the subject matter.

2.6.1 Different Kinds of Mistake

Broadly there are two kinds of mistake: (i) Mistake of fact and (ii) Mistake of law. Further mistake of fact may be either: (a) Bilateral or (b) Unilateral. The mistake of law may be (a) mistake of law of the land and (b) mistake of foreign law.

When both the parties to the agreement are under a mistake of fact essential to the agreement, the mistake is called a bilateral mistake and the agreement is void. For example, A agrees to sell to B a specific cargo of goods supposed to be on its way from London to Mumbai. It turns out that before the day of the bargain the ship conveying the cargo had been cast away and the goods lost. Neither party was aware of the facts. The agreement is void.

Some typical cases of bilateral mistake invalidating the agreement. There may be is a mistake concerning subject matter as to its (i) existence, (ii) identity, (iii) title, (iv) quantity, (v) price.

Example: A, who owns two fiat cars, offers to sell his 'White fiat' for ₹ 80,000. B accepts the offer thinking A is selling his 'Brown Fiat'. There is a mistake as to the identity of the subject matter.

Notes

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

Example: A buys an article thinking it is worth ₹ 10,000 while it is actually worth ₹ 5,000 only. Later he wants to avoid the agreement on the ground of mistake as to the price of the subject matter. The agreement cannot be avoided on the ground of mistake. It is only erroneous opinion as to the value of the subject matter and is not deemed a mistake as to a matter of fact.

2.6.2 Meaning and Effect of 'Unilateral Mistake'

There is a unilateral mistake where only one party to a contract is under a mistake as to a matter of fact. Generally speaking, such a contract is not invalid.

Example: A sold rice to B by sample, and B thinking that they were old rice, purchased them. In fact, the rice were new. B cannot avoid the contract.

Caution Where a person due to his own negligence or lack of reasonable care does not ascertain what he is contracting about, he must bear the consequences.

Exceptional cases in which agreement is void even when there is a unilateral mistake.

Firstly, where the unilateral mistake is as to the nature of the contract. Thus, in Foster v. Mackinnon (1869) LR 4 C.P. 704 an old illiterate man was made to sign a bill of exchange by means of a false representation that it was a guarantee. Held, the contract was void. The old man did not intend to enter into the contract relating to bill of exchange but through the fault of another and without any fault of his own made a mistake as to the nature of the contract.

Secondly, where the unilateral mistake is as to the identity of the person contracted with. Where A intends to contract with B but by mistake enters into a contract with C believing him to be B, the contract is void. In Cundy v. Lindsay and Co. (1878) 3 App. Cas. 459, one Blenkarn, knowing that Blenkiron & Co. were the reputed customers of Lindsay & Co. ordered some goods from Lindsay & Co. by imitating the signature of Blenkiran. These goods were then sold by Blenkarn to Cundy, an innocent purchaser. In a suit by Lindsay & Co. against Cundy for recovery of goods it was held that as Lindsay & Co. never intended to contract with Blenkarn there was no contract between them and as such even an innocent purchaser of the goods from Blenkarn did not get a good title and must return them or pay their price to Lindsay & Co. Similarly, in Lake v Simmons (1927) A.C. 487, a lady X induced Y to deliver possession of two pearl necklaces falsely representing that she was the wife of baron Z and that she wanted them to be shown to her husband for approval. Held, Y intended to contract only with the wife of the baron and not with X herself. Hence the contract was void and X could not convey any title even to a *bona fide buyer.*

Thirdly, a contract may be avoided where there is a unilateral mistake as to quality of performance.

Example: A held an auction for the sale of some lots of hemp and some lots of tow. B thinking that hemp was being sold, bid for a lot of tow for an amount which was out of proportion to it, and was only a fair price for hemp. B could avoid the contract.

2.6.3 Mistake of Law

It may be (i) mistake of law of the land, or (ii) mistake of foreign law. In the first case the rule is *"Ignorantia juris non-excusat".*

Notes

Meaning of *"ignorantia juris non excusat"*. It means ignorance of law is no excuse. A contract is not voidable because it was caused by a mistake as to any law in force in India. Thus, where A and B make a contract grounded on the erroneous belief, that a particular debt is barred by the Limitation Act; the contract is not voidable. (s.21) Further, "A mistake as to a law not in India has the same effect as a mistake of fact".

Mistake of foreign law. The above maxim - "ignorance of law is no excuse" is inapplicable to foreign law. The mistake of foreign law is to be treated as a mistake of fact.

Consequences of mistake on contracts. Mistake renders the contract void and as such in case of a contract which is yet to be performed the party complaining the mistake may repudiate it, i.e., need not perform it. If the contract is executed the party who received any advantage must return it or make compensation for it as soon as the contract is discovered to be void.

Self Assessment

Fill in the blanks:

11. Broadly there are two kinds of mistake which are Mistake of …….and Mistake of law.
12. When both the parties to the agreement are under a mistake of fact essential to the agreement, the mistake is called a ……mistake

2.7 Contract of Guarantee

2.7.1 Purpose of Guarantee

The contracts of guarantee are among the most common business contracts and are used for a number of purposes. These are:

(i) The guarantee is generally made use of to secure loans. Thus, a contract of guarantee is for the security of the creditor.

(ii) The contracts of guarantee are sometimes called performance bonds.

Example: In the case of a construction project, the builder may have to find a surety to stand behind his promise to perform the construction contract.

Also employers often demand a type of performance bond known as a fidelity bond from employees who handle cash, etc., for the good conduct of the latter. If an employee misappropriates then the surety will have to reimburse the employer.

(iii) Bail bonds, used in criminal law, are a form of contract of guarantee. A bail bond is a device which ensures, that a criminal defendant will appear for trial. In this way a prisoner is released on bail pending his trial. If the prisoner does not appear in the court as desired then the bond is forfeited.

2.7.2 Definition and Nature of the Contract of Guarantee (S.126)

A contract of guarantee is defined as "a contract to perform the promise, or discharge the liability, of a third person in case of his default". The person who gives the guarantee is called 'surety'; the person for whom the guarantee is given is called the 'principal debtor', and the person to whom the guarantee is given is called the 'creditor'. A contract of guarantee may be either oral or in writing.

Notes

From the above discussion, it is clear that in a contract of guarantee there must, in effect, be two contracts, a principal contract between the principal debtor and creditor, and a secondary contract between the creditor and the surety. In a contract of guarantee there are three parties, viz., the creditor, the principal debtor and the surety. Therefore, there is an implied contract also between the principal debtor and the surety.

Example: When A requests B to lend ₹ 10,000 to C and guarantees that C will repay the amount within the agreed time and that on C failing to do so, he will himself pay to B, there is a contract of guarantee.

The contract of surety is not a contract collateral to the contract of the principal debtor, but is an independent contract. There must be a distinct promise on the party of the surety to be assumable for the debt. It is not necessary that the principal contract, between the debtor and the creditor, must exist at the time the contract of guarantee is made; the original contract between the debtor and creditor may be about to come into existence. Similarly, under certain circumstances, a surety may be called upon to pay though principal debtor is not liable at all.

Also, where a person gives a guarantee upon a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that other person does not join (s.144).

2.7.3 Fiduciary Relationship

A contract of guarantee is not a contract "uberrimae fidei" (requiring utmost good faith). Nevertheless, the suretyship relation is one of trust and confidence and the validity of the contract depends upon good faith on the part of the creditor. A creditor must disclose all those facts which, under the circumstances, the surety would expect not to exist. So where guarantee is given for good conduct of an employee, the employer's failure to inform the surety of any breach on the part of employee, will discharge the surety. Similarly, where X guarantees the existing and future liabilities of A to B up to a certain amount which limit has already been exceeded, the contract of guarantee can be avoided on the ground of concealment of a materiel fact. However, it should be noted that it is no part of the creditor's duty to inform the surety about all his previous dealings with the debtor.

2.7.4 Kinds of Guarantees

1. ***Oral or Written Guarantee:*** A contract of guarantee may either be oral or in writing (s.126), though a creditor should always prefer to put it in writing to avoid any dispute regarding the terms, etc. In case of an oral agreement the existence of the agreement itself is very difficult to prove.
2. ***Specific and Continuing Guarantee:*** From the point of view of the scope of guarantee a contract of guarantee may either by specific or continuing. A guarantee is a "specific guarantee", if it is intended to be applicable to a particular debt and thus comes to end on its repayment. A specific guarantee once given is irrevocable.

Examples:

(a) A guarantees the repayment of a loan of ₹ 10,000 to B by C (a banker). The guarantee in this case is a specific guarantee.

A guarantee which extends to a series of transactions is called a "continuing guarantee" (s.129).

Notes

(b) A guarantees payment to B, a tea-dealer, to the amount of ₹ 10,000 for any tea he may from time to time supply to C. B supplies C with tea of the value above ₹ 10,000 and C pays B for it. Afterwards B supplies C with tea to the value of ₹ 15,000. C fails to pay. The guarantee given by A was a continuing guarantee and he is accordingly liable to B to the extent of ₹ 10,000.

2.7.5 Rights and Obligations of the Creditor

1. ***Rights of a Creditor:***

   (a) The creditor is entitled to demand payment from the surety as soon as the principal debtor refuses to pay or makes default in payment. The liability of the surety cannot be postponed till all other remedies against the principal debtor have been exhausted. In other words, the creditor cannot be asked to exhaust all other remedies against principal debtor before proceeding against surety.

   The creditor also has a right of general lien on the securities of the surety in his possession. This right, however, arises only when the principal debtor has made default and not before that.

   (b) Where surety is insolvent, the creditor is entitled to proceed in the surety's insolvency and claim the pro rata dividend.

2. ***Obligations Imposed on a Creditor in a Contract of Guarantee:***

   (a) *Not to change any terms of the original contract.* The creditor should not change any terms of the original contract without seeking the consent of the surety. Section 133 provides "any variance made, without the surety's consent, in the terms of the contract between the principal debtor and the creditor, discharges the surety as to the transactions subsequent to the variance".

Example: A banker contracts to lend X ₹ 5,000 on March 4. A guarantees repayment. The banker pays X ₹ 5,000 on January 1. A in this case is discharged from his liability as the contract has been varied as much as the banker might sue X before March 4, but it cannot sue A as the guarantee is from March 4.

   (b) *Not to release or discharge the principal debtor.* The creditor is under an obligation not to release or discharge the principal debtor. Section 134 states: "The surety is discharged by a contract between the creditor and principal debtor, by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor".

Example: A gives a guarantee to banker C for repayment of the debt granted to B. B later contracts with his creditors (including C, the banker) to assign to them his property in consideration of their releasing him from their demands. Here B is released from his debt by the contract with C and A is discharged from his suretyship.

   (c) *Not to compound, or give time to, or agree not to sue the principal debtor.* Section 135 provides, "A contract between the creditor and the principal debtor, by which the creditor makes a composition with or promises to give time to, or not to use the principal debtor, discharges the surety, unless the surety assents to such contract".

   If the time for repayment is extended, the debtor may die or become insane or insolvent or his financial position may become weaker in the meanwhile, with one

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effect that the surety's remedy to recover the money in case the principal debtor defaults, may be impaired. However, there are certain exceptions. These are:

(i) Section 136 states that if the creditor makes an agreement with a third party, but not with the principal debtor, to give extension of time to the principal debtor, surety is not discharged even if his consent has not been sought.

Example: C, the holder of an overdue bill of exchange, drawn by A as surety for B and accepted by B, contracts with M to give time to B. A is not discharged.

(ii) Mere forbearance on the part of creditor to sue the principal debtor, or to enforce any other remedy against him, does not, in the absence of a provision to the contrary, discharge the surety (s.137).

Example: B owes C (a banker) a debt guaranteed by A and the debt becomes payable, but C does not sue B for a year after debt becomes payable. A is not discharged from his suretyship.

(iii) If the creditor releases one of the co-sureties, the other co-surety (or co-sureties) thereby is not discharged. The co-surety released by the creditor is also not released from his liability to the other sureties (s.138).

(d) *Not to do any act inconsistent with the rights of the surety. (s.139).* Where C lends money to B on the security of a joint and several promissory note made in C's favour by B and by A as surety for B, together with a bill of sale of B's furniture, which give power to C to sell the furniture and apply the proceeds in discharge of the note. Subsequently, C sells the furniture, but owing to his misconduct and willful negligence, only a small price is realized, then A is discharged from liability on the note.

2.7.6 Rights, Liabilities and Discharge of Surety

1. ***Rights of Surety:*** Rights of a surety may be classified under three heads: (i) rights against the creditor, (ii) rights against the principal debtor and (iii) rights against co-sureties.

(a) *Rights against the Creditor:* In case of fidelity guarantee, the surety can direct creditor to dismiss the employee whose honesty he has guaranteed, in the event of proved dishonesty of the employee. The creditor's failure to do so will exonerate the surety from his liability.

(b) *Rights against the Principal Debtor*

(i) Right of subrogation: Section 140 lays down that where a surety has paid the guaranteed debt on its becoming due or has performed the guaranteed duty on the default of the principal debtor, he is invested with all the rights which the creditor has against the debtor. In other words, the surety is subrogated to all the rights which the creditor had against the principal debtor. So, if the creditor loses, or without the consent of the surety parts with any securities (whether known to the surety or not) the surety is discharged to the extent of the value of such securities (s.141). Further, the creditor must hand over to the surety, the securities in the same condition as they formerly stood in his hands.

(ii) Right to be indemnified: The surety has a right to recover from the principal debtor the amounts which he has rightfully paid under the contract of guarantee.

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(c) *Rights against Co-sureties*

(i) Right of contribution: Where a debt has been guaranteed by more than one person, they are called co-sureties. s.146 provides for a right of contribution between them. When a surety has paid more than his share or a decree has been passed against him for more than his share, he has a right of contribution from the other sureties who are equally bound to pay with him.

Example: A, B and C are sureties to D for the sum of ₹ 3,000 lent to E. E defaults in making payment. A, B and C are liable, as between themselves to pay ₹ 1,000 each and if any one of them has to pay more than his share, i.e., ₹ 1,000 he can claim contribution from the others, for the amount paid in excess of ₹ 1,000.

If one of the sureties becomes insolvent, the solvent co-sureties shall have to contribute the whole amount equally.

(ii) Where, the co-sureties have guaranteed different sums, they are bound under s. 147 to contribute equally, subject to the limit fixed by their guarantee and not proportionately to the liability undertaken.

Examples:

(a) A, B and C as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of ₹ 10,000, B in that of ₹ 20,000, C in that of ₹ 40,000, conditioned for D's duly accounting to E. E makes default to the extent of ₹ 30,000. A, B and C are each liable to pay ₹ 10,000.

(b) In the above example, if D makes default to the extent of ₹ 40,000, A is liable to pay ₹ 20,000 and B and C ₹ 15,000 each.

2. ***Liability of Surety:*** Unless the contract provides otherwise, the liability of the surety is co-extensive with that of the principal debtor (s. 128). In other words, the surety is liable for all those amounts the principal debtor is liable for.

Example: A guarantees to B the payment of a bill of exchange by C, the acceptor. The bill is dishonored by C. A is liable not only for the amount of the bill but also for any interest and charges which may have become due on it.

The liability of a surety is called as secondary or contingent, as his liability arises only on default by the principal debtor. But as soon as the principal debtor defaults, the liability of the surety begins and runs co-extensive with the liability of the principal debtor, in the sense that the surety will be liable for all those sums for which the principal debtor is liable. The creditor may file a suit against the surety without suing the principal debtor. Further, where the creditor holds securities from the principal debtor for his debt, the creditor need not first exhaust his remedies against the securities before suing the surety, unless the contract specifically so provides. The creditor is even not bound to give notice of the default to the surety, unless it is expressly provided for.

Did u know? **Position of Surety in Case of a Minor Principal Debtor**

According to the decision of the Bombay High Court in Kashiba v. Shripat I.L.R. 10 Bom. 1927 the surety can be held liable, though a minor debtor is not liable. But the later decisions of the Bombay High Court have taken a contrary view. In Manju Mahadeo v. Shivappa Manju and in Pestonji Mody v. Meherbai it was held that as under s.128, the

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liability of the surety is co-extensive with that of the principal debtor, it can be no more than that of the principal debtor and that the surety therefore cannot be held liable on a guarantee given for default by a minor. If a minor could not default, the liability of the guarantor being secondary liability does not arise at all. The same view has been endorsed by the Madras High Court in the case of Edavan Nambiar v. Moolaki Raman (A.I.R. 1957 Mad. 164). It was held that unless the contract otherwise provides, a guarantor for a minor cannot be held liable.

3. ***Discharge of Surety:*** The liability of surety under a contract of a guarantee comes to an end under any one of the following circumstances:

   (a) *By notice of revocation (s.130):* A continuing guarantee may at any time be revoked by the surety, as to future transactions, by notice to the creditor.

Example: A, in consideration of B's discounting, at A's request, bills of exchange for C, guarantees to B, for twelve months, the due payment of all such bills to the extent of ₹ 5,000. B discounts bill for C to the extent of ₹ 2,000. Afterwards, at the end of the three months, A revokes the guarantee. The revocation discharges A from liability to B for any subsequent discount. But A is liable to B for ₹ 2,000 on default of C.

   (b) *By the death of surety (s.131):* The death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee, so far as regards future transactions.

   (c) *By variance in terms of the contract (s.133):* Any variance, made without the surety's consent, in the terms of the contract between the principal debtor and the creditor, discharges the surety as to transactions subsequent to the variance.

Example: A becomes surety to C for B's conduct as a manager in C's bank. Afterwards B and C contract, without A's consent, that B's salary shall be raised and that he shall become liable for one-fourth of the losses on overdrafts. B allows a customer to overdraw and the bank loses a sum of money. A is discharged from his suretyship by the variance made without his consent and is not liable to make good this loss.

   (d) *By release or discharge of principal debtor (s.134):* The surety is discharged by any contract between the creditor and principal debtor, by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor.

Examples:

(i) A gives a guarantee to C for goods to be supplied by C to B. C supplies goods to B and afterwards B becomes embarrassed and contracts with his creditors (including C) to assign to them his property in consideration of their releasing him from their demands. Here A is released from his debt by the contract with C and A discharged from his suretyship.

(ii) A contracts with B for fixed price to build a house for A within a stipulated time, B supplying the necessary timber. C guarantees A's performance of the contract. B omits to supply the timber. C is discharged from his suretyship.

   (e) *By compounding with, or giving time to, or agreeing not to sue the principal debtor (s.135):* A contract between the creditor and the principal debtor by which the creditor makes a composition with, or promises to give time to, or not to sue the principal debtor, discharges the surety. The surety shall, however, be not discharged if (a) he assents

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to such contract, (b) the contract to give time to the principal debtor is made by the creditor with a third person and not with the principal debtor.

Example: C, the holder of an overdue bill of exchange drawn by A as surety for B and accepted by B, contracts with M to give time to B. A is not discharged.

(f) *By creditor's act or omission impairing surety's eventual remedy (s.139):* If the creditor does any act which is inconsistent with the right of the surety, or omits to do any act which his duty to the surety requires him to do and the eventual remedy of surety himself against the principal debtor is thereby impaired, the surety is discharged.

Examples:

(i) B contracts to build a ship for C for a given sum to be paid by installments as the work reaches certain stages. A becomes surety of B's due performance of the contract. C, without the knowledge of A, repays to B the last two installments. A is discharged by this prepayment.

(ii) A puts M as an apprentice to B and gives a guarantee to B for M's fidelity. B promises on his part that he will, at least once a month, see M make up the cash. B omits to see this done as promised and M embezzles. A is not liable to B on his guarantee.

(g) *Loss of security:* If the creditor loses or parts with any security given to him by the principal debtor at the time the contract of guarantee was made, the surety is discharged to the extent of the value of the security, unless the surety consented to the release of such security (s.141).

Example: C advances to B, his tenant ₹ 2,000 on the guarantee of A. C has also a further security for the ₹ 2,000 by a mortgage of B's furniture. C cancels the mortgage. B becomes insolvent and C sues A on his guarantee. A is discharged from liability to the amount of value of the furniture.

Self Assessment

Fill in the blanks:

13. Rights of a surety is classified under three heads which are rights against the creditor, rights against the principal debtor and rights against……..

14. In a contract of guarantee there are three parties, viz., the creditor, the principal debtor and the ……..

Caselet

EOUs not Happy with New Sub-contract Norms

—By G Srinivasan

The recent decision by the Government providing broad guidelines for allowing 100 per cent Export-Oriented Units (EOUs) to undertake sub-contracting has left them "disappointed" as the restriction prescribed in the form of furnishing bank guarantee has compounded the problem. Sources in the EOUs told Business Line here that the safeguards brought in place for sub-contracting stipulates that if raw materials are sent

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to the Domestic Tariff Area (DTA) for processing at the first stage itself, exporters have to provide Bank Guarantee (BG) worth the full value of the duty foregone on the material. Furnishing bank guarantee entails complying with additional procedure, additional documentation, additional costs and additional harassment, they say. The sources note that the solution could have been a simple proviso that the jobber be a reasonably identifiable unit either an SSI unit or with proof of legitimate existence like a municipal licence, a lease licence, ownership proof, one-time certificate from any recognised authority that the jobbing unit exists. Again, they say, as far raw materials being supplied to jobber this could be on the basis of Legal Undertaking (LUT) by the EOU and on input-output norms. When contacted, the Joint Secretary in the Ministry of Commerce, in charge of EOUs, Mr D.K. Mittal, said that there was never a ban on EOU sub-contracting or outsourcing a part of their export production, especially units in various key sectors need to outsource work pertaining to fabrication, dyeing and processing. He said the current Exim Policy (2002-07) while permitting job work has imposed a few restrictions. Thus, the flexibility available to EOUs and units located within EPZs as well as Special Economic Zones (SEZs) has been curtailed by stipulating that job work could be awarded only to units registered within the excise authorities. According to the new procedures, the exporter has to import raw materials at his unit and carry out the first process on his own. Sub-contracting is allowed only for subsequent processes and that too only with units that are registered with the excise department.

Source: thehindubusinessline.com

2.8 Contract of Indemnity

2.8.1 Meaning of Indemnity

Sections 124 and 125 provide for a contract of indemnity. Section 124 provides that a contract of indemnity is a contract whereby one party promises to save the other from loss caused to him (the promisee) by the conduct of the promisor himself or by the conduct of any other person. A contract of insurance is a glaring example of such type of contracts.

A contract of indemnity may arise either by (i) an express promise or (ii) operation of law, e.g., the duty of a principal to indemnify an agent from consequences of all lawful acts done by him as an agent. The contract of indemnity, like any other contract, must have all the essentials of a valid contract. These are two parties in a contraction of identity indemnifier and indemnified. The indemnifier promises to make good the loss of the indemnified (i.e., the promisee).

Example: A contracts to indemnify B against the consequences of any proceeding which C may take against B in respect of a certain sum of ₹ 200. This is a contract of indemnity.

2.8.2 Rights of the Indemnified (i.e., the Indemnity Holder)

He is entitled to recover from the promisor: (i) All damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies; (ii) All costs of suit which he may have to pay to such third party, provided in bringing or defending the suit (a) he acted under the authority of the indemnifier or (b) if he did not act in contravention of orders of the indemnifier and in such a way as a prudent man would act in his own case; (iii) All sums which may have been paid under the terms of any compromise of any such suit, if the compromise was not contrary to the orders of the indemnifier and was one which it would have been prudent for the promisee to make.

Notes

2.8.3 Rights of the Indemnifier

The Act makes no mention of the rights of indemnifier. However, his rights, in such cases, are similar to the rights of a surety under s.141, *viz.*, he becomes entitled to the benefit of all the securities which the creditor has against the principal debtor whether he was aware of them or not.

2.8.4 Commencement of Indemnifier's Liability

Indemnity requires that the party to be indemnified shall never be called upon to pay. Indemnity is not necessarily given by repayment after payment. The indemnified may compel the indemnifier to place him in a position to meet liability that may be cast upon him without waiting until the promisee (indemnified) has actually discharged it.

Self Assessment

Fill in the blanks:

15. A contract of indemnity may arise either by an express promise or…….
16. …….requires that the party to be indemnified shall never be called upon to pay.

2.9 Distinction between a Contract of Guarantee and a Contract of Indemnity

L.C. Mather brought out the distinction between indemnity and guarantee by the following illustration. A contract in which A says to B, 'If you lend £20 to C, I will see that your money comes back' is an indemnity. On the other hand undertaking in these words, "If you lend £20 to C and he does not pay you, I will is a guarantee. Thus, in a contract of indemnity, there are only two parties, indemnifier and indemnified. In case of a guarantee, on the other hand, there are three parties, the 'principal debtor', the 'creditor' and the 'surety'. Other points of difference are:

1. The liability of a promisor is primary and independent in a contract of indemnity. In a contract of guarantee, the liability of the surety is secondary, the primary liability being that of the principal debtor.
2. In the case of guarantee, there is an existing debt or obligation, the performance of which is guaranteed by the surety. In case of indemnity the possibility of any loss happening is a contingency against which the indemnifier undertakes to indemnify.
3. In a contract of guarantee, after discharging the debt, the surety is entitled to proceed against the principal debtor in his own name while in case of indemnity, the indemnifier cannot proceed against third parties in his own name, unless there be an assignment in his favour.

Self Assessment

Fill in the blanks:

17. The liability of a promisor is ……..and independent in a contract of indemnity.
18. In a contract of guarantee, the liability of the surety is……....

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Case Study

Fraud Case – False Information

"I didn't receive the products. The supplier said the goods were detained in the Customs Office because Customs didn't find the original invoice attached to the goods. The supplier explained that it's his company's policy was to issue original invoices only when quantities are above 5 units. He told me to pay for another 2 units for another $150 USD, but I have refused. I paid by Western Union. He registered on your website as a US company, but actually it is Chinese Company. All his information is fraudulent. His is a fraudulent company!"

If you think their price is very attractive and want to deal with them, it is very necessary for you to verify that they are legitimate company and their contact information is correct. In this case, the fraudster is pretending to be a US company, but all his registered information is false. This can be judged easily by calling his company telephone number or by searching the company name on related state government websites.

Western Union is a dangerous payment method, it can be picked up anywhere in the recipient's country, with no way of tracing the person who picked it up. The criminal remains anonymous. So it is a commonly used payment method for con-artists. So try to avoid adopting this payment method and consider other more secure payment methods like escrow.

Questions

1. What would you understand if the seller requests you to send payment to another country instead of his registered country showed on the website?
2. What would be the protection available to the seller of the goods in this scenario?
3. Analyse the ways in which a person can find out the whether the company is fraudulent.

Source: http://resources.alibaba.com/article/35541/Fraud_Case_Study_5_The_Contract_trap_.htm.... by resources admin

2.10 Summary

- When two or more persons agree upon the same thing in the same sense, they are said to consent.
- For a contract to be valid it is not only necessary that the parties consent but also that they consent freely.
- Coercion is committing or threatening to commit any act forbidden by the Indian Penal Code.
- Misrepresentation is also known as simple misrepresentation whereas fraud is known as fraudulent misrepresentation.
- Mistake may be defined as an erroneous belief on the part of the parties to the contract concerning something pertaining to the contract.
- A contract of guarantee is defined as a contract to perform the promise, or discharge the liability of a third person in case of his default.

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- The rights of a surety may be against the creditor, the principal debtor; and co-sureties.
- The liability of surety under a contract of guarantee comes to an end under certain circumstances.
- A contract of indemnity is a contract whereby one party promises to save the other from loss caused to him the promise by the conduct of the promisor himself or by the conduct of any other person.
- In a contract of indemnity, there are only two parties, indemnifier and indemnified.

2.11 Keywords

Coercion: It is (i) the committing or threatening to commit any act forbidden by the Indian Penal Code, or (ii) the unlawful detaining or threatening to detain any property to the prejudice of any person whether with the intention of causing any person to enter into an agreement.

Continuing Guarantee: It is a guarantee which extends to a series of transactions.

Contract of Indemnity: It is that contract whereby one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person.

Specific Guarantee: It is a guarantee which is intended to be applicable to a particular debt; and comes to an end on its repayment.

Undue Influence: A contract is said to be induced by undue influence where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other, and uses that position to obtain an unfair advantage over the other.

2.12 Review Questions

1. A advances to B, a minor, ₹ 500 on the guarantee of C. On demand for repayment B pleads minority. Can A recover that amount from C? Justify.
2. "The liability of a surety is secondary and co-extensive with that of principal debtor." Comment.
3. "An attempt to deceive which does not deceive is no fraud." Comment.
4. P contracts to indemnify R against the consequences of the proceedings which S might take against R in respect of a debt due by R. S obtains judgement against R for the amount. Without paying any portion of the decreed amount, R sues P for its recovery. Comment.
5. B, the proprietor of a newspaper, publishes at A's request libel upon C, in the paper. A promise to indemnify B against the consequences of the publication and all costs and damages of any action in respect thereof. B is sued by C and has to pay damages and also incur expenses. Is A liable to make the loss to B? Justify.
6. "Indemnity is not necessarily given by repayment after payment. Indemnity requires that the party to be indemnified shall never be called upon to pay." Discuss.
7. Analyse the situations where the bilateral mistakes may result in making the contract invalid.
8. A company issues a prospectus giving the false information about the unbounded wealth of Nevada. A shareholder buys shares on the faith of such information. He wants to avoid the contract. Can he do so? Comment.
9. "It is not only the consent but free consent of the parties which is necessary for making the contract binding." Comment.

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10. Analyse the circumstances under which a surety may be discharged from the liability by the conduct of the creditor.
11. Analyse the effects of the mistakes on the validity of the contract.

Answers: Self Assessment

1.	consent	2.	freely
3.	Indian Penal Code	4.	voidable
5.	power	6.	full knowledge
7.	false	8.	damages
9.	fraud	10.	three
11.	fact	12.	bilateral
13.	co-sureties	14.	surety
15.	operation of law	16.	Indemnity
17.	primary	18.	secondary

2.13 Further Reading

Book S S Gupta, *Business Law.*

Online links drambedkarlawcollege.com/3years.pdf

www.vakilno1.com/bareacts/indiancontractact/indiancontractact.html

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Unit 3: Contracts of Bailment and Agency

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Objectives

After studying this unit, you will be able to:

- Explain the concept of Bailment;
- Discuss the impression of termination of bailment;
- Describe the purpose and meaning of agency;
- Recognize the rights and duties of agents.

Introduction

At one time or another, we enter into legal relationships, called bailment and pledge. Bailments are quite common in business also. Traders often store their surplus goods in warehouses; and utilise the services of cold storages for keeping their goods to be taken back as and when required; and factory owners often send machinery back to vendors for repairs.

Before the Industrial revolution, business was carried on largely by individual artisans in their homes and in small family operated shops. As population and trade expanded and division of labour and specialization became the order of the day, there arose the problem of distribution of goods. To meet the rising demand, manufacturers and shopkeepers began to hire others to work for them. These helpers or "servants" as they were called performed whatever physical tasks were assigned to them, under the close personal supervision of the "master".

Today, the legal terms master-servant and employer-employee are used interchangeably. Over time, employers delegated a broader range of responsibilities to their employees – for example, by giving them authority to contract for raw materials, to sell finished products and even to employ other employees. In these expanded roles, the employees became known as agents and their employers were called principals. The Indian Contract Act, 1872, makes provisions as regards agency. Sections 182 to 238 deal with the subject of agency.

3.1 Bailment and Duties and Rights of Bailor and Bailee

3.1.1 Definition of Bailment (S.148)

Bailment is defined as the "delivery of goods by one to another person for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of person delivering them". The person delivering the goods is called the 'bailor' and the person to whom the goods are delivered is called the 'bailee'.

The explanation to the earlier Section points out that delivery of possession is not necessary, where one person, already in possession of goods contracts to hold them as bailee.

The bailee is under an obligation to re-deliver the goods, in their original or altered form, as soon as the time of use for, or condition on which they were bailed, has elapsed or been performed". Let's illustrate, (i) A delivers some clothes to B, a dry cleaner, for dry cleaning. (ii) A delivers a wrist watch to B for repairs. (iii) A lends his book to B for reading. (iv) A delivers a suit-length to a tailor for stitching. (v) A delivers some gold biscuits to B, a jewelers, for making jewellery. (vi) Delivery of goods to a carrier for the purpose of carrying them from one place to another. (vii) Delivery of goods as security for the repayment of loan and interest thereon, i.e., pledge.

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From the definition of bailment, the following characteristics should be noted:

1. ***Delivery of goods:*** The essence of bailment is delivery of goods by one person to another for some temporary purpose. Delivery of goods may, however, be actual or constructive. Actual delivery may be made by handing over goods to the bailee. Constructive delivery may be made by doing something which has the effect of putting the goods in the possession of the intended bailee or any person authorised to hold them on his behalf (s.149).

   Examples:

   (a) A, holding goods on behalf of B, agrees to hold them on behalf of C, there is a constructive transfer of possession from C to A.

   (b) A an owner of a scooter, sells it to B, who leaves the scooter in the possession of A. A becomes a bailee, although originally he was the owner.

   It needs to be noted that bailment is concerned with goods only. Current money, i.e., the legal tender (but not old and rare coins) is not goods. A 'deposit of money', therefore, is not bailment.

2. ***Bailment is based on a contract:*** In bailment, the delivery of goods is upon a contract that when the purpose is accomplished, they shall be returned to the bailor. For example, where a watch is delivered to a watch repairer for repair, it is agreed that it will be returned, after repair, on the receipt of the agreed or reasonable charges.

   Though bailment is usually based on a contract, there are certain exceptions, e.g., the case of a finder of lost goods. The finder of lost goods is treated as a bailee of the lost article, though obviously, there is no contract between the finder and the real owner (s.168).

3. ***Return of goods in specie:*** The goods are delivered for some purpose and it is agreed that the specific goods shall be returned. Return of specific goods (in specie) is an essential characteristic of bailment. Thus, where an equivalent and not the same is agreed to be returned, there is no bailment.

   Caution In a bailment, it is only the possession of goods which is transferred and not the ownership thereof, therefore the person delivering the possession of goods need not be the owner; his business is to transfer possession and not ownership.

3.1.2 Kinds of Bailments

Bailments may be, classified into six kinds as follows:

1. ***Deposit:*** Delivery of goods by one person to another for the use of the former, i.e., bailor;
2. ***Commodatum:*** Goods lent to a friend gratis to be used by him;
3. ***Hire:*** Goods lent to the bailee for hire, i.e., in return for payment of money;
4. ***Pawn or Pledge:*** Deposit of goods with another by way of security for money borrowed;
5. Delivery of goods for being transported, or something to be done about them, by the bailee for reward;
6. Delivery of goods as in (5) above, but without reward.

Notes

3.1.3 Duties and Rights of Bailor and Bailee

Duties of a Bailor

1. ***To disclose known faults in the goods (s.150):*** The bailor is bound to disclose to the bailee faults in the goods bailed, of which the bailor is aware and which materially interfere with the use of them or expose the bailee to extraordinary risks. If he does not make such disclosure, he is responsible for the damage arising to the bailee directly from such faults.

   If the goods are bailed for hire or reward, the bailor is responsible for such damage whether he was or was not aware of the existence of such faults in goods bailed.

Examples:

(a) A lends a horse, which he knows to be vicious, to B. He does not disclose the fact that the horse is vicious. The horse runs away. B is thrown and injured. A is responsible to B for damage sustained.

(b) A hires a carriage of B. The carriage is unsafe though B is not aware of it. A is injured. B is responsible to A for injury.

2. ***Liability for breach of warranty as to title:*** The bailor is responsible to the bailee for any loss which the bailee may sustain by reason that the bailor was not entitled to make the bailment, or to receive back the goods or to give directions respecting them (s.164).

Example: A gives B's car to C without B's knowledge and permission. B sues C and receives compensation. A, the bailor, is responsible to make good this loss to C, the bailee.

3. ***To bear expenses in case of gratuitous bailments:*** Regarding bailments under which bailee is to receive no remuneration, s.158 provides that in the absence of a contract to the contrary, the bailor must repay to the bailee all necessary expenses incurred by him for the purpose of the bailment.

4. ***In case of non-gratuitous bailments:*** The bailor is held responsible to bear only extraordinary expenses.

Example: A car is lent for a journey. The ordinary expenses like petrol, etc., shall be borne by the bailee but in case the car goes out of order, the money spent in its repair will be regarded as an extraordinary expenditure and borne by the bailor.

Duties of a Bailee

1. ***To take care of the goods bailed (s.151):*** In all cases of bailment, the bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quality and value as the goods bailed.

   In case, bailee has taken the amount of care as described above, he shall not be responsible, in the absence of any special contract, for the loss, destruction or deterioration of the thing bailed (s.152).

2. ***Not to make unauthorized use of goods (s.154):*** In case the bailee makes unauthorised use of goods, i.e., uses them in a way not warranted by the terms of bailment, he is liable to

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make compensation to the bailor for any damages arising to the goods from or during such use of them.

Examples:

(a) A lends a car to B for his own driving only. B allows C, his wife, to drive the car. C drives with care, but the car is damaged in an accident. A is liable to make compensation to B for the damage done to the car.

(b) A hires a car in Kolkata from B expressly to drive to Varanasi. A drives with due care, but drives to Cuttack instead. The car meets with an accident and is damaged. B is liable to make compensation to A for the damage to the car.

3. ***Not to mix bailor's goods with his own (Ss. 155-157):*** If the bailee without the consent of the bailor, mixes the goods of the bailor with his own goods and the goods can be separated or divided, the bailee shall be bound to bear the expense of separation or division and any damages arising from the mixture.

Example: A bails 100 bales of cotton marked with a particular mark to B. B, without A's consent, mixes the 100 bales with other bales of his own bearing a different mark. A is entitled to have his 100 bales returned and B is bound to bear all expenses incurred in the separation of the bales and any other incidental damage.

But in case goods are mixed in such a manner that it is impossible to separate the goods bailed from the other goods and deliver them back, the bailor is entitled to be compensated by the bailee for the loss of the goods.

Example: A bails a barrel of flour worth ₹ 450 to B. B without A's consent mixes the flour with flour of his own, worth only ₹ 250 a barrel. B must compensate A for the loss of his flour.

4. ***To return the goods bailed without demand (s.160):*** It is the duty of the bailee to return, or deliver according to the bailor's directions, the goods bailed, without demand, as soon as the time for which they were bailed has expired, or the purpose, for which they were bailed has been accomplished.

   If bailee fails to return the goods at the proper time, he is responsible to the bailor for any loss, destruction or deterioration of the goods from that time (s.161).

5. ***To return any accretion to the goods bailed (s.163):*** In the absence of any contract to the contrary, the bailee is bound to deliver to the bailor, or according to his directions, any increase or profit which may have accrued from the goods bailed.

Example: A leaves a cow in the custody of B to be taken care of. The cow gives birth to a calf. B is bound to deliver the cow as well as the calf to A.

Rights of a Bailee

1. ***The duties of the bailor are, in fact, if looked from the point of view of bailee, the bailee's rights:*** Thus, a bailee can sue bailor for (a) claiming compensation for damages resulting from non-disclosure of faults in the goods; (b) for breach of warranty as to the title and the damage resulting therefrom; and (c) for extraordinary expenses. Thus in the case of wrongful deprivation the bailee has a right to use the same remedies which the owner might have used in the like case.

Notes

2. ***Another right of bailee is the right of lien (Ss. 170-171):*** Lien is a right in one person to retain that which is in his possession, belonging to another, until some debt or claim is paid, Lien, thus presupposes two things: (i) The person vested with the right of lien is in possession of the goods or securities in the ordinary course of business. (ii) The owner (bailor in this case) has a lawful debt due or obligation to discharge to the person in possession of the said goods or securities (bailee in this case). Since, lien is available only until the debt or claim is satisfied, once the debt is satisfied or obligation discharged, the right of lien is extinguished. The property so retained has, then, to be returned to or kept at the disposal of the owner (i.e., bailor). Lien may be of two types: (i) General Lien and (ii) Particular Lien.

   General Lien means the right to retain goods not only for demands arising out of the goods retained but for a general balance of account in favour of certain persons. Particular Lien, on the other hand, means the right to retain the particular goods in respect of which the claim is due. Bailee's right of lien is particular in certain cases whereas general in other cases. Particular Lien is conferred upon a bailee by virtue of the provisions of s. 170. It reads: "Where the bailee has, in accordance with the purpose of the bailment, rendered any service involving the exercise of labour or skill in respect of the goods bailed, he has, in the absence of a contract to the contrary, a right to retain such goods until he receives due remuneration for the service he has rendered in respect of them".

   Examples:

   (a) A delivers a rough diamond to B, a jeweller, to be cut and polished, which is accordingly done. B is entitled to retain the stone till he is paid for the services he has rendered.

   (b) A gives cloth to B, a tailor, to make into a coat. B promises A to deliver the coat as soon as it is finished and to give a three months' credit for the price. B is not entitled to retain the coat until he is paid.

   The provisions of s.171 empower certain categories of bailees to exercise a general lien. These include: bankers, factors, wharfingers, attorneys of High Court and policy brokers. These bailees can retain all goods of the bailor so long as anything is due to them, unless there is a contract to the contrary.

3. ***Right against wrongful deprivation of or injury to goods (Ss.180-181).*** If a third person wrongfully deprives the bailee of the use or possession of the goods bailed, or causes them any injury, the bailee is entitled to use such remedies as the owner might have used in the like case if no bailment had been made and either the bailor or the bailee may bring a suit against the third person for such deprivation or injury. Now, whatever is obtained by way of relief or compensation in such a suit shall, as between the bailor and the bailee, be dealt with according to their respective interest (s.181).

Rights of a Bailor

1. The bailor can enforce, by suit, all duties or liabilities of the bailee.

2. In case of gratuitous bailment (i.e., bailment without reward), the bailor can demand their return whenever he pleases, even though he lent it for a specified time or purpose. But if, on the faith of such bailment, the borrower has acted in such a manner that the return of the thing before the specified time would cause him (i.e., the bailee) loss exceeding the benefit derived by him from the bailment, the bailor must indemnify the borrower for the loss if he compels an immediate return (s.159).

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3.1.4 Termination of Bailment

A contract of bailment terminates or comes to an end under the following circumstances:

1. ***On the expiry of the stipulated period:*** Where bailment is for a specific period, it comes to an end on the expiry of the specified period.

Example: A room cooler is hired by X from Y for a period of 6 months. On the expiry of 6 months X must return the cooler.

2. ***On the accomplishment of the specified purpose:*** In case, bailment is for specific purpose it terminates as soon as the purpose is accomplished.

Examples:

(a) A suit length is given to a tailor to be stitched into a suit. The tailor is bound to return it as soon as the cloth is stitched into suit.

(b) A hires from B certain tents and crockery on marriage of his daughter. The same must be returned as soon as marriage is accomplished.

3. ***By bailee's act inconsistent with conditions of bailment:*** If the bailee does any act with regard to the goods bailed, inconsistent with the conditions of the bailment, the bailor may terminate the bailment (s.153).

Example: A lets to B for hire, a horse for his own riding. B drives the horse in his carriage. A shall have the option to terminate the bailment.

4. ***A gratuitous bailment may be terminated at any time (s.159):*** However, if premature termination causes any loss to the bailee exceeding the benefit derived from the bailment, the bailor must indemnify. Further, a gratuitous bailment terminates by the death of either the bailor or the bailee (s.162).

Self Assessment

Fill in the blanks:

1. The essence of bailment is delivery of goods by one person to another for some ……purpose.
2. In case, bailment is for specific purpose it terminates as soon as the purpose is ……..

3.2 Finder of Lost Goods

Finding is not owning. A finder of lost goods is treated as the bailee of the goods found as such and is charged with the responsibilities of a bailee, besides the responsibility of exercising reasonable efforts in finding the real owner. However, he enjoys certain rights also. They are:

1. ***Right to retain the goods (s.168):*** A finder of lost goods may retain the goods until he receives the compensation for money spent in preserving the goods and/or amount spent in finding the true owner. A finder, however, cannot sue for such compensation. But where, a specific reward has been offered by the owner for the return of the goods lost, the finder may sue for such reward and may retain the goods until he receives it.

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2. ***Right to sell (s.169):*** When a thing which is commonly the subject of sale is lost, if the owner cannot with reasonable diligence be found or if he refuses, upon demand, to pay the lawful charges of the finder, the finder may sell it. (i) when the thing is in danger of perishing or of losing the greater part of its value; (ii) when the lawful charges of the finder in respect of the thing found, amount to two-third of its value.

Self Assessment

Fill in the blanks:

3. A finder of lost goods is treated as the ……of the goods found.
4. A finder of lost goods may retain the goods until he receives the compensation for money spent in preserving the goods and amount spent in finding the……...

3.3 Definition of Agent and Agency and Kinds of Agencies

3.3.1 Meaning of Agent and Agency (S.182)

Agent is "a person employed to do any act for another or to represent another in dealings with third person". Thus, agent is a person who acts in place of another. The person for whom or on whose behalf he acts is called the Principal. For instance, Anil appoints Bharat, a broker, to sell his Maruti Car on his behalf. Anil is the Principal and Bharat is his agent. The relationship between Anil and Bharat is called Agency. This relationship is based upon an agreement whereby one person acts for another in transaction with a third person.

The function of agent is to bring about contractual relation between the principal and a third party. The agent is only a connecting link between the principal and the third party and is rightly called as 'conduit pipe'. The acts of the agent, within the scope of the instructions, bind the principal as if he has done them himself. The phrase *'qui facit per alium facit per se'* contains the principle of agency, which means, he who does through another does by himself. In simple words, the act of agent is the act of the principal.

Agent must be distinguished from a servant. A servant acts under the direct control and supervision of his master and is bound to carry out all his reasonable orders. Agent, on the other hand, though bound to exercise his authority in accordance with lawful instructions of the principal is not subject to his direct supervision and control. Agent, therefore, is not a servant; though a servant, may for some purposes, be his master's agent. Further, agent may work for several principals at the same time, a servant usually serves only one master.

No consideration is necessary to create agency (s. 185). The fact that the principal has consented to be represented by the agent is a sufficient detriment and consideration to support the promise of the agent to act in that capacity. However, in case no consideration has passed to the agent, he is not bound to do the agreed work, but once he begins, he must complete it to the satisfaction of the principal.

Who can Employ Agent?

Any person who is of the age of majority according to the law to which he is subject and who is of sound mind, may employ agent (s.183). No qualifications as such are prescribed for a person to be agent except that he has attained majority and is of sound mind. Thus, a minor or a lunatic cannot contract through agent since they cannot contract themselves personally either. If agent

Notes

acts for a minor or lunatic, he will be personally liable to the third party. Association or group of persons may also appoint agent; for instance, a partnership firm may, transact business through agent. Certain group of persons, because of the very nature of their organisation, must act through agent, e.g., a company, which is an artificial person and thus can transact business only through agent.

Who may be Agent?

Since agent is a mere connecting link or a 'conduit pipe' between the principal and the third party, it is immaterial whether or not the agent is legally competent to contract. Thus, there is no bar to the appointment of a minor as agent. However, in considering the contract of agency itself (i.e., the relation between principal and agent), the contractual capacity of the agent becomes important. Thus, no person who is not of the age of majority and of sound mind can become agent, as to be responsible to his principal (s.184). Thus, if the agent happens to be a person incapable of contracting, then the principal cannot hold the agent liable, in case he misconducts or has been negligent in the performance of his duties.

Example: Rahim appoints Kiran, a minor, to sell his car for not less than ₹ 90,000. Kiran sells it for ₹ 80,000. Rahim will be held bound by the transaction and further shall have no right against Kiran for claiming the compensation for having not obeyed the instructions, since Kiran is a minor and a contract with a minor is void *ab initio*.

3.3.2 Different Kinds of Agencies

A contract of agency may be created by an express agreement or by implication (implied agreement) or by ratification. Thus, there are different kinds of agencies.

Express Agency (S.187)

A person may be appointed as agent, either by word of mouth or by writing. No particular form is required for appointing agent. The usual form of a written contract of agency is the power of attorney on a stamped paper.

Implied Agency (S.187)

Implied agency arises from the conduct, situation or relationship of parties. Implied agency, therefore, includes agency by estoppel, agency by holding out and agency of necessity.

Agency by Estoppel (S.237)

When a person has, by his conduct or statements, induced others to believe that a certain person is his agent, he is estopped from subsequently denying it. The principal is precluded from denying the truth of agency which he himself has represented as a fact, although it is not a fact.

Examples:

1. Prakash allows Anand to represent as his agent by telling Cooper that Anand is Prakash's agent. Later on, Cooper supplied certain goods to Anand thinking him to be Prakash's agent. Prakash shall be liable to pay the price to Cooper. By allowing Anand to represent himself as his agent, Prakash leads Cooper to believe that Anand is really his agent.

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2. Anand owns a shop in Serampur, living himself in Kolkata and visiting the shop occasionally. The shop is managed by Bharat and he is in the habit of ordering goods from Cooper in the name of Anand for the purposes of the shop and of paying for them out of Anand's funds with Anand's knowledge. Bharat has an implied authority from Anand to order goods from Cooper in the name of Anand for the purposes of the shop.

Agency by Holding Out

Though part of the law of estoppel, some affirmative conduct by the principal is necessary in creation of agency by holding out.

Example: Puran allows his servant Amar to buy goods for him on credit from Komal and pay for them regularly. On one occasion, Puran pays his servant in cash to purchase the goods. The servant purchases good on credit pocketing the money. Komal can recover the price from Puran since through previous dealings Puran has held out his servant Amar as his agent.

Agency of Necessity (S.189)

This arises where there is no express or implied appointment of a person as agent for another but he is forced to act on behalf of a particular person.

Examples:

1. The Master of a ship, which is in distress and requires heavy and urgent repairs, can pledge the ship or cargo (without express or implied authority) and raise money in order to execute the voyage. He will be considered as the agent of the owner by necessity.
2. A horse is sent by rail and at the destination is not taken delivery by the owner. The station master has to feed the horse. He has become the agent by necessity and hence the owner must compensate him.

The doctrine of agency by necessity also extends to cases where agent exceeds his authority provided (a) it was not reasonably possible to get the principal's instructions, (b) the agent had taken all reasonable and necessary steps to protect the interests of the principal and (c) he acted *bona fide*.

Agency by Ratification (Ss.196-200)

Where agent does an act for his principal but without knowledge of authority, or where he exceeds the given authority, the principal is not held bound by the transaction. However, s.196 permits the principal, if he so desires, to ratify the act of the agent. If he so elects, it will have the same effect as if the act was originally done by his authority. Agency in such a case is said to be created by ratification. In other words, the agency is taken to have come into existence from the moment the agent first acted and not from the date of principal's ratification. The rule is that every ratification relates back and is equivalent to a previous command or authority.

Example: Lallan makes an offer to Badal, Managing Director of a company. Badal accepts the offer though he has no authority to do so. Lallan subsequently withdraws the offer, but the company ratifies Badal's acceptance. Lallan is bound by the offer. The ratification by the company relates back to the time Badal accepted the offer, thus rendering the revocation of the offer inoperative. An offer once accepted cannot be withdrawn.

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However, for the rule of relation back to apply, the agent while accepting an offer should not show lack of authority, e.g., where he accepts, 'subject to ratification', the rule of relation back does not apply and revocation shall be valid, if communicated prior to such ratification.

Express and implied ratification (s.197): The ratification may be express or implied.

Examples:

1. Amar without Puran's authority lends Puran's money to Kamal. Later Puran accepts interest on the money from Kamal. Puran's conduct implies ratification of the loan.
2. Amar without Puran's authority buys certain goods for him. Afterwards, Puran sells those goods to Kamal. Puran's conduct ratifies the purchase made by Amar.

Requisites of a valid ratification: To be valid, ratification must fulfil certain conditions. These conditions are:

1. The agent must contract as agent; he must not allow the third party to imagine that he is the principal. A person cannot enter into a contract at his own and later shift it to another.
2. The principal must have been in existence at the time the agent originally acted. This condition is significant in case of a company. The preliminary contracts entered into by promoters of a company on its behalf cannot be ratified by the company after incorporation because, if permitted, ratification will relate back to the point of time when promoters originally acted and at that time the company was not in existence. How can a person, not in existence, be a party to a contract?
3. The principal must not only be in existence but must also have contractual capacity at the time of the contract as well as at the time of ratification. Thus, a minor on whose behalf a contract is made cannot ratify it on attaining majority.
4. Ratification must be made within a reasonable time. What is a reasonable time shall vary from case to case.
5. The act to be ratified must be a lawful one. There can be no ratification of an illegal act or an act which is void ab initio.
6. The principal should have full knowledge of the facts (s.198).
7. Ratification must be of the contract as a whole. The principal cannot reject the burden and accept only the benefits.
8. Ratification of acts not within the principal's authority is ineffective. This again is basically relevant in case of companies. The acts of directors which are ultra vires the powers of a company cannot be ratified by the company.
9. Ratification cannot be made so as to subject a third party to damages or terminate any right or interest of a third person (s.200).

Example: Amar holds a lease from Bharat terminable on three months notice. Cooper, an unauthorised person, gives notice of termination to Amar. The notice cannot be ratified by Bharat, so as to be binding on Amar.

Self Assessment

Fill in the blanks:

5. A contract of agency may be created by an express agreement or by ……
6. …… agency arises from the conduct, situation or relationship of parties.

Notes

3.4 Classification of Agents

Agents may be classified from different points of view. One broad classification of agents is: (i) mercantile or commercial agents and (ii) non-mercantile or non-commercial agents. Another classification of agents is: (1) general and (2) special.

3.4.1 Special and General Agents

A special agent is a person appointed to do some particular act or enter into some particular contract. A special agent, therefore, has only a limited authority to do the specified act. If he does anything beyond the specified act, he runs the risk of being personally liable since the principal may not ratify the same. A general agent, on the other hand, is one who is appointed to represent the principal in all matters concerning a particular business, e.g., manager of a firm or managing director of a company.

3.4.2 Mercantile or Commercial Agents

A mercantile or commercial agent may assume any of the following forms: broker, factor, commission agent, del credere agent, auctioneer, banker, Pakka and Katcha Adatias and indentor. A broker is a mercantile agent engaged to buy and/or sell property or to make bargains and contracts between the engager and third party for a commission (called brokerage). A broker has no possession of goods or property. He is merely a connecting link between the engager and a third party. The usual method of dealing by a broker is to make entries of the terms of contract in a book, called the memorandum book and to sign them. He then sends the particulars of the same to both parties. The document sent to the seller is called the sold note and the one sent buyer is called the bought note. A factor is a mercantile agent who is entrusted with the possession of goods with an authority to sell the same. He can even sell the goods on credit and in his own name. He is also authorised to raise money on their security. A factor has a general lien on the goods in his possession. A factor, however, cannot barter the goods, unless expressly authorised to do. Also, he cannot delegate his authority.

A commission agent is agent who is employed to buy or sell goods or transact business. The remuneration that he gets for the purpose is called the commission. A commission agent is not liable in case the third party fails to carry out the agreed obligation. A commission agent may have possession of the goods or not. His lien in case of goods in his possession is a particular lien. A del credere agent is one who, in consideration of an extra remuneration, called a del credere commission, guarantees the performance of the contract by the other party. A del credere agent thus occupies the position of a guarantor, as well as of agent. He is normally appointed in case of deals with foreign nationals, about whom the principal may know nothing.

Did u know? An auctioneer is agent appointed to sell goods by auction. He can deliver the goods only on receipt of the price. An auctioneer can recover the price from the highest bidder (i.e., the buyer) by filing a suit in his own name. In any case, an auctioneer can sell only by public auction and not by a private contract. His position differs from a factor in as much as the auctioneer has a particular lien, whereas the factor has a general lien.

Though the relationship between banker and customer is ordinarily that of debtor and creditor, he acts as his agent when he buys or sells securities on his behalf. Similarly, when he collects cheques, bills, interest, dividends, etc., or when he pays insurance premium out of customer's account, as per customer's mandate, he acts as his agent.

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A Pakka adatia is a person who guarantees the performance of the contract, not only to his principal but also to the broker (shroff) on the other side. A peculiarity of pakka adatia is that he can himself perform the contract instead of offering it to the third party. A Katcha Adatia, on the other hand, does not guarantee the performance of the contract. However, he guarantees the performance on the part of the principal. Thus, he will be responsible to the other broker or shroff who contracts on behalf of the other party, in case of non-performance by his principal.

An indentor is a commission agent, who for a commission procures a sale or a purchase on behalf of his principal, with a merchant in a foreign country. Such agent gets commission at the rates mentioned in the indent.

3.4.3 Non-mercantile or Non-commercial Agents

Some of the agents in this category are: wife, estate agent, counsels (advocates), attorneys. The following principles provide guidelines as regards wife as agent of her husband: (i) If the wife and husband are living together and the wife is looking for necessaries, she is agent. But this presumption may be rebutted and the husband may escape liability if he can prove that (a) he had expressly forbidden his wife from purchasing anything on credit or from borrowing money, (b) goods, purchased were not necessaries, (c) he had given sufficient money to his wife for purchasing necessaries, or (d) the trader had been expressly told not to give credit to his wife. (ii) Where the wife lives apart from the husband, through no fault of hers, the husband is liable to provide for her maintenance. If he does not provide further maintenance, she has an implied authority to bind the husband for necessaries, i.e., he would be bound to pay her bills for necessaries. But where the wife lives apart under no justifiable circumstances, she is not her husband's agent and thus cannot bind him even for necessaries.

3.4.4 Sub-agent and Substituted Agent (Ss. 190-195)

The general rule is that agent cannot appoint agent. The governing rule is enshrined in a maxim 'a delegate cannot further delegate'. Agent being a delegate cannot transfer his duties to another. The principle underlying the rule is that the principal engages agent ordinarily on personal consideration and thus may not have the same confidence in the person appointed by the agent. Hence, sub-agency is not generally recognised. However, s.190 deals with the circumstances as to when and how far agent can delegate his duties. Agent may appoint agent in the following circumstances: (i) where expressly permitted by the principal; (ii) where the ordinary custom of the trade permits delegation; (iii) the nature of agency is such that it cannot be accomplished without the appointment of a sub-agent; (iv) where the nature of the job assigned to the agent is purely clerical and does not involve the exercise of discretion, e.g., if Anthony is appointed to type certain papers, because of lack of time, he assigns the job to another equally competent typist Bharat, the delegation is valid; (v) in an unforeseen emergency.

Under the above-mentioned circumstances stipulated by s.190, if agent appoints another person in the matter of the agency, that other person may assume the position of either a sub-agent or a substituted agent. Section 191 states that a sub-agent is a person employed by and acting under the control of the original agent in the business of agency. Since the sub-agent is appointed by the act and under the control of the agent, there is no privity of contract between the sub-agent and the principal. The sub-agent, therefore, cannot sue the principal for remuneration and, similarly the principal cannot sue the sub-agent for any moneys due from him. Each of them can proceed against his immediate contracting party, viz, the agent except where the sub-agent is guilty of fraud. In that case the principal has a concurrent right to proceed against the agent and the sub-agent. A sub-agent properly appointed, however, can represent the principal and bind him for his acts as if he were agent originally appointed by the principal. But where agent, without having the authority to do so, has appointed a sub-agent, the principal is not represented

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by or responsible for the acts of such a sub-agent. The sub-agent can only bind the agent by contracts entered into with third parties.

Where agent appoints or names another person for being appointed as agent in his place, such person is called a substituted agent (s.194).

Examples:

1. Amar directs Bharat, his solicitor, to sell his estate by auction and to employ an auctioneer for the purpose. Bharat names Cooper, an auctioneer, to conduct the sale. Cooper is not a sub-agent, but is Amar's agent for the conduct of the sale.
2. Amar authorises Bharat, a merchant in Kolkata, to recover the money due to Amar from Cooper and Co. Bharat instructs Dalip, a solicitor to take proceedings against Cooper and Co. for the recovery of the money. Dalip is not a sub-agent but is a solicitor for Amar.

Self Assessment

Fill in the blanks:

7. A ……..agent is a person appointed to do some particular act or enter into some particular contract.
8. Where agent appoints or names another person for being appointed as agent in his place, such person is called a ……agent

3.5 Duties and Rights of Agent

3.5.1 Duties of Agent

The duties of agent towards his principal are:

1. ***To conduct the business of agency according to the principal's directions (s.211):*** The duty of the agent must be literally complied with, i.e., the agent is not supposed to deviate from the directions of the principal even for the principal's benefit. If he does so, any loss occasioned thereby shall have to be borne by the agent, whereas any surplus must be accounted for to the principal.

Examples:

(a) Anil is directed by his principal to warehouse the goods at a particular warehouse. He warehouses a portion of the goods at another place, equally good but cheaper. The goods are destroyed by fire. Anil, the agent, is liable to make good the loss.

(b) A principal instructs his agent to deliver goods only against cash but the agent delivers them on credit. In such a case the agent would be liable for the price which the purchaser fails to pay.

In the absence of instructions from the principal, however, the agent should follow the custom of the business at the place where it is conducted.

2. ***The agent should conduct the business with the skill and diligence*** that is generally possessed by persons engaged in similar business, except where the principal knows that the agent is wanting in skill (s.212).

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Example: Where a lawyer proceeds under a wrong section of law and thereby the case is lost, he shall be liable to his client for the loss.

3. ***To render proper accounts (s.213):*** The agent has to render proper accounts. If the agent fails to keep proper accounts of the principal's business, everything consistent with the proved facts will be presumed against him. Rendering of accounts does not mean showing the accounts, but maintaining proper accounts supported by vouchers.

4. ***To communicate with the principal in case of difficulty (s.214):*** It is the duty of agent, in case of difficulty, to use all reasonable diligence, in communicating with his principal and in seeking to obtain his instructions. In case of emergency, however, the agent can do all that a reasonable man would, under similar circumstances, do with regard to his own business. He becomes agent by necessity.

5. ***Not to make any secret profits:*** Agent should deliver to the principal all moneys including secret commission received by him. He can, however, deduct his lawful expenses and remuneration.

6. ***Not to deal on his own account:*** Agent should not deal on his own account without first obtaining the consent of his principal. If he does so, the principal can claim from the agent any benefit which he might have obtained.

Example: Pawan directs Amar, his agent, to buy a particular house for him. Amar tells Pawan that it cannot be bought, but buys the house for himself. Pawan may, on discovering that Amar has bought the house, compel him to sell it to Pawan at the price he bought.

Further, in case agent deals on his own account, he shall cease to be entitled for his remuneration as agent.

7. ***Not entitled to remuneration for misconduct (s.220):*** Agent who is guilty of misconduct in the business of agency is not entitled to any remuneration in respect of that part of the business which he has misconducted.

Examples:

(a) Amar employs Bharat to recover ₹ 50,000 from Cooper and to lay it out on a good security. Bharat recovers the amount and lays out ₹ 30,000 on good security, but lays out ₹ 20,000 on security which he ought to have known to be bad whereby Amar loses ₹ 5,000. Bharat is entitled to remuneration for recovering ₹ 50,000; and for investing ₹ 30,000. He is not entitled to any remuneration for investing ₹ 20,000 and he must make good the ₹ 5,000 to Amar.

(b) Amar employs Bharat to recover ₹ 10,000 from Cooper. Through Bharat's misconduct the money is not recovered. Bharat is not entitled to any remuneration for his services and must make good the loss.

8. ***Not to disclose confidential information supplied*** to him by the principal.

9. ***To take all reasonable steps for the protection and preservation of the interests entrusted to him*** when the principal dies or becomes of unsound mind (s.209).

3.5.2 Rights of Agent

Agent has a number of rights. These are:

1. ***Right to remuneration (Ss.219-220):*** Agent is entitled to his agreed commission or remuneration and if there is no agreement, to a reasonable remuneration. But the

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remuneration does not become payable unless he has carried out the object of agency, except where there is a contract to the contrary.

2. ***Right of retainer (s.217):*** Agent may retain, out of any sums received on account of the principal in the business of the agency, all moneys due to himself in respect of advances made or expenses properly incurred by him in conducting such business and also such remuneration as may be payable to him for acting as agent. This is known as agent's right of retainer. However, the right of retainer can only be claimed on moneys received by him in the business of agency. He cannot, therefore, retain sums received by him in one business for his commission or remuneration in an other business on behalf of the same principal.

3. ***Right of lien (s.221):*** In the absence of any contract to the contrary, agent is entitled to retain goods, papers and other property, whether movable or immovable of the principal received by him, until the amount due to himself for commission, disbursements and services in respect of the same has been paid or accounted for to him. This lien of the agent is a particular lien confined to all claims arising in respect of the particular goods and property. By a special contract, however, agent may get a general lien extending to all claims arising out of the agency. Since, the word 'lien' means retaining possession, it can be enjoyed by the agent only where the goods or papers are in actual or constructive possession of the agent. The right of lien will, therefore, be lost where he parts with the possession of goods or papers. But if the possession is obtained from the agent by fraud or unlawful means, his lien is not affected by the loss of possession.

4. ***Right of stoppage in transit:*** The agent can stop the goods while in transit in two cases: (a) Where he has purchased goods on behalf of the principal either with his own funds, or by incurring a personal liability for the price, he stands towards the principal in the position of an unpaid seller. Like an unpaid seller, he enjoys the right of stopping the goods in transit if in the meantime the principal has become insolvent. (b) Where agent holds himself liable to his principal for the price of the goods sold, for example, del credere agent, he may exercise the unpaid seller's right of stopping the goods in transit in case of buyer's insolvency.

5. ***Right of indemnification (Ss. 222-224):*** The principal is bound to indemnify agent against the consequences of all lawful acts done by the agent in exercise of authority conferred on him.

Example: John, at Singapore, under instructions from Amin at Kolkata, contracts with Cooper to deliver certain goods to him. Amin does not send the goods to John and Cooper sues John for breach of contract. John informs Amin of the suit and Amin authorises him to defend the suit. John defends the suit and is compelled to pay damages and costs and incurs expenses. Amin is liable to John for such damages, cost and expenses.

Section 223 further provides that agent shall have a right to be indemnified against consequences of acts done in good faith.

Example: B, at the request of A, sells goods in the possession of A, but which A had no right to dispose of. B does not know this and hands over the proceeds of the sale to A. Afterwards C, the true owner of goods, sues B and recovers the value of the goods and costs. A is liable to indemnify B for what he has been compelled to pay to C and for B's own expenses, provided C has acted in good faith and he had no knowledge that the goods did not belong to A.

However, it must be remembered that agent cannot claim indemnification for criminal act, even though the principal had agreed to do so (s.224).

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Examples:

(a) A employs B to beat C and agrees to indemnify him against all consequences of that act. B thereupon beats C and has to pay damages to C for so doing. A is not liable to indemnify B for those damages.

(b) B, the proprietor of a newspaper, publishes, at A's request, a libel (defamation in writing) upon C in the paper and A agrees to indemnify B against the consequences of the publication and all costs and damages of any action in respect thereof. B is sued by C and has to pay damages and also incurs expenses. A is not liable to B on the indemnity.

6. ***Right to compensation for injury caused by principals neglect (s.225):*** The principal must make compensation to his agent in respect of injury caused to such agent by the principal's neglect or want of skill.

Example: A employs B as a bricklayer in building a house and puts up the scaffolding himself. The scaffolding is unskillfully put up and B is in consequences hurt. A must make compensation to B.

Self Assessment

Fill in the blanks:

9. Agent who is guilty of misconduct in the business of agency is not entitled to any remuneration in respect of that part of the business which he has……..

10. The principal is bound to …….agent against the consequences of all lawful acts done by the agent in exercise of authority conferred on him.

Caselet

Insurance Companies Oppose Agent Rebating

—by M Ramesh

Over the years, it has been almost a standard practice for the agents of Life Insurance Corporation to give their customers a part of their commission. They usually paid the first quarter's premium on behalf of the customer. That this practice is illegal, is a fact, and therefore not a matter of opinion. However, there are two views over whether the law should prohibit this 'rebating', or not.

Most life insurance companies support banning of rebating, although they all agree that monitoring this is almost impossible. "There has to be a change in awareness level for all customers to refrain from rebating," says Ms Suniti Ghoshal, Head-Corporate Communications, Aviva Life Insurance (formerly, Dabur CGU Life Insurance).

"This industry has been with a monopoly player, hence certain things have only been done without being questioned much," Ms Ghoshal said, in an e-mail to Business Line.

Other insurance companies agree. "An agent rebates in order to shorten his sales cycle. This shortening of process often leads to misrepresentation resulting in poor service quality," says a spokesman of Max New York Life Insurance. However, another point of view of the same issue is that there is no point in prohibiting rebating by agents, which is

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any way extremely difficult to monitor. Advocates of this view point out that in most countries, insurance companies are even allowed to extend credit to their customers for premiums. In India, a claim is payable if and only if the premium has been received in full. Rebating is in a way an informal credit extended to the customer by the agent.

After all, the agent is paying out of his pocket. Why prohibit rebating only in the insurance industry, when discount is a way of life in all other industries?

But insurance companies do not like it. Mr Dilip Gazaaro, Head-Retail Sales, HDFC Standard Life, says that his company actually dismissed an agent for rebating.

At Aviva, the Financial Planning Advisers are trained to handle such demands, says Ms Ghosal. "They can explain the customer as to why he needs to pay the agent for his service. If the customer can pay substantial amounts for premium, he also needs to ensure that the advice he receives and the service he avails of for his policy are the best in terms of quality and integrity." Max New York Life's spokesman echoes similar views. "We as an industry are also establishing a code of conduct against such practices. At the Life Insurance Executive Council, we have recommended that the penalty for rebating be increased from ₹ 500 to ₹ 10,000." There are others who believe that rebating should continue to be illegal, no matter how difficult it is to monitor. Says Mr N. Raveendran, Director, Alegion Risk Management Services (which proposes to become a general insurance broker), "Legalising rebating would drive away the serious agents who do not usually give rebates". He says that there would come a time, when the society matures enough to be willing to pay for a service, that rebating will automatically go away.

After all, you don't necessarily go to the doctor who charges the least. But legalising rebating would push back the arrival of such a time.

Source: thehindubusinessline.com

3.6 Principal's Duties to the Agent and his Liability to Third Parties

3.6.1 Duties of a Principal

The rights of agent are in fact the duties of the principal. Thus a principal is (i) bound to indemnify the agent against the consequences of all lawful acts done by such agent in exercise of the authority conferred upon him (s.222); (ii) liable to indemnify agent against the consequences of an act done in good faith, though it causes an injury to the rights of third persons (s.223); (iii) bound to compensate his agent in respect of injury caused to such agent by the principal's neglect or want of skill (s.225).

The principal is, however, not liable for acts which are criminal in nature though done by the agent at the instance of the principal (s.224).

3.6.2 Liability of Principal to Third Parties

1. Agent being a mere connecting link binds the principal for all his acts done within the scope of his authority (s.226).

Example: A, being B's agent with authority to receive money on his behalf, receives from C a sum of money due to B. C is discharged of his obligation to pay the sum in question to B.

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2. The principal is liable for the acts of the agent falling not only within the actual authority but also within the scope of his apparent or ostensible authority.

3. Where agent exceeds his authority and the part of what he does, which is within his authority, can be separated from the part which is beyond his authority, so much only of what he does as is within his authority, is binding as between him and the principal (s.227).

Example: A, being the owner of a ship and cargo, authorises B to procure an insurance for ₹ 4,000 on the ship. B procures a policy of ₹ 4,000 on the ship and another for the like sum on the cargo. A is bound to pay the premium for the policy on the ship, but not the premium for the policy on the cargo.

However, where agent does more than he is authorised to do and what he does beyond the scope of his authority cannot be separated from what is within it, the principal is not bound by the transaction (s.228).

Example: Agent is authorised to draw a bill for ₹ 5,000 but he draws a bill for ₹ 10,000, the principal will not be liable even to the extent of ₹ 5,000.

4. The principal will be liable even for misrepresentations made or frauds committed by agent in the business of agency for his own benefit. But misrepresentations made or frauds committed by agents in matters beyond their authority do not affect their principals (s.238).

Example: A, being B's agent for the sale of goods, induces C to buy them by a misrepresentation, which he was not authorised by B to make. The contract is voidable, as between B and C, at the option of C.

5. The principal remains liable to the third parties even where his name was not disclosed. The third parties, on discovering his name, can proceed against him on the contract.

6. The principal is bound by any notice or information given to the agent in the course of business transacted by him.

7. The liability of the principal continues even in cases where agent is held personally liable. Section 223 provides an option to the third parties to either sue the principal or agent or both.

Notes **Undisclosed Principal**

Where agent, though discloses the fact that he is agent working for some principal, conceals the name of the principal, such a principal is called an undisclosed principal. The liability of an undisclosed principal is similar to that of a disclosed principal unless there is a trade custom making the agent liable. However, the undisclosed principal must exist and must also be the principal at the time the contract is made. He cannot be brought into existence as a principal after the contract has been concluded.

3.6.3 Concealed Principal

Where agent conceals not only the name of the principal but the very fact that there is a principal, the principal is called a concealed principal. In such a case, the third parties are not aware of the

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existence of the principal and regard the agent as the person contracting for himself. The third parties, thus, must look to the agent for payment or performance and the agent may sue or be sued on the contract. Legal position in this regard is as follows:

1. If the principal wishes to intervene, he may require the performance of the contract, but the other party has, as against him (principal), the same rights as he would have had as against the agent if the agent has been principal (s.231 para 1).
2. Para II of s.231 provides that in such a case, if the principal discloses himself before the contract is completed the other contracting party may refuse to fulfil the contract, if he can show that if he had known who was the principal in the contract, or if he had known that the agent was not the principal, he would not have entered into the contract.
3. If the principal requires performance of the contract, he can only obtain such performance subject to the rights and obligations subsisting between the agent and the other party to the contract.

Example: A who owes ₹ 500 to B, sells 1,000 rupees worth of rice to B. A is acting as agent for C in the transaction, but B has no knowledge nor reasonable ground of suspicion that such is the case. C cannot compel B to take the rice without allowing him to set off A's debt.

4. In contracts with a concealed principal, the agent is, in the absence of a contract to the contrary, personally liable to the third party. The party may hold either the agent or principal or both liable (s.223).

Example: A enters into a contract with B to sell him 100 bales of cotton and afterwards discovers that B was acting as agent for C. A may sue either B or C, or both for the price of the cotton.

Self Assessment

Fill in the blanks:

11. The principal is liable for the acts of the agent falling not only within the actual authority but also within the scope of his ……...authority.
12. Section ……. provides an option to the third parties to either sue the principal or agent or both.

3.7 Personal Liability of Agent

Agent is only a connecting link between the principal and third parties. Being only a medium, he can, in the absence of a contract to the contrary, neither personally enforce contracts entered into by him on behalf of his principal, nor is he personally bound by them (s.230).

From the above discussion, it may be inferred that agent can enforce contracts personally and be held bound for contracts entered into on behalf of his principal, if there is an agreement to the effect, express or implied. Section 230 enlists the following cases where a contract to this effect shall be presumed to exist: (1) where the contract is made by agent for the sale or purchase of goods for a merchant resident abroad; (2) where the agent does not disclose the name of his principal; (3) where the principal, though disclosed, cannot be sued, for instance, where principal is a minor. Besides, agent incurs a personal liability in the following cases:

1. ***Breach of warranty.*** Where agent acts either without any authority or exceeds his authority, he is deemed to have committed breach of warranty of authority in such a case. He will be

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held personally liable if his acts are not ratified by the alleged principal. Further, agent will be guilty of warranty of authority even where his authority is terminated without his knowledge, e.g., by death or lunacy of the principal.

2. ***Where the agent expressly agrees to be personally bound.*** This sort of stipulation may be provided particularly where principal does not enjoy much creditworthiness and the third parties wish to ensure the payment or performance.

3. ***Where agent signs a negotiable instrument in his own name.*** In case agent signs a negotiable instrument without making it clear that he is signing it as agent only, he may be held personally liable on the same. He would be personally liable as the maker of the note, even though he may be described in the body of the note as the agent (s.28, Negotiable Instrument Act, 1881).

4. Agent with special interest or with a beneficial interest, e.g., a factor or auctioneer, can sue and be sued personally.

5. When agent is guilty of fraud or misrepresentation in matters which do not fall within his authority (s.238).

6. Where trade usage or custom makes agent personally liable.

7. Where the agency is one coupled with interest.

Task Analyse the rights and duties of the agents in insurance industry.

Self Assessment

Fill in the blanks:

13. Where agent acts either without any authority or exceeds his authority, he is deemed to have committed breach of …….of authority in such a case.

14. Agent is only a connecting link between the principal and…….

3.8 Termination of Agency

3.8.1 Circumstances under which Agency Terminates or Comes to an End (S.201)

1. ***On revocation by the principal:*** The principal may, by notice, revoke the authority of the agent at any time. Where the agent is appointed to do a single act, agency may be revoked any time before the commencement of the act. In case of a continuous agency, notice of revocation is essential to the agent as well as to the third parties who have acted on the agency with the knowledge of the principal.

   Where agency is for a fixed period of time and the contract of agency is revoked without sufficient cause, compensation must be paid to the agent (s.205). However, the agency is irrevocable in two cases: (i) Where the authority of the agent is one coupled with interest; i.e., the agent has an interest in the subject-matter of the contract. The principal cannot revoke the authority given to his agent after the authority has been partly exercised so far as regards such acts and obligations already done in the agency (s.204).

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Examples:

(a) A gives authority to B to sell A's land and to pay himself out of the proceeds, the debts due to him from A. A cannot revoke this authority, nor can it be terminated by his insanity or death.

(b) A authorises B to buy 1,000 bales of cotton on account of A and to pay for it out of A's money remaining in B's hands. B buys 1,000 bales of cotton in his own name, so as to make himself personally liable for the price. A cannot revoke B's authority to pay for the cotton.

(c) A authorises B to buy 1,000 bags of rice on account of A and to pay for it out of A's money remaining in B''s hands. B buys 1,000 bags of rice in A's name, so as not to make himself personally liable for the price. A can revoke B's authority to pay for the rice.

2. ***On the expiry of fixed period of time:*** When the agency is for a fixed period of time, it comes to an end on the expiry of that time.

3. ***On the performance of the specific purpose:*** Where agent is appointed to do a particular act, agency terminates when that act is done or when the performance becomes impossible.

4. ***Insanity or death of the principal or agent:*** Death or insanity of the principal or the agent, terminates the agency. But, agent, in such a case, should take all reasonable steps for the preservation of property, on behalf of the legal representatives of the principal (s.209).

5. An agency shall also terminate in case the subject matter is either destroyed or rendered unlawful.

6. ***Insolvency of the principal:*** Insolvency of the principal, not of the agent, terminates the agency.

7. ***By renunciation of agency by the agent:*** If principal can cause termination of agency by revocation, agent may renounce his agency by giving a sufficient notice to that effect. Where, however, agency is for a fixed period and the agency is renounced without a sufficient cause, the principal must be compensated (s.205).

3.8.2 When Termination of Agency takes Effect?

1. The termination of the authority of agent does not, so far as regard the agent, takes effect before it becomes known to him (s.208).

2. As regards third parties, they can continue to deal with the agent till they come to know of the termination of the authority (s.208).

Example: A directs B to sell goods for him and agrees to give B 5% commission on the price fetched by the goods. A afterwards, by a letter revokes B's authority. B, after the letter is sent, but before he receives it, sells the goods for ₹ 100. The sale is binding on A and B is entitled to five rupees as his commission.

3. The termination of the authority of agent causes the termination of authority of all sub-agents appointed by him.

Notes

Self Assessment

Fill in the blanks:

15. When the agency is for a fixed period of time, it comes to an end on the ……..of that time.
16. Insolvency of the ……..terminates the agency

3.9 Power of Attorney

A power of attorney is defined by s.2 (21) of the Stamp Act, as including "any instrument not chargeable with a fee under the law relating to court fees for the time being in force," which empowers "a specified person to act for and in the name of the person executing it". It is the Powers of Attorney Act, 1882, which deals with the subject, but does not define it. In common parlance, a power of attorney is an instrument or a deed by which a person is empowered to act for and in the name of the person executing it. The person executing the deed is known as the Principal or donor and the one in whose favour it is executed is the agent, or the power agent or the power of attorney agent.

Section 2 of the Powers Attorney Act, 1882, provides that the donee may execute any instrument in and with his own name and signature and his own seal, where sealing is required, by the authority of the donor of the power. And such an instrument shall be as effectual in law as if it had been executed by the donor.

As mentioned earlier, no consideration is necessary to create agency. Therefore, the deed of Power of Attorney may stipulate that the agent will not get any remuneration.

3.9.1 A Power of Attorney may be Special or General

If the deed conferring power by one to another relates to one single transaction, it is known as special power of attorney. If the deed conferring power relates to several transactions it is general power of attorney.

3.9.2 Registration

As a general rule, registration of power of attorney is not necessary but if it authorises the donee to recover the rents of an immovable property of the donor for the donee's benefit, it would require registration. And so also a power creating a charge in favour of the donee upon an immovable property referred to therein.

Further s.32 (c) of the Registration Act, 1908, requires that where a document is presented for registration by the agent of a person entitled to present it for registration, such agent must be duly authorised by power of attorney executed and authenticated in manner as mentioned in s.33 of the Act.

Such a power of attorney is to be executed before and authenticated by a registrar or sub-registrar. Unregistered power executed in a foreign country before a notary public can be used by the agent for presentation of document for registration. The power of attorney, however, executed before a notary public in India will not enable the agent to present any document for registration under the Registration Act, 1908.

The power of attorney is required to be engrossed on non-judicial stamp paper. The amount of stamp duty varies with different types of powers as described in the Stamp Act and varies among different States of India. Section 4 of the Power of Attorney Act, 1882 provides that the

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original deed of power can be deposited in the High Court in whose jurisdiction the principal resides and a certified copy of the deed can be obtained from the High Court. Such certified copies are equal to originals and are binding on all.

Further, s.85 of the Indian Evidence Act provides that the Court shall presume that every document purporting to be a power of attorney and to have been executed before and authenticated by a Notary Public, or any Court, Judge, Magistrate, was so executed and authenticated.

Self Assessment

Fill in the blanks:

17. In power of attorney, the person executing the deed is known as the …….and the one in whose favour it is executed is the agent.

18. The power of attorney is required to be engrossed on ……..paper.

Case Study

Canadian Food Inspection Agency (CFIA)

Governmental responsibility for food in Canada is divided among the federal, 10 provincial, three territorial, and thousands of municipal governments. Some 77 pieces of legislation govern food inspection among three levels of government. Federal responsibility centres on export and inter-provincial trade: protecting and expanding export markets for Canadian food products, and facilitating interprovincial trade. In addition, the federal government sets food safety, quality and grading standards for products sold interprovincially and internationally and administers regulations aimed at preventing the production or sale in Canada of dangerous, adulterated or misbranded products. Provinces and municipalities are responsible for:

The intraprovincial aspects of the food industry, including local food processing, the food service industry, and the food retail industry. They decide whether and how to inspect local operations, including restaurants and grocery stores, as well as dairies and meat plants whose products are sold within the province. (Moore and Skogstad, p. 130)

The federal government of Canada faced a number of food security problems in the early 1990s, which facilitated adoption of innovative reform measures:

1. Canada's reputation for high quality food had been damaged by the "tainted tuna" scandal.

2. Resources for additional inspection of fish products were not available; resources were not only scarce but shrinking.

3. The Government wanted to reform its public service along the lines achieved in the United Kingdom and New Zealand, where separate agencies were spun off from government.

4. Developments in international trade and potential developments in interprovincial trade:

   (a) Industry and governments favoured harmonized standards and streamlined inspection to ensure the competitiveness of the Canadian food industry domestically & internationally.

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(b) Canadian producers/processors were vulnerable to trade challenges in a fragmented system.

(c) Gaps resulting from non-inspection or non-rigorous inspection were perceived by processors as a weak link, despite the small percentage of overall production represented and assurances outlined in the Auditor General of Canada's 1994 Report.

(d) Closer integration of the US and Canadian markets under free trade agreements made the industry anxious to reduce the costs and inefficiencies resulting from differing provincial standards e.g. fluid milk.

5. The "national treatment" principle in the North American Free Trade Agreement could be interpreted to mean that imports must meet the provincial standard of the province they enter rather than the standard required for inter-provincial or international trade. This could drag down Canadian food standards to the lowest common denominator.

   (a) Canadian exporters were concerned about being denied access to external markets on the grounds that Canadian food safety standards and inspection systems were not equivalent to those of the markets into which they were shipping.

   (b) The 1994 SPS Agreement required that countries use their food safety and animal, plant and health regulations only to the extent necessary to protect human, animal life or health, not for trade protection purposes.

6. Emergence of alternatives to high-cost prescriptive regulation: New scientific and technological tools furnished the Government with opportunities to shift additional costs and a significant degree of responsibility for food safety to the food industry itself. Risk assessment methods allowed the allocation of food inspection resources on a risk basis. One such risk-based tool, the Hazard Analysis Critical Control Point (HACCP) system, developed for the US space program, was deemed more effective than existing systems in ensuring food safety. Canada was the first government to adopt this system, for its fish inspection program. It was so well accepted internationally that Canadian meat packing plants were subsequently required to conform to US regulations requiring large American meat packing plants to implement a HACCP plan by January 1998.

7. National unity was threatened, and solutions suggested in the winning Liberal platforms in the 1993 and 1997 elections were renewal of the federation, including better coordination of services and reduction in overlap and duplication among governments.

   The Government of Canada consolidated all of its food inspection and quarantine services from Health Canada, Fisheries and Oceans, and Agriculture and Agri-Food Canada into one self-standing Agency effective April 1, 1997. The Agency reports not to a deputy minister but directly to the Minister of Agriculture and Agri-Food. The Agency has separate employer status, and so can hire and fire its own employees, rather than working through the Public Service Commission. It also has a number of financial flexibilities not available to government departments, most notably the capacity to retain revenues.

   Protecting the public interest is a major concern in creating alternate Service Delivery Agencies (ASDs) in Canada. Employing the Auditor General of Canada's definition

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of the public interest when assessing ASDs, the CFIA addressed whether there was an appropriate focus on public objectives, maintenance of public service values and adequate control over public funds and assets. On all counts the CFIA's self-assessment concluded it was serving the public interest.

The Auditor General of Canada was appointed as an external auditor under the CFIA Act, with duties to audit the CFIA's financial statements and assess the fairness and reliability of the performance information provided in the Agency's Annual Report to Parliament. The Auditor General also has authority to conduct periodic value-for-money audits of the Agency.

Clarification of food-related roles and responsibilities of federal government departments has led to:

(a) A more integrated and comprehensive approach (gate-to-plate) to trichinosis in swine, tuberculosis in cattle and zoonotic diseases such as salmonella enteritidis in poultry.

(b) Improved capacity to respond to outbreaks of food-borne illness and threats to the food system presented by medicated feeds and antibiotic residues.

(c) Separation of health and safety standard setting from inspection, permitting new flexibilities for inspection.

(d) Separation of health risk analysis from risk management , thereby fulfilling a World Health Organization principle.

(e) Reduced criticism of conflict of interest because the same department was responsible for promoting and regulating an industry (fisheries).

8. Creation of an agreement on a harmonized National Dairy Regulation and Code and progress on developing harmonized standards and inspection systems for the meat and poultry sector.

9. Significant streamlining and other efficiency gains - $44 million annually.

10. Improved service delivery due to creation of a single point of contact and addressing of specific problems.

11. Increased federal/provincial harmonization and cooperation.

12. Enhanced accountability and reporting to Parliament, with an emphasis on performance.

Questions

1. Analyse the kind of agency it is.

2. Do you think there is a bright future for this kind of agency?

3. What implications you can draw from this case about the food industry?

4. Analyse the ethical behaviour of the company in response to its investors and consumers.

5. Discuss the role and responsibilities of the agency.

Source: http://www.innovation.cc/case-studies/cfia.htm

Notes

3.10 Summary

- The contract of bailment is defined as the delivery of goods by one person to another for some purpose, upon an agreement that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them.
- A contract of bailment terminates under certain circumstances.
- Agent is a person employed to do any act for another or to be represent another in dealings with third persons.
- The person for whom or on whose behalf he acts is called the principal.
- The function of an agent is to bring about contractual relation between the principal and a third party.
- Any person who is of the age of majority according to the law to which he is subject and who is of sound mind, may employ agent.
- A contract of agency may be created by an express agreement or by implication or by ratification.
- Where agent is appointed to do a particular act, agency terminates when that act is done or when the performance becomes impossible.

3.11 Keywords

Agent: He is a person who is employed to do any act for another or to represent another in dealings with third persons.

Bailment: It is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them.

Concealed Principal: Where an agent conceals not only the name of the principal but the very fact that there is a principal, the principal is called a concealed principal.

Lien: It is a right in one person to retain that which is in his possession, belonging to another, until some debt or claim is settled.

Power of Attorney: It is an instrument or a deed by which a person is empowered to act for and in the name of the person executing it.

Principal: He is a person for whom or on whose behalf an agent works.

Sub-agent: He is a person who is a appointed by an agent to work in the matter of agency, and therefore can bind the principal by his acts.

Undisclosed Principal: Where an agent, though discloses the fact that he is agent working for some principal, conceals the name of the principal, such a principal is called an undisclosed principal.

3.12 Review Questions

1. Every ratification relates back and becomes equivalent to a prior command. Comment.
2. A customer entrusts certain important documents for safe custody to his bank. The bank keeps the documents in a wooden box. Later it is found that the documents were destroyed by white ants. What is the bank's liability to the customer?

Notes

3. P authorises A to buy 5 tables for him. A buys 5 tables and 2 chairs for one sum of ₹ 600. Discuss the position of P.
4. X lends a car to Y for going to attend the annual general meeting of MTS Ltd. being held at Juhu. The brakes of the car are not in working condition. This fact is already known to X but he did not tell Y about the defects. Y instead of going to attend the annual general meeting at juhu drives the car to the Gateway of India on a pleasure trip. The car meets with an accident & Y gets injured. Y wants to hold X liable for the injury. Decide whether Y would succeed? Justify.
5. "Bailor is liable to the bailee for loss caused by faults in the goods bailed whether the bailor was aware of the same or not." Comment.
6. Agent who was appointed by a power of attorney, borrowed money on a representation that the power gave him full authority to borrow. The agent produced the agreement of power of attorney which did not authorise the borrowing but the lender without reading it relied on the agents representation. Is the principal bound by the loan? Comment.
7. "A" consigned goods by Railways. The consignment, at the time of delivery, was found damaged. After obtaining a certificate of damages from the Railway Officer, A claimed from the Railways compensation of ₹ 2,300. The general Manager of the Railways sent him a cheque for ₹ 1,300 in full and final settlement. The cheque was encashed, but after a lapse of sometime. A claimed that the payment had satisfied only a part of his claim and demanded payment of the balance. Discuss the claim of A for payment of the balance amount.
8. "The finder of lost goods has no right to file a suit for recovery of expenses incurred by him for finding out the true owner." Comment.
9. Ram gives his watch to Mohan to be used for 2 days during the examination. Mohan keeps the watch for a week. While going to Ram's house to return the watch, Mohan accidentally slips & the watch is badly damaged. Who will bear the loss and why?
10. Agent having an authority to do an act has authority to do every lawful thing which is necessary in order to do such act. Comment.
11. P employs A as his agent to sell 100 bags of sugar and directs him to sell at a price not less than ₹ 120 per bag. A sells the entire quantity at ₹ 110 per bag whereas the market rate on the date of sale was ₹ 115 per bag. Is P entitled to any damages and if so, at what rate?
12. X enters into a contract with Y for buying his car as agent of C without the C's authority. Y reduplicated the contract before C comes to know of it. C subsequently ratifies the contract & sues Y to enforce it. Will he succeed? Justify.

Answers: Self Assessment

1.	temporary	2.	accomplished.
3.	bailee	4.	true owner
5.	implication	6.	Implied
7.	special	8.	substituted
9.	misconducted	10.	indemnify
11.	apparent	12.	223
13.	warranty	14.	third parties

Notes

15. expiry
16. principal
17. Principal
18. non-judicial stamp

3.13 Further Reading


Book

S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.


Online links

www.dateyvs.com/gener03.htm

www.scribd.com/doc/40426028/Bailment-and-Pledge-Agency

Unit 4: Law of Negotiable Instruments

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Objectives

After studying this unit, you will be able to:

- Recognize the meaning and types of negotiable instruments;
- Discuss the endorsement and crossing of cheque;
- Describe the dishonour of cheques;
- Explain the concerned parties to negotiable instruments.

Introduction

The law relating to negotiable instruments is primarily contained in the Negotiable Instruments Act, 1881, which came into force on 1st March, 1882. Bills of exchange, cheques and promissory notes have been dealt with in considerable detail in this Act.

The term 'instrument' means 'any written document by which a right is created in favour of some person'. The word 'negotiable' has a technical meaning whereby rights in an instrument can be transferred by one person to another. Thus, a negotiable instrument is a document by which rights vested in a person can be transferred to another person in accordance with the provisions of the Negotiable Instruments Act, 1881.

The sections quoted in this unit refer to the sections of the Negotiable Instruments Act, 1881, unless otherwise stated. The latest amendment to the Act was done in 1988 by the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988.

4.1 Meaning and Definition of a Negotiable Instrument

4.1.1 Meaning of a Negotiable Instrument

An 'Instrument' as referred to in the Act is a legally recognised written document, whereby rights are created in favour of one and obligations are created on the part of another. The word 'negotiable' means transferable from one person to another either by mere delivery or by endorsement and delivery, to enable the transferee to get a title in the instrument. According to s.13, a negotiable instrument means a promissory note, a bill of exchange or a cheque payable either to the order or to the bearer, whether the words, 'order', or 'bearer' appear on the instrument or not. Although s.13 mentions only three instruments, it does not prohibit any other instrument from being treated as a negotiable instrument provided it possesses the character of negotiability. An instrument may possess the characteristics of negotiability either by statute or by usage.

Promissory note, bill of exchange and cheque are negotiable instruments by statute as they are so recognised by s.13. There are certain instruments which are recognised as negotiable instruments by usage. Thus, bank notes, bank drafts, share warrants, bearer debentures, dividend warrants, scripts and treasury bills are negotiable by usage.

An instrument is called 'negotiable' if it possesses the following features:

1. ***Freely transferable:*** Transferability may be by (a) delivery, or (b) by endorsement and delivery.
2. ***Holder's title free from defects:*** The term 'negotiability' means that not only is the instrument transferable by endorsement and/or delivery, but that its holder in due course acquires a good title notwithstanding any defects in a previous holder's title. A holder in due course is one who receives the instrument for value and without any notice as to the defect in the title of the transferor.
3. ***The holder can sue in his own name:*** Another feature of a negotiable instrument is that its holder in due course can sue on the instrument in his own name.
4. A negotiable instrument can be transferred infinitum, i.e., can be transferred any number of times, till its maturity.
5. ***A negotiable instrument is subject to certain presumptions:*** An instrument, which does not have these characteristics, is not negotiable, but is assignable, i.e., the transferee takes it subject to all equities and liabilities of the transferor.

Example: One G, by means of a fraud, obtained a cheque from F. The cheque was made payable to G or order. G gave the cheque to W in payment of his own debt, but forgot to endorse it. W had no notice of the fraud then, but before he could obtain G's endorsement, he was given notice of the fraud. W does not get a good title to the cheque. In the case of a cheque payable to order, the title passes by endorsement and delivery. As there was no indorsement by G on the cheque, therefore W did not get any title.

Caution It is to be kept in mind that the share certificate, bill of lading, dock warrant, I.O.U., postal order instruments are not negotiable instruments as they do not possess the features mentioned.

Essential Elements of a Negotiable Instrument

After discussing the characteristics of different negotiable instruments, it is with profit, that we can sum up the essential elements of a negotiable instrument. These are as follows:

1. It must be in writing, which includes, typing, computer print out or engraving.
2. The instrument must be signed by the person who is the maker (in the case of a promissory note) or a drawer (as in the case of a bill of exchange or a cheque).
3. There must be an unconditional promise (as in the case of a promissory note) or order (as in the case of a bill of exchange or cheque) to pay.
4. The instrument must involve payment of a certain sum of money only and nothing else.
5. The instrument must be payable at a time which is certain to arrive. If it is payable 'when convenient' the instrument is not a negotiable one. However, if the time of payment is linked to the death of a person, it is nevertheless a negotiable instrument as death is certain, though the time thereof is not.

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6. In case of a bill or cheque, the drawee must be named or described with reasonable certainty.
7. The instrument must be such or in such a state that it can be transferred like cash by mere delivery (as in the case of a bearer instrument) or by delivery and endorsement (as in the case of an order instrument).

Did u know? **The forms in which an Instrument must be Payable so as to Constitute a Negotiable Instrument**

(i)	Pay A;	(ii)	Pay A or order;	(iii)	Pay to the order of A;
(iv)	Pay A and B;	(v)	Pay A or B;	(vi)	Pay A or bearer;
(vii)	Pay bearer.				

4.1.2 Certain Important Concepts and Explanations of Certain Terms

Ambiguous Instrument (S.17)

An ambiguous instrument is one which may be construed either as a promissory note or as a bill of exchange. Regarding such instruments, s.17 provides that the holder may, at this election treat it as either and the instrument shall be thenceforward treated accordingly. Thus, a bill of exchange drawn by a person upon himself may be construed as a promissory note.

Amount Stated Differently in Figures and Words (S.18)

If the amount undertaken or ordered to be paid is stated differently in figures and in words, the amount stated in words shall be the amount undertaken or ordered to be paid.

Inchoate Stamped Instruments (S.20)

An inchoate instrument means an instrument that is incomplete in certain respects. Where one person signs and delivers to another a paper stamped in accordance with the law relating to negotiable instruments then in force in India and either wholly blank or having written thereon an incomplete negotiable instrument, he thereby gives *prima facie* authority to the holder thereof to make or complete, as the case may be, upon it a negotiable instrument, for any amount specified therein but not exceeding the amount covered by the stamp. The person so signing shall be liable upon the instrument in the capacity in which he signed the same, to any holder in due course for such amount. But a person other than a holder in due course cannot recover from the person delivering the instrument anything in excess of the amount intended by him to be paid thereunder.

Parties Standing in Immediate Relationship

The drawer of a bill stands in immediate relation with the acceptor. The maker of a note, bill or cheque stands in immediate relation with the payee, and the endorser with his endorsee. Other signors may by agreement stand in immediate relation with a holder.

Presumptions as to Negotiable Instruments

Sections 118-119 enlist the following presumptions as to negotiable instruments:

1. ***As to consideration:*** Every negotiable instrument is deemed to have been made, drawn, accepted, endorsed, negotiated or transferred for consideration. In Marimuthu Kounder v.

Radhakrishan and Others, AIR 1991 Ker. 39, the Kerala High Court observed that the presumption as to existence of consideration for negotiable instruments is not irrebuttable. When once the court finds that the defendant has executed the promissory note, then the burden is on the defendant to prove that there is no consideration. True, the initial burden rests on the plaintiff, who has to prove that the promissory note is executed by the defendant. If there is an admission by the defendant, certainly there is no burden on the plaintiff to prove the execution of the promissory note. Further, the court observed that where execution is admitted or proved, a presumption is raised in favour of the consideration having been passed and the burden to prove lack of consideration is then with the defendant.

2. ***As to date:*** Every negotiable instrument bears the date on which it is made or drawn.
3. ***As to acceptance:*** Every bill of exchange was accepted within a reasonable time after the date mentioned therein and before the date of its maturity.
4. ***As to transfer:*** Every transfer of a negotiable instrument was made before the date of its maturity in case of an instrument payable otherwise than on demand.
5. ***As to the order of endorsements:*** The endorsements appearing on it were made in the order in which they appear thereon.
6. ***As to lost instruments:*** Where an instrument has been lost or destroyed, that it was duly stamped and the stamp was duly cancelled.
7. ***As to holder-in-due course:*** The holder of the instrument is a holder in due course.
8. ***As to dishonour:*** If a suit is filed upon an instrument which has been dishonoured, the court shall, on proof of the protest, presume the fact of dishonour unless it is disproved.

Capacity of Parties to the Negotiable Instrument

The capacity of a party to draw, accept, make or endorse a negotiable instrument is coextensive with his capacity to enter into contract. Thus, s.11 of the Indian Contract Act, 1872, if negatively interpreted prohibits minors, persons of unsound mind and persons forbidden under any other Act like insolvency to make a valid contract. Thus, a person who is competent to contract "may bind himself and be bound by the making, drawing, acceptance, endorsement, delivery and negotiation of a promissory note, bill of exchange or cheque" (s.26).

Self Assessment

Fill in the blanks:

1. A ……is one who receives the instrument for value and without any notice as to the defect in the title of the transferor.
2. ……..instrument is one which may be construed either as a promissory note or as a bill of exchange.

4.2 Promissory Notes and Bills of Exchange

4.2.1 Definition of a Promissory Note

A promissory note is an instrument in writing (not being a bank or a currency note) containing an unconditional undertaking, signed by the maker to pay a certain sum of money to, or to the order of, a certain person or to the bearer of the instrument (s.4). The following are two illustrations of promissory notes.

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Where A signs instruments in the following terms: (i) "I promise to pay B or order ₹ 500." (ii) "I acknowledge myself to be indebted to B in ₹ 1000, to be paid on demand, for value received."

But, the following are NOT promissory notes: (i) "Mr B, I.O.U. (I owe you) ₹ 1000." (ii) "I am liable to pay you ₹ 500". (iii) "I promise to pay B ₹ 500 and all other sums which shall be due to him." (iv) "I promise to pay B ₹ 500, first deducting thereout any money which he may owe me." (v) "I promise to pay B ₹ 1500 on D's death, provided he leaves me enough to pay that sum." (vi) "I promise to pay B ₹ 500 seven days after my marriage with C." (vii) "I promise to pay B ₹ 500 and to deliver to him my white Maruti Car 1 January next."

Essentials of a Promissory Note

From the definition, it is clear that a promissory note must have the following essential elements:

1. A promissory must be in writing. Writing includes print and typewriting.
2. It must contain an undertaking or promise to pay. Thus, a mere acknowledgment of indebtedness is not sufficient. Also, a receipt for money, if it does not contain an express promise to pay is not a promissory note. But if the receipt is coupled with a promise to pay, it shall be promissory note.

Example: "We have received a sum of ₹ 9,000 from Shri R.R. Sharma. This amount will be repaid on demand. We have received this amount in cash." This is a promissory note.

However, note that the use of the word 'I promise' is not essential to constitute an instrument as a 'promissory note'.

3. The promise to pay must not be conditional. Thus, instruments payable on performance or non-performance of a particular act or on the happening or non-happening of an event are not promissory notes.

Examples:

(a) A promises to pay B ₹ 500 provided C leaves sufficient money in favour of A after C's death. It is not a promissory note.

(b) A promises to pay B ₹ 5000 seven days after his marriage with C. It is not a promissory note.

However, the promise to pay may be subject to a condition which according to the ordinary experience of mankind is bound to happen, e.g., death. Thus, where A promises to pay B a sum of ₹ 10,000 on the death of C, the promise is a valid promise for it is certain that C shall die.

4. The promissory note must be signed by the maker, otherwise it is of no effect. Even if it is written by the maker himself and his name appears in the body of the instrument, it shall not constitute a valid promissory note, if it is not signed by the maker. 'Signature' means the writing of a person's name in order to authenticate the contract contained in the instrument. Signature by an authorised attorney (agent) shall be valid.
5. The instrument must point out with certainty the maker and the payee of the promissory note, e.g., son of……. resident of……, etc. The identification of payee by description does not invalidate the promissory note. For example, the note drawn payable to the 'General Manager of HDFC Ltd.'

Notes

A promissory note cannot be drawn payable to the maker himself. Such a note is nullity. But if it is endorsed by the maker to some other person, or endorsed in blank, it becomes a valid promissory note.

6. The sum payable must be certain or capable of being made certain. Where rate of interest is specified, the sum shall be deemed to be certain. But, expressions like 'market rate of interest' do not make the amount certain since 'market rate' may vary with the source of borrowing, purpose of borrowing, financial standing of the borrower and so on. However, a promissory note containing an undertaking to pay the amount 2% above the 'bank rate' shall be valid. It's because there is only one 'bank rate' (i.e., the rate at which Reserve Bank of India lends to commercial banks) at a given point of time.
7. It must contain a promise to pay money only. If the instrument contains a promise to pay something in addition to money, it cannot be a promissory note. Thus, the following instrument is not a promissory note: "I promise to pay B ₹ 50,000 and also deliver him a Maruti 800".
8. The number, place, date, etc., of a promissory note are usually found but are not essential in law. The date of note is not material unless the amount is made payable at a certain time after date. But even if it does not bear a date, it is deemed to have been made when it was delivered.
9. It may be payable in installments (s.5, para 3).
10. It may be payable on demand or after a definite period. Payable 'on demand' means payable immediately or any time till it becomes time-barred. A demand promissory note becomes time barred on expiry of 3 years from the date it bears.
11. It cannot be made payable to bearer no matter whether it is payable on demand or after a certain time. (s.31 of RBI Act).
12. It must be duly stamped under the Indian Stamp Act. It means that the stamps of the requisite amount must have been affixed on the instrument and duly cancelled either before or at the time of its execution. A promissory note which is not so stamped is a nullity.
13. It cannot be payable to bearer on demand (s.31 of RBI Act).
14. It cannot be crossed unlike a cheque.

Notes **Specimen of a Promissory Note**

₹ 10,000 New Delhi - 1100 01

Jan. 10, 2006

On demand [or six months after date] I promise to pay X or order the sum of rupees ten thousand with interest at 12 per cent per annum only for value received.

To X Sd/-A

Address……..... Stamp

Parties to a Promissory Note

1. ***Maker:*** It is the person who makes the note promising to pay the amount stated therein.
2. ***Payee:*** It is the person to whom the amount of the note is payable.
3. ***Holder:*** It is either the original payee or any other person in whose favour the note has been endorsed.

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4. ***Endorser:*** It is the person who endorses the note in favour of another person.
5. ***Endorsee:*** It is the person in whose favour the note is negotiated by indorsement.

4.2.2 Meaning of a Bill of Exchange

A 'bill of exchange' is defined by s.5 as 'an instrument in writing, containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of, a certain person, or to the bearer of the instrument'.

Features of a Bill of Exchange

1. It must be in writing.
2. It must contain an order to pay and not a promise or request. Words, like 'Please pay ₹ 10,000 to A on demand and oblige,' do not constitute the instrument a bill of exchange.
3. The order must be unconditional.
4. There must be three parties, viz., drawer, drawee and payee. However, one person may assume the role of two parties, e.g., a person may draw a bill of exchange in his own favour, i.e., he may be drawer as well as a payee. He cannot, however, be a drawer as well as a drawee because that will render that instrument a promissory note.
5. The parties must be certain.
6. It must be signed by the drawer.
7. The sum payable must be certain or capable of being made certain.
8. The order must be to pay money and money alone.
9. It must be duly stamped as per the Indian Stamp Act.

Caution All bills of exchange other than 'demand bills' must bear the adhesive stamps of the requisite amount and the same must have been affixed either before or at the time of execution and also cancelled.

10. The number, date and place of the bill are not essential. Oral evidence may be obtained as to date and place of execution.

Notes **Specimen of a Bill of Exchange**

₹ 10, 000

New Delhi - 110 016

Jan. 13, 2006

Six months after date pay to A or order/bearer the sum of ten thousand rupees only for value received.

To X Sd/-Y

Address ……..... Stamp

…….....

Contd...

Notes

Here Y is the drawer, A is the payee and X is the drawee. X will express his willingness to pay 'accepting' the bill by writing words somewhat as below across the face of the bill:

ACCEPTED

Sd-X

Jan. 16, 2006.

The specimen given above is of a usance bill, payable after a specified period of time. A bill of exchange may be drawn payable 'at sight', i.e., on demand or payable 'after certain time after sight' also.

Stamp Duty, Attestation and Registration of a Promissory Note and a Bill of Exchange

A promissory note as well as a bill of exchange are liable to stamp duty. However, an indorsement of a negotiable instrument is exempt from any stamp duty. Neither, a promissory note nor a bill of exchange are to be attested or registered.

Distinction between a Promissory Note and a Bill of Exchange

Table 4.1: Differences between Promissory Note and a Bill of Exchange

	Promissory Note	Bill of Exchange
1.	There are only two parties – the maker (debtor) and the payee (creditor).	There are three parties – the drawer, the drawee and the payee although drawer and payee may be the same person.
2.	A note contains an unconditional promise by the maker to pay the payee.	It contains an unconditional order to the drawee to pay according to the drawer's directions.
3.	No prior acceptance is needed.	A bill payable 'after sight' must be accepted by the drawee or his agent before it is presented for payment.
4.	The liability of the maker or drawer is primary and absolute.	The liability of the drawer is secondary and conditional upon non-payment by the drawee.
5.	No notice of dishonour need be given.	Notice of dishonour must be given by the holder to the drawer and the intermediate endorsers to hold them liable thereon.
6.	The maker of the note stands in immediate relation with the payee.	The maker or drawer does not stand in immediate relation with the acceptor or drawee.

Kinds of Bills

Bills are of different kinds. Some of these are: (1) Inland Bills (2) Foreign Bills (3) Trade and accommodation bills (4) Time Bills (5) Demand Bills (6) Clean Bills (7) Documentary Bills.

1. ***Inland bill:*** An Inland bill or instrument is defined as 'a promissory note, bill of exchange or cheque drawn or made in India and payable in or drawn upon any person resident in India' (s.11). On analysis of the above definition it follows that an inland bill: (a) must be drawn or made in India and made payable in India, or (b) must be drawn in India upon a person resident in India although it may be payable outside India.

Examples:

(a) A of Delhi draws a bill on B of Mumbai payable at Kolkata.

(b) A of Mumbai draws a bill on B of Delhi payable at Yorkshire (U.K.).

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In example (a) the bill is drawn in India and is payable in India and, therefore, is an Inland bill. In example (b) the bill is drawn in India on a person resident in India, though it is payable outside India, it is again an Inland bill.

2. ***Foreign bills:*** According to s.12, a foreign bill is a negotiable instrument which is not an inland instrument, as defined above. Thus, a foreign bill of exchange is (a) drawn in India upon a person resident outside India and made payable outside India, or (b) drawn outside India and payable in India.

Examples:

(a) X of Mumbai draws a bill of exchange on Y of London payable at London.

(b) A of London draws a bill of exchange on B of Delhi payable at Mumbai.

(a) *Bills in sets:* Foreign bills are generally drawn in sets of three, each of which is called a 'via'. It is only one of these three 'vias' that have to be accepted and paid for. With the acceptance and payment of any of them the others become inoperative. If, however, any person endorses different parts of a bill in favour of different persons he and all the subsequent endorsers of each part are liable on such part as if it were a separate bill (s.132). However, as between holders in due course of different parts of the same set, he who first acquired title to his part is entitled to the other parts and the money represented by the bill (s.133).

(b) *Drawee in case of need (s.7):* In case of foreign bills particularly, the drawer mentions another person, besides drawee, who may be approached for acceptance or/and payment in case the need arises. For instance, the drawee may either refuse to accept or pay or may not be available at the given address. Such a person whose name is mentioned as an alternative drawee is called a 'drawee in case of need'. In English Law, he is called 'reference in case of need'. He is so called because primarily the payee is expected to approach the drawee and it is only in case there is a problem (e.g., either the payee has refused or is not available and the like) that the 'drawee in case of need' would be contacted.

3. ***Trade and accommodation bills.*** A trade bill is a bill of exchange issued in respect of a genuine trade transaction. Such bills are drawn by the seller on the buyer in respect of payment of the price of the goods sold and purchased. But, however, all bills are not genuine bills, i.e., they do not represent a trade transaction but are drawn as a convenient mode of accommodating a friend. Thus, X may be in need of money and approaches his friend Y who instead of lending money directly, accepts a bill exchange, say for ₹ 5,000, drawn by X on Y. If the credit of Y is good it lends a currency to the bill and it can be discounted with the banker or any other person. On maturity, X remits the amount to Y who in turn pays it in honouring the bill of exchange on presentment. Thus, it provides an accommodation to the party and is, therefore, called an Accommodation Bill. The language and form of an accommodation bill is, however, similar to a genuine trade bill.

Since an accommodation bill is drawn and accepted without any consideration, it creates on obligation of payment between the parties to the transaction. But if any such party has transferred the instrument with or without endorsement to a holder for consideration, such holder and every subsequent holder deriving title from him, may recover the amount due on such instrument from the transferor for consideration or any prior party thereto (s.43).

Further, it will be pertinent to note here the provision of s.118(a) that every negotiable instrument unless the contrary is proved, "was made or drawn for consideration and that every such instrument, when it has been accepted, indorsed, negotiated, or transferred

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was accepted, endorsed, negotiated, or transferred for consideration." As the consideration in a negotiable instrument is presumed, the party denying the same has to prove his case.

4. ***Time bills (usance bills):*** Time bills, also called as usance bills, are bills payable at a fixed period after date or sight of the bills. Thus, a bill of exchange drawn payable at 3 months after the date it is drawn is a time or usance bill. Similarly, a bill drawn payable at 90 days after sight is again a time or usance bill. A time bill may also be made payable at a fixed period after an event which is certain to happen. Hence, a bill payable at 90 days after the death of the drawer will be a valid time bill.

5. ***Demand bills:*** A bill of exchange or a promissory note is payable on demand when it is made payable 'on demand' or 'at sight' or 'on presentation' (s.21). Thus, no time for payment is mentioned therein (s.19).

6. ***Clean and documentary bills:*** It is a common practice in home as well as foreign trade to deliver to the banker along with the bills of exchange, the documents to title to the goods (for example, Lorry Receipt, Railway Receipt or Bill of Lading). Where the banker is instructed to deliver to the drawee of the bill the documents of title against acceptance of the bill, the bill is called as Documents against Acceptance of Bill (D/A Bill), and where the documents are to be released only against payment, it is called as Documents against Payment of Bill (D/P Bill.) Where no documents of title to goods are enclosed to the bill, it is called a clean bill.

Acceptance of Bills

The acceptance of a bill is the indication by the drawee of his assent to the order of the drawer. Section 7 says that an acceptance is the signature of the drawee of a bill who has signed his assent upon bill and delivered it or given notice of such signing to the holder or to some person on his behalf. After acceptance, the drawee is known an acceptor. Writing the word 'accepted' is immaterial to the establishment of the drawer's responsibility. But, an oral acceptance or writing of the words accepted without the drawee's signature is not an acceptance. An acceptance to be valid must be (a) in writing, (b) signed by the drawee or his agent (c) on the bill of exchange and (d) completed by delivery to the holder or by notice of acceptance to him or some person on his behalf.

1. ***Kinds of acceptance:*** An acceptance of a bill may be general or qualified.

2. ***General acceptance:*** A general acceptance is an acceptance without any condition or qualification. Where the drawee accepts the order of the drawer in absolute, i.e., without adding any condition regarding payment, the acceptance is a general acceptance.

3. ***Acceptance for honour:*** When a bill of exchange has been noted or protested for non-acceptance for the better security and any person accepts it supra protest for honour of the drawer or of any one of the endorsers, such person is called an acceptor for honour (s.7). The question of acceptance for honour does not arise in the case of promissory notes or cheques.

4. ***Presentment for acceptance (s.61):*** It is only bills of exchange that require presentment for acceptance and that too not all but certain kinds of bills only. Bills payable on demand or on a fixed date need not be presented for acceptance. But the following bills must be presented for acceptance otherwise the parties to the bill will not be liable on it. (i) a bill payable after sight. Such a bill has to be presented for acceptance to fix maturity of the bill, (ii) a bill that contains an express stipulation that it should be presented for acceptance before it is presented for payment.

   In case where presentation for acceptance is not necessary but optional, it is always desirable to get a bill accepted as soon as possible, in order to obtain (a) the additional security of the

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acceptor's name on the bill, or (b) an immediate right of resource against the drawer and other parties if the bill is refused acceptance and thereby dishonoured.

5. ***Presentment to whom:*** Presentment for acceptance must be made- (i) to the drawer or his duly authorised agent; (ii) to all the drawees where there are more than one unless they are partners and one has express or implied authority to accept on behalf of all; (iii) to the legal representative, if the drawee is dead; (iv) to the official receiver or assignee, in case the drawee has been declared insolvent.

6. ***Time and place for presentment (Ss. 61 and 62):*** Bills must be presented for acceptance before maturity. Where a period for presentment is specified, it must be presented within that period. Where no period is specified and the presentment is obligatory, it must be made within a reasonable time. Further, the presentment must be made on a business day and within business hours. Regarding place of presentment, a bill should be presented at the place of business and where drawee has no place of business, at his residence. Where the bill is presented at the residence, it must be at the reasonable hour.

7. ***Presentment for acceptance when excused:*** Where presentment for acceptance is obligatory and the holder fails to do so, the drawer and all other parties thereon cease to be liable to him. He is not entitled to a decree, nor can he base his claim on the original consideration. However, presentment is excused under the following circumstances: (i) where the drawee cannot, after reasonable search, be found (s.61), (ii) where the drawee becomes insolvent or is dead, the bill must be presented to the official receiver or official assignee of the insolvent or to the legal representative of the deceased. (iii) where the acceptance is qualified and not absolute (s.91). (iv) where the drawee is a fictitious person or one incapable of contracting, e.g., minor or lunatic (s.91). (v) where, though presentment is irregular, the acceptance is refused on some other ground.

Parties to a Bill of Exchange

(i) The drawer - the person to whom the amount of the bill is payable. (ii) The drawee - the person on whom the bill is drawn. Thus, drawee is the person responsible for acceptance and payment of the bill. In certain cases however a stranger may accept the bill on behalf of the drawee. (iii) The payee - the person to whom amount of the bill is payable. It may be the drawer himself or any other person. (iv) The holder - is the original payee but where the bill has been endorsed, the endorsee. In case of a bearer bill, the bearer or possessor is the holder. (v) The endorser - is the person who endorses a bill. (vi) The endorsee - is the person to whom the bill is negotiated by endorsement. (vii) Drawee in case of need. (viii) Acceptor for honour.

Caselet

Government Waives Stamp Duty on Usance Bills for Exporters

—by KR Srivats

In an export friendly move, the Finance Ministry has decided to refrain from exacting the whole of the stamp duty chargeable on the usance bills of exchange executed by an exporter in an export transaction.

This move, which has come into effect from July 8, of the revenue department spells good news for the exporting community. Exporters have been demanding waiver of stamp duty on foreign bills.

Contd...

Notes

In the run up to the Union Budget, the President of the Federation of Indian Export Organisations (FIEO), Mr Rafeeque Ahmed, had urged the Finance Minister, Mr P. Chidambaram, to withdraw this levy on exporters.

Exporters are required to affix foreign bill stamps on their usance bills of above 90 days and up to 180 days.

Source: thehindubusinessline.com

Self Assessment

Fill in the blanks:

3. The promissory note must be signed by the……., otherwise it is of no effect.
4. The …….of a bill is the indication by the drawee of his assent to the order of the drawer.

4.3 Cheques

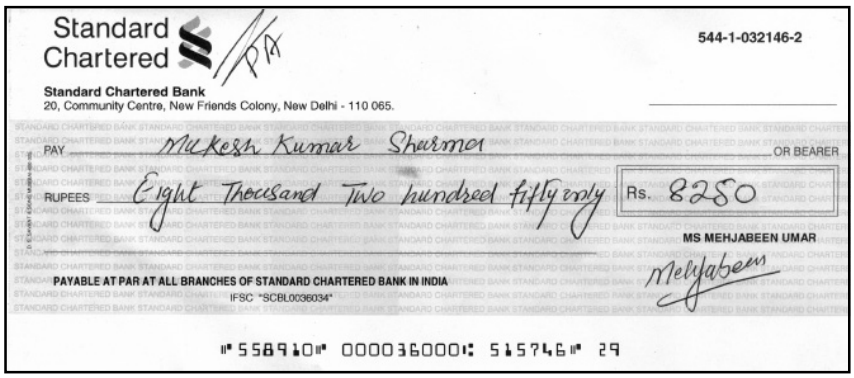
4.3.1 Meaning of a Cheque

A cheque is the usual method of withdrawing money from a current account with a banker. Savings bank accounts are also permitted to be operated by cheques provided certain minimum balance is maintained. A cheque, in essence, is an order by the customer of the bank directing his banker to pay on demand, the specified amount, to or to the order of the person named therein or to the bearer. Section 6 defines a cheque. The Amendment Act, 2002 has substituted new section for s.6. It provides that a 'cheque' is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form.

'A cheque in the electronic form' means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system.

'A truncated cheque' means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.

4.3.2 Specimen of a Cheque


Standard Chartered

544-1-032146-2

Standard Chartered Bank
20, Community Centre, New Friends Colony, New Delhi - 110 065.

PAY Mukesh Kumar Sharma OR BEARER

RUPEES Eight Thousand Two hundred fifty only Rs. 8250

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PAYABLE AT PAR AT ALL BRANCHES OF STANDARD CHARTERED BANK IN INDIA
IFSC "SCBL0036034"

⑈558910⑈ 000036000⑆ 515746⑈ 29

Notes

Every bank has its own printed cheque forms which are supplied to the account holders at the time of opening the account as well as subsequently whenever needed. These forms are printed on special security paper which is sensitive to chemicals and makes any chemical alterations noticeable. Although, legally, a customer may withdraw his money even by writing his directions to the banker on a plain paper but in practice bankers honours only those orders which are issued on the printed forms of cheques.

4.3.3 Requisites of a Cheque

The requisites of cheques are:

1. ***Written instrument:*** A cheque must be an instrument in writing. Regarding the writing materials to be used, law does not lay down any restrictions and therefore cheque may be written either with (a) pen (b) typewriter or may be (c) printed.
2. ***Unconditional order:*** A cheque must contain an unconditional order. It is, however, not necessary that the word order or its equivalent must be used to make the document a cheque. Generally, the order to bank is expressed by the word "pay". If the word "please" precedes "pay" the document will not be regarded as invalid merely on this account.
3. ***On a specified banker only:*** A cheque must be drawn on a specified banker. To avoid any mistake, the name and address of the banker should be specified.
4. ***A certain sum of money:*** The order must be only for the payment of money and that too must be specified. Thus, orders asking the banker to deliver securities or certain other things cannot be regarded as cheques. Similarly, an order asking the banker to pay a specified amount with interest, the rate of interest not specified, is not a cheque as the sum payable is not certain.
5. ***Payee to be certain:*** A cheque to be valid must be payable to a certain person. 'Person' should not be understood in a limited sense including only human beings. The term in fact includes 'legal persons' also. Thus, instruments drawn in favour of a body corporate, local authorities, clubs, institutions, etc., are valid instruments being payable to legal persons.
6. ***Payable on demand:*** A cheque to be valid must be payable on demand and not otherwise. Use of the words 'on demand' or their equivalent is not necessary. When the drawer asks the banker to pay and does not specify the time for its payment, the instrument is payable on demand (s.19).
7. ***Amount of the cheque:*** Amount of the cheque must be clearly mentioned. The amount should be written both in words as well as figures so as to avoid mistakes. Moreover, the amount should be so written as to leave no blank space before or after the words and figures specifying the amount. In case a customer does so, though innocently and his banker pays the forged amount because the forgery is not noticeable in spite of reasonable care, the banker would be justified in debiting his account with the amount actually paid.
8. ***Dating of cheques:*** The drawer of a cheque is expected to date it before it leaves his hands. A cheque without a date is considered incomplete and is returned unpaid by the banks. The drawer can date a cheque with the date earlier or later than the date on which it is drawn. A cheque bearing an earlier date is antedated and the one bearing the later date is called postdated. A postdated cheque cannot be honored, except at the personal risk of the bank's manager, till the date mentioned. A postdated cheque is as much negotiable as a cheque for which payment is due, i.e., the transferee of a postdated cheque, like that of the cheque on which payment is due, acquires a better title than its transferor, if he is a holder in due course. A cheque that bears a date earlier than six months is a stale cheque and cannot be claimed for.

Notes

4.3.4 A Bill of Exchange and a Cheque Distinguished

Though, a cheque is defined as a bill of exchange, it differs from the latter in the following respects:

Table 4.2: Distinction between a Cheque and a Bill of Exchange

Cheque	Bill of Exchange
It must be drawn only on a banker.	It can be drawn on any person including a banker.
The amount is always payable on demand.	The amount may be payable on demand or after a specified time.
The cheque is not entitled to days of grace.	A usance (time) bill is entitled to three days of grace.
Acceptance is not needed.	A bill payable after sight must be accepted.
A cheque can be crossed.	Crossing of a bill of exchange is not possible.
Notice of dishonour is not necessary. The parties thereon remain liable, even if no notice of dishonour is given.	Notice of dishonour is necessary to hold the parties liable thereon. A party who does not receive a notice of can generally escape its liability dishonour thereon.
A cheque is not to be noted or protested in case of dishonour.	A bill is noted or protested to establish dishonour.
The protection given to the paying banker in respect of crossed cheques is peculiar to this instrument.	No such protection is available in the case of bills.

Did u know? **Out-of-date, or Stale and Overdue Cheques**

The paying banker is bound to pay only such cheques as are presented to him for payment within a reasonable time of issue. Usually, the cheque presented after six months of the date mentioned thereon are considered stale and hence are returned by the banker for their confirmation of the drawers. This period of six months is sometimes varied by a special agreement with a particular customer. For example, a company issuing dividend warrants, reduces this period to three months. In any case, the company may revalidate the same on the request of the holder who fails to present it within the stipulated period of three months.

Section 84 provides that if the holder fails to present the cheques for payment within a reasonable time of its issue and in the meanwhile the bank fails causing damage to the drawer, the latter is then discharged as against the holder to the extent of the actual damage suffered by him. The Limitation Act provides that a cheque becomes time-barred after three years from its date of issue.

Self Assessment

Fill in the blanks:

5. A cheque must be drawn on a ……..banker.
6. A cheque in the electronic form means a cheque which contains the exact …….of a paper cheque.

Notes

4.4 Holder and Holder in Due Course

4.4.1 Meaning

According to s.8, a holder of a negotiable instruments is "a person entitled in his own name to the possession thereof and to receive or recover the amount due thereon from the parties thereto. Where the note, bill or cheque is lost or destroyed, its holder is the person so entitled at the time of such loss or destruction". Thus, a person who has obtained the possession of an instrument by theft or under a forged endorsement is not a holder as he is not entitled to recover the amount of the instrument.

A 'holder in due course', on the other hand, is "a person who for consideration became the possessor of a promissory note, bill of exchange or cheque, if payable to bearer, or the payee or endorsee thereof, if payable to order, before the amount mentioned in it becomes payable and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title (s.9)". Thus, where a person receives a negotiable instrument without consideration, he may be a holder but will not be called a holder in due course. Besides, the title of holder of a negotiable instrument is always subject to the title of its transferor whereas a holder in due course acquires a better title than that of its transferor. So where a lost negotiable instrument is transferred to a person who takes it, say, without consideration and thus becomes the holder, he will not be entitled to enforce his claim against its real owner. But, if he is a holder in due course as per s.9, he will be able to establish his claim even against the real owner of that instrument. Also, in order to be a holder in due course the holder must have obtained the instrument before maturity. It he obtains it after the instrument is due, then the right of a holder is that of his transferor (s.59). From the definition of holder in due course as given in s.9 it can be inferred that a holder must satisfy the following criteria so as to be known as a holder in due course: (i) he must have taken the instrument for value; (ii) he must have obtained the instrument before maturity; (iii) the instrument is not incomplete or irregular and does not have any defect on the face of it; (iv) he must have taken the instrument in good faith and without notice of any defect in the title of the person from who he derived his title.

4.4.2 Privileges of a Holder in Due Course

A holder in due course is given certain additional privileges under the Act, which are not available to a holder:

1. ***Privilege against inchoate stamped instruments:*** According to s.20, a person, who signed and delivered to another a stamped but otherwise inchoate (incomplete) instrument, is stopped from asserting, as against a holder in due course, that the instrument has not been filled in accordance with the authority given by him provided the amount filled is covered by the stamp affixed.
2. As per s.3, every prior party to a negotiable instrument, i.e., the maker or drawer, the acceptor and all the intermediate endorsers continue to remain liable to the holder in due course until the instrument is duly satisfied.
3. ***Fictitious drawer or payee:*** Where a bill of exchange is drawn by a fictitious person and is payable to his order, the acceptor cannot be relieved from his liability to the holder in due course. The holder in due course shall, however, have to prove that the instrument was endorsed by the same hand as drawer's signature (s.42).
4. When a negotiable instrument is made, drawn accepted or transferred without consideration and the negotiable instrument gets into the hands of a holder in due course, then the plea

of absence of consideration cannot be raised against him or against any subsequent holder deriving title from him (s.43).

5. Where an instrument is negotiated to a holder in due course, the parties to the instrument cannot escape liability on the ground that the delivery of the instrument was conditional or for a special purpose only (s.46).

6. ***Right of an endorsee from a holder in due course:*** Not only that the title of the holder in due course is not subject to the defect in previous holder's title but once that instrument passes through the hands of a holder in due course, it is purged of all defects. Any person acquiring it takes it free of all defects, unless he was himself a party to the fraud (s.53).

7. ***Estoppel against denial of validity:*** Section 120 provides that no maker of a promissory note and no drawer of a bill of exchange or cheque shall, in a suit thereon by a holder in due course, be permitted to deny the validity of the instrument as originally made or drawn.

8. ***Estoppel against denial of payee's capacity:*** No maker of a note and no acceptor of a bill payable to order is, in a suit thereon by a holder in due course, permitted to deny the payee's capacity at the date of the note or bill to endorse it (s.121).

9. ***Presumption:*** Section 118 provides that every holder is deemed prima facie to be a holder in due course. The burden of proving his title does not lie on him.

10. ***Prior defects (s.58):*** The party liable to pay an instrument cannot, as against a holder in due course, contend that he had lost the instrument or that it was obtained from him by means of an offence or fraud, or for an unlawful consideration.

Example: A cheque is given to an employee of a company to enable him to withdraw money for payment of workers' bonus. He instead transfers the cheque to a bank for consideration. The bank will be entitled to get the payment on the cheque.

11. ***Endorser not permitted to deny the capacity of prior parties:*** The endorser of a negotiable instrument cannot, in a suit thereon by a subsequent holder, deny the signature or capacity to contract of any prior party to the instrument (s.122).

Self Assessment

Fill in the blanks:

7. Where the note, bill or cheque is lost or destroyed, ……..is the person so entitled at the time of such loss or destruction.

8. In order to be a holder in due course the holder must have obtained the instrument before…....

4.5 Negotiation of a Negotiable Instrument

The transfer of an instrument by one party to another so as to constitute the transferee a holder thereof is called 'negotiation'. A bearer instrument is transferable by mere delivery (s.14). An instrument payable to order can be transferred by endorsement and delivery (s.46).

4.5.1 Negotiation and Assignment

The negotiation of an instrument should be distinguished from assignment. Let's first see what is assignment and what are the common points in negotiation and assignment. When a person

Notes

transfers his right to receive the payment of a debt that is called "assignment of the debt". Where, for example, the holder of a life insurance policy takes a loan from a bank, he transfers the right to receive the payment under the policy to the bank, that is an assignment. Where the holder of a note, bill or cheque transfers the same to another, he in essence, gives his right to receive the payment of the instrument to the transferee. Thus, both the assignment and negotiation involve the transfer of the right to receive the payment of debt. However, the rights, which the transferee of an instrument by negotiation acquires are substantially superior to those of an assignee. When an instrument is negotiated, its transferee gets good title irrespective of the defective title, if any, of the transferor. On the other hand, when transfer is made by assignment, the assignee has only those rights, which the assignor possessed.

A negotiable instrument may be transferred by negotiation or assignment. When a negotiable instrument is transferred by negotiation, its transferee, if a holder in due course, gets a better title than its transferor. On the other hand, when the transfer is made by way of assignment, the assignee has only those rights which the assignor possesses. Thus, although law does not prohibit transfer of negotiable instruments by means other than negotiation, transfer by negotiation has certain advantages.

Negotiation by mere delivery: Section 47 provides that a bill or cheque payable to bearer is negotiated by mere delivery of the instrument.

Payable to bearer: An instrument is payable to bearer (1) where it is made so payable, or (2) where it is originally made payable to order but the only or the last indorsement is in blank. A cheque which is originally drawn payable to bearer remains bearer even though it is subsequently endorsed in full. The rule is once a bearer cheque always a bearer cheque, or (3) where the payee is a fictitious person.

In case of negotiation by mere delivery, the transferor incurs no obligation to any party other than the immediate transferee. The transferee becomes the holder of the instrument within the meaning of s.8. The importance of delivery of the instrument cannot be overemphasised; as without it the transferee does not become a holder thereof. Thus, a thief or finder of an instrument cannot be termed as holder. However, if the thief or the finder negotiates the same to another person, then that other person does become the holder of the instrument.

"Subject to the provisions of s.58 a promissory note, bill of exchange or cheque payable to bearer is negotiable by delivery thereof."

Exception: A promissory note, bill of exchange or cheque delivered on condition that it is not to take effect except in a certain event is not negotiable (except in the hands of a holder for value without notice of the conditions) unless such event happens.

Examples:

1. A, the holder of a negotiable instrument payable to bearer, delivers it to B's agent to keep for B. The instrument has been negotiated.
2. A, the holder of a negotiable instrument payable to bearer, which is in the hands of A's bankers, who is at the time the banker of B, directs the bankers to transfer the instrument to B's credit in B's account with the bank. The banker does so and accordingly now possesses the instrument as B's agent. The instrument has been negotiated and B has become the holder of it.

Negotiation by Endorsement and Delivery: Instruments payable to a specified person or to the order of a specified person can be negotiated only by endorsement and delivery. If an instrument payable to order is transferred without endorsement, it is merely assigned and not negotiated and the holder thereof shall not be entitled to the rights of a holder in due course.

Notes

4.5.2 Endorsement

An endorsement is the mode of negotiating a negotiable instrument. A negotiable instrument payable otherwise than to bearer can be negotiated only by indorsement and delivery. An endorsement according to s.15, is "when the maker or holder of a negotiable instrument signs the same otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to endorse the same and is called the endorser". The person to whom the instrument is endorsed is called the endorsee. Usually the endorsement is on the back of the instrument; though it may be even on the face of it. Where no space is left on the instrument, the endorsement may be made on a slip of paper attached to it. This attached slip of paper is called 'Allonge'.

Kinds of Endorsement

Endorsement may take any of the following seven forms:

1. ***Endorsement in blank:*** Where the endorser just puts his signature without specifying the endorsee, the endorsement is said to be in blank (s.160). The effect of such an endorsement is to render the instrument payable to bearer even though originally payable to order (s.54). No further endorsement is needed for its negotiation.

Example: A cheque is payable to 'X or order', and 'X' merely signs on the back of it. This will constitute endorsement in blank. Where an endorsement in blank is subsequently followed by an endorsement in full, the endorser in full will be liable to his immediate endorsee and parties deriving title from him, but not to others (s.55).

2. ***Endorsement in full:*** Where along with endorser's signature, the name of the endorsee is specified, the endorsement is called endorsement in full (s.16). Thus, where the instrument states, 'Pay Y or order', and is signed by 'X', the payee, it constitutes 'endorsement in full'. An endorsement in blank may be converted into 'endorsement in full' by the holder by merely adding above the endorser's signature, a direction to pay to any other person. By doing so, the endorser does not incur any responsibility of an endorser. (s.49).

Example: A cheque is endorsed in blank by 'X'. Y, the holder of the cheque, may convert this 'blank endorsement' into 'endorsement in full' by say, adding the words 'Pay Z or order', above 'X's signature. Y, in this case cannot be held liable on the cheque, if it is dishonoured.

3. ***Restrictive endorsement:*** An endorsement is restrictive which prohibits the further negotiation of a negotiable instrument. Section 50 states: "The endorsement may, by express words, restrict or exclude the right to negotiate or may constitute the endorser an agent to endorse the instrument or to receive its contents for the endorser or for some other specified person."

Example: If a cheque is endorsed 'Pay X only', or 'Pay D for the account of X', it cannot be negotiated further.

4. ***Conditional endorsement:*** A conditional endorsement is one which makes the transfer of the property in a negotiable instrument from the endorser to the endorsee dependent upon the fulfillment of a stated condition. Thus, according to s.52, where an endorser makes his liability on the instrument conditional on the happening of a particular event, it is called conditional endorsement, though such event may never happen. Similarly, the right of the endorser may be made conditional on the happening of a particular event.

Notes

Example: Where the endorsement states "Pay 'X' if he reaches Delhi". In such a case, X can claim payment on the instrument only if he reaches Delhi.

5. ***Endorsement 'sans recourse':*** An endorser of a negotiable instrument may, by express words in the endorsement, exclude his own liability thereon (s.52). Such endorsement is called Endorsement sans recourse; or 'without resource to me'.

Example: Where X endorses a cheque as 'Pay Y or order San Recourse', or 'Pay Y or order without Recourse to me', X will not be liable on the instrument if it is dishonoured.

6. ***Facultative endorsement:*** Where such words are added to an endorsement whereby the endorser waives his right to receive notice of dishonour, the endorsement is termed as 'facultative endorsement'.

7. ***Partial endorsement (s.56):*** Where the negotiable instrument is endorsed for part of the amount, it is called partial endorsement. Such endorsement is not valid.

Did u know? **Negotiation Back**

When a bill of exchange comes back to the acceptor by the process of negotiation, and he becomes its holder, it is called negotiation back.

Effect of Endorsement

An unconditional endorsement of a negotiable instrument followed by its unconditional delivery has the effect of transferring the property therein to the endorsee. The endorsee acquires a right to negotiate the instrument to anyone he likes and to sue all parties whose names appear on it.

The effect of an endorsement in blank and delivery of an instrument originally made, drawn payable to order is to convert it into one payable to bearer and transferable by mere delivery.

The effect of restrictive endorsement is (a) to prohibit or exclude further negotiation, or (b) to constitute the endorsee an agent of endorser to endorse the instrument, or (c) to constitute the endorsee as agent to receive its contents for some other specified persons.

In case joint payees are endorsees, all of them must endorse the instrument otherwise the endorsement is rendered as invalid, even if it is made in favour of the other payee.

Notes **Forged Endorsement (S.85)**

In case an instrument is endorsed in full, it cannot be endorsed or negotiated except by an endorsement signed by the person to whom or to whose order the instrument is payable. Thus, if such an instrument is negotiated by way of a forged endorsement, the endorsee will acquire no title even though he be a purchaser for value and in good faith, because the endorsement is nullity. But where the instrument has been endorsed in blank, it can be negotiated by mere delivery and the holder derives his title independent of the forged endorsement and can claim the amount from any of the parties to the instrument.

For example, A bill is endorsed, "pay to X or order". X endorses it in blank and it comes into the hands of Y, who simply delivers it to A. A forges Y's endorsement and transfers it to B. B, as the holder, does not derive his title through the forged endorsement to Y, but through the genuine endorsement of X and can claim payment from any of the parties to the instrument in spite of the intervening forged endorsement.

Notes

Self Assessment

Fill in the blanks:

9. Section ……provides that a bill or cheque payable to bearer is negotiated by mere delivery of the instrument.

10. Where along with endorser's signature, the name of the endorsee is specified, the endorsement is called ……

4.6 Presentment

Presentment of a negotiable instrument is made for two purposes: (i) for acceptance and (ii) for payment. Before discussing the presentment for payment, it is necessary to refer to the maturity of the instrument.

4.6.1 Maturity (Ss.21-25)

Cheques are always payable on demand but other instruments like bills, notes, etc., may be made payable on a specified date or after the specified period of time. The date on which payment of an instrument falls due is called maturity (s.22). Therefore most of the provisions relating to presentment for payment are linked with the maturity of the instrument. Section 21 provides that a note or bill 'at sight' or 'on presentment' is payable on demand. It is due for payment as soon as it is issued. Therefore the question of maturity arises only in the case of a note or bill payable 'After sight' or 'After date' or at a certain period after the happening of an event which is certain to happen.

Section 22 provides that the maturity of a note or bill is the date on which it falls due. Further, it adds that in calculating the maturity of a note or bill which is not payable on demand, at sight or on presentment, three days - called the days of grace - must be added to the date on which the instrument is expressed to be payable. Thus a note or bill payable after a specified period after date or after sight matures or falls due on the last day of the grace period and must be presented for payment on that day and if dishonoured, suit can be filed on the next day after maturity.

4.6.2 Presentment for Payment

A negotiable instrument must be presented for payment to the maker, acceptor or drawee thereof, as the case may be, by the holder or his agent. In case of default, the parties to the instrument other than the maker, acceptor or drawee are not liable to such holder (s.64). The presentment for payment must be made during the usual hours of business, and at a banker's premises, during banking hours (s.65).

Self Assessment

Fill in the blanks:

11. The date on which payment of an instrument falls due is called…….

12. Presentment of a negotiable instrument is made for two purposes which are for acceptance and for …….

Notes

4.7 Dishonour

4.7.1 Dishonour of a Bill

A bill of exchange may be dishonoured either by non-acceptance or by non-payment. A negotiable instrument is said be dishonoured by non-payment when the maker, acceptor or drawee, as the case may be, makes default in payment upon being duly required to pay the same (s.92). The effect of dishonour of a negotiable instrument whether by non-acceptance or non-payment is to render the drawer and all the endorsers liable to the holder. However, their liability can be invoked only if the holder gives them notice of such dishonour. The drawer is liable only if the instrument is dishonoured by non-payment.

When a negotiable instrument is dishonoured by non-acceptance or non-payment, the holder must give notice of dishonour to the drawer and all other parties whom he seeks to make liable.

4.7.2 Noting

Noting is a convenient method of authenticating the fact of dishonour. Where an instrument is dishonoured, the holder, besides giving the notice as referred to above, should get the bill or promissory note 'noted' by the notary public. The notary public presents the instrument, notes down in his register the date of its dishonour and the reason, if any, given by the acceptor. If the instrument has been expressly dishonoured, the reason why the holder treats it as dishonoured, and the notary's charges should be mentioned. 'Noting' must be made within a reasonable time after dishonour. The holder may cause such dishonour to be noted by the notary public upon the instrument or upon a paper attached thereto or partly upon each (s.99). Every notary is required to have and use a seal, and an act can only be deemed a notarial act if it is done by a notary under his signature and official seal. However, noting is not compulsory in the case of an inland bill or note, but foreign bills must be protested, if so required by the law of the place where drawn.

4.7.3 Protesting (S.100)

The protest is the formal notarial certificate attesting the dishonour of the bill and based upon the noting. After the noting has been made, the formal protest may be drawn up by the notary at his leisure. When the protest is drawn up it relates back to the date of noting.

Sometimes, a bill is protested for better security. This may happen when the acceptor of a bill has become insolvent, or has suspended payment or his credit has been publicly impeached before the maturity of the bill. It should, however, be noted that the acceptor is not bound to give such security, nor can the holder sue the endorsers or drawers before maturity in spite of protest.

Self Assessment

Fill in the blanks:

13. The effect of dishonour of a negotiable instrument whether by non-acceptance or non-payment is to render the drawer and all the endorsers liable to the…….
14. The ……..is the formal notarial certificate attesting the dishonour of the bill and based upon the noting.

Notes

4.8 Crossing of Cheques

Crossing is a unique feature associated with a cheque affecting to a certain extent the obligation of the paying banker and also its negotiable character. It is a peculiar method of modifying the instrument to the banker for payment of the cheque. Crossing on cheque is a direction to the paying banker by the drawer that payment should not be made across the counter. The payment on a crossed cheque can be collected only through a banker. Section 123 defines crossing as, "Where a cheque bears across its face an addition of the words 'and company' or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines simply, either with or without the words, 'not negotiable', that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed generally." The crossing of a cheque is effected by drawing two parallel transverse lines with or without the words 'and company' or any abbreviation thereof. A cheque having the cross mark such as 'X' is not generally regarded as a crossed cheque. A cheque that is not crossed is a called an open cheque.

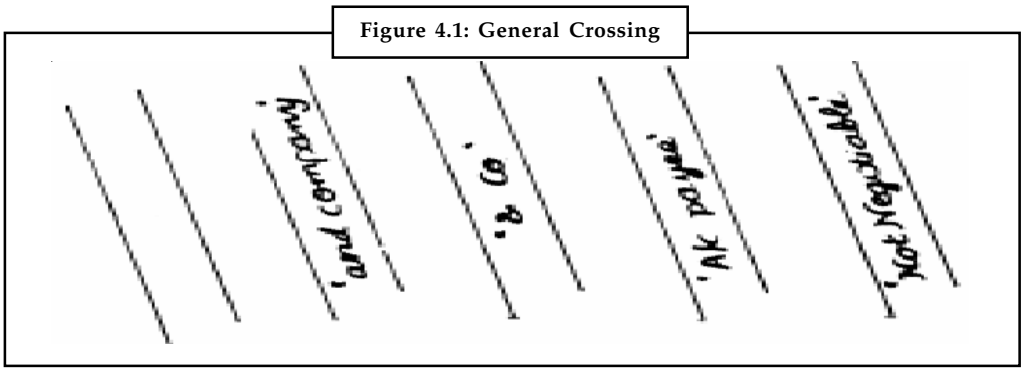
4.8.1 Significance of Crossing

As payment cannot be claimed across the counter on a crossed cheque, crossing of cheques serves as a measure of safety against theft or loss of cheques in transit. By crossing a cheque, a person, who is not entitled to receive its payment, is prevented from getting the cheque encashed at the counter of the paying banker.

4.8.2 Types of Crossing

Crossing may be either (1) General or (2) Special. The term general crossing implies the addition of two parallel transverse lines.

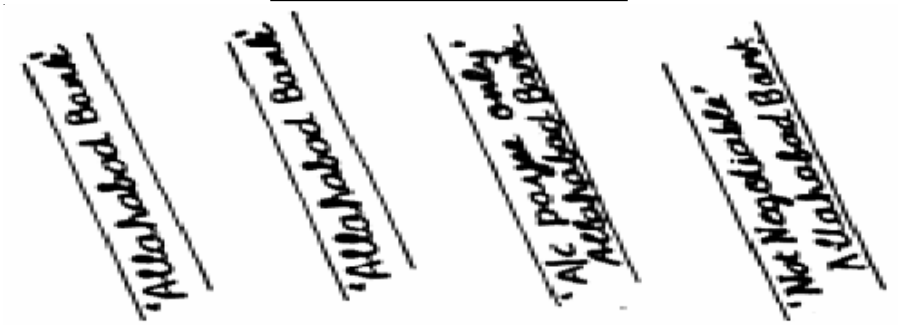
Figure 4.1: General Crossing



Special Crossing' implies the specification of the name of the banker on the face of the cheque. Section 124 in this regard reads: "Where a cheque bears across its face, an addition of the name of banker, either with or without the words 'not negotiable', that addition shall be deemed a crossing, and the cheque shall be deemed to be crossed specially, and to be paid to that banker". The drawing of two parallel lines is not necessary in case of a specially crossed cheque. The object of special crossing is to direct the drawee banker to pay the cheque only if it is presented through the particular bank mentioned therein. Thus, it makes the cheques more safer.

Notes

Figure 4.2: Special Crossing



Not Negotiable Crossing

We have mentioned above that crossing whether 'general' or 'special' may be accompanied by words 'not negotiable'. The effect of inclusion of such words will not be to render the cheques 'non-transferable'. Such cheques can very well be transferred by endorsement and delivery. But as per s.130, a person who takes such a cheque shall not have and shall not be capable of giving a better title to the cheque than that which the person, from whom he took it in the first instance had. Thus, by including the words 'not negotiable', the cheque is deprived of its special feature of negotiability. Such a cheque is like any other goods where the title of the transferee is always subject to the title of the transferor. A bank, therefore, should be extra careful in paying such cheques. The payment should be made only after he is satisfied that the person demanding payment is the person entitled to receive it.

Account Payee Crossing (A/c Payee Crossing)

An A/c payee crossing signifies that the drawer intends the payment to be credited only to the payee's account and in none else. The addition of 'A/c payee' to a crossing has no legal sanctity and the paying banker may ignore such a direction without being liable for any damages. In practice, however, the collecting banker sees to it that such instruction is carried out.

Not Negotiable (A/c Payee Crossing)

The combination of 'not negotiable' and 'A/c payee,' crossing is the safest form of crossing. It has double advantage. The instrument is rendered not negotiable (making the 'paying banker' responsible to see that payment is made to the person who is entitled to receive it) plus A/c payee crossing directs the collecting banker to collect it for the payee only and warns that if the amount is collected for someone else, he may be held liable for damages.

4.8.3 Who can Cross a Cheque?

As noted above, crossing is an instruction to the banker not to pay across the counter. Thus, it lends security to the cheque and ensures payment to the payee or his order. A cheque may be crossed by any of the following: (i) The drawer of a cheque (ii) The holder of a cheque. When a cheque is issued uncrossed, it may be crossed generally or specially by its holder. If the cheque is already crossed generally, he may convert it into special crossing by adding the name of a particular bank. Further, a holder may add the words 'not negotiable' in case of both the types of crossing. However, a holder cannot convert special crossing into general, as it amounts to

material alteration of the cheque. (iii) The banker, in whose favour the cheque has been crossed specially, may again cross it specially in favour of another banker. The latter bank in such a case acts as the agent of the former.

Self Assessment

Fill in the blanks:

15. A cheque that is not crossed is a called an ……cheque.
16. ……Crossing implies the specification of the name of the banker on the face of the cheque.

4.9 The Paying Banker

The 'paying banker' is a term used to denote the position and duties of the drawee-banks in paying the cheques of their customers. Thus, 'paying banker' is a banker upon whom a cheque is drawn.

4.9.1 Payment in Due Course

What is a payment in due course is defined in s.10 and has been given above. The following conditions must be satisfied before a payment of a negotiable instrument can be called as a payment in due course:

1. ***Payment must be in accordance with the apparent tenor of the instrument:*** It is necessary that a payment to constitute a payment in due course should be made at or after maturity. A payment before maturity is not a payment in due course. For example, payment of a post dated cheque is not a payment in due course.
2. ***Payment must be made in good faith and without negligence:*** When there exists suspicious circumstances and the paying banker fails to make any enquiry as to them, the payment is not in due course. So payment is not in due course, where a banker makes payment on a cheque materially altered, without exercising due care.
3. ***Payment must be made to the person in possession of the instrument:*** A payment is not a payment in due course if it is made to a person entitled to receive it. A thief is not said to be in possession of the instrument. Thus, in the event of suspicious circumstances, payment should not be made without drawer's confirmation.
4. ***Payment must be made under circumstances which do not afford a reasonable ground for believing that a person is not entitled to receive payment of the amount mentioned therein:*** So, where a peon of a company presents a cheque for a big amount on behalf of the company, which is contrary to the past experience, the banker should conduct proper enquiry before making payment on such a cheque.
5. ***Payment must be made in money only:*** Payment must be made in money only unless the payee agrees to accept payment in some other form (e.g., bill of exchange or promissory note). Money includes bank notes or currency notes but excludes cheque, bills of exchange, promissory notes and goods.

Thus, under s.10, payment in due course means payment in accordance with the apparent tenor of the instrument made in good faith and without negligence.

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4.9.2 Dishonour of a Cheque on Ground of Insufficiency of Funds

Sections 138 to 142 incorporated by the Amendment Act in 1988 provide for criminal penalties in the event of dishonour of cheques for insufficiency of funds. The drawer, under s.138, may be punished with imprisonment up to 2 years or with a fine up to twice the amount of the cheque or with both. However, in order to attract the aforesaid penalties following conditions must be satisfied:

1. The cheque has been dishonoured due to insufficiency of funds only – either the amount of money standing to the credit of the account is insufficient or that the amount of cheque exceeds the amount arranged to be paid from that account by an agreement with the bank.
2. The payment for which the cheque was issued should have been in discharge of a legally enforceable debt or liability in whole or part of it. It implies that a cheque given as gift will not attract such punishment.
3. The cheque should have been presented to the paying banker within 6 months from the date on which it is drawn or within the period of validity, whichever is earlier.
4. The payee or the holder in due course of the cheque should have given notice in writing to the drawer demanding payment, within 30 days of the receipt of information of dishonour of the cheque from the bank. The court shall take cognisance of the offence under s.138 only if the complaint is made by the payee or by the holder in due course of the cheque.
5. The drawer is liable only if he fails to make the payment within 15 days of such notice period. In other words, the drawer can make payment within 15 days of the receipt of the notice.
6. The payee or holder in due course of the cheque dishonoured should have made a complaint within one month of cause of action arising out of s.138 (i.e., expiry of 30 days' time given to the drawer to make payment s.142).

It may be noted that the holder of a cheque shall be presumed to have received the cheque for discharge, in whole or in part, of any debt or other liability (s.139). The drawer of the dishonoured cheque cannot defend himself on the ground that he had no reason to believe when he issued the cheque, that the cheque may be dishonoured on presentation on account of insufficiency of funds (s.140).

Further, the cheque will be deemed to have been dishonoured for insufficiency of funds in the following situations:

1. where there is a notice of stop-payment to the bank, unless the notice can be justified.
2. where the account has been closed by the drawer.
3. where the payee is directed by the drawer not to present the cheque to the bank for payment.

However, no court shall take cognisance of any offence punishable under s.138 except upon a complaint, in writing, made, by the payee, or, as the case may be, the holder in due course of the cheque. Further, no court inferior to that of a Metropolitan Magistrate or Judicial Magistrate of the First Class shall try any offence punishable under s.138 (s.142).

Offence by Companies

If the person committing an offence is a company, every person, who at the time the offence was committed, was in charge of and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of offence and shall be

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liable to be proceeded against and punished accordingly. Further, a director, manager, secretary or other officer of the company shall be liable to be proceeded against and punished accordingly in case the offence has been committed with his consent or connivance, or is attributable to any neglect on his part in this regard. However, a person will not be liable in case: (i) where such person proves that the offence was committed without his knowledge, or (ii) where he had exercised all due diligence to prevent the commission of such offence. The expression 'Company' here includes any body corporate and includes a firm and association of individuals; and 'Director' in relation to a firm, means a partner in the firm (s.141).

The provisions of Negotiable Instrument (Amendment and Miscellaneous Provisions) Act, 2002 as regards section 138, 141-143 are summarized below:

1. The jail term for the accused has been enhanced from existing 1 year to 2 years (s.138).
2. The period of sending notice by the payee to the drawer has been extended from earlier 15 days to 30 days from the date of receipt of information by him from the bank regarding the return of the cheque as unpaid/bounced. (s.138).
3. Any person who is nominated as a director of the company by virtue of his holding any office or employment in the Central Government or State Government or financial corporation owned or controlled by the central or state government shall not be liable for prosecution under s.138 (s.141).
4. The court can take cognizance of a complaint after the prescribed period of one month, provided sufficient cause exists for not filing the complaint within one month. (s.142).
5. The court can try the cases summarily notwithstanding anything contained in Cr. P.C. and the provisions of section 262 to 265 of Cr.P.C. shall, as far as may be, apply to such trials (s.143).
6. Every trial shall be conducted as expeditiously as possible and an endeavour shall be made to conclude the trial within six months from the date of filing of the complaint (s.143).
7. Notwithstanding anything contained in Cr.P.C. and for the purpose of such trial of bounced cheques, a Magistrate issuing a summons for an accused or a witness may direct a copy of summons to be served at the places where such accused or witness ordinarily resides or carries on business or personally works for gain, by speed post or by such courier services as are approved by a Court of Sessions (s.144).
8. Where an acknowledgment purporting to be signed by the accused or the witness or an endorsement purported to be made by any person authorized by the postal department or the courier services that the accused or the witness refused to take delivery of summons has been received, the court issuing the summons may declare that the summons has been duly served (s.144).
9. Notwithstanding anything contained in Cr. P.C. the evidence of the complainant may be given by him on affidavit and may, subject to all just exceptions, be read in evidence in any enquiry, trial or other proceeding under the Cr. P.C. (s.145).
10. The court may, if it thinks fit, and shall, on the application of the prosecution or the accused, summon and examine any person giving evidence on affidavit as to the facts contained therein (s.145).
11. The court shall, in respect of every proceeding for cheque bounce offences, on production of Bank's slip or memo having thereon the official mark denoting that the cheque has been dishonoured, presume the fact of dishonour of such cheque, unless and until such fact is disproved (s.146).

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12. Notwithstanding anything contained in Cr.P.C. every offence of cheque bouncing shall be compoundable (s.147).

13. The provisions of the Information Technology Act, 2000 are made applicable to Negotiable Instruments Act in relation to electronic image of a truncated cheque and a cheque in the electronic form (sections 5, 81, 39, and 131 of the Negotiable Instruments Act, 1881).

4.9.3 Consequences of a Wrongful Dishonour

If a banker, without justification, dishonours his customer's cheque, he makes himself liable to compensate the customer for any loss or damage. The words 'loss or damage' used in s.31, not only mean the pecuniary loss but also loss of credit or injury to reputation of the customer. Thus, if the customer is a trader or a business man, the damages may be substantial. But, a non-trader is not entitled to recover substantial damages for the wrongful dishonour of his cheque. Thus, a non-trader may be awarded only nominal damages because of the absence of any special loss. In assessing the damages for injury to credit, the Courts give due consideration to various factors, such as financial position and business reputation of the customer and the customs of the trade to which he may belong.

The Amendment Act, 2002 has added an Explanation to s.131. It provides that it shall be the duty of the banker, who receives payment based on an electronic image of a truncated cheque held with him, to verify the prima facie genuineness of the cheque to be truncated and any fraud, forgery or tampering apparent on the face of the instrument that can be verified with due diligence and ordinary case.

4.9.4 Collection of Bills

Unlike cheques, a banker is not charged with the legal responsibility of collection of his customer's bills. But, in fact, no commercial bank can afford to exist without providing this facility to his customers. In collecting bills a banker has to be extra cautious in examining the title of the depositor as the statutory protection contained in s.131 does not extend to bills. Thus, if the title of the banker's customer turns out to be defective, the true owner can claim the amount of the bill from the banker. The banker, though he can claim the amount from his customer, should accept bills for collection only on behalf of the trusted parties. In case of new customers, the bank should extend this facility to customers with a trusted reference.

Task Writing on a bill of exchange is effaced by sea water. Is the instrument invalid? Discuss.

Self Assessment

Fill in the blanks:

17. It is necessary that a payment to constitute a payment in due course should be made at or after……..

18. The provisions of the Information Technology Act, 2000 are made applicable to Negotiable Instruments Act in relation to …….of a truncated cheque

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4.10 International Law Concerning Negotiable Instruments

There are four sections dealing with the international law concerning Negotiable Instruments. These are explained below:

Liability on Foreign Instruments (S.134)

In the absence of a contract to the contrary, the liability of the maker or drawer of a foreign bill, note or cheque is governed in all essential respects by the law of the place where he made the instrument. The respective liability of the acceptor and endorser is governed by the law of the place where the instrument is made payable.

Example: A bill is drawn by A in California, where the rate of interest is 25 per cent and accepted by B, payable in Washington, where the rate of interest is 6 per cent. The bill is indorsed in India and is dishonoured. An action on the bill is brought against B in India. He is liable to pay interest at the rate of 6 per cent only; but if A is charged as drawer, he is liable to pay interest at the rate of 25 per cent.

Law in Respect of Dishonour (S.135)

Where an instrument is made payable in a different country from that in which it is made or endorsed, the law of the country where it is made payable determines what constitutes dishonour and what notice of dishonour is sufficient.

Example: A bill drawn and endorsed in India, but accepted payable in France, is dishonoured. The endorsee causes it to be protested for such dishonour and gives notice thereof in accordance with the law of France, though not in accordance with the rules contained in respect of bills which are not foreign. The notice is sufficient.

Foreign Instruments made in Accordance with Indian Law (S.136)

If a negotiable instrument is made, drawn, accepted or endorsed out of India, but in accordance with the law of India, the circumstance that any agreement evidenced by such instrument is invalid according to the law of the country wherein it was entered into does not invalidate any subsequent acceptance or endorsement made thereon in India.

Presumption as to Foreign Law (S.137)

The law of any foreign country regarding negotiable instruments shall be presumed to be the same as that of India unless and until the contrary is proved.

Self Assessment

Fill in the blanks:

19. There are …….sections dealing with the international law concerning Negotiable Instruments.
20. Where an instrument is made payable in a different country from that in which it is made or endorsed, the law of the country where it is ……determines what constitutes dishonour.

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Case Study

City Limouzines India Ltd. Cheque Bounced – Fraud Case

Deepak is a client of City Limouzines India Ltd. He received a cheque of amount ₹ 6000 dated as 2-Sep-2009 from City Limouzines India Ltd., and deposited same cheque on 7-Sep-2009 in his Bank, which has been bounced with narration "Insufficient Balance".

He called on City Limouzines India Ltd. help line for same, but didn't get any satisfactory response from help line, He called on "Toll Free / 24x7 Helpline: 23814792" at 2:16 PM on dated 12-Sep-2009 a lady picked the call and she didn't show any interest to resolve his query/concern, she hanged the phone with stating that "We will dispatch a letter after 20th Sep then check."

Deepak states that, as per his knowledge and as per company websites "City Limouzines" India Ltd. and ISO approved company. But I am unable to understand that how a cheque of amount ₹ 6000 get bounced with narration "Insufficient Balance"? I sent mail regarding same on given e-mail ID "info@citylimouzines.com" but till date I am not getting any revert from company.

It is very serious case; if company is going to Fraud then it will impact all investors. Thinking this, he lodges a complaint the consumer court requesting them to take legal action against City Limouzines India Ltd.

Questions

1. Analyse the legal actions which should be taken by the Consumer court for the protection of Investors.
2. What penalties should be forced on the company?
3. Every now and then, there are cases of cheque bouncing and dishonour. What precautions and remedies would you suggest for the investors to get them protection from such fraud companies?

Source: http://www.consumercomplaints.in/complaints/city-limouzines-india-ltd-c253425.html

4.11 Summary

- A negotiable instrument means a promissory note, a bill of exchange or a cheque.
- A promissory note is an instrument in writing (not being a bank or a currency note), containing an unconditional undertaking, signed by the maker to pay a certain sum of money to, or to the order of, a certain person or to the bearer of the instrument.
- A bill of exchange is an instrument in writing, containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order, a certain person, or to the bearer of the instrument.
- A cheque is a bills of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand, and it includes the electronic image of a truncated cheque and a cheque in the electronic form.
- The transfer of an instrument by one party to another so as to constitute the transferee a holder thereof is called 'negotiation of the instrument'.

Notes

- Instruments payable to a specified person or to the order of a specified person can be negotiated only by endorsement and delivery.
- Crossing is a unique feature associated with cheques affecting to a certain extent the obligation of the paying banker and also its negotiable character.
- A cheque may have what is known as 'not negotiable' crossing.
- A person who takes such a cheque shall not have and shall not be capable of giving a better title to the cheque than that which the person, from whom he took it in the first instance, had.

4.12 Keywords

Ambiguous Instrument: It is an instrument which may be construed either as a promissory note or as a bill of exchange.

Bill of Exchange: It is a written order by the drawer to the drawee to pay money to the payee.

Cheque: It is a is a negotiable instrument instructing a financial institution to pay a specific amount of a specific currency from a specified demand account held in the maker/depositor's name with that institution.

Crossing: Crossing on cheque is a direction to the paying banker by the drawer that payment should not be across the counter.

Endorsement: It is the mode of negotiating a negotiable instrument.

Holder: A holder is a person who is entitled in his own name to the possession of a negotiable instrument and to receive or recover the amount due thereon from the parties thereto.

Instrument: It means any written document by which a right is created in favour of some person.

Negotiable Instrument: It is a specialized type of contract for the payment of money that is unconditional and capable of transfer by negotiation.

Negotiation: The transfer of an instrument by one party to another so as to constitute the transferee a holder thereof is called 'negotiation'.

4.13 Review Questions

1. Are the following instruments duly signed by A promissory notes?
   (a) "I am liable to X to a sum of ₹ 1000 which is to the paid in installments for rent"
   (b) "I acknowledge myself to be indebted to X by ₹ 500 to be paid on demand for value received".
   (c) "I promise to pay ₹ 5000 and give a Maruti Car to P."
2. "The capacity of a party to draw, accept, make or endorse a negotiable instrument is co-extensive with his capacity to enter into a contract". Comment.
3. "I promise to pay P or bearer a sum of ₹ 5000 less charge involved in documentation of accounts"- signed M. Consider the validity of the following document as a promissory note. Justify.
4. 'A cheque is a bill of exchange drawn on a banker'. Comment.
5. P gives a cheque to L on 2 April & L goes to the bank on 25 June. By that time, the bank has gone into liquidation. L demands payment of the cheques from P. Would he succeed? Justify.

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6. "Issuing of a cheque that bounces is an offence". Comment.
7. P signs a promissory note in favour of M. Who is liable to make payment on the note? Why?
8. Who has the primary liability to pay to the holder in the case of a cheque? Why?
9. Cheques crossed 'not negotiable' are nevertheless transferable. Do you agree? Justify.
10. D draws a bill of exchange on A, payable to P. Who is liable to P
    (a) Until the acceptance is made by A.
    (b) If A accepts the bill of exchange.
    (c) If A does not accept the bill of exchange.
11. D draws a bill of exchange on A, payable to P. P transfers it to X, X to Y & Y to Z. The bill is dishonoured. Who has to give notice of dishonour to whom? Who may transmit the notice to the other parties? Comment.
12. S draws a cheque for ₹ 5000 though he had a credit balance of ₹ 1000/- only. No notice of dishonour is given to D. Can he avoid liability on the cheques? Comment.

Answers: Self Assessment

1.	holder in due course	2.	Ambiguous
3.	maker	4.	acceptance
5.	specified	6.	mirror image
7.	holder	8.	maturity
9.	47	10.	endorsement in full
11.	payment.	12.	maturity
13.	holder	14.	protest
15.	open	16.	Special
17.	maturity	18.	electronic image
19.	four	20.	made payable

4.14 Further Reading


Book

S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.


Online links

www.sudhirlaw.com/Business4.html

www.vakilno1.com/bareacts/negoinstruact/negoinstruact.htm

Unit 5: Law of Sale of Goods

Notes

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Notes

Objectives

After studying this unit, you will be able to:

- Discuss the concept of conditions and warranties;
- Describe the performance of contract of sale;
- Explain the concern of unpaid seller and his rights;
- Recognize the Doctrine of caveat emptor.

Introduction

Transactions in the nature of sale of goods form the subject matter of the Sale of Goods Act, 1930. The Act covers topics such as the concept of sale of goods, warranties and conditions arising out of sale, delivery of goods and passing of property and other obligations of the buyer and the seller. It also covers the field of documents of title to goods and the transfer of ownership on the basis of such documents. The Act came into force on 1st July, 1930. It extends to the whole of India, except Jammu and Kashmir. The sections quoted in this unit refer to the Sale of Goods Act, 1930, unless otherwise stated.

Indian business persons, conducting their business against the backdrop of the Sale of Goods Act, have not found it difficult to work out the several varieties of contracts of sale of goods as resorted to in national and transnational business, such as F.O.B. (Free on Board), C.I.F. (Cost, Insurance and Freight) and ex-ship.

5.1 Definition and Essentials of a Contract of Sale

Section 4 defines a contract of sale as 'a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price'. From the definition, the following essentials of the contract emerge:

1. ***There must be at least two parties:*** A sale has to be bilateral because the property in goods has to pass from one person to another. The seller and the buyer must be different persons. A person cannot buy his own goods. However, a part-owner may sell to another part-owner.

Example: A partnership firm was dissolved and the surplus assets, including some goods, were divided among the partners *in specie.* The sales-tax officer sought to tax this transaction. Held, this transaction did not amount to sale. The partners were themselves the joint owners of the goods and they could not be both sellers and buyers. Moreover, no money consideration was promised or paid by any partner to the firm as consideration for the goods allotted to him. [State of Gujarat V. Ramanlal S. & Co. A.I.R. 1965 Guj. 60].

2. ***Transfer or agreement to transfer the ownership of goods:*** In a contract of sale, it is the ownership that is transferred (in the case of sale), or agreed to be transferred (in the case of agreement to sell), as against transfer of mere possession or limited interest (as in the case of bailment or pledge).

3. ***The subject-matter of the contract must necessarily be goods:*** The sale of immovable property is not covered under Sale of Goods Act. The expression 'goods' is defined in s.2(7).

4. ***Price is the consideration of the contract of sale:*** The consideration in a contract of sale has necessarily to be 'money', (i.e., the legal tender money). If for instance, goods are offered

as the consideration for goods, it will not amount to sale. It will be called a 'barter'. Further, in case there is no consideration, it amounts to gift and not sale. Similarly, the Act is not applicable where the buyer has to perform some act in order to purchase the goods. For example, he has to buy one dozen shirts to obtain a 'free' necktie. Here the buyer's consideration for the necktie is not the payment of cash; it is the act of buying the shirts. Where, however, goods are sold for a definite sum and the price is paid partly in terms of valued up of goods and partly in cash, that is sale. These are known as part-exchange contracts. To sum up: the Act applies only when the buyer pays by cash (or by cheque, credit card, etc.)

Examples:

(a) Fifty chairs, valued at ₹ 300 each, were exchanged for 1000 kilogram of wheat @ ₹ 10 per kilo, the difference to be made up in cash, the contract would be treated as one of sale.

(b) Corn was delivered on the terms that on demand either the agreed price would be paid or an equal quantity of corn, at the agreed price, would be returned, that was held to be a sale.

Payment by installments. In the case of sale of goods, the parties may agree that the price will be payable by installments. Also, the terms may stipulate some amount by way of down payment and the balance by installments. In any case, the ownership in the goods passes to the buyer. In case the possession is handed over to the buyer and he makes a default in payment of any instalment, the seller cannot take back the goods; he can only file a suit for the recovery of the instalment.

5. ***A contract of sale may be absolute or conditional [s.4(2)].***

6. ***All other essentials of a valid contract as per the Indian Contract Act, 1872 must be present.*** Being a specie of contract, sale must conform to all other essentials of a valid contract. Thus, the parties to the contract must be competent to contract, the consent of the parties must be free, the object of the contract must not be unlawful and so on.

Caselet

Sale or Not?

Commodity taxation laws cover only "sale" transactions. The following have not been regarded as "sale" by various courts: (i) Transfer to branches in other States; (ii) transfer of property in goods by way of execution of a works contract; (iii) delivery of goods under hire purchase/instalment schemes; (iv) transfer of right to use any goods, for example, lease/hire-purchase transactions; (v) supply of goods, refreshments and so on, by, among others, clubs to members; and (vi) supply of food, drink and refreshments by hotels, and so on.

Source: thehindubusinessline.com

5.1.1 Sale and Agreement to Sell

Where under a contract of sale, the property (ownership) in the goods is transferred from the seller to the buyer, it is called a sale [s. 4(3)]. Thus, sale takes place when there is a transfer of ownership in goods from the seller to the buyer. A sale is an executed contract.

Notes

Example: Ramanathan sells his car to Bhim for ₹ 1 lakh. If all essential elements of a valid contract are present, it is a sale and therefore the ownership of the car stands transferred from Ramanathan to Bhim. This is so even where the payment of the price or the delivery of the car or both have been postponed.

Agreement to sell means a contract of sale under which the transfer of property in goods is to take place at a future date or subject to some conditions thereafter to be fulfilled.

Example: Amar agrees to sell certain goods to Akbar. The goods are on their way from London to Mumbai in a ship. The ownership in the goods will pass to the buyer when the goods come and the agreement is subject to the condition that the ship arrives at port with the goods.

5.1.2 Distinction between Sale and Agreement to Sell

The distinction between the two is of prime importance as they have different legal repercussions. The rights and duties of the parties vary with the fact whether the contract of sale is an actual sale or an agreement to sell. In a sale, the seller transfers the ownership in the goods at the time of entering into the contract; in the agreement to sell, the ownership is agreed to be transferred later.

Example: A Sales Tax Officer levied the liability of sales tax on a contract of sale amounting to an agreement to sell. Held, there was no such liability, as the transaction did not amount to a completed sale.

The difference between sale and agreement to sell is as follows:

Table 5.1: Difference between Sale and Agreement to Sell

1.	A sale is an executed contract.	It is an executory contract.
2.	Since the ownership has passed to the buyer, the seller can sue the buyer for the price of the goods, if the latter makes a default in payment.	In case of breach, the seller can only sue for damages, unless the price was payable at a stated date.
3.	It creates a *right in rem*, i.e., against the whole world.	It creates a *right in personam*, i.e., against specified person only.
4.	In case of loss of goods, the loss will fall on the buyer, even though the goods are in the possession of the seller. It is because the risk is associated with ownership.	The loss in this case shall be borne by the seller, even though the goods are in the possession of the buyer.
5.	In case, the buyer pays the price and the seller thereafter becomes insolvent, the buyer can claim the goods from the official receiver or assignee, as the case may be.	In this case, the buyer cannot claim the goods but only a rateable dividend for the money paid.
6.	If the buyer becomes insolvent without paying the price, the ownership having passed to the buyer, the seller shall have to deliver the goods to the official receiver or assignee, as the case may be, except where he has a lien over the goods.	Under this, the seller can refuse to deliver the goods to the official receiver or assignee, as the case may be.

Notes

Self Assessment

Fill in the blanks:

1. A sale has to be ……because the property in goods has to pass from one person to another.
2. The consideration in a contract of sale has necessarily to be ……

5.2 Goods and their Classification

5.2.1 Meaning of Goods

'Goods' means every kind of movable property, other than actionable claims and money; and includes stocks and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale. Thus, things like trade marks patents, copyright, goodwill, water, gas, electricity are all goods and therefore, may be the subject matter of a contract of sale. In general, it is only the movables, i.e., things which can be carried from one place to another that form 'goods'. Landed property, therefore, does not constitute goods. However, all such things which are part of the land itself and agreed to be severed from the land under the contract of sale are considered as goods. Thus, where the trees are sold, to be cut and then taken away by the buyer, that will be a contract for a sale of movable property. 'Goods' includes stock and shares of companies incorporated under the Companies Act, 1956.

The term 'goods' excludes money.

Did u know? **What is Money?**

'Money' means legal tender and not the rare coins which can be sold and purchased as goods.

The legal tender money is an essential aspect of every sale because the price of goods, has to be expressed in terms of money and therefore, 'money' itself cannot be subject of a sale. Foreign currency may, however, be bought or sold. Also the term 'goods' excludes actionable claims. The actionable claims are things which a person cannot make use of, but which can be claimed by him by means of a legal action, e.g., a debt.

5.2.2 Documents of Title to Goods

A document of title to goods may be described as any document used as proof of the possession or control of goods, authorizing or purporting to authorise, either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented. Section 2(4) recognises the following as documents of title of goods: bill of lading, dock warrant, warehousekeeper's certificate, wharf certificate, railway receipt, warrant or order for the delivery of goods and any other document used in the ordinary course of business as a document of title.

5.2.3 Classification of Goods

Goods may be classified as existing, future and contingent. Existing goods are those which are owned or possessed by the seller at the time of the contract (s.6). Instances of goods possessed but not owned by the seller are sales by agents and pledges. Existing goods may be either

Notes

(a) specific or ascertained; or (b) generic and unascertained. Specific goods means goods identified and agreed upon at the time a contract of sale is made [s.2 (14)]. Ascertained goods, though normally used as synonym for specific goods may be intended to include goods which have become ascertained subsequently to the formation of the contract. Generic or unascertained goods are goods indicated by description and not specifically identified.

Example: Anthony, who owns a TV show room, has 20 TV sets and agrees to sell any one of them to Bharti. The contract is for unascertained goods, since which particular TV set shall become the subject matter of sale is not individualized at the time of the contract of sale.

Future goods means goods to be manufactured or produced or acquired by the seller after making the contract of sale [s. 2 (6)].

Example: Kulkarni agrees to sell future crop of a particular agricultural field in the next season. This is an agreement to sell future goods.

Contingent goods are the goods the acquisition of which by the seller depends upon a contingency which may or may not happen [s. 6 (2)]. Contingent goods are a part of future goods.

Example: Alka agrees to sell to Bhola a certain painting only if Chetan, its present owner, sells it to her. This painting is classified as contingent goods.

Notes **Meaning of Price**

Price means the money consideration for the sale of goods. Price is an integral part of a contract of sale. If price is not fixed, or is not capable of being fixed, the contract is void ab *initio.* As to how the price is to be fixed Ss. 9 and 10 lay down certain rules. According to s. 9, the price may (i) either be fixed by the contract, or (ii) agreed to be fixed in a manner provided by the contact, e.g., by a valuer or (iii) determined by the course of dealings between the parties.

For example, in a particular trade, there is a usage to deduct discount in determining the price. The usage is implied by the course of dealings between the parties.

In case, price is not capable of being fixed in any of the above three ways, the buyer is bound to pay a reasonable price. What is a reasonable price will vary from case to case. Where, however, there is a market price, that may be a reasonable price.

Section 10 days down that in case price is left to be fixed by the valuer and he fails to fix the same, the agreement becomes void except as to part of goods delivered and accepted regarding which the buyer is bound to pay a reasonable price. If, however, one of the parties prevent the valuer from making the valuation, he would be liable to pay damages to the other contracting party.

Self Assessment

Fill in the blanks:

3. …….goods are those which are owned or possessed by the seller at the time of the contract

4. ……..goods means goods to be manufactured or produced or acquired by the seller after making the contract of sale.

5.3 Conditions and Warranties (Ss.11-17)

Notes

In a contract of sale, parties make certain stipulations, i.e., agree to certain terms. All stipulations cannot be treated on the same footing. Some may be intended by the parties to be of a fundamental nature, e.g., quality of the goods to be supplied, the breach of which, therefore, will be regarded as a breach of the contract. Some may be intended by the parties to be binding, but of a subsidiary or inferior character, e.g., time of payment, so that a breach of these terms will not put an end to the contract but will make the party committing the breach liable to damages. The former stipulations are called 'conditions' and the latter 'warranties'.

Section 12(2) defines a 'condition' as a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated'. A warranty on the other hand, is defined by s.12(3) as a 'stipulation collateral to the main purpose of the contract, the breach of which gives rise to claim for damages but not to a right to reject the goods and treat the contract as repudiated'. Thus, the effect of a breach of a condition is to give the aggrieved party a right to treat the contract repudiated, i.e., if price has been paid, the buyer can claim the refund of price plus damages for breach. On the other hand, in case of breach of warranty, only damages can be claimed, i.e., the buyer must accept the goods and claim damages for the breach of warranty. Whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract. A stipulation may be a condition though called a warranty in a contract [s.12(4)].

Example: Kaushal asks a dealer to supply him a shirt which would not shrink after use and wash. The dealer supplies a shirt which shrinks after use and wash. Kaushal can reject the shirt or keep the shirt and claim damages. Here the stipulation to supply a shirt which would not shrink after use and wash is a condition.

Breach of condition to be treated as breach of warranty (s.13): Under certain circumstances a breach of condition is to be treated as a breach of warranty, i.e., the right to repudiate the contract is deemed to have been lost.

Express and implied conditions and warranties: Conditions and warranties may be either express or implied. They are said to the 'express' when the terms of the contract expressly, provide for them. They are said to be 'implied' when the law deems their existence in the contract even without their actually having been put in the contract. However, an implied condition or warranty may be negative by an express term to the contrary. Section 62 recognises the following two principles: (i) what is expressed makes what is implied to cease and (ii) custom and agreement overrule law.

Express condition or warranty: These may be of any kind that the parties may choose to agree upon, e.g., it may be agreed that delivery of goods shall be made or taken on or before a certain date. Similarly, in a contract of sale of a car, express warranty as to its soundness may be incorporated.

Implied conditions and warranties [s.14-17]: Implied conditions and warranties are deemed to be incorporated by law in every contract of sale of goods unless the terms of the contract show a contrary intention. The implied conditions: (i) condition as to title (s.14), (ii) sale by description (s.15), (iii) condition as to quality or fitness for buyer's purpose [s.16 (1)], (iv) condition as to merchantable quality [s.16 (2)], (v) condition as to wholesomeness, (vi) implied condition in the case of sale by sample (s.17), (vii) implied condition in the case of sale by sample as well as description (s.15).

Condition as to title: Section 14 provides that in a contract of sale unless the circumstances of the contract are such as to show a different intention there is an implied condition on the part of the seller that in the case of a sale, he has a right to sell the goods and that in the case of an agreement

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to sell, he will have a right to sell the goods at the time when the ownership is to pass. The seller will break this implied term, for example, if it transpires that the goods were stolen. As a consequence of this, if the title turns out to be defective, the buyer is entitled to reject the goods and claim refund of the price (if paid) plus damages. This will be allowed even where the buyer has used the goods.

Examples:

1. Kamal purchases a car from Bimal who has no title to it. Kamal uses the car for a few days. After the true owner spots the car and demands it from Kamal, Kamal is bound to hand over the car to its true owner and he can sue Bimal, the seller without title, for the recovery of the purchase price even though he has used the car for a few days.
2. Komal sells goods to Bharat by infringing a trade mark. Bharat has the right to repudiate the transaction on the ground that there is a breach of condition as to the title.

However, this condition as to title may be negatived by an express term in the agreement. The obvious examples are sales made by custom authorities, courts, etc.

Sale by description s.15: Where there is a contract for the sale of goods by description there is an implied condition that the goods shall correspond with the description. A shirt described as 100 per cent cotton, for example, should not contain man-made fibre.

Examples:

1. A ship is sold by description viz.; 'copper-fastened vessel', but actually it was only partly copper-fastened. The condition as to sale by description is broken. This is so even where the ship is sold subject to all faults and defects.
2. A car is sold as a new car. The buyer finds it to be a used one. The buyer may reject the car, or retain the car and claim damages.
3. English sainfoin seeds, duly exhibited by a sample, are sold. The bulk corresponds to the sample but the seeds supplied are giant sainfoin and not the English sainfoin. There is a breach of condition as to description.

Condition as to quality or fitness [s.16 (1)]. As a general rule, a buyer is supposed to satisfy himself about the quality of goods he purchases and is also charged with the responsibility of seeing for himself that the goods suit the purpose for which he buys them. Thus, later on, if the goods purchased turn out to be unsuitable for the purpose for which he bought them, the seller cannot be asked to compensate. This rule is called as caveat emptor – let the buyer beware. There are, however, certain exceptions to this general rule. For example, if you ask the salesman to recommend a heavy duty carpet which would be suitable for a lounge, it should not be threadbare after a couple of months. It is only in these exceptional circumstances that there is an implied condition as to quality or fitness. These circumstances are:

Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required, so as to show that the buyer relies on the seller's skill or judgement and the goods are of a description which it is in the course of the seller's business to supply (whether he is the manufacturer or producer or not). There is an implied condition that the goods shall be reasonably fit for such purpose. For the exception to operate, all the three conditions must be fulfilled, viz.; (a) the purpose must have been disclosed (expressly or impliedly), (b) the buyer must have relied on the skill or judgement of the seller, and (c) the seller's business must be to sell such type of goods.

Notes

Examples:

1. A person who is a draper and has no special knowledge of hot water bottles, purchases a hot water bottle from a chemist. The bottle bursts and injures his wife. The chemist would be liable for refund of price and damages as there is a breach of condition as to fitness.
2. A dealer sells a refrigerator to Bhanu. The refrigerator performs all other functions but fails to make ice. This would amount to a breach of an implied condition.

The above exception does not apply where the specific goods are sold under their patent or trade name.

Examples:

1. A buyer orders a patent smoke consuming furnace by its patent name for his brewery. The furnace supplied is found to be unsuitable for the purpose. The buyer would have no cause of action against the seller.
2. Where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied conditions that the goods shall be of merchantable quality, i.e., the goods shall be free from latent defects (defects which are not apparent or possible of detection by mere inspection). Where, however, the buyer has examined the goods, there shall be no implied condition as regards defects which such examinations ought to have revealed.
3. A condition as to fitness for a particular purpose or as to quality may also arise on account of a custom of trade.

Condition as to merchantable quality [s.16 (2)]. Another implied condition is that the goods must be merchantable. They must be saleable in the market under the denomination mentioned. Thus the quality of goods is such that reasonable persons would accept them as performance of a promise. This means that if you buy a washing machine, it should actually work when you get it home.

Examples:

1. Ameer buys a black yarn from Daleep and finds it to be damaged by white ants. The condition as to merchantability is broken.
2. There is a contract for sale of Manila hemp. The hemp that is supplied, though Manila hemp, is so damaged by sea water that no one in the market would accept it as Manila hemp. The condition as to merchantability is broken.

Where, however, the buyer examines the goods prior to sale, there is no implied condition as to merchantability as regards defects which such examination ought to have revealed.

Example: In a sale of vegetable glue packed in casks, the buyer comes to examine them but simply looks at the outside of the casks. Thus, the defect which could have been discovered by examination is overlooked. The implied condition of merchantability is not applicable.

However, in spite of examination, if the goods have certain latent defects which no examination by a man of ordinary prudence would have revealed, the implied condition as to merchantability subsists.

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Example: A certain skins of 'fair average quality' are sold. The inspection of the skin even by specialist does not show any defects. But, when the skins are processed, certain defects are found which are not visible in their dry condition. The implied condition of merchantability is broken, as the defects were latent.

The implied condition as to merchantability must, however, be construed reasonably and the seller will not be held liable if certain facts are concealed from him and the unsuitability arises because of those facts.

Example: A woman, who has an abnormally sensitive skin, buys a Harris tweed coat and gets rashes through wearing the coat. There is no breach of condition as she has failed to disclose the fact of her skin being extra-sensitive.

As mentioned below, in case of food articles, there is an additional implied condition.

Implied condition as to wholesomeness. The condition of merchantability includes another condition, namely, that of wholesomeness or soundness in the case of sale of provisions or foodstuff. Thus, in the case of food articles, there is an implied condition that the article is fit for human consumption.

Examples:

1. F bought a tin of condensed milk from A, the chemist. The milk contained typhoid germs. F's wife became infected and died. A was liable for damages, because the milk was not fit for human consumption.
2. C bought a bun at M's bakery and broke one of the teeth by biting on a stone in the bun. Held, M was liable for damages to C.

Implied condition in the case of a sale by sample (s.17). A contract for sale by sample is one where there is a term in the contract, express or implied, to that effect. Thus, it should not be assumed to be a sale by sample in all cases where sample is shown. In cases where there are no terms to that effect, it is assumed that the sample is not shown as a condition, but only to enable the buyer to form a reasonable judgement of the goods. In a sale by sample, the implied conditions are: (i) The bulk shall correspond with the sample in quality. This means that if you have curtains made up for you, the quality of the material should match the sample that you examined in the shop. (ii) The buyer shall have a reasonable opportunity of comparing the bulk with the sample. (iii) The goods shall be free from any defects rendering them unmerchantable, which would not be apparent on reasonable examination of the sample.

Examples:

1. Certain shoes are sold by sample. The shoes are found to contain paper not discoverable by ordinary inspection. The buyer is entitled to the refund to the price plus damages.
2. In a contract for the sale of brandy, by sample, the brandy that is supplied has been coloured with a dye. The buyer is not bound by the contract, though the bulk corresponds with sample, since the defect could not have been located on reasonable examination of the sample.

Implied condition in the case of sale by description as well as sample [s.15]. In a sale by description as well as sample, the goods must correspond both with the description as well as with the sample.

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Example: There was a sale of 'foreign refined rape-oil' warranted only equal to sample. The oil supplied was the same as the sample, but it was not 'foreign refined rape-oil, being a mixture of it and other oil. Held, the buyer could refuse to accept the goods.

Implied warranties: There are two implied warranties. These are: (i) quite possession of the goods [s.14 (b)]; and (ii) goods free from any charge or encumbrance [s.14 (c)].

1. ***Warranty of quiet possession [s.14 (b)].*** In a contract of sale, unless contrary intention appears, there is an implied warranty that the buyer shall have and shall enjoy quiet possession of the goods. Thus, if the right of enjoyment or possession of the buyer is disturbed by the seller or any other person, the buyer is entitled to sue the seller for damages.
2. ***Warranty of freedom from encumbrance [s.14(c)].*** The buyer is entitled to another warranty that goods are free from any charge or encumbrance in favour of a third person, not declared to or known to the buyer. Thus, this implied warranty will not be applicable where the buyer has been informed of the encumbrance or has a notice of the same. Further, the claim under this warranty shall be available only where the buyer discharges the amount of encumbrance.

5.3.1 Stipulation as to Time

The question of performance of contract in time is very crucial for business persons who purchase or sell goods. Therefore in every contract for the sale of goods, a time limit for performance of the promise is fixed. If it is not done due to oversight, or for some practical reasons or the parties are unwilling to bind themselves in a rigid manner, then the performance is to be done within a reasonable time. In case the performance is not done by a party as stipulated in the contract, the other party can recover damages for the breach of the contractual stipulation.

Caution There may be cases where timely performance is very crucial for the promisee and damages may not be of much help. In such a case the right to treat the contract as terminated may also not be of much use.

In case of contract for the sale of goods, two rules as to the importance of time are laid down by s. 11. These are: (i) unless a different intention appears from the terms of the contract, stipulation as to time of payment is not deemed to be of the essence of a contract of a sale; (ii) whether any other stipulation as to time is of the essence of the contract or not depends on the terms of the contract.

Thus, the first rule deals with the time of payment. In this case time is not a condition of the contract unless a different intention appears from the terms of the contract. Thus, the failure by the buyer to pay on the stipulated date shall not entitle the seller to treat the contract as repudiated, though he is entitled to withhold delivery until he is paid and resell the goods if the buyer does not pay or tender the price within a reasonable time. Consequently, if before such resale by the seller, the buyer tenders the price, even though it be on a date after the date stipulated in the contract, the seller cannot, in the absence of an intention to the contrary, treat the contract as at an end and refuse to deliver the goods to the buyer.

The second rule leaves the whole thing upon the intention of the parties as is reflected in the contract. In general, stipulation as to time for delivery of goods is considered to be essence of time. Thus, if A has entered into a contract with B to sell a certain thing and promises to deliver

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the same before the weekend, A must deliver the goods before the weekend. If he fails to do so, B is entitled to repudiate the contract.

Self Assessment

Fill in the blanks:

5. Stipulations that may be intended by the parties to be of a fundamental nature are called ……..
6. Stipulation as to time for delivery of goods is considered to be essence of ……..

5.4 Passing of Property in Goods

5.4.1 Meaning of 'Property in Goods'

The phrase 'property in goods' means ownership of goods. The 'ownership' of goods is different from 'possession' of goods. The 'possession' of goods refers to the custody of goods, though normally a person who is in possession of the goods shall also be its owner but it need not necessarily be so. There may be situations where a person is the owner of certain goods but is not in possession of the same or vice versa.

One of the most important questions, in a contract of sale of goods is: When does the property in the goods pass (transfer) from the seller to the buyer? The determination of the exact moment as to when the ownership passes from the seller to the buyer is important because of the following reasons: (i) If the goods are lost or damaged, who will bear the loss shall depend upon as to whether the ownership is with the seller or the buyer. The general rule is risk follows ownership. (ii) In the case of damage to the goods by third parties, it is the owner who can take action. (iii) In the event of insolvency of either seller or buyer, whether the official receiver or assignee, as the case may be, can claim the goods shall depend upon whether the property has passed to the buyer or not.

5.4.2 Rules Regarding Passing of Property in Goods from the Seller to the Buyer

Sections 18 to 25 lay down the rules which determine when property passes from the seller to the buyer. These rules for different kinds of goods are summarised below.

Specific or ascertained goods: In a sale of specific or ascertained goods, the property in them is transferred to the buyer at such times as the parties to the contract intend it to be transferred. The intention of the parties is ascertained from the terms of the contract, the conduct of the parties and the circumstances of the case. Unless a contrary intention appears, the under mentioned rules are applicable for ascertaining the intention of the parties (Ss.20-24).

1. ***Specific goods in a deliverable state:*** In the case of specific goods in a deliverable state, the property passes at the time the contract (unconditional) is made (s.20). The fact that the time of payment or the delivery of the goods or both are postponed does not affect the passing of the property. Section 2(3) states that goods are said to be in a deliverable state when they are in such a state that the buyer would under the contract be bound to take delivery of them.

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Examples:

(a) Ram offers to sell his car to Shyam at ₹ 90,000. Shyam accepts the offer. As soon as the contract is made, the property in the car passes to Shyam. It shall make no difference even if the price is to be paid later or the delivery is postponed to a stated day or even if the goods are sold on credit, because the contract is an unconditional one for the sale of specific goods in a deliverable state.

(b) Pyare agrees to sell Sultan a standing stock of hay for a fixed price payable on 4 February next. The delivery is to be made on 1 of May following. Sultan becomes the owner immediately the contract is made.

Does the endorsement of a railway receipt amount to transfer of goods thereby represented? The endorsement of a railway receipt in favour of another person does not by itself passes property in the goods to the endorsee. It merely constitutes the endorsee the agent of the consignor to receive the goods.

2. ***Specific goods not in a deliverable state:*** In the case of specific goods to which something has to be done by the seller to put them in a deliverable state, property passes only when such thing is done and the buyer has notice thereof (s.21).

Examples:

(a) The whole of the contents of a cistern of oil are sold and the seller has to put the oil in casks to be then delivered to the buyer. The ownership will not pass till the oil is actually put into casks ready for delivery and the buyer is notified accordingly.

(b) A condensing engine, fixed at a particular place, is agreed to be sold FOR (Free On Rail) for a fixed price. The engine is damaged while being taken to the railway station. The seller will himself bear the loss as the ownership has not passed to the buyer. The seller is required, under the contract, to place it on rail before it can be said to be in a deliverable state.

3. Where there is a contract for the sale of specific goods in a deliverable state but the seller is bound to weigh, measure, test or do some other thing with reference to them, for ascertaining the price, the property does not pass till such act or thing is done and the buyer has notice thereof (s.22). However, this section is applicable only where, by contract, the seller has to do something mentioned therein. However, if the buyer wants to weigh goods for his own satisfaction, the section would not apply.

Example: A stock of rice is sold at an agreed price per ton. The rice is to be weighed by the agents of the seller as also of the buyer for ascertainment of the price. A part of the rice is weighed and carried away by the buyer's agent, but the remaining is swept away by floods. The loss of the remainder would be borne by the seller, since the ownership thereof had not passed as the required weighing had not been done.

Unascertained or future goods: When there is a contract for the sale of unascertained goods, property in the goods is not transferred to the buyer unless and until the goods are ascertained (s.18).

Example: Ghanshyam agrees to sell Ram Rattan 200 quintals of wheat out of larger quantity lying in Ghanshyam's godown. The agreed price is to be paid on the day appointed

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under the contract. Unless and until the required quantity of 200 quintals is separated from the larger quantity and the goods have been ascertained the property therein cannot pass from the seller to the buyer.

Section 23 provides that in the case of sale of unascertained goods or future goods by description, property passes to the buyer when goods of that description in a deliverable state are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller.

Unconditional appropriation: The unconditional appropriation of goods may be made either by the seller with the buyer's assent or by the buyer with the seller's assent. Normally goods shall be appropriated by the seller. Where he appropriates the goods to the contract, the property shall pass to the buyer only when the latter has assented to the appropriation. The assent, however, may be given before or after appropriation. Whether the appropriation is done by the seller or the buyer, the assent of the other party must be obtained. Where goods are in the possession of the buyer, he may do the appropriation.

Example: There are 500 bags of wheat lying with the seller and he selects 100 bags out of the lot with the buyer's assent, the ownership of those 100 bags would pass to the buyer as soon as this is done.

Mode of appropriation: The appropriation by the seller may be done by (i) putting the quantity contracted for in suitable receptacles, such as boxes, gunny bags, bottles, etc., with the assent of the buyer, or (ii) deliver to the carrier or other bailee for transmission to the buyer, without reserving the right of disposal.

Example: A seller contracts with a buyer for sale of certain goods with a stipulation that delivery is against payment in cash. No property passes to the buyer till cash payment is made.

Seller reserving the right of disposal: Whether or not the seller has retained the right of disposal over the goods even after delivering them to a common carrier, is a question of fact depending on all the surrounding circumstances. But where the railway receipt (R/R) or bill of leading (B/L) is taken in the name of the buyer or his agent, it is presumed (though rebuttable) that the seller did not retain the right of disposal. If these documents are made out in the seller or his agent's name, the presumption is that the right of disposal is reserved by him.

Section 25 (3) provides that where the seller of goods draws a bill of exchange (B/E) on the buyer for the price, and transmits the B/E along with B/L to the buyer, to secure acceptance or payment of the B/E, the buyer is bound to return the bill of lading if he does not honour the bill of exchange. In case the buyer wrongfully retains the bill of lading, the property in the goods does not pass to him.

Sale on 'approval' or 'sale or return' basis: Where goods are delivered to another person on approval or on 'sale or return' or similar terms, the property passes to him when he (i) signifies his approval or acceptance to the seller; (ii) does any act adopting the transaction e.g., pledges the goods with a third party; or (iii) retains the goods, without giving notice of rejection, beyond the time fixed for the return of goods, or if no time is fixed, beyond a reasonable time.

Sale for cash only or return: In this type of sale, property does not pass to the buyer until paid for. In such a case, if the buyer creates a pledge, it will be invalid, and the seller will have a right to recover the goods from the pledgee.

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5.4.3 Risk Prima Facie Passes with Property

Section 26 (First paragraph) reads: unless otherwise agreed, the goods remain at the seller's risk until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer, the goods are at the buyer's risk whether delivery has been made or not.

Example: A buys goods of B and property has passed to him; but the goods remain in B's warehouse and the price is unpaid. Before delivery a fire burns down the warehouse destroying the goods. A must pay the price of the goods as A was the owner.

Though risk follows ownership, but the parties may agree otherwise thus separating risk from ownership. Thus, the parties may provide by their agreement that the risk shall pass at some time or on some condition not necessarily simultaneous with the passing of the property.

The second paragraph of s. 26 says: Provided that, where delivery has been delayed through the fault of either buyer or seller, the goods are at the risk of the party in fault as regards any loss which might not have occurred but for such fault.

Example: D contracted to supply B 30 quintals of apple juice. Delivery was to be made in weekly truckloads. D crushed the apples as required and put the juice in casks. Deliveries were held up at the buyer's request. Subsequently B took some deliveries and then stopped altogether. The juice, in the meantime, deteriorated. On B's refusal to take up further deliveries and pay for them D filed a suit. Held, the buyer was liable for the loss suffered on account of deterioration of the juice [Demby Hamilton & Co. Ltd., v. Barden (Endeavour Wines) Ltd. (1947)1 ALL ER 435].

Also, risk and property may be separated by a trade custom.

Example: A ordered furs "on approval" with invoice. By the custom of the fur trade the goods are at the risk of the person ordering them on approval. The furs were stolen before the time of approval expired. Held, the buyer must bear the loss although the property had not yet passed to him.

Also, risk and property may be separated by the agreement of the parties. Further, s.40 provides as regards risk where goods are to delivered at a distant place. It reads: Where the seller of goods agrees to deliver them at his own risk at a place other than that where they are when sold, the buyer shall, nevertheless, unless otherwise agreed, take any risk of deterioration in the goods necessarily incident to the course of transit.

Furthermore, risk and property may be separated by a term of the contract.

Example: One of the terms adopted by the coffee board for auction of coffee was that the property in the coffee knocked down to a bidder would not pass until the payment of full price and, in the meantime, the goods would remain with the seller but at the risk and responsibility of the buyer. The clause was held to be valid [Consolidated Coffee Ltd. v. Coffee Board (1980) 3 SCC 358].

Self Assessment

Fill in the blanks:

7. In a sale of ……..goods, the property in them is transferred to the buyer at such times as the parties to the contract intend it to be transferred.

Notes

8. When there is a contract for the sale of ……goods, property in the goods is not transferred to the buyer unless and until the goods are ascertained

5.5 Transfer of Title by Non-owners

Section 27 lays down a general rule as to transfer of title, that is, it is only the owner of goods who can transfer a good title. No one can give a better title than what he himself has. This rule is expressed by the maxim, '*memo dat quod non habet*' which means that no one can give what he himself has not. If the seller, therefore, has no title, or he has defective title, the buyer's title will be equally wanting or defective, as the case may be, though he has purchased in good faith and for value. Section 27 in this regard says that "subject to the provisions of the Act and of any other law at the time in force, where goods are sold by a person, who is not the owner thereof and who does not sell under the authority or with the consent of the owner, the buyer acquires no better title to the goods than what the seller had, unless the owner is precluded by his conduct from denying the seller's authority to sell."

Examples:

1. Akash, the hirer of goods under a hire purchase agreement, sells them to Bhim. Bhim, though a bona fide purchaser, does not acquire the property in the goods. At the most he acquires such an interest as the hirer had.
2. Prakash finds a ring and sells it to Bhanu who purchases it for value and in good faith. The true owner, Tara, can recover the ring from Bhanu, for Prakash having no title could pass none the better.

Exceptions to the general rule: To the above general rule there are certain exceptional circumstances under which even a non-owner may confer a good title on the transferee. These exceptions are laid down by Ss.27-30 and are as follows:

1. ***Sale by a mercantile agent:*** Section 2(9) defines a mercantile agent as an agent having, in the customary course of business as such agent, authority either to sell goods or to consign goods for the purpose of sale, or to buy goods, or to raise money on the security of goods.

   If a mercantile agent, who is in possession of either the goods or documents of title to the goods, with the consent of the owner, sells the goods, in the ordinary course of business as a mercantile agent, the buyer gets a good title to the goods provided he buys them in good faith and for value. Thus a person who, in good faith, buys goods from a factor or an auctioneer will get a good title to them, even though the seller has exceeded the authority, or authority has been revoked by the true owner before sale.

Examples:

(a) A mercantile agent obtained some diamonds from the true owner falsely pretending that he had a customer who wanted to purchase them and he afterwards fraudulently pledges the goods to secure an advance for himself. The true owner would be bound by pledge.

(b) A motor car agent sells the car at a price below that authorised by the owner and misappropriates the proceeds. The innocent purchaser would get a good title.

2. ***Sale by a joint owner:*** Where one of several joint owners of goods has the sole possession thereof, with the consent of the others, any purchaser from such person, for value without notice at that time, of the seller's want of authority to sell, acquires a good title thereto

Notes

against the other joint-owners (s.28). In case of sale by a co-owner, good title can pass to the buyer only if the co-owner was in possession with the consent of the other co-owners.

Example: Radha and Shyam are co-owners of a 'radiogram'. While the radiogram is in possession of Radha, Shyam secretly takes it away and sells it to Pawan, a *bona fide* purchaser for value. Pawan cannot get a good title to the radiogram, because though Shyam was a co-owner, he was not in possession of the radiogram with the consent of the co-owner, i.e., Radha.

3. ***Sale by a person in possession under a voidable contract:*** A person who has obtained possession of goods, under a contract which is voidable on the ground of fraud, misrepresentation, coercion, or undue influence, can convey a good title provided the sale takes place before the voidable contract is avoided (s.29).

Example: Kawal, by exercising undue influence, buys a car from Bimal at a very low price and sells it to Kanta, an innocent purchaser. Kanta has a good title and Bimal cannot recover the car from her even if the contract is subsequently set aside by him due to undue influence of Kawal.

The provisions of s.29 are applicable only to a contract and not to an agreement which is void *ab initio.*

4. ***Sale by a seller in possession of goods after sale:*** Where a seller having sold goods continues in possession thereof or of document of title to the goods, the delivery or transfer by such person or his mercantile agent, by way of sale, pledge or other disposition, will pass a good title to the transferee, if such latter person is a *bona fide* purchaser for value and without notice of the previous sale, etc. (s.30). The seller must be in possession as seller and not in any other capacity. Thus, where the buyer asks the seller to keep the goods as his bailee, the Section will not apply.

Example: Shyam sells 100 bags of sugar to Bali. Bali delays in taking the bags away. In the meantime Shyam sells those bags to another innocent purchaser Kamal who takes it without notice of prior sale and for value. Kamal would get a good title.

5. ***Sale by a buyer in possession of goods:*** Where a person having bought or agreed to buy obtains, with the consent of the seller, possession of the goods or the documents of title to the goods, the delivery or transfer by such person or by a mercantile agent acting for such person, the goods or documents by way of sale, pledge or other disposition thereof will be valid and effective, if the person receiving the same, acted *bona fide* and without notice of the seller's lien, if any [s.30 (2)].

Example: Amrik sells Bhatia some copper and delivers to him a bill of lading with a bill of exchange. The buyer having obtained the bill of lading endorses it to Sultan who takes it without notice of any objection to the buyer's title. Bhatia subsequently becomes insolvent without making payment of the price. The transfer of the bill of lading by Bhatia to Sultan is effective against Amrik and therefore, the latter cannot stop the goods in transit.

However, a person in possession of goods under a hire purchase agreement which gives him only an option to buy is not covered within this section, unless he has exercised his option to buy.

6. ***Sale by an unpaid seller:*** According to s.54 (3), an unpaid seller of goods who has exercised his right of lien or stoppage in transit can, even though the ownership in them has passed

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to the buyer, resell the goods and convey a valid title to another buyer, though no notice of resale has been given to the original buyer.

7. ***Exceptional cases under other Acts:*** There are some exceptions under other laws. These are: (i) Sale by a finder of lost goods under certain circumstances shall be valid against the true owner (s.169, Indian Contract Act, 1872). A finder of goods, may sell them (a) if the owner cannot, with reasonable diligence, be found, or (b) if found, he refuses to pay lawful charges of the finder, or (c) if the goods are in the danger of perishing or of losing the greater part of their value, or (d) if the lawful charges of the finder in respect of the goods found, amount to 2/3 of their value. (ii) Sale by a pawnee or pledgee under s. 176 of the Indian Contract Act, 1872, (iii) Sale by an Official Assignee or Receiver under the Presidency Towns Insolvency Act or Provincial Towns Insolvency Act. (iv) Sale by Liquidator under the Companies Act, 1956.

Self Assessment

Fill in the blanks:

9. Section 27 lays down a general rule as to transfer of title, that is, it is only the ……of goods who can transfer a good title.

10. A person who, in good faith, buys goods from a ……or an auctioneer will get a good title to them, even though the seller has exceeded the authority.

5.6 Performance of a Contract of Sale of Goods

The contract of sale of goods is to be performed. In this context, Ss.31-44 provide for the duties of the seller and the buyer and the rules regarding delivery of goods.

5.6.1 Duties of the Seller and the Buyer

It is the duty of the seller to deliver the goods and of the buyer to accept and pay for them, in accordance with the terms of the contract of sale (s.31). However, no delivery need be given, if the buyer is not willing to pay the price, nor need the buyer pay the price, unless the seller is ready and willing to give delivery, as unless otherwise agreed, delivery and payment of price are concurrent conditions (s.32).

The seller has the duty of giving delivery of goods according to the (i) terms of the contract, and (ii) rules contained in the Act. The buyer of the goods has the duty to pay for the goods, accept delivery and pay compensation to the seller in case he wrongfully refuses to accept delivery.

5.6.2 Delivery

Delivery is defined as a voluntary transfer of possession from one person to another [s.2(2)]. Section 33 provides that delivery of goods sold may be made by doing anything which the parties agree shall be treated as delivery or which has the effect of putting the goods in the possession of the buyer or of any person authorised to hold them on his behalf. Therefore, any other act, in addition to transfer of physical possession, which the parties agree to treat as equivalent thereto, has the effect of delivery.

The delivery of goods therefore, may be actual, symbolic or constructive. In the case of the actual or physical delivery the possession of the goods is handed over by the seller to the buyer. In the case of symbolic delivery, it is made by delivering some symbol that carries with it the real possession or control over the goods, e.g., delivery of a railway receipt properly endorsed, or

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delivery of the key of a warehouse. In the case of constructive delivery or attornment, there is neither change of physical possession of goods, nor delivery of a symbol, but there is only an acknowledgment by the person in possession that he holds them on behalf of another. This type of delivery may be effected in three ways, viz., (i) where the buyer, who is already in possession of the goods as bailee of the seller, holds them as his own, after the sale; (ii) where the seller, who is in possession of goods holds them as bailee of the buyer after the sale; and (iii) where a third person, like a carrier or a warehouseman, who holds the goods, as bailee for the seller agrees and acknowledges to hold them for the buyer.

Rules regarding delivery: The following are the rules regarding delivery of goods:

1. ***Delivery of part of goods sold may amount to delivery of the whole if it is so intended and agreed:*** Where however, the part is intended to be severed from the whole, part delivery does not amount to be delivery of the whole (s.34).

Example: Certain goods lying at a wharf are sold in a lot. The seller instructs the wharfinger to deliver them to the buyer who has paid for them and the buyer thereafter accepts them and takes away a part of them. It amounts to delivery of the whole.

2. ***Unless agreed otherwise, the seller is not bound to deliver goods, till the buyer applies for delivery (s.35):*** Even where the goods are to be acquired by the seller, the duty of the seller ends with notifying the buyer that they have been acquired. It is still the duty of the buyer to apply for delivery.

3. ***Place of delivery:*** Whether it is for the buyer to take possession of the goods or for the seller to send them to the buyer is a question depending in each case on the contract, express or implied, between the parties. Apart from any such contract, goods sold are to be delivered at the place at which they are at the time of the sale and goods agreed to be sold are to be delivered at the place at which they are at the time of the agreement to sell, or if not then in existence, at the place at which they are manufactured or produced [s.36 (1)].

4. ***Time of delivery:*** Where under the contract of sale the seller is bound to send the goods to the buyer, but no time of sending them is fixed, the seller is bound to send them within a reasonable time [s.36 (2)].

5. Unless otherwise agreed, the expenses of and incidental to putting the goods into a deliverable state shall be borne by the seller.

6. ***Demand for and tender of delivery must be at a reasonable hour:*** What is a reasonable hour is a question of fact.

7. ***Delivery of wrong quantity:*** Where the seller delivers to the buyer a quantity of goods less than he contracted to sell, the buyer may reject them. But, if the buyer accepts the goods so delivered he shall be required to pay for them at the contract rate [s.37 (1)]. Where a larger quantity is delivered, the buyer may accept the goods included in the contract and reject the rest or he may reject the whole. If the buyer accepts the whole of the goods so delivered, he shall pay for them at the contract rate [s.37(2)]. Where the goods of the contract description are mixed up with other goods, the buyer may accept the goods which are in accordance with the contract and reject the rest, or may reject the whole, [s.37(3)].

Example: The coal which is supplied is partly according to the contract and partly not. The buyer is entitled to reject the whole.

The above provisions regarding delivery of wrong quantity are subject to any usage of trade, special agreement or course of dealings between the parties [s.37(4)].

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8. ***Installment delivery:*** The buyer is not bound to accept delivery by instalment, unless otherwise agreed.

Example: In a contract of sale of 25 tons of pepper, "October-November shipment' the seller ships 20 tons in November and 5 tons in December. The buyer may refuse the whole.

Where there is a contract for the sale of goods to be delivered by stated installments which are to be separately paid for; and either buyer or seller commits a breach of contract, it is a question depending on the terms of the contract and circumstances of the case whether the breach is a repudiation of the whole contract or a severable breach merely giving a right to claim for damages (s.38).

Generally, a failure to deliver or pay for one installments does not amount to repudiation or breach of the whole contract. But where the breach is such as to lead to a reasonable influence that similar breaches will be committed with reference to the subsequent installments also, the other party is entitled to treat the whole contract as repudiated.

Example: Zafar sells to Yaseen 1,500 tons of meat and bone meat of a specified quality to be shipped 125 tons monthly in equal weekly installments. After about half the meat has been delivered and paid for, Yaseen discovers that it is not of the contract quality and, therefore, refuses to take further deliveries. Yaseen has a right to do so as he is not bound to take the risk of having put upon him further deliveries of goods which do not conform to the contract.

9. ***Delivery to the carrier or wharfinger (s.39):*** The delivery of goods by the seller to a carrier for transmission to buyer or to wharfinger for safe custody is prima facie deemed to be a delivery of the goods to the buyer unless the right of disposal has been retained by the seller.

The seller is bound to make with the carrier or wharfinger such a contract of carriage as properly protects the interest of the buyer except where the contract provides otherwise. If he fails to do so, he is liable in damages to the buyer or the buyer may refuse to treat delivery to the carrier as delivery to himself. As regards insurance, the seller's duty is only to give sufficient notice to the buyer to enable him to insure the goods, unless goods are sent c.i.f. (cost, insurance and freight) or ex-ship.

10. ***Where goods are delivered to a buyer, which he has not personally examined,*** he is not deemed to have accepted them, unless he has reasonable opportunity of examining them and assenting whether they conform to the contract. The provision, will however, be irrelevant where the parties agree otherwise (s.41).

Example: A seller gives notice to the buyer that the contract goods are lying at a certain store house and are ready for delivery against payment of price. The buyer, when he goes to the store house, is only shown two closed casks which are said to contain the goods. This is not a valid offer of delivery by the seller as no sufficient opportunity has been given to the buyer to inspect the goods.

11. ***Buyer not bound to return the rejected goods:*** Unless otherwise agreed, when the goods are delivered to a buyer on sale or return basis and the buyer refuses to accept them, he is not bound to return them to the seller, but it is his duty to inform the seller that he has refused them; otherwise after lapse of a reasonable time, he will be deemed to have accepted them (s.43).

12. ***Liability of the buyer:*** When the seller is ready and willing to deliver the goods and requests the buyer to take delivery and the buyer does not, within a reasonable time after

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such request, take delivery of the goods, he is liable to the seller for any loss occasioned by his neglect or refusal to take delivery and also for a reasonable charge for the care and custody of the goods. The above rule does not affect the seller's right to treat the buyer's refusal or neglect as a repudiation of the contract (s.44).

5.6.3 Passing of Property in Goods in the Case of Foreign Trade

There are certain terms which are used in the contract of sale of goods in foreign trade. These terms reflect a number of conditions which are either attached by the parties or by custom and practice of business people. The most usual of such contracts are: (i) Free on board (F.O.B.) or Free on Airport (F.O.A.) and (ii) Cost, Insurance and freight (C.I.F.) and Ex-Ship.

1. ***F.O.B. or F.O.A contracts.*** This means that the property in goods passes to the buyer only after the goods have been loaded on board the ship, and accordingly, the risk attaches to the buyer only on shipment of goods. Therefore, when price is noted F.O.B., then the seller or shipper has to bear all the expenses up to and including shipment of goods on behalf of the buyer.
2. ***C. I. F contracts:*** It is a contract for the sale of insured goods, lost or not lost, to be implemented by the transfer of certain documents. These documents are (i) Bill of lading; (ii) Insurance policy; (iii) Invoice; (iv) A certificate of origin. This method protects the interests of both the exporter and the importer. The property in the goods passes to the buyer on the delivery of these documents. Thus the difference between F.O.B and C.I.F contracts, so far as the passing of property is concerned, is that in the former the property passes when the goods are put on board a ship, but in the latter case the property passes when the documents are received by the buyer and he pays the price. The buyer pays the price against the documents, even where goods have not yet arrived. Therefore, sometimes it is said that a C.I.F. contract is a contract for the sale of documents. But, the documents represent symbolic delivery of the goods and therefore, a C.I.F. contract is really a contract for the sale of goods. C.I.F. quotation includes F.O.B. price plus cost of freight and premium on marine insurance up to the port of destination.
3. ***Ex-ship contracts:*** Under this agreement the seller has to deliver the goods to the buyer at the port of destination. Therefore, the ownership in the goods will not pass until actual delivery. It will, therefore, be for the exporter to insure the goods to protect his interests. The price quotation will include all expenses up to the point of delivery of the goods at the port of destination.

Self Assessment

Fill in the blanks:

11. Delivery is defined as a ……transfer of possession from one person to another.
12. A ……..is a contract for the sale of insured goods, lost or not lost, to be implemented by the transfer of certain documents.

5.7 Unpaid Seller and his Rights

A contract is comprised of reciprocal promises. In a contract of sale, if seller is under an obligation to deliver goods, buyer has to pay for it. In case buyer fails or refuses to pay, the seller, as unpaid seller, shall have certain rights.

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5.7.1 Who is an Unpaid Seller?

A seller of goods is an unpaid seller when (i) the whole of the price has not been paid or tendered. (ii) a bill of exchange or other negotiable instrument has been received as conditional payment and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise. The term seller includes any person who is in the position of a seller, e.g., an agent of the seller to whom a bill of lading has been endorsed, or a consignee or agent who has paid for the goods or is responsible for the price (s.45).

5.7.2 Rights of an Unpaid Seller

The rights of an unpaid seller may broadly be classified under two heads, namely: (i) Rights under the Ss.73-74 of the Indian Contract Act, 1872, i.e., to recover damages for breach of contract. (ii) Rights under the Sale of Goods Act, 1930: (a) rights against the goods; (b) rights against the buyer personally. The rights against the goods are as follows:

Where the property in the goods has passed to the buyer; (i) Right of lien; (ii) Right of stoppage of goods in transit; and (iii) Right of resale. Where the property in the goods has not yet passed to the buyer, he has an additional right of withholding delivery [s.46 (2)]. The rights against the buyer personally are: (i) Right to sue for price; (ii) Right to sue for damages; (iii) Right to sue for interest.

For example, Akshay buys certain goods from Sudeep, and agrees to pay for them later. Akshay leaves the goods with Sudeep to be sent to him later. Sudeep shall have a right of lien if in the meantime he learns of Akshay's insolvency.

Unpaid seller's lien - how lost. An unpaid seller loses his lien in the following five cases: (i) when the seller delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer, without reserving a right of disposal of the goods to himself, e.g., takes railway receipt or transport receipt in the name of the buyer or his agent; (ii) where the buyer or his agent lawfully obtains possession of the goods; (iii) the seller waives his right of lien; (iv) where the seller assents to a sub-sale by the buyer; (v) where the seller takes a security from the buyer for the payment of the price in place of his lien.

Notes **Lien on Goods (Ss. 47-49)**

The word lien means to retain possession of. An unpaid seller who is in possession of goods is entitled to retain them in his possession until payment or tender of the price in three situations, namely, (a) where the goods have been sold without any stipulation as to credit; (b) where the goods have been sold on credit, but the term of credit has expired; (c) where the buyer becomes insolvent. Lien can be exercised only for non-payment of the price and not for any other charges due against the buyer. For instance, the seller cannot claim lien for godown charges for storing the goods in exercise of his lien for the price. The lien of an unpaid seller is a particular lien, it is a personal right which can be exercised only by him and not by his assignees or his creditors. The unpaid seller may exercise his lien notwithstanding that he is in possession of the goods, as agent or bailee for the buyer. Further, this right of lien is available even after part delivery of the goods has been made, unless such part delivery is made under such circumstances as to show an agreement to waive the lien (s.48).

An unpaid seller, however, does not lose his lien by reason only that he has obtained, a decree for the price of the goods [s.49 (2)]. The lien of the unpaid seller is a possessory lien, that is, once the possession is lost, lien is lost.

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For example, On a sale of certain shares the relevant share certificates and transfer form duly signed are handed over by the seller to the buyer against payment of price by cheque. Subsequently the buyer becomes insolvent. The seller has no lien on the share certificate or transfer form, for his lien ceased when he parted with their possession.

5.7.3 Right of Stoppage in Transit

This right of the unpaid seller consists in preventing the goods from being delivered to the buyer and resuming and regaining their possession while in transit, retaining them till the price is paid. The right of stoppage in transit is earned only where the right of lien is lost and is available only where the buyer has become insolvent (s.50).

Duration of transit [s.51]. Since the right of stoppage in transit can be exercised only during transit, the question of duration of transit is of great significance. Goods are deemed to be in course of transit from the time when these are delivered to a carrier or other bailee for the purpose of transmission to the buyer, until the buyer or his agent in that behalf takes delivery of them from such carrier or other bailee. When does the transit end? The transit comes to an end in the following situations: (i) when the goods reach the hands of the buyer or his agent; (ii) if the buyer or his agent obtains delivery of the goods before they reach their destination; (iii) if after the arrival of the goods at the appointed destination, the carrier or other bailee acknowledges to the buyer or his agent that he holds the goods, on behalf of the buyer or the buyer' agent. It is immaterial that a further destination of the goods was indicated by the contract; (iv) where the carrier or other bailee wrongfully refuses to deliver the goods to the buyer or his agent; (v) if the goods are rejected by the buyer and the carrier or other bailee continues to hold them, even if the seller has refused to receive them back; (vi) when the goods are delivered to a ship, it becomes a question depending on the circumstances of a particular case whether they are in the possession of the master as carrier or as an agent of the buyer. If the ship is chartered by the buyer or is one belonging to the buyer, the transit comes to an end as soon as the goods are loaded on the ship, unless the seller had reserved the right of disposal of the goods; (vii) change of destination. Where goods are agreed to be delivered at a particular place but the buyer then asks the seller to deliver them at a different place, the transit continues till the goods are taken by the buyer or his agent at that place; (viii) effect of part-delivery. Where part delivery of the goods has been made to the buyer or his agent in that behalf, the remainder of the goods may be stopped in transit, unless such part delivery has been given in such circumstances as to show an agreement to give possession of the whole of the goods.

Examples:

1. Badal at Delhi orders goods of Anand at Kolkata. Anand consigns and forwards the goods to Badal. On arrival at Delhi, goods are taken to Badal's warehouse and left there. Badal refuses to take the goods and stop payment. The goods are deemed to be in transit and the unpaid seller can take them back.
2. The goods are delivered on board the ship belonging to the buyer. Under the bill of lading the goods are deliverable to the buyer or his agents. Such a bill of lading is a delivery to the buyer and therefore, there could be no right of stoppage in transit.

How the right of stoppage in transit effected? (s.52). The unpaid seller may exercise his right of stoppage in transit either by taking actual possession of the goods or by giving notice of his claim to the carrier or other bailee in whose possession the goods are. The notice of stoppage may be given either to the person in actual possession of the goods or to the principal. In the latter case (i.e., to the principal) the notice to be effectual, must be given at such time and in such circumstances that the principal, by the exercise of the reasonable diligence, may communicate it to his servant or agent in time to prevent delivery to the buyer. On receipt of the notice from

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the seller, the carrier or other bailees in possession must redeliver the goods to, or according to the directions of the seller. The expense of such redelivery shall be borne by the seller.

Effect of sub-sale or pledge by buyer (s.53). The general rule is that the unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods, which the buyer may have made, unless the seller has assented thereto.

Example: Anil sells to Balbir 10 quintals of grain out of a granary. Balbir then sells (out of 10 quintals) 6 quintals to Chand. Chand after receiving from Balbir the delivery order presents it to Anil. Anil tells Chand that the grain would be delivered in due course. Balbir then becomes insolvent. Anil's right against the 6 quintals is lost since he recognised the title of Chand-the sub-buyer.

The above general principle is, however, subject to certain exceptions. These are:

1. where a document of title to the goods has been issued or lawfully transferred to any person as buyer or owner of the goods and that person transfers the document to a purchaser in good faith and for valuable consideration, the unpaid seller's right of lien or stoppage in transit is destroyed;
2. where the document of title to the goods issued, or lawfully transferred to the buyer has been transferred by him, to a bona fide purchaser for consideration, by way of pledge, the right of lien or stoppage in transit can only be exercised subject to the right of the pawnee.

Table 5.2: Lien and Stoppage in Transit

	Lien	Stoppage in Transit
1.	Available only when the goods are in the possession of the unpaid seller	Available only after the seller has parted with the possession of the goods.
2.	Available, even when the buyer is not an insolvent.	Available only when the buyer becomes an insolvent.

5.7.4 Right of Resale (S.54)

The unpaid seller, who has retained the possession of the goods in exercise of his right of lien or who has resumed possession from the carrier upon insolvency of the buyer, can resell the goods, (i) if the goods are of a perishable nature, without any notice to the buyer and (ii) in other cases after notice to buyer calling upon him to pay or tender the price within a reasonable time and upon failure of the buyer to do so. The seller is entitled to recover from the original buyer damages caused to him by the resale. But if any profit accrues from the resale, such profit shall go to the unpaid seller and not to the buyer. The seller is not acting as the agent of buyer.

Caution The notice of resale to the buyer, however, is necessary except when goods are of a perishable nature.

In case the seller resells the goods without giving the notice to the buyer, he shall not be entitled to recover damages from the buyer for any loss on resale, nor shall be entitled to pocket any profit that may accrue on the resale. The profit, in such as case, shall go to the buyer. In any case, the buyer (who buys in case of resale) acquires a good title to the goods as against the original buyer, notwithstanding that no notice of resale has been given to the original buyer. No notice of resale to buyer is necessary in case of perishable goods. The word 'perishable' is not confined

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to physical deterioration; it also includes commercially perishable goods and goods liable to deterioration so as to make them unmerchantable.

Right of resale is also available where, by the contract, seller has expressly reserved a right of resale in case the buyer makes a default [s. 54(4)]. In case the seller exercises his right of resale under this clause, the original contract is rescinded but, however, without prejudice to the seller's right to recover damages for its breach.

Measure of damages: The measure of damages in case of resale is the difference in the contract price and the price realised on such resale plus the expenses of resale.

Time within which the right of resale to be exercised: The seller must exercise his right of resale within a reasonable time. What is a reasonable time will be determined by the facts of the case.

Some cases when even if the buyer knows of the defect in the seller's title, he will acquire a valid title to the goods: The general rule regarding transfer of property provides that the buyer must have purchased for value and bona fide, i.e., without having knowledge about the defect in the title of the transferor. However, there are three cases where he gets good title, even when he knows that the transferor's title is defective. These are: (i) when an unpaid seller resells the goods in accordance with s.54, (ii) when a sale is made by the finder of lost goods in accordance with s.169 of the Indian Contract Act, 1872. (iii) when the pledgee sells the goods in accordance with s.178 of the Indian Contract Act, 1872.

Right of unpaid seller where the property in the goods has not passed to the buyer: Section 46(2) provides that where the property in the goods has not passed to the buyer, the seller would have the same right of lien and stoppage in transit which he would have had as if the property has passed.

Remedies for Breach of a Contract

In addition to the rights of a seller against goods provided in Ss. 47 to 54, the seller has the following remedies against the buyer personally. (i) suit for price (s.55); (ii) damages for non-acceptance of goods (s.56); (iii) suit for interest (s.56).

1. ***Suit for Price (S.55):*** Where under a contract of sale the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay the price, the seller can sue the buyer for the price of the goods. Where the property in goods has not passed to the buyer, as a rule, the seller cannot file a suit for the price; his only remedy is to claim damages. However, s. 55(2) provides that where under a contract of sale the price is payable on a day fixed irrespective of delivery and the buyer wrongfully neglects or refuses to pay the price, the seller may sue the buyer for the price although the property in the goods has not passed and the goods have not been appropriated to the contract.

Example: A sold certain goods to B for ₹ 5,000 and the price was agreed to be paid before the expiry of ten days of the contract. B fails to pay the price within the stipulated time. A can file a suit for price against B even though the goods have not been delivered or the property in goods has not been passed to B.

2. ***Suit for Damages for Non-acceptance (S.56):*** Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages for non-acceptance. Where the property in the goods has not passed to the buyer and the price was not payable without passing of property, the seller can only sue for damages and not for the price. The amount of damages is to be determined in accordance with the provisions laid down in s. 73 of the Indian Contract Act, 1872. Thus, where there is an available market for the goods prima facie, the difference between the market price and the contract

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price can be recovered. Further, where the seller is ready and willing to deliver the goods and requests the buyer to take delivery, which the buyer does not do within a reasonable time, the seller may recover from the buyer: (i) any loss occasioned by the buyer's refusal or neglect to take delivery, and (ii) a reasonable charge for the care and custody of the goods.

3. ***Suit for Interest (S.61):*** When under a contract of sale, the seller tenders the goods to the buyer and the buyer wrongfully refuses or neglects to accept and pay the price, the seller has a further right to claim interest on the amount of the price. In the absence of a contract to the contrary, the court may award interest at such rate as it thinks fit on the amount of the price. The interest may be calculated from the date of the tender of the goods or from the date on which the price was payable. It is obvious that the unpaid seller can claim interest only when he can recover the price, i.e., if the seller's remedy is to claim damages only, then he cannot claim interest.

Self Assessment

Fill in the blanks:

13. The right of stoppage in transit is earned only where the right of lien is lost and is available only where the buyer has become…….

14. The ……..in case of resale is the difference in the contract price and the price realised on such resale plus the expenses of resale.

5.8 Buyer's Remedies against Seller

The buyer has the following rights against the seller for breach of contract: (i) damages for non-delivery (s.57); (ii) right of recovery of the price; (iii) specific performance (s.58); (iv) suit for breach of condition; (v) suit for breach of warranty (s.59); (vi) anticipatory breach (s.60); (vii) recovery of interest (s.61).

Damages for Non-delivery

Section 57 provides that where the seller wrongfully neglects or refuses to deliver the goods to the buyer, the buyer may sue the seller for damages for non-delivery. The measure of damages is as in the case of a suit for non-acceptance under s.56, i.e., the difference between the contract price and the market price at the time when the goods were to be delivered or, if no time for delivery was fixed, from the time of refusal to delivery. This is if the goods are readily available in the market.

Did u know? If the buyer contracted to purchase the goods for resale and this fact was known to the seller, then the buyer may recover from the seller the difference between the contract price and the resale price.

Right to Recover the Price

The buyer is entitled to refund of price, if already paid, in all cases of non-delivery.

Specific Performance

Section 58 provides that in a contract of sale of specific or ascertained goods, if the seller fails to deliver the goods, the buyer may file a suit for specific performance. The court may, at its

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discretion, order the specific performance of the contract. This remedy is allowed only if damages would not be an adequate remedy or the goods are of a unique nature or of special value.

Example: A contracted to sell a rare painting to B for ₹ 10,000. Later on, A refused to perform his promise. B applies to the court for specific performance of the contract. The court may pass an order directing A to specifically perform his promise.

Suit for Breach of Condition

Where there is a breach of condition, express or implied, on the part of the seller, the buyer can avoid the contract and can reject the goods. But he cannot reject the goods if: (i) he waives the breach of condition and elects to treat it as a breach of warranty, or (ii) the contract is not severable and he has accepted the goods or part of them, or (iii) the contract is for specific goods and the property has passed to him. In all these cases, as provided in s.13, the condition sinks or descends to, or is treated as warranty and the goods cannot be rejected but only a suit for damages can be filed.

Suit for Breach of Warranty (S.59)

Where there is a breach of warranty by the seller, or in case where the breach of condition on the part of the seller is being treated as a breach of warranty, the buyer can sue the seller for damages for such breach. Thus, if the buyer has already paid the price, his only remedy is to sue for damages. In case he has not paid the price, he may set-up against the seller the breach of warranty in diminution or extinction of the price. The measure of damages for breach of warranty is estimated loss ensuing directly and naturally from the breach.

Example: A purchased a second hand typewriter and spent some money in getting it overhauled. Later on, the typewriter was seized from him by police as stolen property. Held: There was a breach of warranty of quiet possession and the buyer could recover damages including the cost of repair.

The right of the buyer under s.59 cannot be exercised by him if he has waived the condition. Also he is duty bound to give notice of his intention to the seller in what respect the goods are defective and whether he is electing to treat the condition as a condition or as a warranty. This notice must be given by the buyer within a reasonable time after he discovers the alleged defect in the goods.

Anticipatory Breach

Where the seller repudiated the contract before the time for performance has come, the buyer has the option; (i) to treat the contract as repudiated and claim damages, or (ii) he may keep the contract open till the date of delivery of goods. Under the former alternative the contract comes to an end and damages will be assessed according to the price then prevailing. In the second case, the contract remains open at the risk and for the benefit of both parties. The party repudiating has an option to perform the contract. Further, in case the repudiating party does not perform the contract on the stipulated date, the measure of damages will be with reference to the price on the day stipulated for delivery.

Recovery of Interest (S.61)

If the buyer has already paid the price and the seller fails to deliver the goods on the due date, the buyer has a right to sue for interest on the amount of the price. In the absence of a contract to the

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contrary, the court may award interest at such rate as it thinks fit on the amount of the price from the date on which the payment was made. However, the buyer can claim interest only when he has a right to recover the price, i.e., he cannot claim interest when his only remedy is to claim damages.

Self Assessment

Fill in the blanks:

15. The buyer is entitled to……., if already paid, in all cases of non-delivery.
16. Section 58 provides that in a contract of sale of ……..goods, if the seller fails to deliver the goods, the buyer may file a suit for specific performance.

5.9 Sale by Auction [S.64]

In the case of sale by auction the following rules apply:

1. When the goods are put up for sale in lots, each lot is deemed prima facie, to be the subject matter of a separate contract of sale.
2. At an auction, the sale is complete when the auctioneer announces its completion by the fall of the hammer or in other customary manner; until such completion any bidder may withdraw his bid. It is also the practice to say 'three times'.
3. A right to bid may be reserved expressly by or on behalf of the seller and where such right is expressly reserved but not otherwise, the seller or any person on his behalf may bid at the auction.
4. Where the sale is not notified to be subject to a right to bid on behalf of the seller, it shall not be lawful for the seller to bid for himself or to employ any person to bid at such sale, or for the auctioneer knowingly to take any bid from the seller or any such person. Any sale contravening this rule shall be treated as fraudulent.
5. The sale may be notified to be subject to a reserved or upset price.
6. If the seller makes use of pretended bidding to raise the price, sale is voidable at the option of the buyer.

Self Assessment

Fill in the blanks:

17. At an auction, the sale is complete when the auctioneer announces its completion by the fall of the hammer or; until such completion any bidder may withdraw his bid, It is called the practice to say ……..
18. In the case of sale by auction, if the seller makes use of pretended bidding to raise the price, sale is ……at the option of the buyer.

5.10 Doctrine of Caveat Emptor

The doctrine of caveat emptor is a fundamental principle of the law of sale of goods. It means 'CAUTION BUYER', i.e., 'let the buyer beware'. In other words, it is no part of the seller's duty to point out defects of his own goods. The buyer must inspect the goods to find out if they will suit his purpose.

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Example: Certain pigs are sold 'subject to all faults'. These pigs, being infected, cause typhoid to other healthy pigs of the buyer. The rule of caveat emptor will apply.

Exceptions to the doctrine of caveat emptor. The doctrine is subject to the following exceptions:

1. Where the seller makes a false representation and buyer relies on that representation, the buyer is entitled to the goods according to that representation.
2. Where the consent of the buyer, in a contract of sale, is obtained by the seller by fraud or where the seller actively conceals a defect in the goods, so that on a reasonable examination the same could not be discovered.
3. Where the buyer makes known to the seller the purpose for which he is buying the goods and the seller happens to be a person whose business is to sell goods of that description, then there is an implied condition that the goods shall be reasonably fit for such purpose (s.6(1)).
4. In case of sale by description, there is an implied condition as to goods being of merchantable quality. However, if the buyer has examined the goods, then this implied condition extends only to hidden or latent defects. The rule of caveat emptor is not applicable to the defects which such examination ought to have revealed.
5. Proof of a reasonable usage or custom of trade may also establish an implied condition as to quality or fitness of the goods for a particular purpose.

   Application of implied conditions in the case of private sale. The rules as to fitness for a particular purpose and merchantable quality do not apply to private sales. In other words, the maxim of caveat emptor would apply. However, the implied condition that the goods must correspond with the description does apply to private sales also. Further the implied condition that the goods must correspond with the sample, in the case of sale by sample, even in the case of private sales, would be applicable.

Task Raman sold 100 quintals of rice to Suman, who paid by cheque. The cheque was dishonoured upon presentation. Raman had given a delivery order to Suman. Suman resold it to Gagan, a buyer in good faith, for consideration, endorsing the delivery order to him. Raman refuses to deliver the goods to Gagan, on the plea of non-payment. Advice Gagan.

Liability of manufacturers in negligence: When goods are purchased by a person from a dealer, then there is a privity of contract between them. Therefore, the implied conditions and warranties, as explained above, can be read as a part and parcel of the contract. But, there is no privity of contract between the buyer and the manufacturer under the Sale of Goods Act, 1930. However, a buyer may have an action in negligence against the manufacturer in respect of physical injuries caused by defects in the goods. [Donoghue v. Stevenson (1932) A. C. 562]. Mr. D did not buy the goods from the seller, it is his friend who had purchased them. Thus, though D did not have a privity of contract with the seller, he could get the manufacturer held liable for the physical injuries, caused to him. D is a stranger to the contract, therefore he could not file a suit against the seller under the Indian Contract Act, 1872, or the Sale of Goods Act, 1930.

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Self Assessment

Fill in the blanks:

19. Doctrine of caveat emptor which is a fundamental principle of the law of sale of goods means .....

20. The rule of Caveat emptor does not apply where the consent of the buyer, in a contract of sale, is obtained by the seller by .....or where the seller actively conceals a defect in the goods.

Case Study

Caveat Emptor or Caveat Venditor: Where are we Heading?

Let the buyer beware is not a phrase that judges use very often nowadays. The age-old rule of caveat emptor rule, which has its origin in common law, has over the times undergone major changes. As the rule was being given a concrete shape, its exceptions also grew with time. This article however, seeks to analyze the gradual death of the rule of caveat emptor and its replacement with a rule, which has subsequent origin i.e. caveat venditor (let the seller beware). This analysis would center around the balancing point of the necessity of disclosure of information by the seller on one side and implications of reasonable inspections done by the buyer on the other.

The History: Caveat Emptor (When it Originated)

As one would trace by its origin, the philosophy behind the rule of caveat emptor was basically the reliance placed by the buyer on his own skill or judgment . It is based on the fundamental premise that once a buyer satisfies himself as to the suitability of the product for his use, he would subsequently have no right to reject the same. The rule of caveat emptor, as it prevailed at the times of its origin, was quite rigid.

If one peruses through the English Sale of Goods Act, 1893, it is not only noticeable but quite evident that the seller's duties as to disclosure requirements when a product is sold was minimal. Buyer's examination of the goods was considered over and above any duty upon the seller to provide information. Concepts like 'fitness of goods' and 'merchantability', which could be used to shift the burden as to quality and fitness on the seller, were not encouraged. Another strong proposition, which was present in the act, was in the form of Section 11(1)(c), which mandated that in cases where there was sale of 'specific' goods, the buyer could not reject the goods on any ground.

Thus it can be noted that the law being bent in the favor of the seller, and in those times, one could not even contemplate a corresponding rule, which would put the burden on the seller (caveat venditor).

The Fallacy and the Need for Change

The approach, which was being adapted when the rule of caveat emptor prevailed in its absolute form, was later characterized as one detrimental to the development of trade and commerce. It is submitted that their lordships were quite correct in saying so because; caveat emptor in its absolute from would certainly be detrimental to the buyer's cause, because till then, the element of 'reasonable' examination was not introduced. Therefore a scenario wherein a buyer would not have any recourse against a seller who has in spite

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of being aware of a latent defect (one which cannot be detected by reasonable examination) not informed the buyer about the same, would certainly not encourage commercial transactions.

Another sound reason, which can be thought of for the dilution of the rule of caveat emptor, is to provide adequate protection to the buyer who buys the good in good faith, which case laws put as, 'reliance on the skill and judgment of the seller'. Thus in order to give proper recognition to the relationship between the buyer and the seller and to generate a scenario wherein commercial transactions are encouraged by the means of proper checks, the rule was subsequently diluted.

The Dilution Process and Origin of Caveat Venditor

For the reasons stated above, the rule of caveat emptor, as far as judicial precedents goes, for the first time suffered a blow by the case of Priest v. Last wherein for the first time, the reliance placed by the seller for the purposes of buying a 'hot water bottle' was taken into account for the purposes of allowing the buyer to reject the goods. This decision was the first traceable decision in common law which gave importance to the reliance placed by the buyer on the seller's skill and judgment. This proposition of law, however is a settled principle of law today.

The Priest decision however, was just a beginning of what could certainly be termed as the diminishing process of the rule of caveat emptor. Where in this decision, the purpose was expressly mentioned and then taken into account, the courts in subsequent cases, opined that the need/purpose of the contract would be evident from the nature of the contract, or might be known to the seller from the course of negotiations between the parties. Thus express mention of the purpose behind a purchase of goods was no longer considered a requisite for proving reliance on the skill and judgment of the seller, which signified a further shift of law in favor of the buyer.

This imposition of obligations upon the seller was also not a smooth process in itself. If one refers to the decisions like that of the House of Lords in the case of Ashington Piggeries Ltd v. Christopher Hill Ltd , where on one hand the majority opined that a generalized purpose should be shoehorned within the meaning of a particular purpose thereby meaning that when the buyer purchases foodstuff meant for animals, he need not mention specifically the type of animals he would feed with the foodstuff. On the other hand the dissenting opinion of Justice Diplock, while rejecting the majority opinion, clearly said that 'the swing from caveat emptor to caveat venditor had gone too far.' Another decision, which goes with the opinion of Justice Diplock, is the decision of New Zealand Court of Appeal in the case of Hamilton v. Paparika wherein the court refused to accept the contention that a water supplier supplying water to horticulture farms should ensure that its water would not harm a specific crop i.e. soil less cherry tomato. The court opined that since the water was serving the generalized purpose in the given case, so any particular purpose should have been communicated to the seller and he could not have known the same by implication.

It is submitted that the valid argument which can be construed out of these case laws is that concerning the variation between the nature of the particularized purpose and the generalized purpose.' But this has an equally sound counter-argument, which is that it should be incumbent upon the seller to specify that his product, which is sold for a generalized purpose would not suit a particular purpose. Or that the product would have to be used in a particular manner in order to serve a particular purpose. This counter-argument is where one can trace the origin of caveat venditor i.e. the need for disclosure on the seller's part.

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Caveat Venditor: Development of the Seller's Obligation

With its origin being traced in the need for disclosure of information for the purposes of facilitating the reason for purchase of the buyer, gradually this rule has gained prominence and the obligations of the seller have been given proper shape along with various statutes and case laws limiting the rule of caveat emptor to 'reasonable examination'. Examples like beer contaminated with arsenic, milk-containing typhoid germs are good enough to establish that courts have been generous enough to exempt the buyer from the duty to examine the goods where the defects could not have been traced in ordinary circumstances.

Another major debate which arises from the above obligation of the seller to make proper disclosure is concerning cases where the seller himself does not come to know of the defect. Where on one hand a learned scholar on sale of goods Benjamin has opined that the seller cannot take the excuse of himself not being aware of the defect in goods. Case laws like Harlingdon & Leinster Enterprises Ltd v. Christopher Hull Fine Art Ltd on the other hand suggest that where the buyer himself has more expertise in a given field than the seller, it would be wrong to suggest that the buyer could have the right to reject the painting sold to him on account of not being of the original painter (this proposition was also rejected in the dissent of Justice Smith in the same case).

It is however submitted that Benjamin's opinion in this regard should be taken as over and above the mandate of judicial precedents, because when the buyer places reliance on the skill and judgment of the seller, the fact that the seller does not possess the same can nowhere be held as a justifiable excuse. Therefore a duty does lie by law on the seller to be aware of the conditions of the goods being sold and making the buyer aware of the same. The various tests for merchantable quality of goods also go on to indicate the same when they emphasize on the 'full knowledge' of the buyer as to the quality of the goods.

The first test which was accepted by the law commission was the statement of Justice Dixon in Australian Knitting Mills v. Grant: (the goods) should be in such an actual state that the buyer fully acquainted with the facts and, therefore, knowing that hidden defects existed and not being limited to their apparent condition would buy them without abatement of the price obtainable for such goods if in reasonably sound order and condition and without any special terms.

The second test was the 'usability test' by the Law Commission comes from the verdict of Lord Reid in the case of Kendall & Sons v. Lillico & Sons Ltd.: What subsection (2) now means by 'merchantable quality' is that the goods in the form in which they were tendered were of no use for any purpose for which goods which goods which complied with he description under which these goods were sold normally to be used, and hence not sellable under that description.

On the basis of the above two tests, the Law Commission came up with its own test for merchantable quality, stating that, ''Merchantable Quality' means that the goods tendered in performance of the contract shall be of such type and quality and in such condition that, having regard to the circumstances, including the pricing and description under which the goods are sold, a buyer with the full knowledge of the quality and characteristics of the goods, including knowledge of any defects, would, acting reasonably, accept the goods in performance of the contract.

It is submitted that from the above mentioned three tests for merchantable quality, it can said that if the goods are supposed to be termed as those of merchantable quality, the buyer having 'full knowledge' about them, would 'acting reasonably' buy the same. Therefore the seller's duty to make the buyer aware of all the defects in the goods being

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sold and all the information relating to the usage of the goods. This obligation of the seller, it is submitted, should be irrespective of his own knowledge and skill, because what matters is not what he has but what he is expected to have. Therefore it can be concluded from the above analysis that the rule of caveat emptor is dying a slow death and is being taken over by the subsequent rule of caveat venditor, the change being attributed to a more consumer oriented market wherein commercial transactions are being encouraged. Such a change, it is submitted will not only help create an appropriate balance between the rights and obligations of the seller and the buyer. But it should be noted that if this trend of change is taken too far, we might end up in retarding transactions due to the approach then becoming extremely pro-buyer who might misuse the protection under law.

Question

Is the concept of 'Caveat Emptor' really dying? Discuss.

Source: legalserviceindia.com

5.11 Summary

- A contract of sale is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price.
- Sale is to be distinguished from an agreement to sell.
- Where under a contract of sale, the property in goods is transferred from the seller to the buyer, it is a called a sale. On the other hand, an agreement to sell means a contract of sale under which the transfer of property in goods is to take place at a future date or subject to conditions thereafter to be fulfilled.
- Goods may be classified as existing, future and contingent.
- In contract of sale, parties make certain stipulations. All stipulations are not treated on the same footing. These stipulations are technically known as conditions and warranties. These conditions and warranties may be express or implied.
- The doctrine of caveat emptor is a fundamental principle of the law of sale of goods. There are however, certain exceptions to the doctrine.
- The Act contains a number of rules for passing the property in the goods from the seller to the buyer.
- The contract of sale of goods is to be performed, as any other contract.
- The act provides for the duties of the seller and the buyer, and rules regarding delivery of goods.
- In case the buyer fails or refuses to pay for the goods, the seller is known as unpaid seller, and he is given certain rights by the law.

5.12 Keywords

Condition: It is a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated.

Delivery: It is defined as a voluntary transfer of possession from one person to another.

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Goods: It means every kind of movable property, other than actionable claims and money; and includes stocks and shares, growing crops, grass and things attached to or forming part of the land which are agreed to severed before sale or under the contract of sale.

Warranty: It is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated.

Unpaid Seller: A seller of goods is an unpaid seller when (i) the whole of the price has not been paid or tendered, or (ii) a bill of exchange or other negotiable instrument has been received as conditional payment and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise.

5.13 Review Questions

1. J, the owner of a Maruti car, wants to sell his car. For this purpose he hands over the car to P, a mercantile agent for sale at a price not less than ₹ 90,000. The agent sells the car for ₹ 80,000 to A, who buys the car in good faith and without notice of any limitation on P's authority. P misappropriated the money also. J sues A to recover the car. Decide giving reasons whether J would succeed.
2. Analyse the circumstances when the right of stoppage in transit ends.
3. A bought 3,000 tins of preserved milk from U.S.A. The tins were labelled in such a way as to infringe the Nestlé's trade mark. As a result, they were detained by the custom authorities. To get the clearance certificate from the customs, A had to remove the labels and had to sell them at a loss. Can A recover damages? Justify.
4. "In every contract for the sale of the goods, a time limit for the performance of the promise is fixed". Analyse the importance of the time clause in the contracts and their performance. What would be the consequences if time limit is not included? Comment.
5. What is the practical importance of knowing the exact moment when the property in goods passes from the seller to the buyer? State and illustrate the rules which determine such moment.
6. You are the buyer and wanted to make the contract for the sale. What are the essential things you will include in the contract to make it valid?
7. A asked for a special quality of Dehradun rice. When the rice was cooked, A found that the quality, though good, was not the same as the one he had asked for. Advise A.
8. 'No one can give what he himself has not'. Elucidate.
9. "Buyer must be aware about the defects in the goods he is purchasing from the seller." Do you agree? Justify.
10. 'Risk prime facie passes with property'. Elucidate.
11. "Sale & agreement to sell is same." Do you agree? Justify.
12. A agrees to sell to B 10 bales of Egyptian cotton out of 90 bales lying in his godown. The godown has been destroyed by fire at the time of contract. A is unaware of this fact. What happens to the contract?
13. A agrees to sell to B 200 tons of potatoes to be grown on his land at a specific price. He sows the crop but without any fault on his part, the yield was only 80 tons. Decide.

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14. A agrees to buy a horse on condition that he will pay the price after a week's trial. The horse died on the third day without the fault of either of the parties. Who shall bear the loss?

15. A hirer obtains possession of a car and immediately sells it to B who purchases it in good faith. Has B become the owner of the car?

Answers: Self Assessment

1.	bilateral	2.	money
3.	Existing	4.	Future
5.	conditions	6.	time
7.	specific	8.	unascertained
9.	owner	10.	factor
11.	voluntary	12.	C. I. F contract
13.	insolvent	14.	measure of damages
15.	refund of price	16.	specific
17.	'three times'.	18.	voidable
19.	'let the buyer beware'.	20.	fraud

5.14 Further Reading

Book S.S. Gulshan, *Business Law,* Excel Books, New Delhi, 2006.

Online links www.financedoctors.net/Notes/60.pdf

www.legalservicesindia.com/articles/condi.htm

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Unit 6: Partnership Act and Limited Liability Act

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Objectives

After studying this unit, you will be able to:

- Describe the meaning and character of partnership;
- Discuss the aspect of partnership deed;
- Recognize the relationship of partners;
- Explain the limited liability act.

Introduction

An individual or a group of persons may decide to start business. One of the first steps to be taken is to determine what kind of business organisation it will be. If only one person starts the business, we call that business sole proprietorship and if a group of persons start the business, that can be either partnership business, or a company or a cooperative form of organisation. Though a business unit may be owned by any of these forms of organisation, usually one form is more suitable than others for a particular business enterprise. The choice will depend upon the considerations such as the type of the product, capital requirements, government control, legal requirements, competitive conditions in the chosen industry, level of taxation, ownership privileges and the like.

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6.1 Meaning and Nature of Partnership

A partnership is defined as "the relationship between persons who have agreed to share profits of a business carried on by all, or by any of them acting for all". On analysis of the definition, certain essential elements of partnership emerge. These elements must be present so as to form a partnership and are discussed below.

1. Partnership is an association of two or more than two persons. There must be at least two persons who should join together to constitute a partnership, because one person cannot become a partner with himself. These persons must be natural persons having legal capacity to contract. Thus, a company (which is an artificial person) cannot be a partner. Similarly, a partnership firm cannot be a partner of another partnership firm. As regards maximum number of partners in a partnership firm, s.11 of the Companies Act, 1956, puts the limit at 10 in case of banking business and 20 in case of any other business.

2. Partnership must be the result of an agreement between two or more persons. An agreement presupposes a minimum number of two persons. As mentioned above, a partnership to arise, at least two persons must make an agreement. Partnership is the result of an agreement between two or more persons (who are known as partners after the partnership comes into existence). The partnership is not a product of status as in the case of Hindu Undivided Family business (s.5). It also does not arise by operation of law as in the case of co-ownership. Similarly, it cannot arise by mere joint acquisition of property. Partnership can arise by contract only.

   The members of a HUF (coparcenary) carrying on a family business cannot be regarded as a partnership firm, because coparcener or members of the family get a share in the business not by virtue of agreement but by virtue of status, i.e., by birth in the family. Of course, this does not mean that there can be no partnership between members of a JHF to carry on a family business in partnership. But where such a fact is alleged, it will have to be established by proper evidence.

   Like any other contract, an agreement to constitute partnership must fulfil all the essentials of a valid contract. Also an agreement between the partners may be express or implied. Further, the partnership agreement may be to execute a particular adventure or for a fixed period.

3. The agreement must be to carry on some business. The term 'business' includes every trade, occupation or profession [s. 2(b)]. Though the word 'business' generally conveys the idea of numerous transactions, a person may become a partner with another even in a particular adventure or undertaking (s. 8). Unless the person joins for the purpose of carrying on a business, it will not amount to partnership. Thus, partnership does not exists between members of a charitable society or a religious association or a building scheme. Similarly, a club is not a partnership.

4. The agreement must be to share profits of the business. The joint carrying on of a business alone is not enough; there must be an agreement to share profits arising from the business. Unless otherwise so agreed, sharing of profits also involves sharing of losses. But whereas the sharing of profits is an essential element of partnership, sharing of losses is not. Thus, a person may become a partner under a distinct understanding that he is not to share losses, but to share only the profits. Though sharing of profits is an essential feature of partnership, the mere fact that a person is given a share in the profits of the business does not necessarily make him a partner.

Example: A, a trader, owed money to several creditors. He agreed to pay his creditors out of the profits of his business (run under the creditors' supervision) what he owed to them.

Notes

Held, the arrangement did not make creditors partners with A in business [Cox v. Hickman, (1860) 8 H.L.C., 268].

Similarly, a servant or agent who receives a share of profits as his remuneration or the seller of goodwill of a business who is given a share of profits as consideration for the sale of goodwill are not by reason of such facts alone, partners.

5. Business must be carried on by all or any of them acting for all. Partnership is based upon the idea of mutual agency. Every partner assumes a dual role – that of a principal and of an agent. The foundation of the law of partnership is agency and it is therefore said that "the law of partnership is a branch of the law of principal and agent". Each partner is an agent binding the other partners who are his principals and each partner is again a principal, who in turn, is bound by the acts of the other partners. Thus the question whether a person is or is not a partner depends on whether he can bind others by his acts or be bound by the acts of others. It is not necessary that partner must actively participate in the conduct of the business. Thus, it is possible to have a partnership, in which one or more of the partners have management and control and some other partner is a sleeping a or dormant partner.

6.1.1 Other Legal Characteristics of Partnership Form of Organisation

Certain other important legal characteristics of partnership organisation are:

1. Unlimited liability. The liability of each partner of the firm is unlimited in respect of the firm's debts. The liability of partners is joint and several and therefore even one of the partners can be called upon to pay the debts of the firm in case the firm's assets are insufficient.
2. No separate legal entity. The partnership firm has no independent legal existence apart from the persons who constitute it.
3. Utmost good faith. A partnership agreement is based on mutual confidence and trust of the partners. The partners must therefore be just and honest towards the other partners. They must disclose all facts and render true accounts relating to the business of the firm and not make any secret profits.
4. Restriction on transfer of interest. No partner can transfer his share to an outsider without the consent of all other partners.
5. Unanimity of consent. No change may be made in the nature of the business without the consent of all partners.

6.1.2 Formation of Partnerships

All the essential elements of a valid contract must be present in a partnership as it is based on an agreement. Therefore, while constituting a partnership. The following points must be kept in mind:

(i) The Act provides that a minor may be admitted to be benefits of partnership.

(ii) No consideration is required to create partnership. A partnership is an extension of agency for which no consideration is necessary.

(iii) The partnership agreement may be express (i.e., oral or writing) or implied and the latter may be inferred from the conduct or the course of dealings of the parties or from the circumstances of the case. However, it is always advisable to have the partnership agreement in writing.

(iv) An alien friend can enter into partnership, an alien enemy cannot.

Notes

(v) A person of unsound mind is not competent to enter into a partnership.

(vi) A company, incorporated under the Companies Act, 1956 can enter into a contract of partnership.

(vii) Section 5 provides that the following persons are not treated as partners: (a) The members of a HUF carrying on family business as such. (b) A Burmese Buddhist husband and wife carrying on business.

6.1.3 'Partners', 'Firm' and 'Firm Name' (s.4)

"Persons, who have entered into partnership with one another are called individually 'partners' and collectively a 'firm' and the name under which their business is carried on is called the 'firm name'". In law, a 'firm' is only a convenient phrase for describing the two or more persons who constitute the partnership and the firm has no legal existence apart from those persons. Thus, if A, B and C are partners in a firm, the firm really means A, B and C taken together. Unlike a joint stock company which is a legal entity under the Companies Act, 1956, a firm has no separate existence apart from its partners. A firm is not a body corporate. The rights and obligations of the firm are in fact the rights and obligations of the partners comprising the firm. The legal position of a firm is that it cannot possess property and, therefore, it cannot be a debtor or a creditor. The rights which a partner enjoys and the duties which he owes, are enjoyed against and owed to the other partners and not to the firm; and if an action between the partners be necessary to enforce such rights and duties, the individual partners and not the firm are the parties to the action. A firm as such cannot be a member of a partnership. Further, as all the partners put together are known as 'a firm', the assets of the firm are joint property of the partners and the partners are personally liable for all the business obligations of the firm.

This is the legal position of partnership, but in business practice, there is a trend to approximate it to an entity with a separate existence from the partners. Thus, we do talk of the assets, liabilities and goodwill of the firm. Its financial statements are prepared. Under s.25 of the Companies Act, 1956, a partnership firm may be a member of a company. Also the firm is recognised as a separate unit for tax purposes. Also under order 30 of the Civil Procedure Code, actions can be instituted by or against the firm in its firm name, whether by the partners or third parties.

Partners may choose any name as their firm's name provided it does not go against the rules relating to trade name or goodwill. That is to say, the name adopted should not be such as will mislead the public into confusing them with a firm of repute already in existence. Further, s. 58(3) provides that a firm name shall not contain any of the following words, namely: Crown, Emperor, Empress, Empire, Imperial, King, Queen, Royal, or words expressing or implying the sanction, approval or patronage of Government except with the written consent of the State Government.

A firm may carry the names of the partners who own it, such as: "Ram & Shyam", or "Ram & Son", or "Ram & Sons", or "Ram Brothers". Further, the use of "& Co." after the name of one of the partners (Ram & Co.) establishes prima facie the existence of a partnership. The name may be a fictitious one also, such as "Ideal Confectionery". Using a fictitious firm name instead of the partners' real names has an advantage. It enhances the future sale price of the business, including goodwill by ensuring that the firm will not have to substitute names of the new owner when the selling partners leave.

From the above discussion, one may infer that partnership is different from a firm. Partnership is merely an abstract legal relation between the partners. But a firm is a concrete thing signifying the collective entity for all the partners. Thus, partnership is an invisible tie which binds the partners together whereas a firm is the visible manifestation of that relationship between the partners who are bound together in a relationship of agency.

Notes

6.1.4 Test of Partnerships

The question whether a particular group of persons constitutes a partnership or not, is often a difficult one to decide. Section 6, in this regard, lays down that in determining whether a particular group of persons constitutes a partnership, regard is to be had to the real relations between the parties as shown by all relevant facts taken together. Thus, the use of the word 'partner' does not make a partnership, when there is none. If all the relevant facts taken together show that all the essentials of partnership are present, the group of persons will be called partnership, otherwise not. Of the essentials of partnership, sharing of profits is an important criterion but is not conclusive. Section 6 has categorically laid down that receipt by a person of a share of the profits of a business does not of itself make him a partner with the persons carrying on the business. In particular, the receipt of share or payment by the following does not of itself make the receiver a partner with the persons carrying on the business. (i) a lender of money to persons engaged or about to engage in any business; (ii) a servant or agent as remuneration; (iii) the widow or child of a deceased partner, as annuity; or (iv) a previous owner or part-owner of the business, as consideration for the sale of the goodwill or share thereof.

In all the above cases, the element of agency, so necessary to constitute partnership, is absent. A creditor or the widow and children of deceased partners cannot bind the firm by any act done on behalf of the firm. Similarly, where two persons, who jointly own a house, let out the same to a tenant and divide the rents among themselves, they are only co-owners but not partners with respect to the house or rent, because the idea of representation of one person by the other is absent. Thus, the true test of partnership is agency and not sharing of profits.

6.1.5 Partnership Distinguished from some other Organisations

Partnership and co-ownership: Co-ownership means joint ownership. A and B jointly purchase a house, they are co-owners but not necessarily partners. The following points of distinction between the two may be noted.

	Partnership	Co-ownership
1.	It arises from contract.	It may, besides contract, arise by status, e.g., *A* and *B* inherit a house from their father.
2.	It always implies a business.	It may exist without any business.
3.	It involves sharing of profits and losses.	It does not always involve the sharing of profits or losses because it may exist without any business.
4.	Each partner is the agent of other.	A co-owner is not the agent of the other co-owners.
5.	A partner cannot transfer his interest without the consent of all other partners.	A co-owner may transfer his interest to a third party without the consent of other co-owners.
6.	A partner can claim a share in the surplus assets of the firm, but not a share in the properties of the firm *in specie*.	A co-owner can claim division of the joint property in *specie*.

Partnership and Company

Distinction between partnership and the company incorporated under the Companies Act, 1959, is as follows:

Notes

(i) ***Legal status:*** A partnership firm has no existence apart from its members. A company is a separate legal entity distinct from its members.

(ii) ***Mutual agency:*** Partnership is founded on the idea of mutual agency – every partner is an agent of the rest of the partners. A member of a company is not an agent of other members.

(iii) ***Liability of members:*** Liability of a partner is unlimited, i.e., even his own personal assets are liable for the debts of the firm. Liability of a member or shareholder of a limited company is limited to the extent of the amount remaining unpaid on shares held by him or the amount of guarantee as mentioned in the memorandum of association of the company.

(iv) ***Transfer of interest:*** A partner cannot transfer his interest without the consent of all other partners. A shareholder, subject to restrictions contained in the articles can freely transfer his share.

(v) ***Duration of existence:*** Unless there is a contract to the contrary, the death, retirement or insolvency of a partner results in the dissolution of the firm. A company enjoys a perpetual succession. Death or retirement or insolvency of a member does not affect the existence of a company.

(vi) ***Minimum membership***: The minimum number of persons required to form a partnership is 2. The minimum number required to form a private company is 2 and in the case of a public company the minimum number should be 7.

(vii) ***Maximum membership:*** A partnership cannot be formed with persons exceeding 20. The number is limited to 10 in the case of a banking business. In the case of a public company there is no limit to the maximum numbers of members. However, a private company cannot have more than 50 members.

(viii) ***Audit:*** The audit of the accounts of a firm is not compulsory, whereas the audit share counts of a company is mandatory.

6.1.6 Partnership and Joint Hindu Family (JHF) Business

A JHF is a Hindu joint family carrying on a trade or business inherited from its ancestors. Section 5 lays down that the relation of partnership arises from contract and not from status and in particular the members of Hindu Undivided Family (HUF) carrying on a family business as such are not partners in such business. However, the Act does not prohibit the members of JHF to enter into partnership amongst themselves. The principal differences between a partnership and a JHF business are as follows:

(i) ***Creation:*** Partnership is essentially the result of an agreement between the parties whereas a JHF is the result of status.

(ii) ***Admission:*** In a partnership, new partners can be admitted only with the consent of all the existing partners, whereas in JHF business a person becomes a member merely by his birth in that family.

iii) ***Female members:*** A female member of the family does not become a member of a JHF business, though she can join partnership business as a full fledged partner.

(iv) ***Minor members:*** A minor cannot be a member of a partnership firm except that he may be admitted to the benefits of an already existing partnership firm. Minors, in the case of JHF, are members of the family business right from the moment of their birth.

(v) ***Death of a member:*** Death of a partner dissolves the firm, unless otherwise agreed to by the partners. The death of a member of a JHF business leaves the firm unaffected.

(vi) ***Mutual agency***: Every partner is an agent of the rest of the partners and therefore, his acts bind the firm. In case of JHF business, it is the Karta who has the authority to contract and bind the family, other coparcenaries cannot do so.

(vii) ***Liability***: Every partner is liable to an unlimited extent. In case of JHF business, only Karta is liable to an unlimited extent, the liability of other coparceners is limited to the extent of their share in the profits of the family business unless they took part in the act or transaction done by the Karta.

Notes **Partnership and Club**

A club is an association of persons with the objective of promotion of some beneficial or social object such as promotion of health or providing recreation for its members. It does not have the objective of earning profits and if, during the course of its operations, it makes some surplus, then it is ploughed back for achieving its objectives. A member of a club is not liable to a creditor of the club. The club is generally brought into existence as an incorporated body either under the Societies Registration Act, or the Companies Act, 1956. Therefore, a member of a club is not agent of other members and the death or resignation of a member does not affect its existence. A club differs from partnership inasmuch as there is no business and thus no motive of earning profits and sharing them.

6.1.7 Various Forms of Partnership

Partnership for a Fixed Period

In this case, the partnership is constituted for a fixed period of time. The partnership comes to an end at the expiry of the fixed period. However, s.17(b) provides that if the partners continue to carry on the business after the expiry of the fixed period, the rights and liabilities of partners remain the same as they were before the expiry of the fixed period and the partnership becomes a 'partnership at will'.

Partnership at Will

In accordance with s.7, a partnership is called a partnership at will where; (i) it is not constituted for a fixed period of time and (ii) there is no provision made as to the determination of partnership in any other way. Therefore such a partnership has no fixed or definite date of termination. Accordingly death or retirement of a partner does not affect the continuance of such a partnership. Section 43(1) provides that such a firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

Particular Partnership

In accordance with s.8 a particular partnership is one which is formed for a particular adventure or a particular undertaking. Such a partnership is usually dissolved on the completion of the adventure or undertaking.

Example: Two auditors, engaged in a particular audit, may be regarded as partners in the firm created for doing such an audit.

Notes

Limited Partnership

In this type of partnership, the liability of certain partners is limited to the amount of capital which they have agreed to contribute to the business. In a limited partnership, there will be at least one general partner whose liability is unlimited and one or more special partners whose liability is limited. This type of partnership is prevalent in USA and European countries. In India, it is not available, though unsuccessful attempts have been made in the beginning of nineties to enact Limited Partnership Act.

Illegal Partnership

A partnership can be formed for genuine business purposes which are not illegal or prohibited by law. Thus, if a partnership is formed to carry on smuggling activities which are prohibited by law, then such a partnership will be an illegal one. Section 11 of the Companies Act, 1956, defines an "illegal association". It provides that an association of more than 10 persons in case of banking and more than 20 persons for other business, the object of which is the acquisition of gains, must be registered either under the Companies Act or any other law. If it is not so registered then the association shall be an illegal association. A partnership, being an association of persons, has to follow s. 11 of the Companies Act, 1956. Therefore, a partnership cannot exceed the maximum limit of partners, i.e., 10 in the case of banking business and 20 in the case of non-banking business.

A partnership may be illegal in either of the following two ways: (i) by being formed to do an illegal business, e.g., to carry on a business of illicit liquor; or (ii) where the number of partners exceed the maximum, limit. An illegal partnership can, however, be sued. But in case where a person contracts with such a firm knowing its illegal character, he cannot sue on such a contract.

Self Assessment

Fill in the blanks:

1. All the essential elements of a ……must be present in a partnership as it is based on an agreement.
2. In accordance with s.8, a ……partnership is one which is formed for a particular adventure or a particular undertaking.

6.2 Registration of Firms (Ss.58-59)

6.2.1 Application for Registration

Section 58 lays down the procedure for registration of partnership firms. A partnership firm may be registered at any time by post, or delivering to the Registrar of Firms of the area in which any place of business of the firm is situated or proposed to be situated, a statement in the prescribed form and accompanied by the prescribed fee, stating: (i) the firm's name, (ii) the place or the principal place of business of the firm, (iii) the names of any other places where the firm carries on business, (iv) the date when each partner joined the firm, (v) the names in full and addresses of the partners and (vi) the duration of the firm. The statement must be signed by all the partners, or by their agents especially authorised in that behalf and duly verified. When the Registrar of Firms is satisfied that the provisions of s.58 have been duly complied with, he registers the firm by recording an entry of the statement in a register called the Register of Firms and shall file the statement (s.59). He then issues under his hand a Certificate of registration. Registration is effective from the date when the Registrar files the statement and makes entries in the Register of Firms.

Notes

When an alteration is made in the name of the firm or in the location of its principal place of business, s. 60 requires that the information be sent to the Registrar of Firms.

6.2.2 Miscellaneous Provisions as regards Registration

Sections 60-63, 67-68 and 70 contain following provisions having a bearing on registration of firms:

1. ***Alterations.*** Any alteration relating to the following matters in the case of a registered firm must be intimated to the Registrar of Firms: (a) Alteration's in firm, name and principal place of business (s.60), (b) closing and opening of branches (s.61), (c) changes in the name and addresses of partners (s.62), (d) changes in the constitution of a registered firm (s.63), (e) election by a minor, on attaining majority, to continue as partner or severe his connection with the firm (s.63), (f) dissolution of the firm (s.63). The Registrar of Firms will incorporate these changes in the Register of Firms.
2. ***Penalty for false particulars:*** Section 70 provides that any person who signs any statement, amending statement, notice or intimation as regards a registered firm and as required under the Act should be true and complete. If any person knowingly, or without belief in its truth, furnishes false or incomplete information, he is punishable with imprisonment which may extend to three months or with fine or with both.
3. ***Rectification of mistakes:*** Section 64 empowers the Registrar of Firms to rectify any mistake in order to bring the entry in the Register of Firms relating to any firm in conformity with the documents relating to the firm filed with him. Further, on an application made by all the parties who have signed any document relating to a firm filed with the Registrar, he may rectify any mistake in such document or in the record or note thereof made in the Register of Firms.
4. ***Amendment of register by order of court***: Section 65 provides that a court deciding any matter relating to a registered firm may direct the Registrar to amend any entry in the Register of Firms.
5. ***Inspection of register and filed documents***: Section 66 provides that the Register of Firms shall be open to inspection by any person on payment of a fee as prescribed for the purpose. Further all the statements, notices and intimations filed with the registrar shall be open to inspection, subject to conditions and fee prescribed.
6. ***Grant of copies***: Section 67 provides that the Registrar shall, on applications furnish to any person on payment of the prescribed fee a certified copy of any entry in the Register of Firms.
7. ***Rules of evidence***: Section 68 provides that any statement, notice or intimation recorded with the Registrar by any person shall be a conclusive proof against him of any fact stated therein. Entries relating to a firm in the Register of Firms may be proved by producing certified copies of the entries.

Did u know? **Registration of Firms is Optional**

The Act does not provide for compulsory registration of firms. It is optional and there is no penalty for non-registration. But at the same time s.69 has effectively, ensured registration of firms by introducing certain disabilities that an unregistered firm suffers from. The firm cannot, for example, sue any person for the price of the goods supplied by it. The disabilities associated with the non-registration of a firm are given by s.69.

Notes

It is to be reiterated that a partnership firm can be formed and brought into existence without any registration with whatsoever authority. In other words, registration with the Registrar of Firms does not create a partnership firm. A firm already in existence can get itself registered at any time to protect itself and the outsiders dealing with it.

6.2.3 Effects of Non-registration

Section 69 lays down the consequences of non-registration of a firm. There are:

(i) ***Suits between partners and firm:*** A partner of an unregistered firm cannot sue the firm or his present or past copartners for the enforcement of any right (a) arising from a contract or (b) conferred by the Partnership Act. He can do so if (a) the firm is registered and (b) he is or has been shown in the Register of Firms as a partner in the firm. Thus, if a partner of an unregistered firm is not paid his share of profits, he cannot claim it through a suit in the court. However, if a right is conferred upon a partner under any other law, he can enforce such a right. Thus, in the case of an unregistered firm, a partner can file a petition for enforcement of an arbitration clause included in the partnership agreement. Also an unregistered firm cannot file a suit against its own partners.

(ii) ***Suits between firm and third parties:*** No suit can be filed, if it is for more than ₹ 100, on behalf of an unregistered firm against any third party for the purpose of enforcing a right arising from a contract until the firm is registered and the name of the person filing the suit appear as a partner in the Register of Firms.

Example: An unregistered firm supplies goods worth ₹ 10,000 to Shyam. He refuses to pay the amount due. The firm has no legal remedy against him.

A suit can be brought only by or on behalf of a registered firm and that also by one whose name appears as a partner in the Register of Firms. Third parties are at full liberty to file suits against the firm and the partners.

(iii) ***Claim of set-off:*** An unregistered firm or any partner thereof cannot claim a set-off in a proceeding instituted against the firm by a third party to enforce a right arising from a contract, until the registration of the firm is effected.

Example: Shyam buys certain goods worth ₹ 20,000 from an unregistered firms Sunil & Co. The firm is already indebted for ₹ 25,000 to Shyam. The firm, being an unregistered firm, cannot compel Shyam to accept ₹ 5,000 as the final settlement, i.e., the difference between ₹ 25,000 and ₹ 20,000, the right of set-off being not available to the firm.

However, non-registration does not affect certain transactions. These are:

(a) The right of a third party to file suit against the firm and its partners.

(b) The right of a firm to enforce rights arising otherwise than from contracts.

Example: Gyan infringes the trade mark of Khosla & Co., an unregistered firm. The firm has a right to sue Gyan for the infringement of its trade mark.

(c) The enforcement of any right of a partner to sue for the dissolution of a firm or for accounts of a dissolved firm, or any right or power to realise the property of a dissolved firm.

(d) The powers of an Official Assignee (or Receiver) or Court under the Presidency Towns Insolvency Act, or the Provincial Town Insolvency Act, to realise the property of an insolvent partner.

Notes

(e) The rights of a firm or its members who have no place of business in the territories to which the Act extends.

(f) Any suit or claim of set off not exceeding ₹ 100 in value provided the suit is of such a nature that it has to be filed in the Small Causes Court. Proceedings incidental to such suits, e.g., execution of decrees, are also allowed.

Self Assessment

Fill in the blanks:

3. When an alteration is made in the ……of the firm or in the location of its principal place of business, s. 60 requires that the information be sent to the Registrar of Firms.

4. Section 70 provides that any person who signs any statement, amending statement, notice or intimation as regards a registered firm and as required under the act should be …….and complete.

6.3 Partnership Deed or Agreement or Articles of Partnership

A Partnership can be formed either by Oral or Written Agreement. In France and Italy, the law requires all partnership agreements to be in writing. But in England, USA and India, written agreement is not compulsory. But in order to avoid misunderstanding and litigation, it is desirable to enter into a written agreement which is called Partnership deed or agreement. The partnership deed is required to be stamped according to the provisions of the Stamp Act, 1899. Each partner should possess a copy of the Deed. The Partnership Deed is not a public document (in the case of a company, a memorandum of association is a public document) and therefore binds only third parties so far as they have notice of it. A properly drawn up deed of partnership contains clauses on the following. (i) Name of the firm. (ii) Names and addresses of the partners. (iii) Nature of partnership business. (iv) The town and place where the business will be carried on. (v) The commencement and duration of partnership. (vi) All details to the amount of capital contributed by each partner. (vii) The proportion in which the profits and losses are to be shared. (viii) Loans and advances by partners and interest payable thereon. (ix) The amounts that can be withdrawn by the partners and the rate of interest. (x) Rate of interest, if any, allowed on capital contribution. (xi) The duties, powers and obligations of all the partners. (xii) Salary, if any, payable to the partners for managing the firm. (xiii) Maintenance of accounts and audit. (xiv) The basis of valuation of goodwill on the death or retirement of a partner or the introduction of a new partner. (xv) Method of admitting a partner. (xvi) The methods by which a partner may retire and the arrangement for the payment of dues of a retired or deceased partner. (xvii) Method of operating a bank account. (xviii) Arrangements in case a partner becomes insolvent. (xix) Conduct and management of business. (xx) Arbitration in matters of dispute among partners. (xxi) The methods of revaluation of assets and liabilities on admission or retirement or death of a partner. (xxii) Settlement in the case of dissolution of partnership. (xxiii) Any other clause or clauses which may be found necessary in any particular kind of business.

Partnership Agreements and Contract Law

Section 3 provides that the unrepealed provisions of the Indian Contract Act, 1872 save insofar as they are inconsistent with the provisions of this Act, shall continue to apply to firms. Also s. 2(e) provides that "expressions used but not defined in this Act and defined in the Indian Contract Act, 1872, shall have the meanings assigned to them in that Act". As a partnership agreement is a contract, the provisions of the Indian Contract Act, 1872, are applicable to it.

Notes

Free consent. All partners must consent to the partnership agreement. Otherwise, they obviously lack the intent necessary to form the partnership. Alleged partners may assert all the flaws which mar free consent, such as fraud, coercion and undue influence.

Legal purpose. A partnership agreement must have a legal purpose. No court will enforce a partnership agreement for an illegal object. Suppose X and Y run a shop dealing in smuggled goods. No court will enforce their partnership agreement against one another or a debt owed to them by one of their clients.

Capacity. Section 11 of the Indian Contract Act, 1872, provides, inter alia, that every person "is competent to contract who is of the age of majority…." Thus a minor is not competent to contract. But a contract with a minor is void as against him but not as against the other party. Also we have noted in Chapter 7 on Agency that a minor may be appointed as an agent. Also s. 30(1) provides that with the consent of all the partners for the time being, a minor may be admitted to the benefits of partnership. Further, where a court declares a partner insane or a partner is shown to be of unsound mind, another partner may seek dissolution of the partnership. Because partnership requires mutual agency, a lunatic may not be a partner, since he cannot act as an agent.

Writing. A contract need not be in writing. Accordingly, a partnership agreement need not be in writing. It may be oral, written or implied from the parties' conduct. However, because disputes easily develop over oral agreements, parties should have a written agreement. No particular form need be used. As most partnership agreements are complex, so the help of a lawyer is advisable.

Right to select one's partner. No one can become a member of a partnership that is being formed, or join an already existing partnership without the consent of all the members of the firm. This is in accordance with the concept of delectus personae (latin for "choice of persons"). Each partner has been given the right to choose each of the other partners whose torts or other possible wrongdoings could cause great personal financial loss. Unless the partners have expressly agreed otherwise, the composition of the firm cannot be changed without the consent of the partners.

Self Assessment

Fill in the blanks:

5. The ……is required to be stamped according to the provisions of the stamp act, 1899.
6. In England, USA and India, ……...agreement of partnership is not compulsory.

6.4 Relations of Partners to One Another

The relation of the partners of a firm to one another arises through an agreement between them. Such an agreement may be express or may be implied from the course of dealings between them. It may be varied by their consent and such consent may be expressed or may be implied by a course of dealings [s.11(1)]. Where there is no specific agreement or where the agreement is silent an a certain point, or where no agreement exists, the relations of partners to one another as regard their rights and duties are governed by Ss.9-17 of the Act.

6.4.1 Rights of Partners

Subject to the contract between the partners, every partner has the following rights:

(i) To take part in the conduct of the firm's business [s.12(a)].

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(ii) To express his opinion on any matter, but in case of difference of opinion regarding ordinary matters of the business, he is bound by the majority decision. However, no change can be made in the nature of the business without the consent of all the partners [s.12(c)].

(iii) To have access to and inspect and copy any of the books of the firm [s.12 (d)].

(iv) To share equally in the profits [s.13 (b)].

(v) To rank as a joint owner of the property of the firm. The property of the firm includes all property and rights and interest in property originally brought into stock of the firm, or acquired by purchase or otherwise, by or for the firm or for the purposes and in the course of the business of the firm and includes also the goodwill of the business.

(vi) To do, in an emergency, all such acts as are reasonably necessary to protect the firm from loss.

(vii) To claim interest @ 6 per cent per annum on any amount advanced by him beyond the amount of capital that he agreed to subscribe [s.13(c)].

(viii) To be indemnified by the firm in respect of liabilities incurred by him in the ordinary course of business [s.13 (e)].

(ix) To continue in the partnership, i.e., not to be expelled. A partner may, however, be expelled if a power to expel is conferred upon the partners and power is exercised bona fide by a majority of partners [s.33 (i)].

(x) To resist the introduction of a new partner. No new partner can be introduced into the firm unless all the partners consent thereto [s.31 (1)].

(xi) To seek retirement from the firm. A partner may retire (i) with the consent of all other partners, or (ii) in accordance with an express agreement by the partners, or (iii) where the partnership is at will, by giving notice in writing to all the partners of his intention to retire [s.32 (1)].

(xii) To carry on a competing business after he leaves the firm. Every outgoing partner has a right to carry on a competing business, but, without using the firm's name or soliciting the firm's customers or in any way representing himself as carrying on the business of the firm, unless he has been restrained by reasonable agreement from carrying on a similar business for a specified period of time within specified local limits [s.36 (1)].

(xiii) To share subsequent profits as an outgoing partner. Where any partner in a firm has died or otherwise ceased to be a partner and the surviving or continuing partners carry on the business of the firm with the property of the firm, without any final settlement of accounts, as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled, at the option of himself or his representatives, to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm, or interest @ 6 per cent per annum on that share from the date on which it ought to have been paid up, to the date of payment, whichever is later (s.37).

6.4.2 Duties of Partners

Section 9 provides for general duties of partners. (i) They are bound to (a) carry on the business of the firm to the greatest common advantage, (b) to be just and faithful to each other and (c) to render true accounts and full information of all things affecting the firm to any partner or his legal representative. (ii) Every partner shall indemnify the firm for loss caused to it by his fraud in the conduct of the business of the firm (s.10). (iii) To attend diligently to his duties in the

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conduct of the firm's business without any remuneration [s.13 (a)]. (iv) If restrained by an agreement with other partners, a partner has a duty not to carry on any business other than that of the firm while he is a partner [s.11 (2)]. (v) If a partner carries on any business competing with that of the firm, he shall account for and pay to the firm all profits made by him in that business [s.16 (b)]. (vi) To account for any profit, including secret profit, derived by a partner from any transaction of the firm, or from the use of the property, or business connection of the firm or the firm's name [s.16 (a)]. (vii) Not to assign his share in the partnership. Where a partner makes such an assignment the partnership may be dissolved. (viii) Unless otherwise agreed, he is to contribute equally to the losses of the firm. (ix) To indemnify the firm for any loss caused to it by his wilful neglect in the conduct of the business of the firm (s.13).

6.4.3 Firm's Property

Sometimes it becomes necessary to distinguish the joint property of the partners (i.e., firm's property) from the personal property of the partners. For example, on the dissolution of a firm, the firm's debts are first paid out of the joint assets of the partners. Also, firm's property can be used only for the purposes of the business of the firm. A partner cannot treat the firm's property or a part thereof as his own. Further, he cannot assign his interest in firm's property to anyone. Furthermore, some personal property of one or more partners may be employed or used for the purpose of the firm.

Example: A was the owner of a colliery. A joined hands in partnership with B for the purpose of working the colliery. They shared the profits of the venture. The colliery does not become the property of the firm; it continues to be A's personal property.

It is open to the partners to agree among themselves as to what shall be the property of the firm. Section 14 lays down rules for determining the intention of the partners for this purpose. Thus, in the absence an agreement to the contrary, the firm's property includes: (i) all property originally brought into the common stock of the firm; (ii) all rights or interests in the property, originally so brought; (iii) all property acquired, by purchase or otherwise, by or for the firm and all rights and interests in any property so acquired; (iv) all property acquired for the purpose and in the course of the business of the firm and all rights and interests in any property so acquired; and (v) goodwill of the business of the firm.

Section 14 further provides that, unless intention to the contrary appears, property and rights and interests in property acquired with money belonging to the firm are deemed to be property of the firm.

Example: A and B are the partners. A buys some shares in a company with money belonging to the firm. The shares constitute firm's property.

Example: A and B are partners. They buy a property in the name of a fictitious person with money belonging to the firm. The property shall be deemed to be the firm's property.

Example: A is the owner of a colliery. He enters into partnership with B for working the colliery. He sells the same to the firm. Colliery becomes the firm's property.

6.4.4 Firm's Goodwill

Section 14 further provides that the property of a firm, subject to the contract between the partners, includes the goodwill of the business. As it is a part of the partnership property, it can be sold either separately or along with the other property of the firm (s.55 (1)].

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Section 15 provides that subject to the contract between the partners, the property of the firm shall be held and used exclusively for the purposes of partnership.

6.4.5 Personal Profits Earned by Partners

Section 16 provides that if a partner derives any profit for himself from any transaction of the firm, or from the use of the property or business connection of the firm or the firm name, he shall account for that profit and pay it to the firm. A partner can use the property of the firm for the purposes of business of the firm only and not for his personal advantage.

Profits earned by engaging in a competing business. Section 16 provides that no partner can carry on any business which is likely to compete with the business of the firm, except with the consent of the other partners. In case any partner is so engaged in a competing business, then he must account for the profits thereof to the firm and must also compensate the firm for any loss sustained by his carrying on such business. Further, s.53 provides that not only during the continuance of the firm, but also after dissolution of the firm and during the winding up, a partner may be prohibited and can be restrained from carrying on a competing business in the name of the firm or using the property of the firm.

It is worth reiterating that s.12 of the Indian Contract Act, 1872, provides that an agreement in restraint of trade is void. But s.11 permits an agreement between partners that a partner shall not carry on business other than the business of the firm as long as he is a partner. In practice, such a clause generally appears in partnership agreements. In the absence of any such arrangements, partners are free to engage in any private business of their own, provided the same does not compete with the firm's business.

Self Assessment

Fill in the blanks:

7. The relation of the partners of a firm to one another arises through a ……..between them.
8. Section 14 further provides that the property of a firm, subject to the contract between the partners, includes the ……of the business.

6.5 Relations of Partners to Third Parties

Subject to s.18 every partner is the agent of the firm for the purposes of the business of the firm.

6.5.1 Implied Authority of a Partner

A partner's authority may be express or implied. It is express, when it is fixed between the partners by mutual agreement. The agreement may, however, be oral or written. It is implied when the law impliedly gives certain powers to a partner, i.e., the law presumes that every partner has the power to do certain acts unless negatived by an express agreement.

Sections 19 and 22 deal with the subject of implied authority of a partner. The two sections when read together provide that the act of a partner which is done to carry on in the usual way, business of the kind carried on by the firm, binds the firm, provided the act is done in the firm's name, or in any manner expressing or implying an intention to bind the firm. Such authority of a partner to bind the firm is called his implied authority. The implied authority of a partner thus extends only to such acts, which (i) are common in the type of business carried on by the firm and (ii) are done by him in the usual way of carrying on the firm's business. Thus, if it is usual to give

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credit to customers, in a particular business, the giving of credit by a partner to a customer will bind the firm. But if a usual act is done in an unusual manner, this must raise a suspicion as to the authority of a partner and the protection on the ground of implied authority may not be available.

In connection with a partner's implied authority, judicial decisions have made a distinction between a trading and a non-trading partnership. In the case of a trading firm a partner can borrow money on behalf of the firm [Saremal v. Kapurchand, 48 Bom. 176]; but in the case of a non-trading firm, unless the power to borrow is given expressly by the partnership deed, a partner cannot borrow money or pledge property of the firm, on behalf of the firm, so as to bind the firm. In case of trading firms, however, the implied authority of a partner extends also to drawing and accepting bills of exchange and making and endorsing promissory notes.

6.5.2 Matters in which there is no Implied Authority

Clause 2 of s.19 gives the negative rule. It enlists what does not fall within the implied authority of a partner. That is to say that the authority of a partner to bind the firm, which is implied by law, does not extend unless expressly provided by the partnership deed, to the following matters: (i) The submitting of a dispute, relating the business of the firm for arbitration. (ii) Opening of a bank account on behalf of the firm in the personal name of a partner. A partner can open a bank account in the name of the firm, but not in his own name unless so authorised by the other partners. (iii) Compromising or relinquishing any claim or portion of a claim which the firm may have against a third party. (iv) Withdrawal of a suit or proceeding filed on behalf of the firm. (v) Admission of any liability in a suit or proceeding against the firm. (vi) The acquisition of immovable property belonging of the firm. (vii) Transfer of any immovable property belonging to the firm. (viii) Entering into partnership on behalf of the firm.

Besides the above restrictions, the partners in a firm may, by contract between the partners, restrict the implied authority of any partner. But unless the outsider otherwise knows, he is not bound of the restriction by any such private contracts between the partners (s.20).

6.5.3 Liabilities of a Partner

Liability of a partner stems from not complying with his duties under the Partnership Act. Thus, in view of s.9, a partner shall be liable for (i) not carrying on the business of the firm to the greatest common advantage; (ii) not being just and faithful to other partners and (iii) failure to render true accounts and full information of all things affecting the firm to any partner or his legal representative.

Section 10 provides that every partner shall be liable to indemnify the firm for any loss caused to it by his fraud in the conduct of the business of the firm. Also, every partner has (i) To account for and pay to the firm all profits made by him in any business competing with that of the firm [s.16(b)]. (ii) To account for any profit, including secret profit, derived by a partner from any transaction of the firm, or from the use of the property or business connection of the firm or the firm's name [s.16 (a)]. (iii) To contribute equally towards the losses of the firm, in the absence of an agreement to the contrary. (iv) To indemnify the firm for any loss caused to it by his wilful neglect in the conduct of the business of the firm (s.13). Section 25 makes every partner liable jointly with all other partners and also severally for all the acts of the firm done while he is a partner.

An 'act of the firm' is defined by s.2 (a) as "any act or omission by all the partners, or by any partner or agent of the firm, which gives rise to a right enforceable by or against the firm". Where a partner's implied authority is curtailed by an agreement between himself and other partners, an act of the partner within his implied authority, but beyond his actual authority would be binding on the firm, unless the third party knows of the curtailment of the implied authority.

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Caution There is no difference between active partners and dormant partners as regards liability to third parties. A dormant partner is also liable to an unlimited extent for all the debts of the firm.

6.5.4 Liability of a Firm for Wrongful Acts of a Partner (Ss.26-27)

Where, by the wrongful act or omission of a partner acting in the ordinary course of the business of a firm, or with the authority of his partners, loss or injury is caused to any third party or any penalty is incurred, the firm is liable therefor to the same extent as the partner.

Also, the firm is liable to make good the loss where – (i) a partner acting within his apparent authority receives money or property from a third party and misapplies it, or (ii) a firm, in the course of its business, receives money or property from a third party and the money or property is misapplied by any of the partners while it is in the custody of the firm.

6.5.5 Implied Authority and Third Parties

The provisions concerning how far third parties are affected by the implied authority, its extension and curtailment are summarised at one place for the convenience of the reader.

(i) ***Extension and restriction of a partner's implied authority:*** Section 20 provides that the partners may, by contract between them, either extend or restrict the implied authority of any partner. In spite of any such restriction if a partner does, on firm's behalf, any act which falls within his implied authority, the firm will be bound unless the person with whom he is dealing is aware of the restriction or does not know or believe the partner to be a partner. Also a third party is not affected by a secret limitation of a partner's authority unless he has actual notice of it.

(ii) ***Acts in emergency***: Section 21 provides that a partner can bind the firm by all his acts done in an emergency, with a view to protecting the firm from any loss, provided he has acted in the same manner as a man of ordinary prudence would have acted in the like circumstances. However, such acts bind the firm but do not form part of the partner's implied authority.

(iii) ***Effect of admission by partners:*** Section 23 provides that partners can make binding admission in relation to partnership transactions made in the ordinary course of business. Such an admission by a partner is evidence against the firm. An admission or representation by a partner will not, however, bind the firm if his authority on the point is limited and the other party has knowledge of the restriction.

(iv) ***Effect of notice to an acting partner:*** Section 24 provides that a partner who habitually acts in the business of the firm on any matter relating to the affairs of the firm operates as notice to the firm except in the case of a fraud on the firm committed by or with the consent of that partner.

(v) ***Liability of a partner for acts of the firm***: Every partner is liable jointly with all the other partners and also severally, for all acts of the firm done while he is a partner (s.25).

(vi) ***Liability of the firm for wrongful acts of a partner:*** Section 26 provides that the firm is liable to the same extent as the partner for any loss or injury caused to a third party by the wrongful acts or omission of a partner, if they are done by the partner while acting (a) in the ordinary course of the business of the firm, or (b) with the authority of the partners. This section makes the firm liable for the torts committed by a partner.

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(vii) ***Liability of firm for misapplication by partners:*** Section 27 provides that a firm is liable to make good the loss where (a) a partner acting within the scope of his apparent authority receives money or property from a third party and misapplies it, or (b) the firm in the course of its business receives money or property from a third party and the same is misapplied by any of the partners while it is in the custody of the firm.

6.5.6 Types of Partners

There are different types of partners. A person who deals with a firm may have to ascertain, at some time or the other (such as where the firm has made a default) as to not only who the partners are, but also to what extent each is liable. The liability is different for different classes of partners.

1. ***Actual, active or ostensible partner:*** Such a partner is a person who becomes a partner by an agreement, brings capital, actively participates in the functions and management of the business and shares its profits and losses. He binds himself and other partners, so far as third parties are concerned, for all the acts done by him in the ordinary course of the business and in the name of the firm. Such a partner must give a public notice of his retirement from the firm in order to absolve himself from the liability for the acts of the other partners done after his retirement.

2. ***Sleeping or dormant partner***: A sleeping partner is one who does not take an active part in the business of the firm. Sometimes he is called as a financing partner as he contributes to the capital only but does not participate in the management of the business. Such a partner is liable like any other partner of the firm for the debts of the firm, even though his existence is kept a secret from the parties dealing with the firm. His position may well be compared with an undisclosed principal. But a sleeping partner, unlike other active or known partners, is not required to give public notice in order to absolve himself from liability for the acts of other partners after he ceases to be a partner. He is not liable for any act of the firm after he ceases to be partner even if he does not give a public notice. Also his insanity or any such other disability does not dissolve the firm.

3. ***Nominal partner:*** Sometimes persons lend their names and credit to the firm but neither contribute any capital nor take active part in the management of the business. Such partners are called nominal partners. As the title suggests, such persons are partners only in name. His name is used as if he were a partner of the firm, though actually he is not. He is not entitled to share profits of the firm but is liable for all the acts of the firm as if he is the real partner.

4. ***Partner in profits only:*** If a partner is entitled to a certain share of profit without being liable for the losses, he is known as partner in profit only. He is not allowed to take part in the management of the firm, but is liable for all the acts of the firm.

5. ***Sub-partner:*** A sub-partnership comes into existence when one of the partners agree to share the profits derived by him from the firm with a third person. This third person is called a 'sub-partner'. A sub-partner is not a partner in the eye of law and therefore, has no right against the firm. He is also not liable for the acts of the firm nor can he bind the firm by his acts.

6. ***Partner by estoppel or holding out***: Sometimes a person who is not a partner in a firm may under certain circumstances, be liable for its debts as if he were a partner. Such a person may be either a partner by estoppel or a partner by holding out. If any person behaves in such a way that others consider him to be a partner, he will be held liable to those persons who have been misled and lent finance to the firm on the assumption that he is a partner. Such a person is known as a partner by estoppel. He is not a true partner of the firm is and also not entitled to any share in the profits of the firm.

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If any person declared that so and so is a partner in a firm, that concerned person immediately after coming to know of that should deny it. If he fails to deny, he will be liable to those persons who extend credit to the firm on the basis of his being a partner. Such a partner is known as a partner by holding out. Section 28 thus contemplates the following two situations: (i) A person who by words spoken or written or by conduct represents himself to be a partner in a firm. (ii) A person who knowingly permits himself to be represented to a partner in a firm. Such a person is liable as a partner in that firm to anyone who has, on the faith of any such representation, given credit to the firm. However, such a partner does not acquire any claim thereby on the firm.

Example: Partner retires from a firm but does not give notice of his retirement. He is a partner by holding out.

Example: Kulkarni induces Sarabhai to believe that he (Kulkarni) is a partner of a firm known as K & Co. Sarabhai believing that Kulkarni is a partner, gives credit to K & Co. Kulkarni will be responsible for compensating Sarabhai. Kulkarni will not be heard to say that he is not a partner of K & Co.

The doctrine of holding out, however, is not applicable in the following cases: (i) The liability of a partner by holding out does not extend to torts (i.e., civil wrongs) committed by other partners of the firm. (ii) The liability does not extend to bind the estate of a decreased partner, where after a partner's death the business of the firm is continued in the old firm's name [s.2 (28)]. (iii) There is no liability of the partner by holding out where he has been adjudicated insolvent (s.45).

7. ***Working partner:*** A partner, because of his special qualifications, may be assigned the management and control of business. Such a partner is known as 'working partner'. A working partner normally receives a fixed amount of salary, besides his share in the profits of the firm. Other partners, however, remain liable to the third parties for all his acts.

8. ***Incoming partner***: Section 31 provides that subject to the contract between the partners and to the provisions of s.30 (which deals with the position of a minor partner) a person can be introduced as a partner into a firm with the consent of all the existing partners. Thus, a person who is admitted as a partner into an already existing firm with the consent of all the existing partners is called an 'incoming partner'. An incoming partner does not become liable for any acts of the firm done before his admission as a partner. However, where he specifically agrees to bear the past liabilities, he will be liable to the other partners for the same. Third parties, however, cannot hold him liable since there is no privity of contract between the new partner and the creditors.

9. ***Outgoing partner:*** A partner who leaves a firm in which the rest of the partners continue to carry on business is called an 'outgoing' or retiring partner. A partner may retire: (i) with the consent of all the other partners; (ii) in accordance with an express agreement by the partners; or (iii) where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire [s.32 (1)].

A retiring partner continues to remain liable to third parties for all the acts of the firm until public notice is given of his retirement. Such a notice may be given either by the retiring partner or by any member of the reconstituted firm. A partner who retires from a firm does not cease to be liable for the debts or obligations of the firm incurred before his retirement. A retiring partner will also be liable to third parties for the transactions of the firm begun but unfinished at the time of his retirement. A retiring partner may, however, be discharged from any liability to any third party for the acts of the firm done before his retirement if it is so agreed with the

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third party and the partners of the reconstituted firm. Such an agreement may be implied from the course of dealings between the firm and the third party after he had knowledge of the retirement.

Though a partner may retire, he cannot be expelled unless such a power is conferred by contract between partners and is exercised in good faith (s. 33). A retiring partner is entitled to have a share in the subsequent profits till his accounts are finally settled (s.37).

6.5.7 Minor as a Partner

Partnership, being a contract, a minor cannot enter into partnership, he being incapable of contracting. An agreement with or by a minor is void *ab initio.* However, if all the partners agree, a minor may be admitted to the benefits of an already existing firm. The rights and liabilities of a minor partner are defined by s.30 as follows: (i) He has a right to such share of the property and of the profits of the firm as may be agreed upon between the partners. (ii) He may have access to and inspect and copy any of the accounts of the firm. (iii) Minor's share in the property and the profits of the firm is liable for the acts of the firm, but the minor is not personally liable for any such act. (iv) He has no right, while he continues to be a partner, to file a suit against other partners for accounts or for payment of his share in the profits or the property of the firm. He can do so only when he wants to severe his connection with the firm. (v) When he files a suit for severing his connection with the firm, his share shall be determined by valuation, according to the principles laid down in s.48, for making accounts of a dissolved partnership. (vi) At any time within six months of his attaining majority, or of his obtaining the knowledge that he had been admitted to the benefits of partnership, whichever date is later, the minor may give public notice that he has elected to become or that he has elected not to become a partner of the firm. If he elects to be a partner, or if he fails to give public notice to the effect that he does not elect to be a partner, he would be liable for the debts of the firm contracted since the time he was admitted to the benefits of the partnership.

Notes The mode of giving public notice is laid down in s. 72. The notice is to be published in the local Official Gazette and in at least one vernacular newspaper circulating in the district where the firm has its place or principal place of business. In the case of a registered firm, there is an additional compliance, i.e., a copy of the public notice is to be sent to the Registrar of Firms.

Self Assessment

Fill in the blanks:

9. Sections 19 and 22 deal with the subject of ……authority of a partner.
10. A ……partner is one who does not take an active part in the business of the firm.

6.6 Changes in a Firm

The Act contemplates the following changes in a firm: (i) change in the duration of a firm; (ii) change in the nature of business or undertakings and (iii) change in the constitution of a firm.

A partnership may be entered into for a fixed period of time. When the fixed period is over, it comes to an end. However, the partners may carry on the business even after the expiry of the fixed period and the partnership becomes 'partnership at will'. Section 12 (c) provides that

subject to contract between the partners no change may be made in the nature of the business without the consent of all the partners. Thus, a change in the nature of the business can only be brought about by the consent of all the partners. A change in the constitution of a firm takes place when (i) a new partner is introduced as a partner in a firm (s.31), (ii) a partner retires from a firm (s.32), (iii) a partner is expelled from a firm (s.33), (iv) a partner is adjudicated as an insolvent (s.34), (v) a partner dies (s.35), (vi) a partner transfers his interest in the firm by sale, mortgage or charge (s.29).

6.6.1 Rights and Liabilities of Incoming Partners

Section 31 provides that subject to a contract between partners and to the provisions regarding minors in a firm, no new partner can be introduced into a firm without the consent of all the existing partners. Such a partner enjoys all the rights as are conferred upon him by the Act and by the contract between him and the existing partners. The liability of a new partner ordinarily commences from the date when he is admitted as a partner, unless he agrees to be liable for obligations incurred by the firm prior to that date. But such an agreement is binding only on the partners and does not give the right to any creditor of the firm to sue the new partner for past debts of the firm. This is because there is no privity of contract between the creditor and the new partner. At the same time, the acts of the old partners cannot be ratified by the new partner. This is in accordance with s. 196 of the Indian Contract Act, 1872, which provides that for the purpose of ratification of agency, the principal must be in existence at the time when the act was done.

The new partner, however, would be liable for the acts of the old firm only if (i) the reconstituted firm after his admission assumes the liabilities of the old firm and (ii) the creditors accept the new firm as their debtor and discharge the old firm from its liability. The process of substituting the old firm by the new firm is done by what is known as novation. Novation is the technical term used in a contract for substituted liability, of course, not confined only to case of partnership.

6.6.2 Rights and Liabilities of a Retired Partner

An outgoing partner means a partner who has retired from a firm. The firm is reconstituted by the remaining partners. Section 32 contemplates three ways in which a partner may retire from the firm, viz., (i) he may retire at any time with the consent of all other partners; (ii) where there is an agreement between the partners about retirement, a partner may retire in accordance with the terms of that agreement; (iii) where the partnership is at will, a partner may retire by giving to his partners a notice of his intention to retire. Section 32 clearly comprehends a situation where a partner may retire without dissolving the firm.

Section 36 permits a retiring partner to carry on business competing with that of the firm and he may advertise such business, but subject to a contract to the contrary, he cannot use the name of the firm or represent himself as carrying on the business of the firm or solicit customers of the firm after he has left. However, the partner may agree with his partners that on his retiring from the firm, he will not carry on a business similar to that of the firm within a specified period or within specified local limits. Such an agreement will not be in restraint of trade if the restraint is reasonable. Section 53 provides for a similar rule to such an agreement in case of sale of the firm's goodwill. Further, the retiring partner has the right to receive his share of the property of the firm, including goodwill, as the amount due to him is to be construed as a debt payable by the firm.

Furthermore, s.37 provides that a retiring partner, where the continuing partners carry on the business of the firm with property of the firm without any final settlement of account with him, is entitled to claim from the firm such share of the profits made by the firm, since he ceased to be a partner, as is attributable to the use of his share of the property of the firm. In the alternative, he can claim interest at the rate of 6 per cent per annum on the amount of his share in the firm's

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property. However, if by a contract between the partners, an option has been given to the continuing partners to purchase the interest of the retired partner and the option is duly exercised, the retired partner or his estate will not be entitled to any further share of the profits.

Liability of the retired partner: Section 32 provides that a retired partner continues to be liable for all the acts of the firm done before his retirement unless he is discharged from his liability. He may be discharged from liability to any third party for the acts of the firm done before his retirement if (a) there is an agreement made by him with such third party and the remaining partners. (This implies the principle of novation); (b) there is an implied agreement to the above effect. Such an agreement may be implied by a course of dealing between such third party and the remaining partners, after the third party had knowledge of the retirement.

Further, s.32 provides that a retired partner, along with other partners at the time of his retirement, continues to be liable as partner to third parties for any act done by any of them after the retirement of the partner until a public notice is given of the retirement. This implies the principle of holding out. The public notice of the retirement of a partner may be given either by the retired partner or any of the partners of the reconstituted firm. A retired partner, however, is not liable for the acts of the firm done after his retirement, provided the persons dealing with the firm do not know that he was a partner as such. This, in fact, refers to the retirement of a sleeping or dormant partner.

6.6.3 Expulsion of a Partner

Section 33 provides that a partner may not be expelled from a firm by a majority of partners except in exercise, in good faith, of powers conferred by the contract between the partners. Thus, a partner may be expelled from the firm if (i) the power of expulsion is conferred by a contract between the partners, (ii) the power is exercised by a majority of the partners and (iii) the power is exercised in good faith. The test of good faith will be satisfied if (i) the expulsion is in the interest of the partnership, (ii) a notice of expulsion has been served on the partner and (iii) the partner to be expelled has been given an opportunity of being heard.

In case a partner is expelled without satisfying the conditions above mentioned, the expulsion would be irregular and he does not cease to be a partner. In such a situation, he may either claim reinstatement as a partner, or sue for the refund of his share of capital and profits in the firm. The rights and liabilities of an expelled partner are the same as those of a retired partner.

6.6.4 Insolvency of a Partner

Section 34 provides that where a partner in a firm is adjudicated insolvent, he ceases to be a partner on the date on which the order of adjudication is passed whether or not the firm is thereby dissolved.

Caution It is to be noted that ordinarily but not invariably, the insolvency of a partner results in dissolution of a firm but the partners may specifically provide that on such a contingency the firm shall not be dissolved.

Section 34 further provides that the estate of the insolvent partner is not liable for the acts of the firm done after the date of order of adjudication. It is not mandatory to give a public notice to the effect that a partner has been adjudged an insolvent. In any case the firm is not liable for any act of the insolvent partner after the date of order of adjudication.

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6.6.5 Death of a Partner

Section 42(c) provides that a firm is dissolved by the death of a partner, in the absence of a contract to the contrary. Section 35 deals with a situation where after the death of a partner, the firm continues its business without dissolution and provides that the estate of the deceased partner is not liable for any act of the firm done after his death. Proviso to s.45 lays down an identical rule applicable to a case where the death of a partner has caused dissolution of the firm. A public notice of the death of a partner is not required.

Transfer of Partner's Interest: A partner may transfer his interest in the firm by sale, mortgage or charge. The transfer may be absolute or partial. But as the partnership relationship is based on mutual confidence, the assignee of a partner's interest cannot enjoy the same rights and privileges as the assignor. Section 29 provides that the transferee, during the continuance of the firm, is not entitled to (i) interfere in the conduct of business of the firm or (ii) require accounts of the firm, or (iii) inspect books of the firm.

The transferee of the partner's interest is entitled to receive share of profit of the assignor. However, he is bound to accept the profits as agreed to by the partners, i.e., he cannot challenge the accounts.

On the dissolution of the firm or if the transferring partner ceases to be a partner, the transferee will be entitled, against the remaining partners, to receive the share of assets of the firm to which the transferring partner is entitled. Also for the purpose of ascertaining that share, he is entitled to an account as from the date of dissolution.

6.6.6 Rights and Duties of Partners in some Specific Situation

Section 17 contemplates rights and duties of partners under the following three specific situations: (i) where a change occurs in the constitution of a firm, (ii) where a firm constituted for a fixed term continues to carry on business after the expiry of that term and (iii) where a firm constituted to carry out one or more adventures carries out other adventures.

Subject to contract between the partners, where a change occurs in the constitution of the firm, the mutual rights and duties of the partners in the reconstituted firm remain the same as they were immediately before the change, as far as may be.

In case a partnership is created for a fixed term or for a particular adventure, it would naturally come to an end on the expiry of such term or on the completion of such adventure. But sometimes the partners continue the business even after the expiry of the term or completion of the adventure, without any new agreement. In such a situation, s.17 provides that the mutual rights and duties of the partners remain the same as they were before the expiry so far as they may be consistent with the incidents of a partnership at will. Further, where a firm constituted for one or more adventures or undertakings, carries out other adventures or undertakings, the mutual rights and duties will remain the same. This is subject to the contract between the partners.

6.6.7 Revocation of Continuing Guarantee as a Result of Change in the Firm

Section 38 provides that a continuing guarantee given to a firm or to a third person in respect of the transactions of the firm is revoked as to future transactions from the date of any change in the constitution of the firm. This provision is subject to an agreement to the contrary and if the surety has not given his assent to the change. This provision is intended to protect the surety's interest.

Notes

Self Assessment

Fill in the blanks:

11. A partnership entered into for a fixed period of time, the partners still carry on the business even after the expiry of the fixed period so the partnership becomes……...

12. …….partner means a partner who has retired from a firm.

6.7 Dissolution

6.7.1 Dissolution of Firm and Dissolution of Partnership

Section 39 provides that the dissolution of partnership between all the partners of a firm is called the "dissolution of the firm". It follows that if the dissolution of partnership is not between all the partners, it would not amount to "dissolution of firm", but it would nevertheless be "dissolution of partnership". Thus, dissolution of firm always implies dissolution of partnership, but dissolution of partnership need not lead to dissolution of firm. Dissolution of partnership may involve merely a change in the relation of the partners and not the dissolution of the firm.

Example: Where A, B and C were partners in a firm and C died or was adjudged insolvent, the partnership firm would come to an end; but if the partners had agreed that the death, retirement, insolvency of the partner would not dissolve the firm on the happening of these contingencies, the 'partnership' would certainly come to an end although the 'firm' or as the Act calls it, a 'reconstituted firm', might continue under the same name.

Thus, a reconstitution of a firm involves a change in the relation of partners whereas in the case of dissolution of firm, there is complete severance of relationship between all partners. Admission of a new partner amounts to reconstitution of the firm.

Example: Ram, Rahim and Singh are partners of a firm RRS & Co. Singh retires or dies and the partnership deed provides that in the event of such a happening, the firm shall continue. Then the firm will be called a reconstituted firm, having two partners – Ram and Rahim. Now the relation between Ram and Rahim does not remain the same as it was between Ram, Rahim and Singh.

Example: Ram, Rahim and Singh are partners in a firm. Robert is introduced as a new partner. Now the relation between Ram, Rahim, Singh and Robert will be different from the relation between Ram, Rahim and Singh. Thus, the firm consisting of the four partners is a reconstituted firm.

6.7.2 Another Classification of Methods of Dissolution

The different methods of dissolution are: (i) mutual agreement, (ii) notice, (iii) operation of law, (iv) the happening of a certain contingency and (v) a decree of a court.

Dissolution of partnership: It may be reiterated that the dissolution of partnership may lead to dissolution of firm. The dissolution of partnership takes place in any of the following circumstances:

(i) ***By the expiry of term:*** Where the partnership is for a fixed term, the firm gets dissolved at the end of the period, unless the partners have made a contract to the contrary [s.42(a)].

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(ii) ***By the completion of adventure:*** Where a partnership has been constituted for carrying out a particular adventure, such partnership comes to an end on the completion of the adventure. This is in the absence of an agreement to the contrary [s.42(b)].

(iii) ***By the death of a partner:*** A partnership, whether at will or for a fixed period, is dissolved by the death of a partner, unless there is a contract to the contrary [s.42(c)].

(iv) ***By the insolvency of a partner:*** A partnership whether for a fixed period or at will is dissolved by the adjudication of a partner as an insolvent. This is subject to the contract to the contrary between the partners [s.42(d)].

(v) ***By the retirement of a partner:*** Where a partner retires from the partnership, then the partnership is dissolved, but not the firm necessarily. However, if there are only two partners and one of them retires then the dissolution of partnership would be dissolution of firm.

On the happening of the contingencies mentioned above the remaining partners may continue in the firm in pursuance of an express or implied contract to that effect. If they decide not to continue, the firm is dissolved automatically. These methods of dissolution are also known as "contingent dissolution" as the dissolution depends on the happening of a contingency and unless otherwise agreed, partnership will stand dissolved on the happening of any of the above mentioned events. Also dissolution under s. 42 is known as 'optional dissolution' because the partnership may continue if the partnership agreement so provides.

6.7.3 Dissolution of Firm

When the relationship existing between all the partners of the firm comes to an end, it is called dissolution of the firm. It naturally involves closing down the business. There is no question of 'reconstituted firm' in such a case. A firm may be dissolved in any of the following ways:

(i) ***By mutual consent:*** Section 40 provides that a firm may, at any time, be dissolved with the consent of all the partners. This applies to all cases whether the firm is for a fixed period or otherwise.

(ii) ***By agreement:*** Section 40 also provides for the dissolution of a firm in accordance with a contract between the partners. The contract providing for dissolution may have been incorporated in the partnership deed itself or in a separate agreement.

Though the same section provides for these two methods of dissolution, they are different. If all the partners give consent, the firm may be dissolved irrespective of what is contained in the partnership deed. But in dissolution by agreement, the partners have to follow the terms thereof, whether some of the partners consent or not. However, there is one commonality between these two methods. The dissolution in both of them is based on the general principle that a contract may be discharged by agreement – either a existing one or by consent later on.

(iii) ***By the insolvency of all the partners but one:*** If all the partners or all the partners but one become insolvent, there is a dissolution of the firm. Section 41 calls this as compulsory dissolution.

(iv) ***By business becoming illegal:*** Section 41 provides that a firm is dissolved by the happening of any event which makes it unlawful for the business of the firm to be carried on or for the partners to carry it on in partnership. But, if the partnership relates to more than one adventure, the illegality of one or more of them does not prevent the lawful adventure from being carried on by the firm.

(v) ***Partners becoming alien enemies:*** Section 41 also covers cases of partnership between persons some of whom become alien enemies by a subsequent declaration of war. In such

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a case partnership is dissolved, because trading with an alien enemy is against public policy.

Section 41 covers cases of compulsory dissolution of firm by operation of law.

(vi) ***By notice of dissolution of partnership at will***: Section 43 provides that where the partnership is at will, a partner may give a notice in writing to the other partners of his intention to dissolve the firm. The notice must state the intention to dissolve the firm and be in writing. The firm is dissolved as from the date mentioned in the notice as the date of dissolution, or if no date is mentioned then from the date of communication of the notice.

Filing a suit for dissolution is not a notice as required by this section. In such a case, the date of dissolution will be the date of passing of the preliminary decree for dissolution [Banarsi Das v. Kanshi Ram , A I R (1983) S.C. 1165].

6.7.4 Dissolution by Court (s.44)

At the suit of a partner, the court may dissolve a firm on any of the following grounds:

(a) ***If a partner has become of unsound mind:*** The application in this case may be made by any of the partners or by the next friend of the insane partner. In the case of insanity of a dormant partner, the court will not order dissolution, unless a very special case is made out for dissolution.

(b) ***Permanent incapacity of a partner:*** The court may order for dissolution of partnership, if a partner becomes permanently incapable of performing his duties as a partner. The application for dissolution, in such a case, may be made by any of the partners and not by the incapacitated partner. However, where a partner is attacked with paralysis which, on evidence, is found to be curable, dissolution may not be granted.

(c) ***Misconduct of a partner affecting the business***: If a partner is guilty of conduct which is likely to affect prejudicially the carrying on of the business of the firm, the court may order dissolution.

Examples:

(i) A partner of a mercantile firm is engaged in speculation in cotton. This act may be regarded a sufficient ground for dissolution of the firm.

(ii) A partner of a firm is travelling on the railway without a ticket and with intent to defraud. The court may grant dissolution. Also, the court may grant dissolution for conviction for an offence involving moral turpitude. Thus, a partner may misapply money of a client, or he may be involved in an adultery. In any case, the suit for dissolution can only be brought by the other partners.

(d) ***Wilful and persistent disregard of partnership agreement by a partner***: If a partner wilfully and persistently commits a breach of the partnership agreement regarding management, or otherwise conducts himself in such a way that is not reasonably practicable for the other partners to carry on business in partnership with him, the court may order dissolution. Continuous refusal by a partner to attend to his duties in the partnership business, the fact of hostility between the partners which makes cooperation between them impossible, have been held to be sufficient reasons for dissolution. The suit for dissolution under this ground can be brought by a partner other than the guilty partner.

(e) ***Transfer of interest or share by a partner:*** If a partner transfers, in any way (e.g., by sale, mortgage or charge), his whole interest in the partnership to a third party (outsider) or allows his share to be charged in execution of a decree against him or allows the same to

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be sold for arrears of land revenue or for charges recoverable as land revenue, the court may dissolve the partnership. The transfer of a part of his share by a partner to any third party is not permissible unless otherwise agreed. A partner can, however, transfer even the whole of his share to a partner in the firm, because no new partner is introduced thereby.

(f) The court can also dissolve partnership where the business of the firm cannot be carried on save at a loss. The court can order dissolution even though the partnership is for a fixed period [Rehmat-un-nisa-v. Price, 42 Bom. 380].

(g) ***Just and equitable:*** The court can order dissolution on any other ground which in the opinion of the court is a fit ground for dissolution of partnership. Dissolution on this ground has been granted in case of deadlock in the management, disappearance of the substratum of the business, partners not on speaking terms, etc.

6.7.5 Consequences of Dissolution

On the dissolution of a firm, it becomes necessary to wind up the affairs of the firm, i.e., the assets are realised, the liabilities paid out and surplus, if any, distributed amongst the partners or their representatives according to their respective rights.

6.7.6 Settlement of Accounts (s.48)

Usually the Deed of Partnership contains an accounting clause according to which the final accounts between partners are settled. In the absence of such an agreement, s.48 provides as follows:

(i) The losses, including losses on capital, must be paid, first from profits, next out of capital and lastly, if necessary, by contribution of each partner in proportion to his share in profits.

(ii) The assets of the firm, including sums contributed by partners to make up deficiency of capital, shall be applied as follows: (a) in paying debts of the firm to outsiders; (b) in paying each partner rateably for advances made by him to the firm as distinct from capital; (c) in paying each partner, rateably, amount due for capital contribution and (d) the residue in paying each partner in accordance with his share in the profits of the firm.

(iii) If a partner becomes insolvent or otherwise cannot pay his share of the contribution, the solvent partners must share rateably the available assets (including their own contribution to the capital deficiency), i.e., the available assets will be distributed in proportion to their original capital. This is called the rule in Garner v. Murray (1904)1 Ch. 57.

Caution It is to be noted that the period of limitation according to the Limitation Act for a suit for accounts on dissolution is three years. If a partner fails to bring such a suit against one partner within the period, the whole claim is barred against the remaining partners also.

Sale of goodwill after dissolution. Section 55 provides that in settling the accounts of a firm after dissolution, goodwill shall, subject to contract between the partners, be included in the assets and it may be sold either separately or along with other property of the firm.

Where the goodwill of a firm is sold after dissolution, a partner may carry on a business competing with that of the buyer and he may advertise such business but subject to agreement

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between him and the buyer, he may not (a) use the firm's name; (b) represent himself as carrying on business of the firm; or (c) solicit the custom of persons who were dealing with the firm before its dissolution.

Any partner may, upon the sale of goodwill of a firm, make an agreement with the buyer that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits. Such an agreement shall be void if the restrictions imposed are unreasonable.

Restraint of trade by buyer of goodwill. Section 54 provides that partners may, upon or in anticipation of dissolution of the firm, make an agreement that some or all of them will not carry on a business similar to that of the firm within a specified period or within specified local limits. Such an agreement shall be valid if the restrictions imposed are reasonable.

Example: **Illustrating the ruling in Garner v. Murray**

1. A, B and C were partners, sharing profits and losses equally, with capital contribution of ₹ 30,000, ₹ 15,000 and ₹ 3,000, respectively. On dissolution it is found that, after paying the debts of the firm and advances made by the partners, the assets are ₹ 21,000. Thus, the deficiency comes to ₹ 27,000 (i.e., total capital – assets), which is to be met by the partners equally. Now the total assets available are ₹ 48,000. This amount will be distributed rateably among the partners. However, in actual practice it will not be necessary for A and B to pay ₹ 9,000 each in cash but notional adjustment may be made so that C, whose capital contribution was only ₹ 3,000 will have to pay ₹ 6,000. Now the total assets available for distribution between A and B would be ₹ 21,000 + 6,000 = ₹ 27,000, A getting ₹ 21,000 and B ₹ 6,000.
2. Sometimes it so happens that one or more of the partners is insolvent and so cannot contribute anything towards the deficiency. Thus, in the above case if C is insolvent and nothing can be recovered from him, the assets will be distributed as follows: A and B will bring in their share of deficiency, increasing the assets from ₹ 21,000 to ₹ 39,000. The total assets would be distributed between A and B in their capital ratio, i.e., 2:1. A will get ₹ 26,000 and B ₹ 13,000. Thus, A on the whole will lose ₹ 13,000 and B ₹ 11,000. This settlement of accounts is in accordance with the rule laid down in Garner v. Murray. From the calculations it is obvious that the remaining partners are suffering loss in accordance with the amount of capital contributed. Thus, A suffers more loss than B even though they are sharing profits and losses equally.
3. The principle enunciated above will also apply if C in the case mentioned in illustration above, though not insolvent, fails to contribute his share of the deficiency. Out of the total amount of ₹ 21,000, A will get ₹ 17,000 and B ₹ 4,000. The court will pass a decree for ₹ 4,000 in favour of A against C and for ₹ 2,000 in favour of B against C.

6.7.7 Rights and Liabilities of Partners on Dissolution

There are certain consequences of dissolution of a firm. Most of these consequences affect the rights and liabilities of partners. Therefore, the rights and liabilities of partners are discussed here.

Rights of a Partner on Dissolution

(i) ***Right to have business wound up:*** Section 46 provides that on a partnership being dissolved, any partner or his representative has a right against the other partners to have (a) the

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property of the firm applied in payment of debts of the firm and (b) the surplus distributed amongst the partners or their representatives according to their respective rights. The right of a partner is often called a partner's lien. The word 'lien' as used here is not to be interpreted in its technical sense, it is a convenient mode of referring to the right.

(ii) ***Rights to have the debts of the firm settled out of the property of the firm:*** Section 49 provides that where there are joint debts due from the firm and also separate debts due from any partner, the property of the firm shall be applied in the first instance in payment of the debts of the firm and if there is any surplus, then the share of each partner shall be applied first in the payment of his separate debts and the surplus if any in the payment of debts of the firm.

(iii) ***Right to personal profits earned after dissolution:*** Section 50 provides that if any partner earns any profit from any transaction connected with the firm after its dissolution, he must share it with the other partners and the legal representatives of the deceased partner.

(iv) ***Rights to return of premium on premature dissolution:*** Section 51 provides that where a partner has paid a premium on entering into partnership for a fixed term and the firm is dissolved before the expiration of that term, he shall be entitled to repayment of the premium or of such part thereof as may be reasonable (regard being had to the terms of and to the length of time during which he was a partner) unless the dissolution is (i) due to the death of a partner, or (ii) his own misconduct, or (iii) in pursuance of an agreement containing no provision for the return of the premium or any part of it.

(v) ***Right where partnership contract is rescinded for fraud or misrepresentation:*** Section 52 provides that in case a partner was induced to join the firm by the fraud of any partner, he may, on discovering the fraud, rescind the agreement and have refund not only of the premium but also of the capital paid. His rights are: (i) He has a lien on the surplus assets after the debts of the firm have been paid, for any sum paid by him to purchase a share in the firm and for any capital contributed by him. (ii) He is entitled to rank as a creditor of the firm in respect of any payment made by him towards the debts of the firm. (iii) He has a right to be indemnified by the partner guilty of fraud or misrepresentation against all the debts of the firm.

(vi) ***Rights to restrain partners from use of firm property***: Section 53 provide that after a firm is dissolved, every partner or his representative may restrain any other partner or his representatives from carrying on a similar business in the firm's name or from using any of the property of the firm for his own benefit, until the affairs of the firm have been completely wound up. This right is subject to; (a) a contract to the contrary between the partners and (b) the right of a partner who has purchased firm's goodwill.

Liabilities of a Partner on Dissolution

(i) Liability for acts of partners done after dissolution and public notice. The first step in the process of dissolution is to give a public notice of dissolution. If it is not done then the partners continue to be liable to third parties for any act done by any of them which would have been an act of the firm if done before the dissolution. This principle, however does not apply in certain cases. In other words, the liability does not attach for the acts done after the dissolution of firm and no notice of dissolution be given. These are: (a) the estate of a deceased partner, (b) the insolvent partner and (c) the sleeping or dormant partner who retires (s.53).

(ii) Continuing authority of partners for purposes of winding up. The commencement of dissolution does not at once terminate the authority of the partner. Section 47 provides that after the dissolution of a firm, the authority of each partner to bind the firm and the

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other mutual rights and obligations of the partners continue, so far as may be necessary to; (a) wind up the affairs of the firm and (b) complete transactions begun but not unfinished at the time of the dissolution. However, the proviso to s. 47 provides that the firm in dissolution would not be liable for the act of any partner who has been adjudicated insolvent. But, if a partner represents himself or knowingly permits himself to be represented as a partner of the insolvent partner, the firm is liable on the ground of 'holding out'.

Mode of Giving Public Notice (s.72): A public notice is required to be given when (i) a partner retires or is expelled from a registered firm; (ii) a registered firm is dissolved; (iii) a minor, on attaining majority has to elect to become or not to become a partner in a registered firm.

The public notice relating to the above matters is given: (i) by notice to the Registrar of Firms under s.63 (regarding recording of changes in the constitution of a firm); (ii) by publication in the official gazette; (iii) by publication in at least one vernacular newspaper circulating in the district where the firm to which it relates has its place or principal place of business. In other cases where public notice has to be given, it is given by publication in (i) the official gazette and (ii) at least one vernacular newspaper circulating in the district where the firm to which it relates has its place or principal place of business. The consequences of not giving the public notice where it is required to be given under different provisions of the Act are as follows:

1. If a minor admitted to the benefits of partnership fails to give public notice within six months of his attaining majority or of his obtaining knowledge that he had been admitted to the benefits of partnership, whichever date is later, that he has elected to become or not to become a partner in the firm, he shall become partner in the firm on the expiry of the said six months and is liable as a partner of the firm [s.30 (5)].
2. If a retiring partner does not give a public notice of his retirement from the firm, he and the other partners shall continue to be liable as partners to third parties for any act done by any of them which would have been act of the firm done before the retirement [s.32 (3)].
3. If in case of expulsion of a partner from the firm, a public notice is not given, the expelled partner and the other partners shall continue to be liable to third parties dealing with the firm as in the case of a retired partner [s.33 (2)].
4. If on the dissolution of a registered firm, a public notice is not given, the partners shall continue to be liable to third persons of any act done by any of them which would have been an act if the firm of done before the dissolution [s.45 (1)].

Task Describe the mode of settling accounts of a firm after dissolution with special reference to a case where one of the partners has become insolvent and nothing is recoverable from his estate.

Self Assessment

Fill in the blanks:

13. When the relationship existing between all the partners of the firm comes to an end, it is called ……..of the firm.
14. If a partner is guilty of conduct which is likely to affect prejudicially the carrying on of the business of the firm, the …….may order dissolution.

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Case Study

Demystifying Limited Liability Partnership

—by V. Pattabhi Ram & Mithun D'Souza

If she weren't a shade confused, she wouldn't be Wafers! Her uncle, a star CFO, was her inspiration and she wished to be like him - jet setting, globe trotting and knowledgeable. At the campus interview her senior had picked a job for ₹ 9 lakh and gosh he wasn't even a rank holder. Wafers knew that the industry offered fat pay packs but her heart actually lay in consulting. She wanted to join one of the Big Four firms with the long-term goal of becoming the next C. K. Prahalad. Her professor had once told the class, "In life, you should do what the heart tells you." He was talking about careers!

China said, "For chartered accountants there are a plethora of opportunities in the new international trading regime." Wafers agreed. She recalled reading in the ICAI website that "Opportunities would emerge at three fundamental levels in the WTO regime. At the government level, at the revenue authorities level and at the business unit level." China was surprised. "Wow! These CA students are so analytical," he told himself. "You mean to say, accounting firms will have opportunities at the international level," queried Muskan, Wafer's niece. She was in Class X.

"Yeah," said Wafers. And added, "Actually, the opportunities are not just in the industry. They are in practice as well." China remarked, "But that comes with a huge price. If the pink papers are to be believed, accounting firms in the US have millions of dollars worth of legal suits pending against them." Muskan asked, "So?" "So," replied China, "the liberalised trade scenario which offers potential to provide services across international borders will augment greater liability to firms in case of default." Muskan looked definitely confused.

Wafers explained. "Legally, accounting firms in India are allowed to function as sole proprietary concerns or as partnership firms. A partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or anyone of them acting for all." This set Muskan thinking. "So will I be liable for my partners' shortcomings even if I have been honest in conducting my duties," she asked. "That's the general idea," said China impressed by the kid asking the right questions.

"This traditional model is not equipped to meet the multi-competency, multi-disciplinary and multi-locational requirements of today's global and domestic clients," said China.

Wafers added, "Moreover, the major chunk of all benefits is drawn by the creamy layer of large firms." She had read a research report on "Who are India's top auditors and how much do they charge," which had, among others, documented the great divide in the accounting profession. "This is why the accounting fraternity is in favour of limited liability partnership," (LLP) she added. "But what is LLP?" asked China. Ha, that's why she loved China. The walking encyclopaedia had no inhibitions about seeking a clarification on a doubt, if he had one.

"A limited liability partnership is a form of organisation which shields a partner's assets from limitless liabilities that may accrue from the omissions and commissions of other partners," answered Wafers. Not for nothing was Wafers considered strong in law. "In LLP, every partner will be an agent of the partnership and not of the other partners," she added. "Isn't this a merger of the partnership form of organisation and the company form?" remarked China.

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"Exactly," said Wafers. "It promises perpetual succession and a distinct legal identity were it to become law. Further, it requires only a minimum of two partners, having no cap on the maximum number of partners a firm can have," she added. "Section 11," said China hurriedly, "of the Companies Act bars the formation of a partnership consisting of more than 20 persons. Won't the firm have to register itself as a company?" "Yes and No." said Wafers "If LLP becomes law, Section 11 will have to be amended. The idea is to make LLP a vehicle for business expansion.

"How?" asked Muskan. Replied Wafers, "Because of the legal stipulation of unlimited liability among partners, Indian partnerships are mostly restricted to family members and persons who know each other thoroughly." She added, "LLP being a form of partnership having characteristics of a company will limit liability in the case of business failure or professional negligence litigation to the partner responsible." "You mean, only the negligent partner will be penalised and not the whole firm," asked China. "Yes," said Wafers.

China played the devil's advocate. "Is it possible to prove that only a particular partner was negligent and not the others?" Wafers replied, "They will have to divide work amongst themselves appropriately. This could create disputes between partners, but crystal clear division of duties between partners will go a long way in reducing the same."

"Excellent," said Muskan. "The LLP form of organisation would help the small and medium practitioners by encouraging networking and specialisation of functions."

Wafers had a word of caution, "The decision to go for LLP will be based on the interplay of costs and benefits." China continued his black hat thinking, "Other forms of organisation are tried and tested. Why then should one go for something new?" Wafers answered this question philosophically quoting John Rockefeller, "If you want to succeed, you should strike out new paths rather than travel the worn out paths of accepted success." China smiled.

Source: thehindubusinessline.com

6.8 Limited Liability Act

The company being a separate person, its members are not as such liable for its debts. Hence, in the case of a company limited by shares, the liability of members is limited to the nominal value of shares held by them. Thus, if the shares are fully paid up, their liability will be nil. However, companies may be formed with unlimited liability of members or members may guarantee a particular amount. In such cases, liability of the members shall not be limited to the nominal or face value of the shares held by them. In case of unlimited liability companies, members shall continue to be liable till each paisa has been paid off. In case of companies limited by guarantee, the liability of each member shall be determined by the guarantee amount, i.e., he shall be liable to contribute up to the amount guaranteed by him.

Unlimited liability of a member of a limited liability company. In the following cases, a shareholder or member shall lose the privilege of limited liability:

1. Where members of the company are reduced below the statutory minimum, viz., 7 in case of a public company and 2 in case of a private company and the company carries on the business for more than 6 months while the members are so reduced, every person who is a member during the time that it so carries on business after those 6 months and is aware of the fact that it is operating with fewer than the requisite number shall be personally liable for the whole of the debts contracted during that time (s.45).

Notes

2. Where in the course of winding up, it appears that any business of the company has been carried on with intent to defraud creditors; the Court may declare the persons who were knowingly parties to the transaction personally liable without limitation of liability for all or any of the debts or other liabilities of the company (s.542).

The liability of members of a registered company may be limited or unlimited (s.12). It may be limited by shares, or by guarantee or by both (i.e., shares and guarantee).

A company limited by shares is a registered company having the liability of its members limited by its memorandum of association to the amount, if any, unpaid on the shares respectively held by them. The amount remaining unpaid on the shares can be called up at any time - during the lifetime of the company or at the time of winding up. However, a shareholder cannot be called upon to pay more than the amount remaining unpaid on his shares. His personal assets cannot be called upon for the payment of the liabilities of the company, if nothing remains to be paid on the shares purchased by him. Such a company is also known as a 'Share Company.'

A company limited by guarantee is one having the liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound up. Such a company is also known as 'guarantee company'. The liability of the members of a guarantee company is limited by a stipulated sum mentioned in the memorandum. The guaranteed amount can be called up by the company from the members only at the time of winding up if the liabilities of the company exceed its assets.

Notes The name of an LLC must contain the words "Limited Liability Company" or the abbreviation "LLC"; the name of a member or manager; must not be the same as or similar to the name of any corporation, limited partnership, business, trust or LLC, registered, formed or organised under the laws of Anguilla or reserved under this or any other Act; and must not be a name prohibited – by any other law in force in Anguilla, or by regulations made by the Governor under section 87.

Limited Liability Partnership

A limited liability partnership is a partnership in which some or all partners have limited liability. It exhibits elements of partnerships and corporations. In an LLP one partner is not responsible or liable for another partner's misconduct or negligence. In an LLP, some partners have a form of limited liability similar to that of the shareholders of a corporation. LLP must also have at least one "general partner" with unlimited liability. Unlike corporate shareholders, the partners have the right to manage the business directly.

As opposed to that, corporate shareholders have to elect a board of directors under the laws of various state charters. The board organizes itself and hires corporate officers who then have as "corporate" individuals the legal responsibility to manage the corporation in the corporation's best interest. An LLP also contains a different level of tax liability than a corporation.

Limited liability partnerships are distinct from limited partnerships in some countries, which may allow all LLP partners to have limited liability, while a limited partnership may require at least one unlimited partner and allow others to assume the role of a passive and limited liability investor. As a result, in these countries the LLP is more suited for businesses where all investors wish to take an active role in management.

Notes

Did u know? The Limited Liability Partnership Act 2008 was published in the official Gazette of India on January 9, 2009 and has been notified with effect from 31st March 2009.

However, the Act has been notified with limited sections only. The rules have been notified in the official gazette on April 1, 2009. The Lok Sabha (Lower House) granted its assent to the Bill on December 12, 2008 which was earlier passed by the Rajya Sabha (Upper House) in October 2008. The first LLP was incorporated in the first week of April 2009. For Income Tax purposes, an LLP is treated as any other partnership firm.

Features of LLP

The salient features of the LLP Act, 2008 are as under:

1. The LLP has an alternative corporate business vehicle that would give the benefits of limited liability but allows its members the flexibility of organizing their internal structure as a partnership based on an agreement.
2. The LLP Act does not restrict the benefit of LLP structure to certain classes of professionals only and would be available for use by any enterprise which fulfills the requirements of the Act.
3. While the LLP has a separate legal entity, liable to the full extent of its assets, the liability of the partners would be limited to their agreed contribution in the LLP. Further, no partner would be liable on account of the independent or unauthorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business decisions or misconduct.
4. LLP shall be a body corporate and a legal entity separate from its partners. It will have perpetual succession. Indian Partnership Act, 1932 shall not be applicable to LLPs and there shall not be any upper limit on number of partners in an LLP unlike an ordinary partnership firm where the maximum number of partners can not exceed 20, LLP Act makes a mandatory statement where one of the partners to the LLP should be an Indian.
5. Provisions have been made for corporate actions like mergers, amalgamations etc.
6. While enabling provisions in respect of winding up and dissolutions of LLPs have been made, detailed provisions in this regard would be provided by way of rules under the Act.
7. The Act also provides for conversion of existing partnership firm, private limited company and unlisted public company into a LLP by registering the same with the Registrar of Companies (ROC).

Self Assessment

Fill in the blanks:

15. In a ……..Partnership one partner is not responsible or liable for another partner's misconduct or negligence.
16. In the case of a company limited by shares, the liability of members is limited to the …….value of shares held by them.

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6.9 Formation of an LLC

One or more persons may form an LLC by signing articles of formation in prescribed form and filing them with the Registrar. The articles of formation must contain-

(a) The name of the LLC;

(b) The address of its first registered office and the name and address of its first registered agent;

(c) If the LLC proposes to have a specific date of dissolution, the latest date on which the LLC must dissolve;

(d) If the LLC will be formed on a date subsequent to the date of filing of the articles of formation, that date; and

(e) Any other matters as the members may determine.

An LLC is formed on the date specified in the certificate of formation issued by the Registrar under subsection (6). It is a separate legal entity, the existence of which as a separate legal entity shall continue until it is dissolved. If he is satisfied that the requirements of this Act in respect of formation have been complied with, the Registrar must, upon receipt of articles of formation, register the articles in the Register and issue a certificate of formation. The certificate of formation must specify the date of the formation of the LLC, which must be-

(a) The date of registration of the articles of formation; or

(b) If a later date for the formation of the LLC is specified in the articles of formation that date.

6.9.1 LLC Agreement

A written agreement concerning the affairs of an LLC and the conduct of its business may be entered into by the members of the LLC either before, after or at the time of the signing of articles of formation and the agreement shall take effect, whenever entered into, on the formation of the LLC or upon such other date as may be provided in the agreement.

The articles of formation may be amended at any time and for any lawful purpose by filing articles of amendment in prescribed form with the Registrar specifying-

1. The name of the LLC; and

2. The amendment to the articles.

6.9.2 Powers of Court

If a person required to sign a document under this Act fails or refuses to do so, any other person who is adversely affected by the failure or refusal may apply to the Court to direct the signing of the document. If, on an application made under subsection (1), the Court finds that any person required to sign a document has failed or refused to do so, it-

(a) May order the person to sign the document; and

(b) May order the Registrar to register the document, whether or not the document has been signed.

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If a person required executing an LLC agreement or amendment thereof fails or refuses to do so, any other person who is adversely affected by the failure or refusal may apply to the Court to direct the execution of the LLC agreement or amendment thereof. If the Court finds in respect of subsection (1) that the LLC agreement or amendment thereof should be executed and that any person required to execute the LLC agreement or amendment thereof has failed or refused to do so, it shall make an order granting appropriate relief.

Task Analyse the ways in which mergers and acquisitions affects the limited liability companies.

Self Assessment

Fill in the blanks:

17. One or more persons may form an LLC by signing …….of formation in prescribed form and filing them with the Registrar.
18. A LLC is formed on the date specified in the …….issued by the Registrar under subsection (6).

6.10 Summary

- A partnership is defined as the relationship between persons who have agreed to share profits of a business carried on by all, or by any of them acting for all.
- A partnership firm may be registered at any time by post, or delivering to the Registrar of Firms of the area in which any place of business of the firm is situated or proposed to be situated but the Registration of Firms is Optional.
- Persons, who have entered into partnership with one another are called individually 'partners' and collectively a 'firm' and the name under which their business is carried on is called the 'firm name'
- A written agreement between the partners which covers the various clauses is called Partnership deed. The partnership deed is required to be stamped according to the provisions of the Stamp Act, 1899.
- The relation of the partners of a firm to one another arises through an agreement between them. Such an agreement may be express or may be implied from the course of dealings between them.
- An outgoing partner means a partner who has retired from a firm. The firm is reconstituted by the remaining partners.
- The dissolution of partnership between all partners of a firm is called dissolution of the firm but if the dissolution of partnership is not between all the partners, it would not amount to dissolution of firm, it is called dissolution of partnership.
- In case of company limited by shares, the liability of the members is limited to the nominal value of shares held by them.
- Fully paid shares leads to nil liability.
- LLC is only for the limited liability but not for the unlimited liability

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6.11 Keywords

Dissolution of the Firm: The *dissolution of partnership* between all the partners of a firm is called the dissolution of the firm.

Economic Interest: It means a member's share of the profits and losses of an LLC and a member's right to receive distributions of the LLC's assets.

Foreign LLC: It means an LLC formed under the laws of any foreign jurisdiction.

Goodwill: *It* is an accounting concept meaning the value of an entity over and above the value of its assets.

LLC: Limited Liability Company

LLP: It is the partnership where all or some partners have limited liability.

Partnership Deed: *It* is an agreement between the partners which covers the various clauses required for management of the firm.

6.12 Review Questions

1. What is a partnership? Briefly state special features of a partnership on the basis of which its existence can be determined under the Indian Partnership Act.
2. Explain the procedure for getting a partnership firm registered. When is such a registration treated as complete?
3. Explain the following: (i) Partner by holding out, or by estoppel. (ii) Dormant or sleeping partner. (iii) Nominal partner. (iv) Sub-partner. (v) Working partner. (vi) Incoming partner. (vii) Outgoing partner. (viii) Limited partnership.
4. What are the provisions of the Indian Partnership Act with regard to the admission of a minor into the partnership? What will be his rights and liabilities during his minority and after he has attained the majority?
5. Enumerate the rights and duties of partners inter se.
6. What is meant by the implied authority of a partner to bind the firm? State the acts of a partner for which he does not have the implied authority to bind the firm.
7. Analyse the advantages of formation of companies with limited liabilities. Analyse the power of the government in such companies.
8. Do you think it is wiser enough on the part of the companies to form a company with a limited liability? Justify.
9. Your company is a private limited concern and after running the company for 5 years, now you want to wind up the company. Analyse the liability of the members of the company.
10. Critically examine the limited liability act with its pros & cons.
11. A and B purchased a tea shop by contributing equal amounts. They incurred some expenses in decoration of the shop. They leased the shop on an understanding to share the rent equally. Are A and B partners?
12. A, B and C are three partners in a firm. According to partnership deed, A is entitled to half of the partnership property and profits. A becomes insolvent but B and C continue the

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firm's business without paying A's share of assets in the firm. Can A's official receiver recover any of the profits made by the firm after A's insolvency?

13. A and B run a firm of solicitors. C, a client seeks A's advice on ways to improve her income. A advises her to bring the title deeds of the property to him. He also obtains C's signature on a plain paper which he converts into a sale deed in his favour. Thereafter, he sells the property and misappropriates the money. Is the firm liable to C for A's fraud.

14. A, B and C run a partnership firm. The firm orders some machinery from a supplier. After the placing of order but before actual delivery of machinery, A dies. The machinery is later on delivered to the firm. In the meantime, the remaining partners become insolvent and the firm fails to pay. Explain whether A's private estate is liable for the price of the machine, and against whom the suppliers of machinery can obtain a decree for the recovery of price.

15. A and B carry on a banking firm in partnership. A, without B's knowledge, receives some money from C and uses the same for his personal benefit. Is the firm liable to make good C's money?

Answers: Self Assessment

1.	valid contract	2.	particular
3.	name	4.	true
5.	partnership deed	6.	written
7.	agreement	8.	goodwill
9.	implied	10.	sleeping
11.	'Partnership at Will'	12.	Outgoing
13.	dissolution	14.	court
15.	Limited Liability	16.	nominal
17.	articles	18.	certificate of formation

6.13 Further Readings

Book

S S Gupta, *Business Law*

Online links

india.gov.in/allimpfrms/allacts/3167.pdf

www.llp.gov.in/

Unit 7: Concept of a Company

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CONTENTS

Objectives

After studying this unit, you will be able to:

- Explain the notion of a company;
- Discuss the features of a company;
- Describe the classification of companies.

Notes

Introduction

The Companies Act, 1956 defines the word 'company' as a company formed and registered under the Act or an existing company formed and registered under any of the previous company laws (s.3). This definition does not bring out the meaning and nature of the company into a clear perspective. Also s.12 permits the formation of different types of companies. These may be (i) companies limited by shares, (ii) companies limited by guarantee and (iii) unlimited companies. The vast majority of companies in India are with limited liability by shares. Therefore, it is advisable to define the term 'company' keeping in mind this type of company. However, a brief description of other types of companies will be given later.

7.1 Concept of a Company

A company, in its ordinary, non-technical sense, means a body of individuals associated for a common objective, which may be to carry on business for gain or to engage in some human activity for the benefit of the society. Accordingly, the word 'company' is employed to represent associations formed to carry on some business for profit or to promote art, science, education or to fulfil some charitable purpose. This body of individuals may be incorporated or unincorporated.

An Unincorporated Association: An unincorporated association enjoys the advantage of having a large number of members, who contribute sums of money to a common pool for running a business undertaking. A partnership firm is an example of an unincorporated association.

An Incorporated Association: An association of individuals may be incorporated according to the law of the land. For example, Reliance Industries Limited is an incorporated association formed under the Companies Act, 1956. An incorporated association is a legal person, separate and distinct from its individual members. Where an association is incorporated, it becomes a body corporate acquiring a legal entity or personality. Since it is created under the provisions of law, it is known as legal or artificial person as opposed to a natural person.

Notes The word 'Company' is colloquially applied to both unincorporated associations (such as a partnership firm) and incorporated associations (such as a company incorporated under the Companies Act, 1956). However, the Indian legal system regards partnership firms and partnership law distinct from the companies and the company law.

Legal Person: Any entity, recognised by the law as capable of rights and duties is a 'person'. The law, while regulating rights and duties of persons, divides them into: (i) natural persons; and (ii) artificial persons.

Natural persons are human beings of different degrees of capacity, and sometimes acting for themselves and at other times through agents or as agents. An artificial person is created and devised by laws for the purpose of the society and is known as 'company'. Such artificial persons possess rights and owe obligations almost similar to those of natural persons, but have no physical existence.

Body Corporate or Corporation: Section 2(7) provides that a 'Body Corporate' or 'Corporation' includes a company incorporated outside India. However, it does not include (i) a corporation sole; (ii) a cooperative society registered under any law relating to cooperative societies; and

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(iii) any other body corporate, not being a company, which the Central Government may, by notification in the Official Gazette, specify in this behalf.

Thus the word 'body corporate' or 'corporation' has a wider connotation than the word 'company'. A corporation is an association of persons, incorporated according to the law of the land and clothed with legal personality. It is a legal entity separate from the persons who constitute it. A corporation may be either a 'sole corporation' or an 'aggregate corporation'. A sole corporation consists of one corporator or member only at any given time, who enjoys corporate personality by virtue of his capacity as occupant of some public office for the time being. Some examples are: Queen of England, President of the Indian Union, etc. An aggregate corporation consists of a number of individuals contemporaneously associated so that in the eyes of the law they form a single person, for example, a municipal corporation, an incorporated company.

Definition of a Company

Lord Lindley has described the company as "associations of many persons who contribute money or money's worth to a common stock and employs it in some trade or business; and who share the profit and loss (as the case may be) arising therefrom". The common stock so contributed is denoted in money and is 'the capital' of the company. The persons who contribute it, or to whom it belongs, are members. The proportion of capital to which each member is entitled is his 'share'. The member may sell his share in the company, thus withdrawing himself and making someone else a member to whom he transfers shares. Thus, shares in a company are transferable. As a natural consequence of transferability of shares, the company has what is commonly known as perpetual succession. With the withdrawal or death of a member of a company, the latter does not come to an end.

Did u know? The life of the company is independent of the lives of the members of the company. Members may come and members may go, the company continues until it is dissolved.

Gower, L.C.B. in his book entitled '*The Principles of Modern Company Law*' gives an interesting example. He says, 'During the war, all the members of one private company, while in general meeting, were killed by a hydrogen bomb. But the company survived, not even a hydrogen bomb could destroy it'.

Section 34(2) gives the effect of registration of a company by identifying the features it acquires as a consequence thereof.

Self Assessment

Fill in the blanks:

1. A corporation is an association of persons, incorporated according to the law of the land and clothed with ……personality.
2. An artificial person is created and devised by laws for the purpose of the society and is known as ……..
3. Where an association is incorporated, it becomes a …….acquiring a legal entity.

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7.2 Features of a Company

On the basis of the above observations, we may spell out the following characteristic features of a company:

7.2.1 Incorporated Association

A company must be incorporated or registered under the Companies Act. Minimum number required for the purpose is 7, in case of a public company and 2, in case of a private company (s.12). It may also be mentioned that as per s.11, an association of more than 10 persons, in case of banking business and 20 in case of any other business, if not registered as a company under the Companies Act, or under any other law for the time being in force, becomes an illegal association.

7.2.2 Artificial Person

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

7.2.3 Separate Legal Entity

Unlike partnership, company is distinct from the persons who constitute it. Section 34(2) says that on registration, the association of persons becomes a body corporate by the name contained in the memorandum. Lord Macnaghten in the famous case of Salomon v. Salomon & Co. Ltd. (1877) AC 22 observed that:

A company is at law a different person altogether from the subscribers…..; and though it may be that after incorporation the business is precisely the same as it was before and the same persons are managers and the same hands receive the profits, the company is at law not the agent of the subscribers or trustee for them. Nor are the subscribers as members liable, in any shape or form, except to the extent and in the manner provided in the Act.

7.2.4 Limited Liability

The company being a separate person, its members are not as such liable for its debts. Hence, in the case of a company limited by shares, the liability of members is limited to the nominal value of shares held by them. Thus, if the shares are fully paid up, their liability will be nil. However, companies may be formed with unlimited liability of members or members may guarantee a particular amount. In such cases, liability of the members shall not be limited to the nominal or face value of the shares held by them. In case of unlimited liability companies, members shall continue to be liable till each paisa has been paid off. In case of companies limited by guarantee, the liability of each member shall be determined by the guarantee amount, i.e., he shall be liable to contribute up to the amount guaranteed by him.

Unlimited Liability of a Member of a Limited Liability Company

In the following cases, a shareholder or member shall lose the privilege of limited liability:

1. Where members of the company are reduced below the statutory minimum, viz., 7 in case of a public company and 2 in case of a private company and the company carries on the business for more than 6 months while the members are so reduced, every person who is a member during the time that it so carries on business after those 6 months and is aware

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of the fact that it is operating with fewer than the requisite number shall be personally liable for the whole of the debts contracted during that time (s.45).

2. Where in the course of winding up, it appears that any business of the company has been carried on with intent to defraud creditors, the Court may declare the persons who were knowingly parties to the transaction personally liable without limitation of liability for all or any of the debts or other liabilities of the company (s.542).

7.2.5 Separate Property

Shareholders are not, in the eyes of the law, part owners of the undertaking. In India, this principle of separate property was best laid down by the Supreme Court in Bacha F. Guzdar v. The Commissioner of Income Tax, Bombay (Supra). The Supreme Court held that a shareholder is not the part owner of the company or its property, he is only given certain rights by law, e.g., to vote or attend meetings, to receive dividends. Similarly, in R.F. Perumal v. H. John, it was observed that no member can claim himself to be owner of the company's property during its existence or on its winding up. In still another case, it was observed that even where a shareholder held almost entire share capital, he did not even have an insurable interest in the property of the company. It was the case of Macaure v. Northern Assurance Co. Ltd., and the facts were as follows:

'Macaure' held all except one share of a timber company. He had also advanced substantial amount to the company. He insured the company's timber in his personal name. On timber being destroyed by fire his claim was rejected for want of insurable interest. The Court applying principle of separate legal entity held that the insurance company was not liable.

7.2.6 Transferability of Shares

Since business is separate from its members in a company form of organisation, it facilitates the transfer of member's interests. The shares of a company are transferable in the manner provided in the Articles of the company (s.82). However, in a private company, certain restrictions are placed on such transfer of shares but the right to transfer is not taken away absolutely.

7.2.7 Perpetual Existence

A company being an artificial person cannot be incapacitated by illness and it does not have an allotted span of life. The death, insolvency or retirement of its members leaves the company unaffected. Members may come and go but the company can go forever.

7.2.8 Common Seal

A company being an artificial person is not bestowed with a body of natural being. Therefore, it has to work through its directors, officers and other employees. But, it can be held bound by only those documents which bear its signature.

Did u know? **What is the signature of the company?**

Common seal is the official signature of a company.

The articles of association of the company provide for putting the seal of the company on documents. Apart from those documents, the company seal is to be put on power of attorney, deed of lease, share certificates, debentures, debenture trust deed, deed of mortgage, promissory notes, negotiable instruments (except cheques), agreement of hypothecation, loan agreements

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with banks and financial institutions, contract of employment, guarantees issued by the company and all formal documents and documents executed on stamp papers.

Use of seal outside India (s.50). Where a company has any business or transaction in a place outside India a facsimile (exact reproduction) of the common seal may be kept there. The seal should also contain the name of the place where the seal would be used. For such use there must be power in the articles. A person must be properly authorised to use the seal, who shall sign his name and also put the name of the place and the fact that he has been authorised to do so by the specified resolution.

As per s.48, a company may, by writing under its common seal, empower any person, either generally or in respect of any specified matters, as its attorney, to execute deeds on its behalf in any place either in or outside India. It further provides that a deed signed by such an attorney on behalf of the company and under his seal where sealing required, shall bind the company and have the same effect as if it were under its common seal.

7.2.9 Company may Sue and be Sued in its own Name

Fallout of separate legal entity is that the company, if aggrieved by some wrong done to it may sue or be sued in its own name.

Example: In Rajendra Nath Dutta v. Shibendra Nath Mukherjee (1982) (52 Comp. Cas. 293 Cal.), a lease deed was executed by the directors of the company without the seal of the company and later a suit was filed by the directors and not the company to avoid the lease on the ground that a new term had been fraudulently included in the lease deed by the defendants. Held that a director or managing director could not file a suit, unless it was by the company in order to avoid any deed which admittedly was executed by one of the directors and admittedly also the company accepted the rent. The case as made out in the plaint was not made out by the company but by some of the directors of the company and the company was not even a plaintiff. If the company was aggrieved, it was the company which was to file the suit and not the directors. Therefore, the suit was not maintainable.

Self Assessment

Fill in the blanks:

4. The shares of a company are transferable in the manner provided in the ……..of the company.
5. ……..is the official signature of a company.
6. A company is at law a different person altogether from the……..

7.3 Lifting of the Corporate Veil

The advantages of incorporation are allowed to be enjoyed only by those who want to make an honest use of the 'company'. In case of a dishonest and fraudulent use of the facility of incorporation, the law lifts the corporate veil and identifies the persons (members) who are behind the scene and are responsible for the perpetration of fraud.

Following are some such cases:

1. ***For the protection of revenue:*** The Court may not recognise the separate existence of a company where the only purpose for which it appears to have been formed is the

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tax-evasion or circumvention of tax obligation. D was a rich man having dividend and interest income. He wanted to avoid surtax. For this purpose, he formed four private companies, in all of which he was the majority shareholder. The companies made investments and whenever interest and dividend incomes were received by the companies, D applied to the companies for loans which were immediately granted and never repaid. In a legal proceeding the corporate veils of all the companies were lifted and the incomes of the companies treated as if they were of 'D' [In re Dinshaw Maneckjee Petit (1927) Bom. 371].

2. ***Where the company is acting as agent of the shareholders,*** then the shareholders will be held liable for its acts. There may be an express agreement to this effect or such agreement may be implied from the facts of a particular case.

3. ***Where a company has been formed by certain persons to avoid their own valid contractual obligation,*** the court may proceed on the assumption as if no company existed.

Example: A sold his business to B and agreed not to compete with him for a given number of years within reasonable local limits. A, desirous of re-entering business, in violation of the contractual obligation, formed a private company with majority shareholdings. B filed a suit against A and the private company and the court granted an injunction restraining A and his company with going ahead in the competing business (Gilford Motor Co. v. Horne (1933) 1 Ch. 935).

4. ***Where a company has been formed for some fraudulent purpose or is a 'sham',*** the court will lift the corporate veil to identify the perpetrator of the fraud.

   In Delhi Development Authority v. Skipper Construction Company (P) Ltd. [1996] 4 SCALE 202, the skipper construction company failed to pay the full purchase price of a plot to DDA. Instead construction was started and space sold to various persons. The two sons of the directors who had business in their own names claimed that they had separated from the father and the companies they were running had nothing to do with the properties of their parents. But no satisfactory proof in support of their claim could be produced. Held, that the transfer of shareholding between the father and the sons must also be treated as a sham. The fact that the director and members of his family had created several corporate bodies did not prevent the court from treating all of them as one entity belonging to and controlled by the director and his family.

5. ***Where a company formed is against public interest or public policy,*** for the purpose of determining the character of the members, the Court may lift the corporate veil.

Example: C company was floated in London for marketing tyres manufactured in Germany. The majority of C's shares were held by the German nationals residing in Germany. During World War I, C Company filed a suit against D company for the recovery of trade debt. The D company contended that C company was an alien enemy company (Germany being at war with England at that time) and that the payment of the debt would be a trading with the enemy. The Court agreed with the contention of the defendants [Daimler Co. Ltd. v. Continental Tyre and Rubber Co., (1916) 2AC 307].

6. ***Where device of incorporation is used for some illegal or improper purpose*** [PNB Finance Ltd. v. Shital Prasad Jain (1983) 54 Comp. Cas 66 (Delhi)]. S, the financial advisor of a financing public limited company was given a loan of ₹ 15 lakhs by the company to purchase immovable properties in Delhi. A pronote with regard to the same was also executed by S. S diverted the amount of the loan to three public limited companies floated

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by him and his son. These companies, in turn, applied the amount in purchasing immovable properties at New Delhi. The Delhi High Court refrained the defendants from in any manner alienating, transferring, disposing of or encumbering the properties in question.

7. ***Where the number of members falls below the statutory minimum*** (i.e., seven in the case of a public company and two in the case of a private company) and the company continues to carry on business for more than six months while the number is so reduced. In such a case, every person who is a member of the company during the time that it so carries on business after those six months and has knowledge of that fact, shall be severally liable to the creditors for the payment of the company's debts contracted during that period. Such a member can be sued severally (i.e., directly) by the creditors of the company. Both the privileges of limited liability and that of the separate legal entity are lost. The creditors are permitted to look behind the company to the shareholders for the satisfaction of their claims (s.45).

8. ***Where prospectus includes a fraudulent misrepresentation.*** In case of a prospectus containing fraudulent misrepresentation as to a material fact, Ss. 62 and 63 make the promoters, directors, etc., personally liable not only in damages but they may even be prosecuted in terms of fine up to ₹ 50,000 or imprisonment up to 2 years or both.

9. Where a negotiable instrument is signed by an officer of a company on behalf of the company without mentioning the name of the company thereon, he is personally liable to the holder of the instrument, unless the company has already made the payment on the instrument [s.147 (4) (c)].

10. ***Holding and Subsidiary Companies (Ss. 212-213).*** In the eyes of law, the holding company and its subsidiaries are separate legal entities. However, in the following cases, a subsidiary company may lose its separate identity to a certain extent:

    (a) Where at the end of its financial year, a company has subsidiaries, it may lay before its members in general meeting not only its own accounts, but also a set of group accounts showing the profit or loss earned or suffered by the holding company and its subsidiaries collectively and their collective state of affairs at the end of the year;

    (b) The Central Government, where it feels desirable, may direct the holding and subsidiary companies to synchronize their financial years;

    (c) The Court may, on the facts of a case, treat a subsidiary company as merely a branch or department of one large undertaking owned by the holding company.

11. ***Investigation into related companies.*** Section 239 provides that if it is necessary for the satisfactory completion of the investigation into the affairs of a company, the Inspector appointed to investigate may look into the affairs of another related company in the same management or group.

12. ***For investigation of ownership of a company.*** The separate legal entity may be disregarded under s.247. This Section authorises the Central Government to appoint one or more Inspectors to investigate and report on the membership of any company for the purpose of determining the true persons who are financially interested in the company and who control or materially influence its policy.

13. ***Where in the course of winding up of a company,*** it appears that any business of the company has been carried on, with intent to defraud creditors of the company, or any other persons, or for any fraudulent purpose, the court on the application of the Liquidator, or any creditor or contributory of the company, may, if it thinks proper, declare that any persons who are knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the court may direct (s.542).

Notes

Self Assessment

Fill in the blanks:

7. Where a company has been formed for some fraudulent purpose, the court will lift the ……..to identify the perpetrator of the fraud.
8. Where the company is acting as agent of the shareholders, then the …… will be held liable for its acts.
9. In case of a fraudulent use of the facility of……, the law lifts the corporate veil and identifies the persons who are behind the scene and are responsible for the perpetration of fraud.

7.4 Illegal Association

Section 11 provides that no company, association or partnership consisting of more than 10 persons for the purpose of carrying on the business of banking and more than 20 persons for the purpose of carrying on any other business can be formed unless it is registered under the Companies Act or is formed in pursuance of some other Indian Law. Thus, if such an association is formed and not registered under the Companies Act, it will be regarded as an 'Illegal Association' although none of the objects for which it may have been formed is illegal.

Effects of an Illegal Association

Following are the effects of an association being illegal:

1. Every member is personally liable for all liabilities incurred in the business.
2. Members are punishable with fine which may extend up to ₹ 1,000.
3. Such an association cannot enter into any contract.
4. Such an association cannot sue any of its members or any outsider, not even if the association is subsequently registered as a company.
5. It cannot be sued by a member or an outsider for any debts due to it because it cannot contract any debt.
6. It cannot be wound up even under the provisions relating to winding up of unregistered companies.
7. Where an association is illegal and the business had been carried on for some years, none of its members can sue for partition because partition would involve realisation of the assets of the company and payment of its debts, the very things which would be done in a suit for dissolution of partnership or winding up of a company.
8. The illegality of an illegal association cannot be cured by subsequent reduction in the number of its members.
9. The profits made by an illegal association are, however, liable to assessment to income-tax.

Self Assessment

Fill in the blanks:

10. The profits made by an illegal association are liable to assessment to……...
11. Illegal association cannot enter into any…….
12. Illegal association cannot sue any of its members or……..

Notes

7.5 Classification of Companies

Companies can be classified into three categories according to the mode of incorporation. If a company is incorporated by a charter granted by the monarch, it is called a Chartered Company and is regulated by that charter. For example, the East India Company came into being by the grant of a Royal Charter. Such type of companies do not exist in India. A company which is created by a special Act of the Legislature is called a Statutory Company and is governed by the provisions of that Act. The State Bank of India and the Industrial Finance Corporation of India are two examples of statutory companies. A company brought into existence by registration of certain documents under the Companies Act, 1956 is called Registered Company.

The liability of members of a registered company may be limited or unlimited (s.12). It may be limited by shares, or by guarantee or by both (i.e., shares and guarantee).

A company limited by shares is a registered company having the liability of its members limited by its memorandum of association to the amount, if any, unpaid on the shares respectively held by them. The amount remaining unpaid on the shares can be called up at any time - during the lifetime of the company or at the time of winding up. However, a shareholder cannot be called upon to pay more than the amount remaining unpaid on his shares. His personal assets cannot be called upon for the payment of the liabilities of the company, if nothing remains to be paid on the shares purchased by him. Such a company is also known as a 'Share Company.'

A company limited by guarantee is one having the liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound up. Such a company is also known as 'guarantee company'. The liability of the members of a guarantee company is limited by a stipulated sum mentioned in the memorandum. The guaranteed amount can be called up by the company from the members only at the time of winding up if the liabilities of the company exceed its assets.

Notes A pure 'guarantee company' does not have a share capital. The working funds, if required, are raised from source like fees, donations, subsidy, endowments, grants, subscriptions and the like. Such a company is generally formed for the purpose of promotion of art, science, culture, charity, sport, commerce or for some similar purpose.

A company limited by shares as well as by guarantee is a hybrid form of company which combines elements of the guarantee and the share company. Such a company raises its initial capital from its shareholders, while the normal working funds are provided form other sources such as fees, charges, subscription, etc. Every member of such a company is subject to a two-fold liability, i.e., the guarantee which may become effective in the winding up of the company and the liability to pay up to the nominal amount of his share which may become effective during the lifetime of the company or at the time of winding up.

An unlimited company is a company not having any limit on the liability of its members. The members of such a company are liable, in the event of its being wound up, to the full extent of their fortunes to meet the obligations of the company. However, the members are not liable to the company's creditors. The company, being a separate legal entity from the persons who constitute it, is liable to its creditors. If the creditors cannot obtain payment from the company, they may petition the court for the winding up of the company. The Liquidator will then call upon the members to contribute to the assets of the company without limitation of their liability for the payment of the debts of the company.

Notes

7.5.1 Private and Public Companies

Either of the above kinds of companies (i.e., a limited liability company and an unlimited liability company) may be private or public (s.12).

A private company can be formed by merely two persons by subscribing their names to the Memorandum of Association. It means a company which has a minimum paid-up capital of one lakh rupees or such higher paid up capital as may be prescribed; and by its Articles:

1. restricts the rights of its members to transfer shares;
2. limits the number of its members to fifty, excluding its employee-members or past employee-members; provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purpose of this definition, be treated as a single member;
3. prohibits an invitation to the public to subscribe to its shares and debentures; and
4. prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.

A public company means a company which (a) is not a private company; (b) has a minimum paid-up capital of ₹ 5 lakhs or such higher paid-up capital as may be prescribed; (c) is a private company which is a subsidiary of a company which is not a private company. Section 12 prescribes the minimum number of members as seven who have to subscribe their names to the memorandum of association but there is no restriction with regard to the maximum number of members of a public company. A public company may or may not invite public to subscribe to its share capital. In case, it decides to invite public to subscribe to its share capital, then it has to issue a prospectus. In case, it decides not to invite public to subscribe to its share capital and arranges the capital privately then it need not issue a prospectus; it has simply to submit a statement in lieu of prospectus with the Registrar of Companies at least three days before it can make allotment of shares. The articles of such a company do not contain provisions restricting the right of members to transfer their shares.

Caution It has to be remembered that under the Securities (Contracts) Regulation Act, 1956, shares and debentures of public companies only are capable of being dealt in on a stock exchange.

7.5.2 Distinction between Private and Public Company

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

1. In the case of a private company minimum number of persons to form a company is two while it is seven in the case of a public company.
2. In case of a private company the maximum number of members must not exceed fifty whereas there is no such restriction on the maximum number of members in case of a public company.
3. In private company the right to transfer shares is restricted, whereas in case of public company the shares are freely transferable.
4. A private company cannot issue a prospectus, while a public company may, through prospectus, invite the general public to subscribe for its shares or debentures.

Notes

5. A private company can commence business immediately after receiving the certificate of incorporation, while a public company can commence business only when it receives a certificate to commence business from the Registrar.
6. A private company need not hold a statutory meeting but a public company must hold a statutory meeting and file a statutory report with the Registrar.
7. The directors of a private company are not required to file with the Registrar written consent to act as directors or sign the memorandum of association or enter into a contract for their qualification shares. But the directors of a public company must file with the Registrar their written consent to act as directors, must sign the memorandum and must enter into a contract for their qualification shares.
8. Directors of a private company may be appointed by a single resolution, but it is not so in case of a public company.
9. Directors of a private company are not required to retire by rotation, but in case of a public company, at least two-third of the directors must retire by rotation.
10. The number of directors in a private company may be increased to any extent without the permission of the Central Government, but in case of a public company if the number of directors is to be more than twelve then the approval of the Central Government is necessary.
11. Two members have to be personally present to form the quorum in a private company but in a public company this number is five members.
12. In a private company, there are no restrictions on managerial remuneration.
13. In addition to the above, a private company enjoys some special privileges. A public company enjoys no such privileges.
14. A private company cannot issue share warrants.

7.5.3 Special Privileges and Exemptions Available to a Private Company

A private company enjoys certain special privileges which are not available to a public company. It is so because in a private company the money is raised from few people and generally they belong to the same family or group or are close friends. Therefore, not much public interest is involved therein. But in case of public companies where the money is raised from general public and the number is quite large, it is necessary to safeguard their interests, hence several restrictions are imposed on public companies.

Following are the special privileges available to a private company:

1. A private company can be formed with only two members [s.12 (1)].
2. A private company can proceed to allot shares without waiting for the minimum subscription (s.69). The reason is that a private company is not required to offer shares to the public.
3. A private company is not required to issue a prospectus. Therefore, it can allot shares without issuing a prospectus or delivering to the Registrar a statement in lieu of prospectus [s.70 (3)].
4. A private company need not offer further issue of shares to the existing shareholders, i.e., a private company is free to allot new issue to outsiders [s.81(3)].
5. A private company can issue any kind of shares and allow disproportionate voting rights since Ss. 85 to 89 of the Act are not applicable to it. [s.90(2)].

Notes

6. A private company can commence business immediately after its incorporation [s.149(7)].
7. It need not have an index of members [s.151(1)].
8. A private company is not required to hold a statutory meeting or to file a statutory report with the Registrar of Companies [s.165(10)].
9. Only two members, who are personally present at the meeting, shall form the quorum unless the articles provide for a larger number [s.174(1)].
10. In case of a private company, poll can be demanded by one person present in person or by proxy, if not more than seven persons are present; if the number present is more than seven, two members present in person or by proxy can demand a poll [s.179(1)(b)].
11. A private company need have a minimum of two directors only [s.252 (2)].
12. All the directors may be appointed by a single resolution.
13. The directors of a private company need not file their written consent to act as directors or to take up their qualification share (Ss.264 &266).
14. The directors of a private company need not retire by rotation (s.255).
15. Section 266 dealing with restrictions on appointment or advertisement of directors is not applicable to a private company [s.266 (5)(b)].
16. Where a new director is to be appointed, a special notice of fourteen days is required. This provision is not applicable to a private company, unless it is a subsidiary of a public company [s.257(2)].
17. Directors of a private company can vote on a contract in which they are interested (s.300).
18. A private company is exempted from restrictions regarding managerial remuneration.

Loss of Privileges by a Private Company: Section 43 provides that if a private company contravenes any of the three conditions included in its Articles as per s.3(1) (iii), then it will be treated as if it is a public company and it will then result in loss of privileges and exemptions to which it is normally entitled to.

The provision to s.43 states that if the contravention of any of the three restrictions contained in the articles was accidental, or if the Central Government is satisfied that it is just and equitable to grant relief, it may relieve the company from these consequences on the application by the company or any other interested person.

7.5.4 Conversion of Private Company into a Public Company

Section 44 provides for conversion of a private company into a public company. The procedure is:

1. The company in general meeting must pass a special resolution altering its articles in such a manner that they no longer include the provisions of s.3(1) (iii) which are required to be included in the articles of a private company. On the date of the passing of the resolution, the company ceases to be a private company and becomes a public company.
2. Within thirty days of the passing of the special resolution altering the articles, the company shall file with the Registrar (i) a printed or typewritten copy of the special resolution and (ii) a prospectus or a statement in lieu of prospectus.

   If default is made in filing the resolution and the prospectus or the statement in lieu of prospectus, the company and every officer in default shall be liable to a fine up to ₹ 5,000 for every day of default.

Notes

3. If the number of members is below seven, steps should be taken to increase it to at least seven whilst the number of directors should be increased to at least three, if there are only two directors.
4. The word 'Private' is to be deleted before the word 'Limited' in the name.

7.5.5 Conversion of Public Company into a Private Company

There is no direct or express provision in the Act for the conversion of a public company into a private company except a reference in the proviso to s.31(1). A public company having a share capital and membership within the limits imposed upon private companies by s.3(1) (iii), may become a private company by following the procedure as given below:

1. The company in general meeting has to pass special resolution for altering the articles so as to include therein the necessary restrictions, limitations and prohibitions and to delete any provision inconsistent with the restrictions. For instance, a private company has to put certain restrictions on the right of members to transfer their shares.
2. The word 'Private' should be added before 'Limited'.
3. The approval of the Central Government to the alteration in the articles for converting a public company into a private company should be obtained.
4. Within one month of the date of the receipt of the order of approval, a printed copy of the altered articles must be filed with the Registrar.
5. With thirty days of the passing of the special resolution, a printed or typewritten copy thereof should be filed with the Registrar.

Task The directors of a public limited company accepted a bill of exchange on behalf of their company. But the word 'Ltd.,' was omitted from the name of the company at the time of acceptance of the bill of exchange. Who can be held liable for the payment of the bill?

7.5.6 Holding and Subsidiary Companies

Where a company has control over another company, it is known as the Holding Company and the company over which control is exercised is called the Subsidiary Company. A company is deemed to be under the control of another if:

1. that other controls the composition of its Board of Directors; or
2. the other company holds more than half in nominal value of its equity share capital (where a company had preference shareholders, before commencement of this Act, enjoying voting rights with that of equity shareholders, for the purpose of control, holding company should enjoy more than half of the total voting power);
3. it is a subsidiary of a third company which itself is a subsidiary of the controlling company. For example, where company 'B' is a subsidiary of company 'A' and company 'C' is a subsidiary of company 'B', then company 'C' shall be a subsidiary of company 'A'. If company 'D' is a subsidiary of company 'C', then company 'D' shall also be a subsidiary of company 'B' and consequently also of company 'A'.

Thus, in order to be holding company, a company must either control the composition of the Board of Directors or hold more than half of the nominal value of the equity share capital of another company.

Notes

Control of composition of board of directors. The composition of the Board of Directors of a company shall be deemed to be controlled if the latter has the power, without the consent or concurrence of the other person, to appoint or remove the holders of all or majority of the directorships.

A company shall be deemed to have the power to appoint a person as a director in other company in the following cases:

1. Where a person cannot be appointed thereto without the exercise in his favour by the company of such a power of appointment.
2. Where a person's appointment or directorship follows necessarily from his appointment as director, or manager of, or to any other office or employment in the company.
3. Where a directorship is held by an individual nominated by the company or a subsidiary thereof.

In determining whether one company is a subsidiary of another, following shall be disregarded:

1. Any shares held or power exercisable by the other company in a fiduciary capacity shall be treated as not held or exercisable by it.
2. Any shares held or power exercisable in a company by any person under provisions of its debentures or of a trust-deed for securing any issue of such debentures shall be disregarded.
3. Any shares held or power exercisable by, or by a nominee for a company or its subsidiary, other than as in clause (2) above, shall be treated as not held or exercisable by it if the ordinary business of that other company is lending money and the shares are held or power is exercisable only by way of security in the ordinary course of business.

However, shares held or power exercisable by any person as a nominee of that other company shall be treated as held or exercisable by the said company. Thus, the shares held or power exercisable by a subsidiary shall be treated as 'held' or 'exercisable' by the holding company. For example, 'B' and 'C', are subsidiaries of company 'A', and both of them hold together more than half of the equity share capital of company 'D' then 'D' shall be deemed to be a subsidiary of 'A' although it has not made any direct investment nor 'B' or 'C' singly hold more than 50% shares, in the company 'D'.

Did u know? **One-man Company**

A member may hold virtually the entire share capital of a company. Such a company is known as a 'one-man company'. This can happen both in a private company and a public company. The other member/members of the company may be holding just one share each. Such other members may be just dummies for the purpose of fulfilling the requirements of law as regards minimum membership.

7.5.7 Non-trading Company or Association not for Profit

The name of a limited company must end with the word 'limited' in the case of a public company and with 'private limited' in the case of a private limited company (s.13). But, s.25 permits the registration, under a license granted by the Central Government, of associations not for profit with limited liability without using the word 'limited' or 'private limited' to their names on certain conditions. Such a company must have the objects of promoting commerce, arts, science, religion, charity or any other useful object and must apply its profits, if any, or other income in promoting its object and must prohibit payment of any dividend to its members. As soon as it obtains a license and is registered accordingly, it will have the same privileges and obligations

Notes

that a limited company has under the Act. This licence is revocable by the Central Government and on revocation, the Registrar will put 'Limited' or 'Private Ltd' against the company's name in the Register maintained by him. But before taking such a step, the Central Government has to give a written notice of its intention to revoke the licence and also an opportunity to be heard in the matter.

It is worth noting that even a partnership firm can be a member of such a company, in its own name. But on dissolution of the partnership, its membership of the company will come to an end [s.25 (4)].

7.5.8 Government Company

Section 617 defines a Government Company as any company in which not less than 51% of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments and includes a company which is a subsidiary of a Government Company.

Government Companies are as much governed by the provisions of the Companies Act as any other company; but by virtue of s.620 the Central Government may direct that any of the provisions of the Act will not apply to them or shall apply only with such exceptions, modifications and adaptations as may be notified by the Government. However, the Central Government cannot exempt the Government Companies from the provisions of Ss.619 and 619-A which specifically deal with such companies.

Section 619 provides that the auditor of a Government Company shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor-General of India. The ceilings on the number of audits to be undertaken by an auditor under s.224 are equally applicable to audit of Government Companies. The Comptroller and Auditor General of India have the power to direct the manner in which the accounts are to be audited and to give instructions to the auditor in regard to any matter relating the performance of his functions. He is also empowered to get a supplementary test audit of accounts conducted by persons authorised by him. The auditor of the Government Company has to submit a copy of his audit report to the C.&A.G.I. who has the right to comment upon, or supplement the audit report in such manner as he thinks fit. Such comments or supplementary audit report must be placed before the annual general meeting of the company at the same time and in the same manner as the auditor's report.

Section 619-A provides that the Central Government must place before both House of Parliament an annual report on the working and affairs of each Government Company to be prepared within three months of its annual general meetings, together with a copy of the audit report and any comments upon or supplement to, such audit report, made by the C.& A.G.I. Where a State Government is a participant in a Government Company, this report has, likewise, to be placed before the State Legislature.

Section 619-B provides that the provisions of s.619 as stated above also apply to a company in which the Central Government or any State Government or any Government Corporation hold either singly or jointly not less than 51% of the paid-up share capital.

7.5.9 Foreign Company

Foreign Company is a company incorporated in a country outside India and has a place of business in India.

However, where not less than 50% of the paid-up share capital (whether equity or preference or partly equity and partly preference) of a company incorporated outside India and having an

Notes

established place of business in India, is held by one or more citizens of India or by one or more Indian bodies corporate, such company shall comply with such of the provisions of the Act as may be prescribed with regard to the business carried on by it in India.

Section 592 requires that every foreign company which establishes a place of business in India, must, within 30 days of the establishment of such place of business, file with the Registrar of Companies at New Delhi and also the Registrar of Companies of the State in which such place of business is situated: (a) a certified copy of the memorandum and articles of the company and if they are not in English, then a certified translation thereof; (b) the full address of the registered office of the company; (c) a list of the directors of the company and its secretary with full particulars of their nationality, address and business or occupation; (d) the names and addresses of one or more persons resident in India who are authorised to accept service of process or notice or other documents to be served on the company; and (e) the address of the principal place of business in India.

Section 593 provides that in case of any alteration in any of the above particulars, the company has to file with the Registrar of Companies a return of such alteration within the prescribed time.

Section 594 makes the application of the provisions regarding books of account to be kept by a company under s.209 to a foreign company so far as it concerns its business in India. The books of account must be kept at the principal office in India and three copies of balance sheet, profit and loss account and other documents must be delivered to the Registrar with a list in triplicate of all places of business in India.

Section 595 requires a foreign company to exhibit conspicuously on the outside of every office or place of business in India the name of the company and 'limited' or 'private limited,' if it is a limited company and the country in which it is incorporated in English as well as in the local languages in general use in the locality in which the office is situated. Also the prospectus issued in India must contain this information.

Section 596 provides the procedure for service of any process, notice or other documents on a foreign company and it shall be deemed to have been served, if addressed to any person whose name has been delivered to the Registrar of Companies under s.592.

Section 597 provides that the foreign company must also deliver the documents under s.592 to the Registrar of Companies, New Delhi.

Section 598 provides penalty for default in complying with any of the foregoing requirements. The company and every officer of the company who is in default shall be punishable with fine up to ₹ 10,000 and in the case of a continuing default with an additional fine up to ₹ 1000 for every day during which the default continues.

Section 599 provides that the foreign company which fails to comply with the foregoing provisions is prohibited from enforcing any contract by way of a suit, set-off or counter-claim, although it will be liable to be sued in respect of any contract it may have entered into.

Section 584 provides for the winding up of a foreign company. Where a foreign company, which has been carrying on business in India, ceases to carry on such business in India, it may be wound up as an unregistered company under Part X (Ss.582-590), notwithstanding the fact that the company has been dissolved or ceased to exist under laws of the country in which it was incorporated

Self Assessment

Fill in the blanks:

13. A company limited by shares as well as by guarantee is a ……form of company which combines elements of the guarantee and the share company.

Notes

14. Where a company has control over another company, it is known as the Holding Company and the company over which control is exercised is called the ……Company.

15. In the case of a private company minimum number of persons to form a company is two while it is …….. in the case of a public company.

Case Study

Salomon's Limited Liability

Salomon carried on business as a leather merchant. He sold his business for a sum of £30,000 to a company formed by him along with his wife, a daughter and four sons. The purchase consideration was satisfied by allotment of 20,000 shares of £1 each and issue of debentures worth £10,000 secured by floating charge on the company's assets in favour of Mr. Salomon. All the other shareholders subscribed for one share of £1 each. Mr. Salomon was also the managing director of the company. The company almost immediately ran into difficulties and eventually became insolvent and winding up commenced. At the time of winding up, the total assets of the company amounted to £6,050; its liabilities were £10,000 secured by the debentures issued to Mr. Salomon and £8,000 owing to unsecured trade creditors.

The unsecured sundry creditors claimed the whole of the company's assets, viz. £6,050 on the ground that the company was a mere alias or agent for Salomon.

Question

Do you agree to the claims of the unsecured trade creditors? Comment.

7.6 Summary

- A company is an association of many persons who contribute money or money's worth to a common stock, and employs it in some business, and who share the profit and loss arising there from.
- Shares in a company are transferable.
- An association of persons, once incorporated under the Companies Act, 1956 become a legal entity, having its own entity separate from its members.
- The company, being a separate person, its members are not as such liable for its debts.
- A company limited by shares is a registered company having the liability of its members limited by its memorandum of association to the amount, if any, unpaid on the shares respectively held by them.
- The advantages of incorporation are allowed to be enjoyed only by those who want to make an honest use of the 'company'.
- In case of a dishonest and fraudulent use of the facility of incorporation, the law lifts the corporate veil and identifies the persons who are behind the scene and are responsible for the perpetration of fraud.
- If such an association is formed and not registered under the Companies Act, it will be regarded as an 'Illegal Association' although none of the objects for which it may have been formed is illegal.

Notes

- Where a company has control over another company, it is known as the Holding Company and the company over which control is exercised is called the Subsidiary Company.
- Foreign Company is a company incorporated in a country outside India and has a place of business in India.

7.7 Keywords

Common Seal: It is the official signature of a company.

Holding Company: Where a company has control over another company, it is known as the Holding Company.

Public Company: It means a company which is not a private; has a minimum paid-up capital of ₹ 5 lakhs.

Subsidiary Company: The Company over which control is exercised is called the Subsidiary Company.

Unlimited Company: It is a company not having any limit on the liability of its members.

7.8 Review Questions

1. "The legal personality of a company is distinct from its members individually and collectively". Comment and point out the circumstances when the separate entity of a company is disregarded by the courts.
2. Explain the meaning of 'Perpetual Succession' and 'Common Seal' in the case of a company.
3. Write explanatory notes on:
   (i) Minimum number of members of a company
   (ii) 'Illegal Association'
   (iii) Maintenance of minimum number of members of a company.
4. Savoy Ltd., had eight members at the time of incorporation. Within two months, two of the members transferred their shares to one of the existing members. By the end of the year, the company went into liquidation. All the shares are fully paid-up. The creditors of the company sought to recover their dues from the company. The liquidator demanded money from the shareholders, who refused to accept any liability; their shares being fully paid-up. Explain the legal position.
5. A husband and wife who were the only two members of a private ltd., company were killed in a motor accident. Does the company also die with them?
6. State the principles of law laid down in Salomon vs Salomon & Co.
7. What is the significance of the concept of limited liability?
8. What do you understand by 'Corporate Veil'? When is this said to be lifted?
9. State the various classes of companies that can be formed under the act. Explain the characteristics of each.
10. What does a private company have to do in order to become a public company?

Notes

Answers: Self Assessment

1.	legal	2.	company
3.	body corporate	4.	Articles
5.	Common seal	6.	subscribers
7.	corporate veil	8.	shareholders
9.	incorporation	10.	income-tax
11.	contract	12.	outsider
13.	hybrid	14.	Subsidiary
15.	seven		

7.9 Further Reading

Book S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.

Online links isid.org.in/pdf/CompLaw.PDF

www.vakilno1.com/bareacts/companiesact/companiesacts.htm

Unit 8: Formation of a Company

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Discuss about the promotion of a company;
- Recognize the significance of registration;
- Explain the context of flotation;
- Describe the aspects concerning certificate of business.

Introduction

The whole process of formation of a company may be roughly divided, for convenience, into four parts. These are: (i) Promotion; (ii) Registration/Incorporation, (iii) Floatation/Raising of capital; and (iv) Commencement of business.

8.1 Promotion

Promotion is a term of wide importance denoting the preliminary steps taken for the purpose of registration and floatation of the company. The persons who assume the task of promotion are called promoters. The promoter may be an individual, syndicate, association, partnership or a company.

Notes

8.1.1 Who is a Promoter?

Perhaps, the true test of whether a person is a promoter, whether he has a desire that the company be formed and is prepared to take some steps necessary, therefore, which may or may not involve other persons and implements his plans to form the company. However, persons assisting the promoters by acting in a professional capacity do not thereby become promoters themselves. The solicitor who drafts the articles, or the accountant who values assets of a business to be purchased, are merely giving professional assistance to the promoters. If, however, a professional goes further than this, e.g., by introducing his client to a person who may be interested in purchasing shares in the proposed company, he would be regarded as a promoter.

Did u know? **Sections that uses term promoter**

This term has not been defined under the Act, although the term is used expressly in Ss.62, 69, 76, 478 and 519.

8.1.2 Duties and Liabilities of Promoters

(Promoters' Legal position) Promoters have been described to be in fiduciary relationship (relationship of trust and confidence) with the company. He should not make any secret profit at the expense of the company he promotes, without the knowledge and consent of the company and if he does so, the company can compel him to account for it. A promoter is not forbidden to make profit, but to make secret profit.

In Gluckstein vs. Barnes (1900) AC 240, a syndicate of persons was formed to buy a property called 'Olympia' and resell it to a company to be formed for the purpose. The syndicate first bought the debentures of the old Olympia company at a discount. Then they bought the company itself for £ 1,40,000. Out of this money provided by themselves, the debentures were repaid in full and a profit of £ 20,000 made thereon. They promoted a new company and sold Olympia to it for £ 1,80,000. The profit of £ 40,000 was revealed in the prospectus but not the profit of £ 20,000.

Held: Profit of £ 20,000 was a secret profit and, the promoters of the company were bound to pay it to the company because the disclosure of this profit by themselves in the capacity of vendors to themselves in the capacity of directors of the purchasing company, was not sufficient.

Disclosure to be made to whom? In Erlanger vs New Sombrero Phosphate Co., (39 LT 269), it was held that the disclosure should be made to an independent and competent Board of directors. This duty is not discharged if the disclosure is made to the Board of directors who are mere nominees of the majority shareholders/promoters, or are in his pay.

Where it is not possible to constitute an independent Board of directors, the disclosure should be made to the whole body of persons who are invited to become shareholders and this can be done through the prospectus. Thus, the promoters have to ensure that 'the real truth is disclosed to those who are induced by the promoters to join the company.'

Caution The relationship of trust and confidence requires the promoter to make a full disclosure of all material facts relating to the formation of the company.

Liabilities of a promoter are:

1. ***For non-disclosure:*** In case a promoter fails to make full disclosure at the time the contract was made, the company may either: (i) rescind the contract and recover the purchase price

where he sold his own property to the company, or (ii) recover the profit made, even though rescission is not claimed or is impossible, or (iii) claim damages for breach of his fiduciary duty. The measure of damages will be the difference between the market value of the property and the contract price.

2. ***Under the Companies Act:*** (i) Promoter is liable to the original allottee of shares for the misstatements contained in the prospectus. It is clear that his liability does not extend to subsequent transferees. He may also be imprisoned for a term which may extend to 2 years or may be punished with fine up to ₹ 50,000 for such untrue statements in the prospectus (s.62 and 63). (ii) In the course of winding up of the company, on an application made by Official Liquidator, the court may make a promoter liable for misfeasance or breach of trust (s.543). The court may also order for the public examination of the promoter (Ss.478 and 519).

Notes Where there are more than one promoters, they are jointly and severally liable and if one of them is sued and pays damages, he is entitled to claim contribution from other or others. However, the death of a promoter does not relieve his estate from liability arising out of abuse of his fiduciary position.

Self Assessment

Fill in the blanks:

1. ……is a term of wide importance denoting the preliminary steps taken for the purpose of registration and floatation of the company.
2. The persons who assume the task of promotion are called……..
3. Promoters have been described to be in ……relationship with the company.
4. Under the Companies Act promoter is liable to the …….allottee of shares for the misstatements contained in the prospectus.

8.2 Registration (Ss.12, 33)

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

Section 33 states that for the purpose of registration of a company, the following three documents are required to be presented to the registrar of the State in which the registered office of the company is to be situated: (i) the memorandum of the company; (ii) the articles, if any; (iii) the agreement, if any, which the company proposes to enter into with any individual for appointment as its managing or whole-time director or manager.

The documents in (i) and (ii) above are required to be signed by seven persons in the case of a public company and by two persons in the case of a private company. As we shall see later, certain types of companies need not frame their own articles, in that case "Regulations for Management of a Company Limited by Shares" (given in Table A of Schedule I to the Act, 1956) may be adopted.

Notes

Section 33 also requires a declaration to be filed with the registrar along with the memorandum and the articles. This is known as "Statutory Declaration of Compliance." It can be made by an advocate of supreme court or high court, an attorney or pleader entitled to appear before a high court, or a company secretary or a chartered accountant in whole-time practice in India, who is engaged in the formation of the company, or by a person named in the articles as a director, manager or secretary of the company. The declaration must certify that all requirements of the Act and Rules made thereunder in respect of registration have been complied with.

Section 266 requires that if the first directors are appointed by the articles then the following must be complied with before the registration of articles with the registrar: (i) written consent of those directors to act, signed by themselves, or by an agent duly authorised in writing; and (ii) an undertaking in writing signed by each such director to take from the company and pay for his qualification shares (if any), unless he has taken his qualification shares and paid or agreed to pay for them, or signed the memorandum for a number of shares not less than the qualification shares.

Section 266 is applicable only to a public company having a share capital.

The following two documents, though not required to be filed for the purpose of registration, are usually delivered along with the aforesaid documents. (i) The address of the registered office of the company (s.146). (ii) Particulars regarding directors, manager and secretary, if any (s.303).

These two documents are required to be submitted within thirty days of registration of the company.

8.2.1 Availability of Name

Section 20 states that a company cannot be registered by a name, which in the opinion of the Central Government is undesirable. Therefore, it is advisable that promoters find out the availability of the proposed name of the company from the registrar. For the purpose, three names in order of priority should be filed with the registrar.

8.2.2 Certificate of Incorporation/Consequences of Incorporation

When the aforesaid documents have been filed with the registrar and the necessary fees paid, the registrar will, if he is satisfied, enter the name of the company on the register maintained by him (s.33) and then will issue a certificate of incorporation under his signature as a token of registration of the company on the date noted on it (s.34). This certificate serves the same purpose in the case of a company which a birth certificate does in the case of a natural person.

On registration, the company comes into existence as a legal person distinct from its members who constitute it, from the earliest moment of the day of incorporation stated in the certificate of incorporation, with rights and liabilities similar to a natural person, competent to enter into contracts (s.34).

The certificate of incorporation is conclusive evidence that all the requirements of the Companies Act in respect of registration and of matters precedent and incidental thereto have been complied with. Accordingly, if a memorandum is found to be materially altered after signature but before registration (Peel case, (1867) 2 Ch App 674), or is signed by only one person for all the seven subscribers or the signatories be all infants (Moosa Goolam Ariff vs. Ebrahim Gulam Ariff ILR (1913) 40 Cal 1 PC), the certificate would be nevertheless conclusive and would not affect the status and existence of the company as a legal person although such irregularities might give rise to claim between the subscribers.

This provision prevents the reopening of matters prior and contemporaneous to the registration and essential to it and it places the existence of the company as a legal person beyond doubt.

Notes

In the case of Moosa vs. Ebrahim (supra), the memorandum was signed by two adult persons and by a guardian of the other five members, who were minors. The registrar, however, registered the company and issued a certificate of incorporation. The court held the certificate to be conclusive for all purposes.

In another case of Jubilee Cotton Mills Ltd. vs. Lewis (1924) AC 958, the registrar issued a certificate of incorporation on January 8th, but dated it January 6th, which was the date he received the documents. On January 6th, the company had made an allotment of share to Lewis.

Held: That the certificate was conclusive evidence of incorporation on January 6th and that the allotment was not void on the ground that it was made before the company was incorporated.

Caution If a company has been incorporated with illegal objects, the illegal objects would not become legal by the issue of the certificate of incorporation.

Section 36 states that, on registration, memorandum and articles of the company bind the company and its members to the same extent as if they respectively had been signed by the company and by the members and contained covenants on its and their part to observe all the provisions contained in the memorandum and articles.

Self Assessment

Fill in the blanks:

5. A company cannot be registered by a name, which in the opinion of the Central Government is……..
6. The certificate of incorporation is ……..evidence that all the requirements of the Companies Act in respect of registration and of matters precedent and incidental thereto have been complied with.
7. The promoters will have to get together at least …….persons in the case of a public company to subscribe to the memorandum of association.

8.3 Floatation

When a company has been registered and has received its certificate of incorporation, it is ready for 'floatation', that is to say, it can go ahead with raising capital sufficient to commence business and to conduct it satisfactorily.

We have seen earlier under 'classification of companies' that a private company is prohibited from inviting public to subscribe to its share capital. Therefore, when a private company is formed, the necessary capital is obtained from friends and relatives by private arrangement.

In the case of a public company also, the promoters may not invite public to subscribe to its share capital and may arrange the capital privately as in the case of a private company. In such a case, the intention of the promoters is to avail of the advantages of incorporation not available to a private company, e.g., to have unlimited number of members, to confer unrestricted right to transfer shares on the members, etc.

However, by far a large number of public companies raise their capital in the very first instance by inviting public to subscribe to their share capital.

Notes

Notes Section 70 makes it obligatory for every public company to take either of the following two steps: (i) Issue a prospectus in case public is to be invited to subscribe to its capital, or (ii) Submit a 'statement in lieu of prospectus' with the registrar at least 3 days before the allotment, in case capital has been arranged privately.

Self Assessment

Fill in the blanks:

8. When a private company is formed, the necessary capital is obtained from friends and relatives by …….

9. When a company has been registered and has received its…….., it is ready for floatation.

10. Section 70 makes it obligatory for every public company to issue a ……in case public is to be invited to subscribe to its capital.

11. ……means company can go ahead with raising capital sufficient to commence business and to conduct it satisfactorily.

8.4 Commencement of Business

We have mentioned earlier that one of the privileges of a private company is that it has neither to issue a prospectus nor to submit a statement in lieu of prospectus with the registrar. It can go ahead with the allotment of shares without these formalities and, therefore, can commence business immediately after the certificate of incorporation has been obtained. Section 149 exempts a private company from obtaining a certificate to commence business.

However, in the case of every public company having a share capital, it is absolutely necessary to obtain a certificate to commence business. This certificate can be obtained only after 'floatation' of the company.

The procedure for obtaining this certificate varies with the fact whether the company has issued a prospectus or not. If the company has issued a prospectus, then the procedure stated in s.149 (1) becomes applicable, and if it has not issued a prospectus, then the procedure as laid down in s.149 (2) shall apply.

Where the Company has issued a prospectus. s.149 (1) provides that if a company having a share capital has issued a prospectus, it shall not commence business or exercise any borrowing powers unless:

(a) Shares up to the amount of the minimum subscription have been allotted by the company;

(b) Every director of the company has paid to the company, on each of the shares taken or contracted to be taken by him and for which he is liable to pay in cash, the same proportion as is payable on application and allotment on the shares, offered for public subscription;

(c) No money is, or may become, liable to be repaid to the applicants for shares or debentures offered for public subscription, for failure to apply for, or to obtain permission for the shares to be dealt in any recognised stock exchange;

(d) There has been filed with the registrar a duly verified declaration by one of the directors or the secretary or, where the company has not appointed a secretary, a secretary in

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whole-time practice in the prescribed form (Form No. 19) that clauses (a), (b) and (c) (mentioned above) have been complied with.

Where the company has not issued a prospectus. If a public company having a share capital has not issued a prospectus, s.149 (2) requires that it shall not commence business or exercise its borrowing powers unless:

(a) It has filed with the registrar a statement in lieu of prospectus;

(b) Every director of the company has paid to the company on each of the shares taken or contracted to be taken by him and for which he is liable to pay in cash, the same proportion as is payable on application and allotment on the shares payable in cash;

(c) There has been filed with the registrar duly verified declaration by one of the directors or the secretary or where the company has not appointed a secretary, a secretary in whole-time practice in the prescribed form, that clause (b), as stated above, has been complied with.

When the company has complied with these conditions, the registrar will issue a certificate to commence business.

Did u know? **Penalty provisions related to certificate to commence business**

Penalty: If any public company having a share capital commences business or exercises borrowing power without obtaining the certificate to commence business, then every person at fault is liable to a fine up to ₹ 5000 for every day of default.

The certificate to commence business entitles the company to commence business given in the main objects clause of the memorandum. No business given in the 'other objects' clause can be commenced without obtaining prior approval of the shareholders by special resolution. However, the Central Government may, on an application made by the board of directors allow a company to commence business in the 'other objects' clause, even if only ordinary resolution is passed by the company in general meeting.

Task A company was incorporated on 6 October, 2005. The certificate of incorporation of the company was issued by the registrar on 15 October, 2005. The company, on 10 October, 2005 entered into a contract which created its contractual liability. The company denies the said liability on the ground that it is not bound by the contract entered into prior to issue of certificate of incorporation. Decide, under the provisions of the Companies Act, 1956, whether the company can be exempted from the said contractual liability?

Self Assessment

Fill in the blanks:

12. Section …….. exempts a private company from obtaining a certificate to commence business.

13. In the case of public company having a share capital, it is absolutely necessary to obtain a ……

14. The certificate to commence business can be obtained only after …….. of the company.

Notes

15. The certificate to commence business entitles the company to commence business given in the main ……..clause of the memorandum.

Case Study

Holding Co-formation: SBI 'Putting Everything in Place'

SBI on its way to form a holding company for its insurance and asset management ventures, will ensure that all legal issues, some of which had cropped up recently when the ICICI group initiated a similar plan, are adequately addressed.

SBI, which may allow a few strategic investors to take minor stakes in the company, is looking at a smooth formation, Mr O.P. Bhatt, Chairman, said.

The bank's plan assumes significance in the context of the recent move by its peer, which had faced certain critical issues, at least temporarily.

SBI, which will in due course consider the possibility of listing the holding outfit too, intends to go ahead with its formation fairly early. The company will enable the bank to bring about greater synergy in its operations, it is felt.

Insurance, MF business

The holding company is aimed at SBI's insurance and mutual funds businesses. The insurance company, a joint venture with Cardiff, is known to be making quick strides in a rapidly evolving market.

The funds business, a joint venture with Societe Generale, has recently crossed a crucial landmark on the AUM (assets under management) front. Both Cardiff and SG are large players internationally.

Credit, Deposit Growth

The bank on another front is targeting a credit growth of about 25 per cent and a deposit growth of about 20 per cent. It is also aiming to shore up its capital base adequately. As things stand, the Government's share in SBI's equity will not come down below 55 per cent. It is now roughly 59 per cent.

Incidentally, interest rates, the Chairman told newspersons while replying to a question, have more or less peaked.

SBI, one of the select players permitted by the pension regulator to provide pension fund management, is lining up a separate company for the purpose.

It intends to pursue the pension venture on its own and not tie up with any other entity, foreign or otherwise.

Holding Co's Valuation

The proposed holding company's valuation currently stands at about $7 billion, Mr Bhatt maintained, adding that the figure is based chiefly on the kind of business recorded by the State Bank group's insurance company.

The valuation is 'live' — it is expected to change frequently with time — and is based on calculations worked out by the bank internally. The strategic investors that may be allowed to come in by the bank will hold 5-10 per cent in the proposed company.

Contd...

Notes

The holding firm will account for a critical part of the State Bank group's plan for the future, it is pointed out.

The group is soon expected to see some action on the subsidiaries, courtesy a proposal to start offering shares to the public.

Question

What are the advantages and obstacles in the move of this formation process taken by SBI?

Source: http://www.thehindubusinessline.in/2007/08/03/stories/2007080352230600.htm

8.5 Summary

- Promotion is a term of wide importance denoting the preliminary steps taken for the purpose of registration and floatation of the company.
- The persons who assume the task of promotion are called promoters.
- Promoters have been described to be in relationship of trust and confidence with the company.
- Where there are more than one promoters, they are jointly and severally liable and if one of them is sued and pays damages, he is entitled to claim contribution from other or others.
- For purpose of registration of company, three documents required to be presented to the registrar are (i) the memorandum (ii) the articles, if any; (iii) the agreement, if any, which the company proposes to enter into with any individual for appointment as its managing or whole-time director or manager.
- A company cannot be registered by a name, which in the opinion of the Central Government is undesirable.
- The certificate of incorporation is conclusive evidence that all the requirements of the Companies Act in respect of registration and of matters precedent and incidental thereto have been complied with.
- When a company has been registered and has received its certificate of incorporation, it is ready for 'floatation', that is to say, it can go ahead with raising capital sufficient to commence business and to conduct it satisfactorily.
- In the case of every public company having a share capital, it is absolutely necessary to obtain a certificate to commence business. This certificate can be obtained only after 'floatation' of the company.
- The certificate to commence business entitles the company to commence business given in the main objects clause of the memorandum.

8.6 Keywords

Articles of Association: They are basic internal rules of operation for a business that govern what tasks need to be done, what positions are required to perform and how the processes in place are to be performed.

Certificate to Commence Business: A certificate that entitles the company to commence business given in the main objects clause of the memorandum.

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Floatation: It means company can go ahead with raising capital sufficient to commence business and to conduct it satisfactorily.

Memorandum of Association: The document that governs the relationship between the company and the outside and one of the documents required to incorporate a company.

Promoter: The persons who assume the task of promotion are called promoters.

8.7 Review Questions

1. Who is a promoter of a company? Discuss, citing legal cases, his legal position in relation to the company he promotes.
2. What are the liabilities of promoters under the Companies Act, 1956?
3. Describe the various stages of incorporation of a public company limited by shares. What documents are required to be filed for incorporation? Discuss the nature and purpose of such documents.
4. State the steps you would take to obtain a certificate of incorporation.
5. What are the conditions precedent to be complied with by a company for obtaining a certificate to commence business? Are these conditions applicable to all classes of companies?
6. What are the steps you would take to get hold of Certificate of commencement of business in the case of a public limited company?
7. A promoter stands in a fiduciary relationship with the company he promotes. Explain.
8. Akash and Suman have been carrying on business in partnership as building contractors in a small town for some years. They carry on most of the work themselves and only occasionally employ labour. They have no plans to enlarge the area of their operations. It has been suggested to them that they ought to trade as a private company limited by shares. What are the alleged advantages of trading as a private company limited by shares? Are there any disadvantages in so trading?
9. Shyam forges all the seven signatures on a memorandum of association, and he obtains a certificate of incorporation. After some time, the registrar comes to know and wants to revoke the certificate. Can he do so?
10. The registrar of companies issued a certificate of incorporation on 8 January, 2006. However, by mistake, the certificate was dated 5 January, 2006. An allotment of shares had been made on 7 January, 2006. Can the allotment be declared void on the ground that it was made before the company was incorporated?

Answers: Self Assessment

1.	Promotion	2.	promoters
3.	fiduciary	4.	original
5.	undesirable	6.	conclusive
7.	seven	8.	private arrangement
9.	certificate of incorporation	10.	prospectus
11.	Floatation	12.	149

13. certificate to commence business.
14. floatation
15. objects.

Notes

8.8 Further Reading

Book S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.

Online links madaan.com/incorporateprocedure.html

www.companyformationindia.com/

Notes

Unit 9: Memorandum of Association

CONTENTS

Objectives

After studying this unit, you will be able to:

- Recognize the meaning and significance of memorandum of association;
- Explain the doctrine of ultra vires;
- Discuss about the alteration of memorandum;
- Describe the guidelines for availability of names.

Introduction

The memorandum of association of a company is its charter which contains the fundamental conditions upon which the company alone can be incorporated. It tells us the objects of the company's formation and the utmost possible scope of its operations beyond which its actions cannot go. Thus, 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.

Notes

9.1 Form and Contents

The memorandum serves a two-fold purpose. It 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. Thus, the intending shareholder can find out the field in – or the purpose for – which his money is going to be used by the company and, what risk he is taking in making the investment. Also, anyone dealing with the company, say, a supplier of goods or money, will know whether the transaction he intends to make with the company is within the objects of the company and not ultra vires its objects.

Section 14 requires that the memorandum of a company shall be in one of the forms as shown in Tables B, C, D and E in Schedule I to the Act, as may be applicable in the case of the company, or in a form as near thereto as circumstances admit. Section 15 requires the memorandum to be printed, divided into paragraphs, numbered consecutively and signed by at least seven persons (two in the case of a private company) in the presence of at least one witness, who will attest the signature. Each of the members must take at least one share and write opposite his name the number of shares he takes. Section 13 requires the memorandum of a limited company to contain: (i) the name of the company, with 'limited' as the last word of the name in the case of a public company and 'private limited' as the last words in the case of a private company; (ii) the name of the State, in which the registered office of the company is to be situated; (iii) the objects of the company, stating separately 'main objects' and 'other objects'; (iv) the declaration that the liability of the members is limited; and (v) the amount of the authorised share capital, divided into shares of fixed amounts. These contents of the memorandum are called compulsory clauses and are explained.

9.1.1 The Name Clause

The promoters are free to choose any suitable name for the company provided:

1. The last word in the name of the company, if limited by shares or guarantee is 'limited' unless the company is registered under s.25 as an 'association not for profit' [s.13(1) (a) & s.25].
2. In the opinion of the Central Government, the name chosen is not undesirable [s.20(1)].

Did u know? The Department of Company Affairs has issued guidelines for deciding availability of names. However these are not exhaustive but only illustrative of what is considered as an undesirable name under s.20.

3. The name of the company should not be identical or should not too nearly resemble the name of another registered company.

9.1.2 Two Similar Names

In case of two similar names, the resemblance between the two names must be such as to be calculated to deceive. A name shall be said to be calculated to deceive where it suggests some connection or association with the existing company.

Example: In Society of Motor Manufacturers and Traders Ltd. vs. Motor Manufacturers and Traders Mutual Assurance Ltd. (1925) 1 Ch. 675, the plaintiff company brought an action to restrain the defendant company to use the said name. But, Lawrence, J., held "anyone who took the trouble to think about the matter, would see the defendant company was an insurance

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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."

Example: In Asiatic Govt. Security Life Insurance Co. Ltd. vs. New Asiatic Insurance Co. Ltd. (1939) 9 Comp. Cas. 208, the court held the two names were not too identical and therefore did not restrain the defendant from using their name.

Example: In Ewing vs. Buttercup Margarine Co. Ltd. (1917), 2 Ch 1, the plaintiff who carried on business under the name of the Buttercup 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.

Example: In Executive Board of the Methodist Church in India vs. Union of India (1985) 57 Comp. Cas. 443 (Bom), the Methodist Church in India sought registration of a company in the name of 'Methodist Church in India Trust Association'. There was already existing a company bearing the name Methodist Church in Northern India Trust Association (P) Ltd.' in Calcutta. The former secretary of the latter's association informed the registrar that the said company had not functioned since 1970; that no annual reports or minutes had been filed with the registrar since 1970; and that some directors had died and some had left. The question was whether in these circumstances the Calcutta company was a bar to the registration of the new company.

Held: If a company is practically defunct, it is not a bar to registration of a new company with a similar name.

9.1.3 Use of Certain Keywords as Part of the Name

The Department of Company Affairs has clarified that if a company used any of the following key words in its name, it must have a minimum authorised capital mentioned against the keywords in the Table below:

Key words		Required Authorised Capital (₹)
(i)	Corporation	5 crore
(ii)	International, Globe, Universal Continental, Inter-continental, Asiatic, Asia, being the first word of the name	1 crore
(iii)	If any of the words at (ii) above is used within the name (with or without brackets)	50 lakh
(iv)	Hindustan, India, Bharat, being the first word of the name	50 lakh
(v)	If any of the words at (iv) above is used within the name (with or without brackets)	5 lakh
(vi)	Industries/Udyog	1 crore
(vii)	Enterprises, Products, Business, Manufacturing	10 lakh

Guidelines for Availability of Names for Companies

The Central Government has issued clarifications under s. 20.

Notes

9.1.4 Publication of Name (s.147)

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 of business in a conspicuous position in letters easily legible and in the language in general use in the locality.

The Department of Company Affairs has clarified that exhibition of its name in English alone, without at the same time showing it in the local language will not be sufficient in compliance with the requirements of the section.

The words 'outside of every office' do not mean outside the premises in which the office is situated [Dr. H.L. Batliwala Sons & Co. Ltd. vs. Emperor (1941) 11 Comp. Cas. 154 (Bom)]. Where office is situated within a compound, the display outside the office room, though inside the building, is sufficient.

(b) Have its name engraved in legible characters on its seal.

(c) Have its name and address of its registered office mentioned in legible characters in all business letters, bill heads, negotiable instruments, invoices, receipts, etc.

Caution **Penalty**

If a company does not paint or affix its name and the address of its registered office in the prescribed manner, the company and every officer of the company who is in default shall be punishable with fine up to ₹ 500 per day till the default continues.

Also, every officer of a company or any person on its behalf who signs or authorises to be signed on behalf of the company any bill of exchange, hundi, promissory note or cheque, etc., wherein the name of the company is not mentioned in the prescribed manner, shall be personally liable to the holder of such bill of exchange, hundi, promissory note, cheque, etc., for the amount thereof unless it is paid by the company. The personal liability, however, will not be incurred in the following cases:

1. The holder of a negotiable instrument, on which the company's name has been incorrectly stated, will not be able to enforce the personal liability under s.147(4) against the officer concerned if the error was due to the holder's own act [Durham Fancy Goods Ltd. vs. Michael Jackson (Fancy Goods) Ltd. and Another (1968) 2 Q.B. 839].
2. The word 'Limited' is abbreviated to 'Ltd.' (P. Stacey & Co. vs. Wallis (1912) 28 T.L.R. 219.
3. There is an accidental omission of the word 'limited' [Dermatine Co. vs. Ashworth (1905) 21 T.L.R. 510]. In this case, a bill of exchange was accepted on behalf of a limited company. The rubber stamp of the company was longer than the paper. As a result, the word 'limited' did not appear on the instrument.

Held: The directors who accepted the bill of exchange were not personally liable because omission was neither deliberate nor of negligent origin. It was an obvious error of most trifling kind and the mischief aimed at by the Act did not here exist.

The registered office clause [s.13(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 it is also the address at which company's statutory books must normally be kept and to which notices and all other communications can be sent. The notice of the exact situation (address) of the registered office may be given to the registrar within 30 days from the date of incorporation (s.146).

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As in the case of publication of the company's name, s.147 also makes similar provisions regarding publication of the registered office of the company.

The objects clause [s.13 (1) (d)]: The objects clause defines the objects of the company and indicates the sphere of its activities. A company cannot do anything beyond or outside its objects and any act done beyond them 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 ultra vires. Thus, a trading company has an implied power to borrow money, draw and accept bills of exchange.

Section 13, read along with Tables 'B', 'C', 'D' and 'E', requires the company to divide its objects clause into three parts: (a) Main objects of the company to be pursued by the company on its incorporation; (b) Objects incidental or ancillary to the attainment of the main objects; and (c) Other objects of the company not included in (a) and (b) above. A company may, on receipt of certificate to commence business, pursue any business given in the 'main objects'. In the case of companies (other than trading companies) with objects not confined to one State, the memorandum must give the name of the State(s) to whose 'territories the objects extend'. No business given in 'other objects' can, however, be commenced unless prior approval of shareholders with regard thereto is obtained by way of special resolution passed in general meeting [s.149 (2A)]. Where special resolution is not passed, the Central Government, may on an application made by the board of directors, allow a company to commence business in the 'other objects', provided the votes cast in favour of the resolution exceed the votes cast against the resolution, if any [s.149(2B)].

The objects of the company must not be illegal, immoral or opposed to public policy or in contravention of the Act.

Liability clause [s.13 (2)]: This clause states the nature of liability of the members. In case of a company with limited liability, it must state that liability of members is limited, whether it be by shares or by guarantee. This means that in case of a company limited by shares, a member can be called upon at any time to pay to the company the amount unpaid on the shares held by him. In case of companies limited by guarantee, this clause will state the amount which every member undertakes to contribute to the assets of the company in the event of its winding up.

Notes The association clause [s.13(4)(c)]: At the end of the memorandum of every company there is an association or subscription clause or a declaration of association which reads something like this:

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

Then follow the names, addresses, descriptions, occupations of the subscribers and the number of shares each subscriber has taken and his signature attested by a witness.

In the case of an unlimited company, this clause need not be given in the memorandum. In fact, the absence of this clause in the memorandum means that the liability of its members is unlimited.

As per s.45, under certain circumstances the liability of members of a limited company becomes unlimited. [Para 2.4]

The capital clause [s.13 (4) (c)]: This clause states the amount of share capital, with which the company is registered and the mode of its division into shares of fixed value, i.e., the number of

shares into which the capital is divided and the amount of each share. If there are both equity and preference shares, then the division of the capital is to be shown under these two heads.

Self Assessment

State whether the following statements are true or false:

1. In the case of an unlimited company, liability clause need not be given in the memorandum.
2. The memorandum is to be printed, divided into paragraphs, numbered consecutively and signed by at least seven persons in the case of a public company in the presence of at least one witness.
3. The liability clause defines the objects of the company and indicates the sphere of its activities.

9.2 Doctrine of Ultra Vires

We have mentioned earlier that a company cannot go beyond its objects mentioned in its memorandum. The company's activities are confined strictly to the objects mentioned in its memorandum and if they go beyond these objects, then such acts will be ultra vires. The object of declaring such acts as ultra vires is to protect the interests of shareholders and all others who deal with the company. Some points worth noting as regards doctrine of ultra vires are:

1. A company exists only for the objects which are expressly stated in its objects clause or which are incidental to or consequential upon these specified objects.
2. Any act done outside the express or implied objects is ultra vires.
3. The ultra vires acts are null and void ab initio. The company is not bound by these acts; and neither the company nor the other contracting party can sue upon it.

Examples:

(i) A company with the objects, namely (a) to make and sell or lend on hire railway carriages and wagons and all kinds of railway plant, fittings, machinery and rolling stock; (b) to carry on the business of mechanical engineers and general contractors; (c) to purchase, lease, work and sell mines, minerals, land and buildings; (d) to purchase and sell as merchants timber, coal, metals or other materials. The company contracted to finance the construction of a railway bridge in Belgium and, there was evidence that the agreement had been ratified by all the members. Later, the company repudiated the agreement and was sued for breach of contract. In its defence the company repudiated its lack of capacity to enter into a contract which was outside the scope of its objects clause. The other party brought an action for damages for breach of contract. His contentions were that the contract in question came well within the meaning of the words 'general contractors' and, was, therefore, within the powers of the company and secondly, that the contract was ratified by the majority of the shareholders.

Held: That the term general contractors must be taken to indicate the making generally of such contracts as were connected with the business of mechanical engineers. If the term 'general contractors' was so interpreted it would authorise the making of contracts of any and every description, such as, for instance, of fire and marine insurance and the memorandum in place of specifying the particular kind of business, would virtually point to the carrying on of business of any kind whatsoever and

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would, therefore, be altogether unmeaningful. Hence, the contract was entirely beyond the objects in the memorandum of association. [Ashbury Railway Carriage and Iron Co. vs. Riche (1875) LR 7 HL 653].

(ii) The objects clause of a company included making of costumes, gowns and similar things within the clothing trade. However, it extended its activities to the manufacture of veneered panels and became indebted to three parties: (a) builders of the veneered panels factory; (b) suppliers of veneers; and (c) fuel merchants. In the meantime the company went into liquidation and liquidator rejected the claim of the three creditors. The creditors filed suits for the recovery of money.

Held: The contention of the liquidator was correct as all the three contracts were clearly ultra vires.

4. In case a company is about to undertake an ultra vires act, the members of a company (even a single member) can get an order of injunction from the court restraining the company from going ahead with the ultra vires act.

5. If the directors have exceeded their authority and done something then such matter can be ratified by the general body of the shareholders, provided the company has the capacity to do so by its memorandum of association.

Example: A company has the power to borrow money, but the articles of the company provide that in case the directors borrow more than ₹ 50,000, they should get prior approval by the company in general meeting. The directors issue debentures to the extent of ₹ 75,000 without getting the approval from the shareholders. The company in general meeting may ratify the act of directors as it is intra vires the company, though ultra vires the powers of the directors of the company.

6. Any property acquired by a company under an ultra vires transaction may be protected by the company against damage by third persons.

7. The directors and other officers can be held liable to compensate the company for any loss occasioned to it by an ultra vires act.

8. The directors and other officers shall be personally accountable to the third parties.

9. The money or property gained through an ultra vires transaction if available in specie or capable of being identified shall be restituted (restored) to the other party.

Caution In case, an ultra vires loan, taken by a company is used for payment of its intra vires debts, the lender of the ultra vires loan is substituted in place of the creditor who has been paid off and as such he (the lender) can recover the money.

Self Assessment

State whether the following statements are true or false:

4. Any act done outside the express or implied objects is ultra vires.

5. Any property acquired by a company under an ultra vires transaction may be protected by the company against damage by third persons.

6. If the directors of a company have exceeded their authority and done something then such matter cannot be ratified by the general body of the shareholders, even if the memorandum of association of company provided the company has the capacity to do it.

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7. The directors and other officers cannot be held liable to compensate the company for any loss occasioned to it by an ultra vires act.

9.3 Alteration of Memorandum

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

9.3.1 Change of Name

Section 21 provides that the name of a company may be changed at any time by passing a special resolution at a general meeting of the company and with the written approval of the Central Government. However, no approval of the Central Government is necessary if the change of the name involves only the addition or deletion of the word 'private' (i.e., when a public company is converted into a private company or vice versa).

If through inadvertence or otherwise, a company has been registered with a name which is identical with or too closely resembles with the name of an existing company, the company may change its name by passing an ordinary resolution and by obtaining the approval of the Central Government in writing (s.22).

The change of name must be communicated to the registrar within 30 days of the change. The registrar shall then enter the new name on the register in the place of the old name and shall issue a fresh certificate of incorporation with necessary alterations [s.23(1)]. 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 [s.23(2)].

However, the change of name shall not affect any rights or obligations of the company or render defective any legal proceeding 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 [s.23(3).]

Within 30 days of the passing of the special resolution, a printed or a typewritten copy of the resolution should be sent to the registrar.

9.3.2 Change of Registered Office

This may include:

1. ***Change of registered office from one premises to another premises in the same city, town or village:*** The company may do so anytime. A resolution passed by the board of directors shall be sufficient. However, notice of the change should, within 30 days after the date of the change, be given to the registrar who shall record the same (s.146).
2. ***Change of registered office from one town or city or village to another town or city or village in the same State (s.146):*** In this case, the procedure is:
   (i) A special resolution is required to be passed at a general meeting of the shareholders;
   (ii) A copy of it is to be filed with the registrar within 30 days;
   (iii) Within 30 days of the removal of the registered office, notice of the new location has to be given to the registrar who shall record the same.
3. ***Shifting of the registered office from one place to another within the same State (s.17A):*** The shifting of the registered office of a company from the jurisdiction of one registrar to

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the jurisdiction of another registrar, within the same state shall also require confirmation by the regional director. For this purpose, an application is to be made in the prescribed form and the confirmation shall be communicated within four weeks. Such confirmation is required to be filed within two months with the registrar who shall register and certify the same within one month. Such a certificate shall be conclusive evidence of the compliance of all requirements under the Act.

Did u know? At present, there are more than one registrar in two states. These states are Maharashtra and Tamilnadu. In Maharashtra, the offices of the registrars are in Pune and Mumbai. In Tamilnadu, the offices of the registrars are in Chennai and Coimbatore.

4. ***Change of registered office from one state to another State:*** Section 17 provides for the shift of the registered office from one State to another, and such shifting involves alteration of memorandum. The change of registered office from one locality to another in the same city or from one city to another in the same State does not involve alteration of memorandum.

   The shifting of the registered office from one State to another can be done, by a special resolution which is required to be confirmed by the Central Government. The Central Government, before confirming the resolution, will satisfy itself that sufficient notice has been given to every creditor and all other persons whose interests are likely to be affected by the alteration, including the registrar and the Government of the State in which the registered office is situated. Also, the Central Government will give an opportunity to members and creditors of the company, the Registrar and other persons interested in the company to be heard. The Central Government may confirm the resolution on such terms and conditions as it thinks fit.

   It was made clear in Zuari Agro Chemicals Ltd. vs. F. S. Wadia and Others (1974) 44 Comp. Cas. 465 that the Company Law Board (now Central government) will not substitute its own wisdom or judgement for the collective wisdom or judgement of the company expressed in special resolution. But the bona fides of the company's application for change can be screened.

9.3.3 Loss of Revenues of a State, whether Relevant Consideration

In Orient Paper Mills Ltd. vs. State, AIR (1957) Ori. 232 it was observed that a State whose interests are affected by the change has a locus standi to oppose shifting of registered office of a company. Accordingly, the Orissa High Court declined to confirm the change of registered office from Orissa to West Bengal, *inter alia,* on the ground that in a Federal Constitution every State has the right to protect its revenue and, therefore, the interest of the State must be taken into account.

But in Minerva Mills Ltd. vs. Govt. of Maharashtra (1975) 45 Comp. Cas 1(Bom.), Justice Ray of the Bombay High Court held that the Company Law Board (now Central government) cannot refuse confirmation on the ground that the change would cause loss of revenue to a State or would have adverse effects on the general economy of the State. The question of loss of revenue to one State would have to be considered in the perspective of total revenues for the Republic of India and no parochial considerations should be allowed to turn the scale in regard to the change of registered office from one State to another within India.

Similar view was expressed in Rank Film Distributors of India Ltd. vs. Registrar of Companies, West Bengal [AIR (1969) Cal. 32]. i.e. that State has no statutory right under s. 17 to oppose the shifting of the registered office from one State to another.

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A printed or a typewritten copy of the special resolution both under s.146 and s.17 should be sent to the registrar within 30 days of its passing.

A certified copy of the order of the Central Government should be filed within three months thereof with the registrar of each State – the old and the new State. If it is not filed within the prescribed time, then the alteration shall, at the expiry of such period, become void and inoperative.

A notice of the new location of the registered office must be given to the registrar of the State to which the office has been shifted, within 30 days after the change of the office (s.146).

A company is in a position to shift its registered office from one State to another for certain purposes only. These are discussed in the following paragraph (under 'Alteration of objects' – the grounds being common).

9.3.4 Alteration of Objects Clause

Section 17 empowers a company by a special resolution duly confirmed by the Central Government, to alter the objects or to change the place of its registered office from one State to another if the alteration is sought on any of the following grounds:

1. ***To carry on its business more economically and more efficiently:*** In Dalmia Cement (Bharat) Ltd., In re (1964) 34 Comp. Cas. 729 (Mad.), the court observed that whether a company can carry on its business more economically or more efficiently is a matter for the judgement of the directors. If the directors consider that under the existing circumstances, it will be convenient and advantageous to combine the new objects with the existing objects and, if it appears that such a conclusion may be fairly arrived at, the court (now Central government) will not go behind it and hold an enquiry as to whether the opinion of the directors is well founded or is justified.

   The true legal position, observed the Delhi High Court, is that the business must remain substantially the same and the additions, alterations and changes should only be steps-in-aid to improve the efficiency of the company [Delhi Bharat Grain Merchants Assn. Ltd., In re (1974) 44 Comp. Cas. 214 (Delhi)].

   In Re, Scientific Poultry Breeders Association (1933) 3 Comp. Cas. 89 (CA), a company's memorandum prohibited payment of remuneration to the members of its governing body. It wanted for efficient management, amendment in the memorandum to enable it to pay remuneration to its governing body members. The change was allowed.

2. ***To attain its main purpose by new or improved means:*** For the companies registered after 10th October, 1965, there is no difficulty in ascertaining the main purpose because the memorandum would state it. But for the companies registered earlier, one has to look not only to the memorandum but also to what has actually been done.

3. ***To enlarge or change the local area of its operation:*** In Indian Mechanical Gold Extracting Company, In Re (1891) 3 Ch. 538, the company's business was confined to the 'Empire of India'. It wanted to enlarge its operations by dropping these words. It was allowed to do so on the condition that the word 'Indian' was also dropped from its name.

4. ***To carry on some business which under existing circumstances may be conveniently or advantageously combined with the business of the company:*** In fact, most of the amendments sought in objects clause are based on this ground. This clause enables a company to diversify. The working of the clause makes its scope very wide in as much as, any activity which may either conveniently or advantageously be combined with the existing business, may be allowed.

5. ***To restrict or abandon any of the objects specified in the memorandum:*** Even for deleting any portion of the object clause, the procedure laid down in s.17 has to be followed.

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6. ***To sell or dispose off the whole or any part of the undertaking:*** Where a company wishes to adopt a cut-back or retrenchment strategy, i.e., where it feels that it has either grown too big or diversified in various directions that managing becomes difficult or uneconomical, it may alter its objects to sell or dispose off any of its undertakings.

7. ***To amalgamate with any other company or body of persons:*** A printed or a typewritten copy of the special resolution is required, to be filed with the registrar within 30 days of the passing thereof. Also, a petition is to be filed with the Central Government for confirmation of the special resolution. The Central Government, being satisfied that the notice of the resolution was given to all persons whose interests are likely to be affected by the alteration, including the registrar and the State Government and having heard them, may confirm the alteration either wholly or in part.

   A certified copy of the order of the Central Government together with a printed copy of the altered memorandum, must be filed within three months of the date of the order, with the registrar. The registrar will register the documents and issue, within one month a certificate which will be conclusive evidence that everything required has been done (s.18). If the required documents are not filed within the prescribed time, the alteration and the order of the Central Government confirming the alteration, shall, at the expiry of such period, become void and inoperative (s.19).

Example: The objects clause of memorandum of a company empowers it to carry on distillery business and any other business that is allied to it. The company wants to alter its memorandum so as to include the cinema business in its objects clause. The company may make the proposed alteration if the cinema business may conveniently or advantageously be combined with the existing business.

9.3.5 Alteration of Liability Clause (s.38)

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, where the company is a club or any other similar association, and the alteration in the memorandum requires the member to pay recurring or periodical subscription or charges at a higher rate, although he does not agree in writing to be bound by the alteration, it shall be binding on him.

Notes In case of unlimited liability company, the liability may be made limited. The alteration will, however, not affect any debts, liabilities, obligations or contracts entered into by or with the company before the conversion.

9.3.6 Alteration of Capital Clause

This clause deals with alteration of share capital.

Section 94 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 by issuing fresh shares;

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2. to consolidate and divide all or any of its share capital into shares of larger amount than its existing shares;
3. to convert all or any of its fully paid-up shares into stock and reconvert the 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 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.

Task A company is engaged in jute business. The members unanimously pass a resolution to start business in rubber. The proposed alteration in the objects clause is submitted to the Company Law Board for its approval. Advise the Board if the same could be approved or not.

Self Assessment

State whether the following statements are true or false:

8. The shifting of the registered office from one State to another can be done, by an ordinary resolution in which no confirmation is required by the Central Government.
9. The liability of a member of a company cannot be increased unless the member agrees in writing.
10. A company can alter its object clause in order to carry on its business more economically and more efficiently.
11. Alteration of memorandum do not allow change of registered office from one premises to another premises in the same city.

Case Study

TCI goes for Diversification

The board of directors of Transport Corporation of India Ltd (TCI) has approved a resolution to enable the company diversify into power production and distribution business.

The company plans to generate power by conventional, non-conventional, thermal, solar, hydel, geo-hydel, wind and/or tidal waves. Towards this, TCI proposes to enter into joint venture agreements with either Indian or foreign players.

However, since the existing memorandum of association of the company does not contain these activities, the TCI board has decided to seek approvals of its shareholders to amend the main objects clause of the memorandum of association.

Accordingly, the company has decided to go in for postal ballot, wherein the duly-filled ballot forms would have to reach the scrutiniser appointed by the company by May 29.

In a notice to the shareholders, TCI said the scrutiniser would complete the scrutiny process and announce the results by June 5.

Source: thehindubusinessline.com

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9.4 Guidelines for Availability of Names

According to the clarifications issued by the government, in following cases, a name is considered undesirable and a company is not allowed to be registered with such a name:

1. If the name is identical with or too nearly resembles the name by which a company is already registered, or the names under which well known firms and other bodies are doing business, then such names are considered undesirable for a new company.
2. If the proposed name is identical with or too nearly resembles a name of a company in liquidation, then adoption of such a name by a new company is considered undesirable. It is because the name of the company in liquidation is borne on the register of companies maintained by the registrar till it is finally dissolved. Further, a name which is identical with or too closely resembles the name of a company dissolved as a result of liquidation proceedings, cannot also be allowed for a period of two years 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 court under s. 559.
3. If the proposed name differs from the name of an existing company merely in the addition or subtraction of word like New, Modern etc., then the new name (such as New Bata Shoe Company, Nav Bharat Electronics, etc.) should not be allowed.
4. Where the proposed name closely resembles a popular or abbreviated description or names of important companies (e.g., TISCO, ICI, WIMCO, etc.) then, such words should not be allowed as name of a new company even though they have not been registered as trade marks by the existing company.
5. A name, the use of which is prohibited under the provisions of Emblem and Names (Prevention of Improper Uses) Act, 1950.
6. Any name for the proposed company which connotes government participation or patronage is considered undesirable unless circumstances justify. Thus, the words National, Union, Central, President, Rashtrapati, etc., cannot be used as a part of the name of a new company.
7. Any name for the proposed company, which implies association or connection with, or patronage of a national hero or any person held in high esteem is considered undesirable. Thus, the words 'Mahatma Gandhi', 'Jawahar Lal Nehru', cannot be used as a part of the name for a company.
8. Any name for the proposed company, which includes the word 'cooperative' (or sahkari or the equivalent word of 'cooperative') in regional languages of the country.
9. Where the proposed name of the company includes a proper noun, which is not a name or a surname of a director, then such a name is considered undesirable. However, for sentimental reasons, sometimes the names of relatives such as wife, son and daughter of the director may be allowed, provided one other word suggested makes the name quite distinguishable.
10. The proposed name of company shall not be allowed, where it includes the name of a registered trade mark unless, the consent of the owner of the trade mark has been produced by the promoters.
11. Where the name of the proposed company is intended or is likely to produce a misleading impression regarding the scope of its activities, which would be beyond the resources at its disposal.

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Example: The name 'Universal Engineering Company Pvt. Ltd.' will not be allowed if it is to operate only as a small scale unit with limited range of product and financial resources.

12. A name for a company, which suggests a business, which is not proposed to be undertaken by it, shall be considered to be undesirable.

13. A proposed name, which is the exact Hindi translation of the name of an existing company will not be allowed.

14. Further, if a name of the proposed company falls within the categories mentioned below, then it shall not be allowed. These are:

    (a) If it is not in consonance with the proper objects of the company, as set out in its memorandum of association.

    (b) If it includes any word or words which are offensive to any section of the public.

    (c) If the name is only a general one, like Cotton Textile Mills Limited or Y2K Ltd.

    (d) If the proposed name has a close phonetic resemblance to the name of a company in existence, for example, JK Industries Limited and Jay Kay Industries Ltd.

    (e) If it is different from the name/names of the existing company/companies only to the extent of having the name of place within brackets before the word 'Limited', then it shall not be allowed.

Example: Indian Press (Delhi) Limited, should not be allowed in view of the existence of the company named 'Indian Press Ltd'.

Self Assessment

State whether the following statements are true or false:

12. The words National, Union, Central, President, Rashtrapati, etc., can be used as a part of the name of a new company.

13. If the name is identical with or too nearly resembles the name by which a company is already registered then such names are considered undesirable for a new company.

14. A name for a company, which suggests a business, which is not proposed to be undertaken by it, shall be considered to be desirable.

15. A proposed name, which is the exact Hindi translation of the name of an existing company will be allowed.

9.5 Summary

- The memorandum serves a two-fold purpose. It 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.
- The memorandum is to be printed, divided into paragraphs, numbered consecutively and signed by at least seven persons (two in case of private company) in the presence of at least one witness.
- The objects clause defines the objects of the company and indicates the sphere of its activities.
- Liability clause states the nature of liability of the members.

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- The company's activities are confined strictly to the objects mentioned in its memorandum and if they go beyond these objects, then such acts will be ultra vires.
- In case a company is about to undertake an ultra vires act, the members of a company can get an order of injunction from the court restraining the company from going ahead with the ultra vires act.
- 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.
- Section 17 empowers a company by a special resolution duly confirmed by the Central Government, to alter the objects or to change the place of its registered office from one State to another.
- If the proposed name of a company differs from the name of an existing company merely in the addition or subtraction of word like New, Modern etc., then the new name should not be allowed.
- Any name for the proposed company which connotes government participation or patronage is considered undesirable unless circumstances justify.

9.6 Keywords

***Capital Clause*:** This clause deals with alteration of share capital.

Liability Clause: A clause in the memorandum of association that states the nature of liability of the members.

Memorandum of Association: The document that governs the relationship between the company and the outside and one of the documents required to incorporate a company.

Objects Clause: The objects clause defines the objects of the company and indicates the sphere of its activities.

Public Company: It means a company which is not a private; has a minimum paid-up capital of ₹ 5 lakhs.

Ultra Vires: The Company's activities are confined strictly to the objects mentioned in its memorandum and if they are beyond these objects, then such acts are known as *'ultra vires'.*

9.7 Review Questions

1. Define memorandum of association and state its contents.
2. State the rule laid down in 'Ashbury Railway Carriage Co. vs. Riche's case.
3. Explain the various clauses included in the memorandum of:
   (i) A limited company and
   (ii) An unlimited company.
4. Discuss the legal significance of the different clauses in the memorandum of association.
5. Describe the steps to be taken by a company to effect changes in the location of its registered office from:
   (i) One place to another place in the same city;
   (ii) One city to another city in the same state;

Notes

(iii) One state to another state.

6. Describe the circumstances under which the alteration of objects clause is permissible. Also describe the formalities to be complied with for changing the objects clause. [Para 6.4]

7. How are alterations made in a memorandum of association?

8. Write explanatory notes on:

   (i) Doctrine of ultra vires and its implications.

   (ii) Change of name clause.

9. M/s XYZ Ltd., a company having its registered office at Mumbai (Maharashtra State), desires to shift its registered office to Pune (Maharashtra State). Describe the procedure applicable in this case under the Companies Act, 1956.

10. The main object of a company is to manufacture cement. Seeing the potential for new business the board of directors decided to go in for manufacture of steel and steel related products. These are included in the 'other objects' of the company. Can the company undertake the aforesaid new business?

11. Advise Asiatic Government Security Life Assurance Co. Ltd. whether it can seek injunction against the New Asiatic Insurance Co. Ltd. which was subsequently formed, restraining it from having in its name the word 'Asiatic' on the ground that it has caused confusion and can deceive the public.

12. The directors of a company registered and incorporated in the name 'Mars Textile India Ltd.' desire to change the name of the company entitled 'National Textiles and Industries Ltd.'

    Advise as to what procedure is required to be followed under the Companies Act, 1956.

13. The directors of a company borrow ₹ 50,000 from **A** on a transaction which is ultra vires the company. Discuss the rights of **A** against the company and its directors. [Hint: A can hold directors personally liable. The company can be held liable only if the money has been used to pay ultra vires debts of the company or in case any assets have been purchased for the company, these may be attached. Also see Para 6.3]

14. The objects clause of the memorandum of XYZ Pvt. Ltd. New Delhi authorised to do trading in mangoes. The company, however entered into partnership with Mr. A and traded in mangoes and incurred liabilities to Mr. A. The company, subsequently, refused to admit the liability to A on the ground that trading in mangoes was ultra vires the company. Advise, whether stand of the company is legally valid and if so, give reasons in support of your answer.

15. ABC Ltd., wishes to shift their registered office from Nehru Place, New Delhi to a new premises at 81, Kasturba Gandhi Marg, New Delhi. State the procedure.

Answers: Self Assessment

1.	True	2.	True
3.	False	4.	True
5.	True	6.	False
7.	False	8.	False
9.	True	10.	True

Notes

11. False
12. False
13. True
14. False
15. False

9.8 Further Reading

Book S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.

Online links assamagribusiness.nic.in/memo.pdf

www.ril.com/downloads/pdf/MOA.pdf

Notes

Unit 10: Articles of Association

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the meaning and purpose of Articles of Association;
- Discuss about the alteration of articles;
- Explain the doctrine of constructive notice;
- Recognize the significance of doctrine of indoor management.

Introduction

The articles of association of a company are its bye laws and regulations, which govern the management of its internal affairs and the conduct of its business. They define the duties, rights, powers and authority of the shareholders and the directors in their respective capacities, and of the company, and the mode and form in which the business of the company is to be carried out. The articles of a company have a contractual force between company and its members, as also between the members *inter se* in relation to their rights as such members. The articles cannot supersede the objects as set out in the memorandum of association [Birds Investments Ltd. vs. C.I.T. (1965) 35 Comp. Cas. 147 Cal.]. The memorandum, lays down the scope and powers of the company, whereas the articles govern the ways in which the objects of the company are to be carried out. Also the alteration of memorandum involves elaborate procedure, whereas the

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articles can be framed and altered by the members by passing a special resolution. The memorandum is the area, beyond which the actions of the company cannot go; inside that area, the shareholders may make such regulations for their own governance as they think fit. However, the articles must not be inconsistent with the memorandum. Also, as in the case of memorandum, the articles of the company must not contain anything which is repugnant to the provisions of the Companies Act (s.9).

10.1 Articles – Registration, Subject Matter and Inspection

Section 26 states that a public company limited by shares may register articles of association, signed by the subscribers to the memorandum. If, however, it does not register its own articles, then the articles given in Table A of Schedule I automatically becomes applicable. Further, even if it does register articles of its own, Table A will still apply automatically unless it has been excluded or modified. There are actually three possible alternatives in which such a company may adopt articles: (i) it may adopt Table A in full or, (ii) it may wholly exclude Table A and set out its own regulations in full, or (iii) it may set out is own articles and adopt part of Table A. The alternatives (ii) and (iii) are often employed; and partial adoption of Table A has particular advantage for small companies, because of economy in printing and also because any provision of Table A is legally beyond any doubt.

As regards a company limited by guarantee and unlimited liability, and a private company limited by shares, s.26 provides for compulsory registration of articles prescribing regulations for the company. However, they may adopt any of the appropriate regulations of Table A.

In any case, the articles of a company must be: (i) printed, (ii) divided into paragraphs, numbered consecutively, (iii) signed by subscribers to the memorandum in the presence of at least one witness who shall attest the signatures. Also, articles are to be stamped with requisite stamp under the Stamp Act and filed with the registrar along with the memorandum (s.3).

Did u know? The Articles are subordinate to and are controlled by memorandum.

The articles of a company usually deal with the following matters:

1. The business of the company;
2. The amount of capital issued and the classes of shares into which the capital is divided; the increase and reduction of share capital;
3. The rights of each class of shareholders and the procedure for variation of their rights;
4. The execution or adoption of a preliminary agreement, if any;
5. The allotment of shares; calls and forfeiture of shares for non-payment of calls;
6. The transfer and transmission of shares;
7. The company's lien on shares;
8. The exercise of borrowing powers including issue of debentures;
9. The general meetings, notices, quorum, proxy, poll, voting, resolution, minutes;
10. The number, appointment and powers of directors;
11. The dividends – interim and final – and general reserves;
12. The accounts and audit;
13. The keeping of books – both statutory and others.

Notes

A company shall, on being so required by a member, send to him within seven days of the requirement, on payment of one rupee, a copy of the articles. If a company makes a default, the company and every officer of the company who is in default, shall be punishable with fine up to ₹ 500 (s.39).

Self Assessment

Fill in the blanks:

1. Section 26 states that a public company limited by shares may register articles of association, signed by the subscribers to the…….
2. Articles are to be stamped with requisite stamp under the ……..and filed with the registrar along with the memorandum.
3. If a public company limited by shares does not register its own articles, then the articles given in ……. of Schedule I automatically becomes applicable.

10.2 Alteration of Articles

Section 31 provides that subject to the provisions of the Act and to the conditions contained in its memorandum, a company may, by special resolution alter or add to its articles.

Caution It is requisite that a printed or typewritten copy of every special resolution altering the articles must be filed with the registrar within 30 days of the passing of the special resolution.

The right to alter, just by passing a special resolution is so important that a company cannot in any manner deprive itself of the power to alter its articles. Also, the power to reduce or increase the number of members in the case of a company limited by guarantee without share capital, from time to time, as given in the articles can be done by a special resolution of the general body of members. However, in spite of the power to alter its articles, a company can exercise this power subject to certain limitations. These are:

1. The alteration must not exceed the powers given by the memorandum or conflict with the other provisions of the memorandum.
2. The alteration must not be inconsistent with any provisions of the Companies Act or any other statute. Example: No company can purchase its own shares (s.77) and if the articles of a company are altered so as to have the power to purchase its own shares, then such power will be void.
3. The altered articles must not include anything which is illegal, or opposed to public policy or unlawful.
4. The alteration must be bona fide for the benefit of the company as a whole. The alteration will not, however, be bad merely because it inflicts hardship on an individual shareholder.

Example: A company had a lien on all shares "not fully paid" 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 striking out the words "not fully paid-up" and thus gave 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.

Notes

Held: 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 [Allen vs. Gold Reefs of West Africa Ltd. (1900) 1 Ch. 656].

Example: By an alteration in the articles, a company was empowered 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, although only one member was at that time within the ambit of alteration, as the alteration was bona fide and for the benefit of the company [Sidebottom vs. Kershaw Leese & Co. (1920) Ch. 154 (C.A.)].

5. The alteration must not constitute a fraud on the minority by the majority. If the alteration is not for the benefit of the company as a whole, but for majority of the shareholders, then the alteration would be bad.

Caution An alteration to the articles must not discriminate between the majority shareholders and the minority shareholders so as to give the former an advantage of which the latter have been deprived.

Example: In Brown v. British Abrasive Wheel Co. (1919) 1 Ch. 290, the majority which held 98 per cent of the shares passed a special resolution that upon the request of holders of 9/10th of the issued shares, a shareholder shall be bound to sell and transfer his shares to the nominee of such holders at a fair value. The alteration was held to be invalid since it amounted to an oppression of minority.

6. There cannot be alteration of the articles so as to compel the existing members to take or subscribe for more shares or in any way to contribute to the share capital, unless they have given their consent in writing (s.38).

7. 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 (s.31).

8. A company cannot justify breach of contract with third parties or avoid a contractual liability by altering articles.

9. The amended regulation in the articles cannot operate retrospectively, but only from the date of amendment [Pyare Lal Sharma vs. Managing Director, J&K Industries Ltd. (1990) 67 Comp. Cas. 195 SC].

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

Self Assessment

Fill in the blanks:

4. A company by ……resolution can alter or add to its articles.

Notes

5. The alteration in articles must be …….for the benefit of the company as a whole.
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 …….

10.3 Effect of Memorandum and Articles/Binding Force of Memorandum and Articles

Section 36 provides that the memorandum and articles, when registered, bind the company and its members to the same extent as if, they had been signed and sealed by each member and contained covenants on the part of each member to observe and be bound by all the provisions of the memorandum and 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 neither a company nor its members are bound to outsiders. These relationships are discussed herein below:

10.3.1 Members Bound to Company

Each member must observe the provisions of the articles and memorandum. For instance, a company has a right of lien on members' shares, or to forfeit the shares for non-payment of calls. Every member is bound by whatever is contained in the memorandum and articles.

Example: 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 true value.

Held: That the trustee was bound by the articles, as shares were purchased by 'B' in terms of the articles. [Borland Trustees vs. Steel bros. Co. Ltd. (1901) 1 Ch. 279].

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. The articles are the regulations of the company binding on the company and on its shareholders. Further, the shareholders cannot among themselves enter into an agreement, which is contrary to or inconsistent with the articles of the company.

10.3.2 Company Bound to Members

Similarly, a company is bound to members by whatever is contained in its memorandum and articles. 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 transactions. An individual member can make the company fulfil its obligations to him, such as to send the notice for the meetings, to allow him to cast his vote in the meetings.

10.3.3 Members Bound inter se

The articles bind the members inter se, i.e., one to another so far as rights and duties arising from the articles are concerned.

It is well settled that, the articles will have a contractual force between the company and its members as also, between the members inter se in relation to their rights as such members.

Notes

Example: 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 the 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) Ch. 1].

10.3.4 Whether a Company or Members Bound to Outsiders?

The memorandum or articles do not confer any contractual rights to outsiders against the company or its members, even though the name of the outsider is mentioned in the articles.

Example: The articles of a company provided that Eley should be 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.

Held: His suit 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. The 'breach of contract' was there but in his capacity as a non-member [Eley v. Positive Government Security Life Assurance Co., (1876) 1 Ex. D. 88].

10.3.5 Whether Directors are Bound by whatever is Contained in the Articles?

The directors of the company derive their powers from the articles and be subject to limitations, if any, placed on their powers by the articles. If they contravene any provisions of articles, two parties may be affected: (1) the company itself and (2) the outsiders.

In case of contravention of the provisions of the articles, the directors render themselves liable to an action at the instance of the members. However, members may ratify the act of the director, if they so desire. But if as a result of the breach of duty any loss has resulted to the company, the directors are liable to refund to the company any damage so suffered.

Further, where the directors contravene the provisions of the articles it may affect outsiders' interest also. This is explained below with the help of a case, viz., Royal British Bank vs. Turquand (1856) 119 ER 886.

Notes The legal effect of articles may be summed up as follows:

1. The articles constitute a contract between the company and its members.
2. The articles bind the members to the company.
3. The articles bind the company to members as members.
4. The articles bind members to members.
5. The articles do not bind the company to outsiders.
6. The articles do not bind the company to any member in a capacity other than that of a member.

Notes

Task A limited company is formed with its articles stating that, Mr. Srivastava shall be the solicitor for the company and that he shall not be removed except on the grounds of misconduct. Can the company remove Mr. Srivastava from the position even though he is not guilty of misconduct?

Self Assessment

Fill in the blanks:

7. The articles bind the members……., i.e., one to another so far as rights and duties arising from the articles are concerned.
8. The memorandum or articles do not confer any …….rights to outsiders against the company or its members
9. Where the directors contravene the provisions of the articles it may affect ……. interest also.

10.4 Constructive Notice of Articles and Memorandum

Section 610 provides that the memorandum and articles, when registered, become public documents and then they can be inspected by anyone on payment of a nominal fee. 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.

Did u know? **What is 'Doctrine of Constructive Notice?**

Every person dealing with the company is presumed to have read its articles and memorandum 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, it is presumed that he has "constructive notice" of them.

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 cannot claim under the bill.

Example: In Kotla Venkataswamy vs. Ram Murthy AIR (1934) Mad. 579, the articles provided that, all deeds and documents of the company shall be signed by the managing director, secretary and working director. A mortgage deed was accepted with secretary and working director's signature only.

Held: The deed was invalid.

Example: If a person enters into a contract which is beyond the powers of the company, he does not acquire any right under the contract against the company.

Notes

Self Assessment

Fill in the blanks:

10. The memorandum and articles, when registered, become …….documents.
11. Every person dealing with the company is presumed to have read its articles & memorandum and, understood them in their……; this is known as 'Doctrine of Constructive notice.
12. After registration Articles and memorandum can be inspected by anyone on payment of a…….

10.5 Doctrine of Indoor Management

The doctrine of constructive notice throws a burden on people entering into contracts with the company that they are presumed to have read the documents, though in fact, they might not have read them. On the other hand, the doctrine of indoor management 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, they are not bound to enquire into the regularity of internal proceedings. An outsider is not expected to see that the company carries out its internal regulations.

Example: The directors of a company were authorised by the articles to borrow on bond such sums of money as should from time to time, by a resolution of the company in general meeting, be authorised to be borrowed. 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 [The Royal British Bank vs. Turquand supra].

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

1. ***Knowledge of irregularity:*** The rule does not protect any person, who has actual or constructive notice of the want of authority of the person acting on behalf of the company.

Example: The articles of a company empowered the directors to borrow up to £ 1,000. They could exceed the limit of £ 1,000 with the consent of the company in general meeting. Without such consent, they borrowed £3,500 from themselves and took debentures. The company refused to pay the amount.

Held: Their debentures were good to the extent of £ 1,000 only as they had notice of the internal irregularity [Howard vs. Patent Ivory Co. (1888) 38 Ch. D. 156].

2. ***No knowledge of articles:*** 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.

Example: T was a director in an 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 never read the articles. Later, it was found that the directors of the company did not delegate their powers to T. Plaintiffs relied on the rule of Indoor Management.

Notes

Held: They could not, because they did not know the existence of the power to delegate. [Rama Corporation vs. Proved Tin and General Investment Co. (1952) 1 All ER 554].

3. ***Void or illegal transactions:*** The rule does not apply to transactions which are void or illegal ab initio, e.g., forgery.

Example: The secretary of a company forged the signatures of two of the directors required under the articles on a share certificate and issued the certificate without authority. The applicants claimed to be entitled to be registered as members of the company.

Held: The certificate was a nullity and the holder of the share certificate could not take advantage of the doctrine of indoor management [Ruben vs. Great Fingal Consolidated (1906) AC 439].

4. ***Negligence:*** If an officer of a company does something, which would 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 inquiry, he cannot rely on the rule.

Example: A person who was sole director and principal shareholder of a company, paid into his own account, cheques drawn in favour of the company. The bank should have made enquiries as to the power of the director. The bank was put upon inquiry and was accordingly not entitled to rely upon the ostensible authority of director [A. L. Underwood vs. Bank of Liverpool (1924) 1 K. B. 775].

Self Assessment

Fill in the blanks:

13. The ……throws a burden on people entering into contracts with the company that they are presumed to have read the documents.
14. The ……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.
15. The ……rule does not protect any person, who has actual or constructive notice of the want of authority of the person acting on behalf of the company.

Case Study

RIL wants Change in Reliance Energy's Articles of Association

Reliance Industries, the largest shareholder in Reliance Energy, has voted in favour of entrusting itself with the power to appoint the majority of directors on the REL board.

Earlier these powers were vested with Mr Anil Ambani, REL Chairman and Managing Director.

According to sources, RIL was among the 97.24-per cent REL shareholders who voted in favour of the changes to its Articles of Association, a set of rules that govern day-to-day workings of a company, through a postal ballot. The result of which was announced today.

Contd...

Notes

The altered Article envisages that so long as the Reliance Group of Companies holds 26 per cent or more of REL's paid-up voting equity share capital, it will have the right to appoint majority of REL's directors on the board of the company.

Reliance Industries had earlier said that it had not sought in any withdrawal of powers conferred on Mr Anil Ambani. It had also said that RIL had not been consulted by REL before the proposed re-amendment of the relevant articles of association. The move to alter the articles of association was seen as part of the ongoing differences between the Ambani brothers over control of the ₹ 99,000-crore Reliance Group, of which REL is a subsidiary.

REL had, by way of a special resolution, asked shareholders to mail their votes through postal ballot for a change in its Articles of Association.

The company had sought permission to change Article 131 (a), 131 (a) (ii) and 131 (aa), which allowed Mr Anil Ambani the power to appoint one-third or majority of the total directors on REL's board, choose the Vice-Chairman of the company and even decide the tenure of the Chairman, Vice-Chairman and the directors appointed by him.

REL sought to vest these powers with its prime shareholder, Reliance Industries.

Question

Why does Reliance want alteration in Reliance Energy's articles?

Source: thehindubusinessline.com

10.6 Summary

- The articles of association of a company are its bye laws and regulations, which govern the management of its internal affairs and the conduct of its business.
- The articles of a company must be printed, divided into paragraphs, numbered consecutively and signed by subscribers to the memorandum in the presence of at least one witness who shall attest the signatures.
- A company may, by special resolution alter or add to its articles, subject to the provisions of the companies Act and to the conditions contained in company's memorandum.
- 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.
- The articles are the regulations of the company binding on the company and on its shareholders.
- The articles bind the members inter se, i.e., one to another so far as rights and duties arising from the articles are concerned.
- The memorandum or articles do not confer any contractual rights to outsiders against the company or its members, even though the name of the outsider is mentioned in the articles.
- The memorandum and articles, when registered, become public documents and then they can be inspected by anyone on payment of a nominal fee.
- Every person dealing with the company is presumed to have read the articles and memorandum and, understood them in their true perspective. This is known as 'Doctrine of Constructive Notice'.

Notes

- The doctrine of indoor management 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.

10.7 Keywords

Articles of Association: These are a company's bye laws and regulations, which govern the management of its internal affairs and the conduct of its business.

Doctrine of Constructive Notice: This doctrine enunciates that any person dealing with the company is presumed to have read its memorandum and articles.

Doctrine of Indoor Management: This doctrine enunciates that any person dealing with the company is entitled to assume that he provisions of the article have been observed by the company.

Inter se: The provision of articles which bind the members one to another so far as rights and duties arising from the articles are concerned.

Public Company: It means a company which is not a private; has a minimum paid-up capital of ₹ 5 lakhs.

10.8 Review Questions

1. What are the articles of association? Enumerate some of the items included therein.
2. Discuss whether it is legally compulsory for a company to have its own articles of association.
3. What restrictions should the articles provide to give a company the status of a private company?
4. Distinguish between articles and memorandum.
5. Explain the procedure laid down in the Companies Act, 1956 to alter the articles of a company.
6. Discuss the limits upon the powers of a company to alter its articles.
7. Discuss the binding effect of memorandum and articles, when registered, on the members and outsiders.
8. Explain the doctrine of constructive notice. Are there any exceptions to the said doctrine?
9. Explain and illustrate the Doctrine of Indoor Management. What are the exceptions to this rule?
10. Explain the rule laid down in the Royal British Bank vs. Turquand and state the exceptions to the rule.
11. Comment on the following:
    (i) The power of altering the articles is wide, yet it is subject to a number of limitations.
    (ii) The Doctrine of Indoor Management is a silver lining to strangers dealing with the company.
    (iii) Every person dealing with the company is deemed to have notice of the contents of its memorandum and articles.
    (iv) Explain the significance of Table A. Should a company have a special set of articles?

Notes

12. State the inter-relationship of Doctrine of Indoor Management with the Doctrine of Constructive Notice.
13. Examine the legal effect of the articles. How far is a provision depriving the company of the power to alter the articles valid?
14. Explain the circumstances in which an outsider dealing with the company cannot claim relief on the ground of 'indoor management'.

Answers: Self Assessment

1.	memorandum	2.	Stamp Act
3.	Table A	4.	special
5.	bona fide	6.	Central Government
7.	inter se	8.	contractual
9.	outsiders'	10.	public
11.	true perspective	12.	nominal fee
13.	doctrine of constructive notice	14.	doctrine of indoor management
15.	doctrine of indoor management		

10.9 Further Reading

Book S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.

Online links www.gandhis.com/downloads/company_in_india.pdf

www.icra.in/Files/Content/ArticlesofAssociation.pdf

Unit 11: Prospectus, Shares and Share Capital

Notes

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Notes

Objectives

After studying this unit, you will be able to:

- Describe the meaning and registration of prospectus;
- Discuss about the allotment of shares;
- Recognize the concept of share and share capital;
- Explain the method of alteration of share capital.

Introduction

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

A share "as a share in the share capital of a company and includes stock except where a distinction between stock and share is expressed or implied". It means the capital of a company, or the figure in terms of so many rupees divided into shares of a fixed amount, or the money raised by the issue of shares by a company.

Notes

In corporate law, a stock certificate or share certificate is a legal document that certifies ownership of a specific number of stock shares in a corporation. In large corporations, buying shares does not always lead to a stock certificate.

11.1 Prospectus

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

11.1.1 Steps which are Necessary before the Issue of Prospectus

A private company is prohibited from inviting public to subscribe to its share capital and it arranges its share capital privately. The shares are subscribed by a small number of persons who are known to the promoters or are related to them by family connections.

A public company may also decide not to invite public to subscribe to its share capital and arrange its capital privately as in the case of a private company. Under such circumstances, the public company is required to submit a statement in lieu of prospectus with the Registrar of Companies at least three days before the allotment of shares is made.

However, a public company limited by shares, generally issues shares to the public for which it have to issue a prospectus. In that case it has to follow the procedure below.

After the certificate of incorporation is obtained, the affairs of the company are taken over by the first directors appointed in accordance with the provisions of law. They will elect one of their members as the chairman of the Board of Directors, if none is named in the articles of association. The Board attends to the following matters: (i) Appointment of various expert agencies such as bankers, auditors, secretary, etc. (ii) Entering into underwriting contract, brokerage contracts. (iii) Making arrangements for the listing of shares on stock exchanges. (iv) Drafting a prospectus for the purpose of issue to the public.

The appointment of a banker is necessary as it has to receive the share application along with application moneys. The appointment of first auditor is in the hands of Board of directors and it becomes necessary, as we shall see later, to make the appointment before the issue of prospectus. The appointment of company secretary is obligatory in case of companies, having the prescribed paid-up share capital (presently, ₹ 50 lakhs or more). In other companies also, the appointment of a company secretary is desirable.

11.1.2 Underwriting

The Board of Directors enters into underwriting contracts with underwriters. Underwriting, in its simplest form, consists of an undertaking by some person or persons that if the public fails to take up the issue, he or they will do so. In return for this undertaking, the company agrees to pay the underwriter a commission on all shares or debentures, whether taken up by the public or by the underwriters.

Section 76 prescribes certain conditions subject to which underwriting commission may be paid. These are:

1. The authority to pay is given in the articles of the company. Authority in the Memorandum is not sufficient.
2. The commission payable cannot be more than 5 per cent of the issued price of shares and per cent of the price of debentures.

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3. The commission can be paid only on shares issued to the public.
4. The payment must be strictly by way of 'commission' and not merely a device to issue shares at a discount.
5. The rate of commission and the number of shares and debentures which the underwriters have agreed to subscribe for a 'commission' should be disclosed in the prospectus.
6. The names of the underwriters and the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations must be disclosed in the prospectus.

When prospectus is issued to the public and the issue is a success, i.e., the issue has been subscribed fully, the underwriters are not required to take up the shares, but they receive their commission. On the other hand, if the issue is a failure, i.e., the issue has not been subscribed fully, the underwriters have to take up the shares not subscribed for by the public and pay for them. In this case also, they will get their commission.

Under s.69, as we shall see later, a company must receive applications equivalent to the minimum subscription as mentioned in the prospectus, otherwise money become refundable to the applicants. But when the issue is underwritten, the company is sure of getting the minimum subscription, as the underwriters act as insurers against under-subscription.

Did u know? **Sub-underwriting**

Every underwriter has a certain limit up to which he would go in for taking risk by entering into an underwriting contract. The underwriters usually choose to spread their risk by using sub-underwriters who agree to take a certain number of shares for which they accept responsibility and for which they receive a commission out of the commission received by the underwriters. The difference between the commissions paid by them to the sub-underwriters is known as overriding commission. SEBI Guidelines relating to underwriting. SEBI guidelines for disclosure and investor protection provide rules as to underwriting.

11.1.3 Brokerage Contracts

In addition to underwriters, a company may also enter into brokerage contracts with brokers. A broker is a person who undertakes to 'place' shares, i.e., find persons who will buy shares, in consideration of an agreed brokerage and if he fails to place any of the shares, he is not personally liable to take them, nor is he entitled to any brokerage in respect of shares not placed. The underwriter, on the other hand, is bound to take up the shares, which the public has not taken and is entitled to the whole of the agreed commission.

Caution It may be noted that there must be authority in the articles to pay brokerage and the brokerage must be disclosed in the prospectus, or statement in lieu of prospectus, as the case may be and it should pay a reasonable brokerage (s.76).

11.1.4 Listing of the Shares on a Stock Exchange

Shares of a public company may be sold or purchased on stock exchange. But for this purpose the company has to get permission from the stock exchange authorities. Section 73 provides that it is necessary for every public company, before issuing shares or debentures for public subscription

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by issue of a prospectus, to make an application for listing the security in one or more recognised stock exchanges. This is known as listing of the shares. The information that permission has been obtained from the stock exchange or that an application for getting permission has been made or will be made, may be mentioned in the prospectus.

The eligibility criteria for listing of securities of a company are: (i) minimum issued equity capital of a company should be ₹ 3 crores; and (ii) the minimum public offer of equity capital shall be not less than 25% [Rule 19(2)].

For listing of its shares, the company has to comply with all the requirements of the Securities Contracts (Regulation) Rules, 1957. Rule 19 (2) (b), requires that at least 25% of each class or kind of securities issued by the company shall be offered for public subscription through newspaper advertisement for a period not less than 3 days and that allotment to such applicants shall be made fairly and unconditionally.

11.1.5 Structure of Share Capital

The amount of authorised capital and its subdivision into equity and preference share capital is given in the Memorandum of Association which is prepared before the certificate of incorporation is obtained. After obtaining the certificate of incorporation and before the issue of prospectus, the Board of directors have to take a decision regarding the total amount of capital which is to be raised by issue of shares and the kinds of shares to be issued. A company cannot issue capital exceeding the authorised capital mentioned in the memorandum. How much capital should be raised at a particular time? It depends upon a number of factors, such as the purpose for which the capital is required (whether for acquiring fixed assets like plant and machinery, etc., or for providing additional working capital); the alternative sources of raising capital (e.g., debentures, public financial institutions and so on). The directors should also decide about the ratio of equity to preference share capital. For certain purposes the Central Government has fixed this ratio at 3:1. Also, the amount of capital in each category, i.e., equity and preference and the amount to be called up at the time of application, allotment, etc., are to be decided. Also, the Board of directors have to decide about the type of preference shares to be issued.

11.1.6 Time of Floatation

The Board of directors will then decide about the time of issue of prospectus. It is advisable to consider the condition of the capital market, the investors' mood, fiscal and monetary policies of the Government and the state of business conditions before issuing a prospectus.

11.1.7 Definition of a Prospectus

A prospectus, as per s.2 (36), means any document described or issued as prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in or debentures of a body corporate. Thus, a prospectus is not merely an advertisement; it may be a circular or even a notice. A document shall be called a prospectus if it satisfies two things: (1) It invites subscriptions to share or debentures or invites deposits. (2) The aforesaid invitation is made to the public.

What constitutes an offer to the public? Section 67 lays down two-way criteria as to what shall constitute an invitation to the public. These are:

1. An invitation to the public shall include an invitation to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner. However, a document by way of

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invitation to existing members or debenture holders to subscribe to shares or debenture by way of right is not a prospectus [s.56 (5)].

2. An invitation shall not be an invitation to the public if it cannot be calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the invitation. Thus, it will not be an invitation to public where B, a friend of A who receives the invitation, also desires to subscribe, but his offer shall be refused because he was not invited to make the same. On the other hand, it will become an invitation to public where his (B's) offer shall also be accepted.

The offering of shares of kith and kin of a director is not an invitation to the public to buy shares. Further, the learned judge in this case held that in all cases the determination of the question of an offer being made to the public depends upon the facts and language of the notice and the particular circumstance of each case.

If a company (other than non-banking finance company and Public Financial Institution) makes an offer to 50 or more persons, it will be treated as a public issue. In other words, private placement by a company shall come under the purview of a 'public issue'.

11.1.8 Small Depositors (S.58AA)

To protect small depositors, sections 58AA and 58AAA provide:

(i) A small depositor is one who has deposited, in a financial year a sum not exceeding ₹ 20000 in a company and includes his successors, nominees and legal representatives. However, the term does not include those small depositors (a) who renewed their deposits voluntarily; or (b) whose repayment is not made due to death or stay order of a competent court or authority.

(ii) Any company accepting deposits shall have to inform the Tribunal, on monthly basis, the names and addresses of each small depositor about its default in repayment of deposit or payment of interest thereon. A period of 60 days is prescribed for intimation of any default to the Central Government which shall, after giving the depositor an opportunity of being heard, pass an appropriate order within 30 days from the date of receipt of such intimation from the defaulting company.

Such a defaulting company is prohibited to accept further deposits from small depositors at any time until the defaults are made good.

(iii) The total numbers of small depositors and the amount due to them in respect of which default is made the fact of whatever of interest accrued on deposits shall be stated in all future advertisements and application forms inviting deposits from the public. Further every application form for accepting deposits shall contain a statement that the applicant has been apprised or every past default of the company in repayment of deposits and for payment of interest thereon to the small depositors.

(iv) Every director of such a defaulting company shall be prohibited to be appointed as a director of any public company for 5 years from the date of the default.

(v) No such defaulting company shall directly or indirectly make any loan to any body corporate, give guarantee or provide security or acquire security of any body corporate till such default continues.

(vi) Every non-compliance is punishable with imprisonment up to 3 years and also fine not less than ₹ 500 for everyday.

(vii) An aggrieved depositor is also entitled to make an application to Tribunal for redressal of his grievance against the company.

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Default in acceptance or refund of deposits to be cognizable (s. 58AAA). Every offence connected with or arising out of acceptance of deposits under s. 58A or s. 58AA is a cognizable offence under the Code of Criminal Procedure, 1973.

Dating of prospectus (s.55). Section 55 states that every prospectus must be dated and that date is deemed to be the date of publication of the prospectus.

Powers of SEBI. Section 55A provides that the provisions contained in sections 55 to 58, 59 to 81, 108-110, 112-113, 116-122, 206, 206A and 207, so far as they relate to issue and transfer of securities and non-payment of dividend shall be administered by SEBI in the cases: (a) in case of listed companies; (b) in case of those public companies which intend to get their securities listed on any recognised stock exchange in India. In any other, case, the Central Government shall be the administering authority.

11.1.9 Contents of a Prospectus

Section 56 lays down that the matters and reports stated in Schedule II to the Act must be included in a prospectus. The format of a prospectus is divided into three parts. In the first part brief particulars are to be given about matters mentioned below:

1. ***General information.*** Under this head information is given about (i) Name and address of registered office of the company. (ii) Name(s) of stock exchange(s) where application for listing is made. (iii) Declaration about refund of the issue if minimum subscription of 90 per cent is not received within 90 days from closure of the issue. (iv) Declaration about the issue of allotment letters/refunds within a period of 10 weeks and interest in case of any delay in refund, at the prescribed rate, under s.73. (v) Date of opening of the issue. (vi) Date of closing of the issue. (vii) Name and address of auditors and lead managers. (viii) Whether rating from CRISIL or any rating agency has been obtained for the proposed debentures/preference shares issue. If no rating has been obtained, this should be answered as 'No'. (ix) Names and address of the underwriters and the amount underwritten by them.
2. ***Capital structure of the company.*** (i) Authorised, issued, subscribed and paid-up capital. (ii) Size of the present issue, giving separately reservation for preferential allotment to promoters and others.
3. ***Terms of the present issue.*** (i) Terms of payment. (ii) How to apply. (iii) Any special tax benefits.
4. ***Particulars of the issue.*** (i) objects. (ii) Project cost. (iii) Means of Financing (including contribution of promoters).
5. ***Company management and project.*** (i) History and main objects and present business of the company. (ii) Promoters and their background. (iii) Location of the project. (iv) Collaborations, if any. (v) Nature of the product. (vi) Export possibilities. (vii) Future prospects (viii) Stock market data for share/debentures of the company including high and low price in each of the last three years and monthly high and low during the last six months, if applicable.
6. Certain prescribed particulars in regard to the company and other listed companies under the same management which made any capital issue during the last 3 years.
7. Outstanding litigations relating to financial matters or criminal proceedings against the company or directors under Schedule XIII.
8. Management perception of risk factors (e.g., sensitivity to foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost/time overrun, etc.)

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

General Information shall include information on matters like: (i) Consent of directors, auditors, solicitors, managers to the issue, Registrars to the issue, Bankers of the Company, Bankers to the issue and experts. (ii) Change, if any, in directors and auditors during the last 3 years and reasons therefore. (iii) Procedure and time schedule for allotment and issue of certificates. (iv) Names and address of Company Secretary, legal advisor, Lead Managers, Co-managers, Auditors, Bankers to the issue. (v) Authority for the issue and details of resolution passed therefor.

Financial information includes: (i) reports of the auditors of the company with respect to its profits and losses and assets and liabilities, and the dividends paid during the five financial years immediately preceding the issue of prospectus; (ii) report by the accountants (who should be named) on the profits or losses for the preceding 5 financial years and on the assets and liabilities on a date which must not be more than 120 days before the date of the issue of the prospectus.

Statutory and Other information includes information about: (i) Minimum subscription. (ii) Expenses of the issue. (iii) Underwriting commission and brokerage. (iv) Previous public or rights issue; if any, giving particulars about date of allotment, refunds, premium/discount, etc. (v) Issue of shares otherwise than for cash. (vi) Commission or brokerage on previous issue. (vii) Particulars about purchase of property, if any. (viii) Revaluation of assets, if any. (ix) Material contracts and time and place where such documents may be inspected. (x) Debentures and redeemable preference shares or other instruments issued but remaining outstanding on the date of the prospectus and terms of their issue.

Part III of the Schedule gives explanations of certain terms and expressions used under Part I and Part II of the Schedule.

11.1.10 SEBI Guidelines Relating to Disclosure on Prospectus

Every prospectus submitted to Stock Exchange Board of India (SEBI) for vetting shall, in addition to the requirements of schedule II to the Act, contain/specify certain particulars as are announced from time to time.

11.1.11 Abridged Form of Prospectus

Section 56(3) requires that no one shall issue any form of application for shares in or debentures of a company unless the same is accompanied by a memorandum (Known as 'Abridged Prospectus') containing such salient features of prospectus as may be prescribed. Thus, instead of appending full prospectus, an 'abridged prospectus' need only be appended to the application form.

In order to provide for greater disclosure of information to prospective investors so as to enable them to take an informed decision regarding investment in shares and debentures, Form 2-A has been prescribed as a format of abridged prospectus. It is further required that the abridged prospectus and the share application form should bear the same printed number and the two should be separated by a perforated line. Accordingly, the investor may detach the application form before submitting the same to the company or the designated bankers.

When 'abridged prospectus' not necessary. In the following circumstances, an 'abridged prospectus' containing the prescribed particulars as per Form 2A need not accompany the application forms: (i) In the case of a bona fide invitation to a person to enter into an underwriting agreement with respect to the shares or debentures. (ii) When shares or debentures are not offered to the public.

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(iii) Where offer is made only to existing members/debenture holders of the company by way of rights, whether with or without the right of renunciation. (iv) In the case of issue of shares or debentures which are in all respects similar to those previously issued and dealt in and quoted on a recognised stock exchange.

Penalty: Non-compliance of the aforesaid provisions by any person shall attract punishment in terms of fine which may extend to ₹ 5,000.

Besides, the omission from a prospectus of a matter required to be included by s.56 may give rise to an action for damage at the instance of a subscriber for share or debentures who has suffered loss thereby. It should be noted that the Act does not say that directors shall be liable, but this seems to be implied from s.56 (4).

11.1.12 Draft Prospectus to be made Public

SEBI requires making public the draft prospectus filed with it. The lead Merchant Bankers shall simultaneously file copies of the draft document with the stock exchanges where the issue is proposed to be listed. Lead Merchant Bankers shall also make copies available to the public. Lead Managers/stock exchanges can charge an appropriate sum from the person requesting such a copy.

11.1.13 The Expert's Consent to the Issue of Prospectus

A prospectus may contain a statement purporting to be made by an expert. The term 'expert' includes an engineer, a valuer, an accountant and any other person whose profession gives authority to a statement made by him. The reports from an expert must not be included in a prospectus unless: (i) such expert is unconnected with the formation or management of the company (s.57); (ii) he gave his consent (s.58); (iii) he is competent to make the report, valuation or statement; (iv) a statement that he has given and not withdrawn his consent thereto appears in the prospectus (s.58).

If the report of the expert is published in contravention of the above mentioned provisions, every person who is knowingly a party to the issue of the prospectus shall be punishable with fine up to ₹ 50,000 (s.59).

11.1.14 Registration of the Prospectus (s.60)

A copy of the prospectus duly signed by every director or proposed director must be delivered to the Registrar before its publication. Further, every copy of the prospectus on its face must state that a copy has been delivered for registration. The copy must have attached to it the following documents namely:

(i) the consent of the expert to file the prospectus;

(ii) a copy of every contract required to be specified in the prospectus or a memorandum giving full particulars of a contract not reduced to writing;

(iii) a copy of every contract appointing or fixing the remuneration of a managing director or manager;

(iv) the consent in writing of a person, if any, named in the prospectus as the auditor, legal adviser, attorney, solicitor, banker to the company to act in that capacity;

(v) consent of directors under s.266;

(vi) a copy of the underwriting agreement, if any; and

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(vii) when the persons making the reports relating to profits and losses, assets and liabilities, etc., in respect of a business proposed to be acquired have made adjustments to them, a signed statement by them stating the adjustments and the reasons for the same.

11.1.15 Prospectus by Implication

Section 64 has been designed to check the by-passing of the provisions of s.56 as given above by making an offer of sale of shares or debentures through the medium of Issue Houses. The process involves allotment of shares to an Issue House who, in turn, will issue advertisement offering shares for sale. Since the advertisement is not issued by the company, it does not amount to a prospectus and thereby liability of non-compliance of s.56 provisions cannot be invoked. To check this malady, s.64 provides that all documents containing offer of shares or debentures for sale shall be included within the definition of the term 'prospectus' and shall be deemed as prospectus by implication of law. All enactments and rules of law as to the contents of prospectuses and as to the liability in respect of statements and omissions from prospectuses shall apply in respect of such documents.

Further, s.64 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 6 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.

In case a document is deemed as prospectus, then it must contain the following information in addition to the information required to be stated in prospectus under s.56: (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.

For purposes of registration of a prospectus under s.60, the persons making the offer of sale to the public are to be deemed as directors of the company.

Where the person making the offer is a company or a firm, the documents (i.e., deemed prospectus) must be signed by at least two directors or one-half of the partners as the case may be.

Circumstances under which a document containing an offer for sale of shares or debentures be not deemed to be a prospectus. A document containing an offer for sale of shares or debentures is a prospectus or not depends upon whether it extends an invitation to the public to subscribe or not. The prima facie test of 'public offer' or 'public invitation' is whether the terms of the offer or invitation are such that, despite its limited circulation, it is open to any person who so chooses to bring his money and apply for shares in response to the invitation. If the offer or invitation is so open, then it constitutes a 'public offer'. If, on the other hand, an offer or invitation can be accepted only by the person to whom it is made and none other, then it will not be deemed to be an offer or invitation to the public.

The word 'public' includes any section of the public (s.67). It may, thus, include all registered medical practitioners in Delhi, all advocates of High Court of Delhi, all Englishmen living in India.

However, in the following cases, the document inviting subscription to shares or debentures of a company shall not be deemed as invitation to the public and hence shall not be a prospectus:

1. A circular inviting existing shareholders or debenture holders of the company. Although s.67(1) provides that such an offer shall be an offer to the public yet in view of the provisions of s. 67 (3) and (4) and that of s. 56 (5), considered view of the authors on the subject is that

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it does not amount to a public offer. The circular containing offer of rights shares is, therefore, not a prospectus.

2. The offering of shares to the kith and kin of a director is not an invitation to the public to buy shares [Rattan Sigh v. Moga Transport Co. Ltd. (1959)]. Such an offer, therefore, shall not be deemed as prospectus.

3. Where an invitation is made by the management of a company to selected persons for subscription or purchase by the persons receiving the offer or invitation, the shares or debentures and such invitation or offer is not calculated directly or indirectly to be availed of by other persons, such invitation or offer shall not be deemed as prospectus [s.67(3)]. However, this is in applicable in a case where the offer or invitation to subscribe for shares or debentures is made to fifty persons or more. In Nash v. Lyne (1929), a document marked 'strictly confidential' containing particulars of a proposed issue of shares was sent by the managing director to a co-director and through him passed on privately to a small circle of friends of the director. The House of Lords held that it was not a prospectus, as there had been no issue to the public.

4. Where a new company, by a circular, offered to buy all the shares of two existing companies and issued its own shares in exchange of those shares, it does not amount to an offer to the public as it neither involves an offer for the purchase of shares for money, nor an invitation for subscription of shares.

Is the issue of prospectus compulsory? When prospectus is not required to be issued? No, issue of prospectus by a company is not compulsory in the following cases:

(i) A private company is not required to issue a prospectus.

(ii) Even a public company need not issue a prospectus if the promoters or directors feel that they can mobilise resources through personal relationship and contacts. In such cases, the company is required to file a statement called 'statement in lieu of prospectus' with the Registrar of Companies.

(iii) A company may issue any forms of application for shares or debentures accompanied by a memorandum containing the prescribed salient features of prospectus (instead of prospectus). However, in such a case, a copy of the prospectus must be made available to any person on request [s.56 (3)].

(iv) Where the application form is issued in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to the shares or debentures (s.56 (3)].

(v) Where the application form is issued in relation to shares or debentures not offered to the public [s.56 (3)].

(vi) Where the shares or debentures are offered to existing holders of shares or debentures (i.e., rights issue) with or without the right of renunciation in favour of other persons [s.56 (5)].

(vii) Where invitation to the public for subscription to the shares or debentures of a company is made in the form of an advertisement, ordinarily called as "prospectus announcement" [s.66].

11.1.16 Self Prospectus and Information Memorandum (Ss.60A and 60B)

Section 60A makes provisions for a self-prospectus in certain situation. A 'shelf-prospectus' means a prospectus issued by any financial institution or bank for one or more issues of the securities or class of securities specified in that prospectus.

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Any public financial institution, public sector bank or scheduled bank whose main object is financing shall file a shelf prospectus with the registrar. In such a situation such a company need not file a prospectus afresh at every stage of offer of securities by it within a period of validity not exceeding one year.

But a company filing a shelf prospectus is required to file an information memorandum (as given in s. 60B below) 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 within such period as may be prescribed by the Central Government, prior to making of a second or subsequent offer of securities under the shelf prospectus.

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

Where an update of information memorandum is filed every time an offer of securities is made, such memorandum together with the shelf prospectus shall constitute the prospectus.

11.1.17 Information Memorandum

Section 60B provides as follows as regards information memorandum:

(i) A public company making an issue of securities may circulate information memorandum to the public prior to filing of a prospectus.

(ii) A company inviting subscription by an information memorandum is bound to file a prospectus prior to the opening of the subscription lists and the offer as a red-herring prospectus, at least three days before the opening of the offer.

The 'red-herring' prospectus means a prospectus which does not have complete particulars on the price of the securities offered and the quantum of securities offered.

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

(iv) Any variation between the information memorandum and the red-herring prospectus shall be highlighted as variations by the issuing company.

(v) Every variation as made and highlighted under (iv) is to be individually intimated to the persons invited to subscribe to the issue of securities.

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

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

(viii) Any application for subscription which is acted upon by the company or underwriters or bankers to the issue without having given enough information of any variations, or the particulars of withdrawing the offer or opportunity for canceling the postdated cheques

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or stock-invest or stop payments for such payments shall be void. Further, the applicants shall be entitled to receive a refund or return of its postdated cheques or stock-invest or subscription moneys on cancellation of its application, as if the said application had never been made and the applicants are entitled to receive back their original application and interest at 15% from the date of encashment till payment of realization.

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

11.1.18 Statement in Lieu of Prospectus (S.70)

If a public company makes a private arrangement for raising its capital then it must file a statement in lieu of prospectus with the Registrar at least three days before any allotment of shares or debentures can be made. Schedule III contains a model form of a Statement in Lieu of Prospectus in pursuance of s.70; Schedule IV contains a model form of a Statement in Lieu of Prospectus when a private company is converted into a public company in pursuance of s.44. If allotment of shares or debenture is made without filing the Statement in lieu of prospectus, the allottee may avoid it within two months after the statutory meeting, or where no such meeting is to be held, within two months of the allotment. Contravention also renders the company and every director liable to a fine up to ₹ 10,000.

Self Assessment

Fill in the blanks:

1. A document shall be called a ……if it satisfies two things which includes It invites subscriptions to share or debentures or invites deposits and the aforesaid invitation is made to the public.
2. A copy of the prospectus duly signed by every director or proposed director must be delivered to the ……before its publication.
3. For purposes of registration of a prospectus under s.60, the persons making the offer of sale to the public are to be deemed as ……of the company.

11.2 Liability Concerning Prospectus

11.2.1 Liability for Untrue Statements in the Prospectus (Ss.62-63)

The prospective shareholders are entitled to all true disclosures in the prospectus. The persons issuing the prospectus are bound to state everything accurately and not omit material facts.

What is an untrue statement? According to s.65 (1): (a) A statement included in a prospectus shall be deemed to be untrue, if the statement is misleading in the form and context in which it is included; and (b) where the omission from a prospectus of any matter is calculated to mislead, the prospectus shall be deemed in respect of such omission, to be a prospectus in which an untrue statement is included. The expression 'included' with reference to a prospectus means, included in the prospectus itself or contained in any report or memorandum appearing on the face thereof or by reference incorporated therein or issued therewith.

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Example: A company issued a prospectus. All the statements included therein 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 [Rex v. Kylsant, (1932) 1 K. B. 442].

A person who has applied for shares in the company and who has been allotted shares has certain remedies against the company and the persons issuing the prospectus. But a buyer of shares in the open market or a subscriber to the memorandum has no such right. If, however, a prospectus is issued with the object of including persons to buy shares in the open market, any person who buys shares even in the open market on the basis of the statements made in it has a right of action if the statements are untrue or there is material omission from the prospectus.

A false statement or omission of material facts gives rise to civil as well as criminal liability.

11.2.2 Civil Liability (S.62)

Where a prospectus is issued inviting persons to subscribe for shares in, or debentures of a company, the following persons shall be liable to pay compensation to every subscriber for loss or damage he may have sustained by reason of any untrue statement included in the prospectus on the faith of which he had applied for the shares or debentures:

1. every person who is a director of the company at the time of the issue of the prospectus;
2. every person who has authorised himself to be named and is named in the prospectus as a director, or as one having agreed to become a director, either immediately, or after an interval of time;
3. every promoter of the company; and
4. every person (including an expert) who has authorised the issue of the prospectus. But an expert is liable only in respect of his own untrue statements.

Thus, an allottee of shares, who had applied for shares on the faith of prospectus containing untrue statements has remedies available against the different persons, i.e., the company, directors, promoters and experts.

Remedies against the company. Any person who, relying on misstatements in or omission of material facts from a prospectus, takes shares from the company may: (1) rescind the contract to take the shares; (2) claim damages. The effect of the rescission of the contract would be that the shareholder would give up the shares and get back his money with interest. He must, however, take action to rescind to contract: (a) within a reasonable time, (b) before proceedings to wind up the company have commenced; and (c) before he does anything (after he comes to know of the misstatements in the prospectus), which is inconsistent with the right to repudiate, e.g., to accept dividends. The allottee can claim relief only if he can show that the misstatement or omission was: (i) one of fact and not of law, nor an expression of opinion, (ii) material; and (iii) acted upon by him.

The second right of the allottee against the company is to sue for damages for deceit. In order to succeed, the allottee must, in addition to the three facts mentioned above (in connection with the rescission of contract), prove: (i) that those acting on behalf of the company acted fraudulently; (ii) that those purporting to act on behalf of the company were authorised to act in its behalf; and (iii) that he suffered a loss or damages.

Notes

Caution It is important to remember that the allottee cannot both retain the shares and get damages from the company. In actual practice, suit for damages against the company is rarely filed. The usual claim against the company is for rescission of the contract of allotment. Damages are generally claimed from the directors, promoters and other persons who had authorised the issue of the prospectus personally, or from experts who had signed reports referred to in the prospectus.

Remedies against directors or promoters. A shareholder who had been induced to take shares may claim from the directors or promoters or from any one else responsible for untrue statement occurring in the prospectus: (i) damages for fraudulent misrepresentation; (ii) compensation under s.62; (iii) damages for non-compliance with the requirements of s.56 regarding contents of the prospectus.

1. ***Damages for fraudulent misrepresentation.*** An allottee of shares may bring an action for deceit, i.e., fraudulent misrepresentation. There must be an intention to defraud and that is to be proved by him. The directors, etc., will not be liable for the tort of deceit if they honestly believed the statements to be true. The facts in Derry v. Peek were as follows: The directors of a Tramway Company issued a prospectus stating that they had the right to run tram-cars with steam power instead of with horses as before. In fact, the Act incorporating the company provided that such power might be used with the sanction of the Board of Trade. But the Board of Trade refused to give permission and the company had to be wound up. P, a shareholder sued the directors for damages for fraud. The House of Lords held that the directors were not liable in fraud because they honestly believed what they said in the prospectus to be true.

2. ***Compensation for untrue statement (s.62).*** Another remedy available to an allottee of shares for misstatements in a prospectus is to file a suit for compensation under s.62. A claim can be made, whether the statements are fraudulent or innocent. Section 65 provides that a statement is deemed to be untrue if it is misleading in the form and context in which it is issued. It is not necessary for the allottee to prove any fraud or knowledge on the part of the directors that the statement was untrue.

   If a director pays damages under s.62, he is entitled to recover contributions from his co-directors, if they, too, are guilty of misstatement, misrepresentation, untrue statement; and on the death of the co-directors, from their estates.

3. ***Defences available to avoid civil liability [s.62(2)].*** Section 62 names persons who are liable to pay compensation but certain defences are available to them. In a claim for compensation, the director may prove in defence that:

   (i) he withdrew his consent to act as director before the issue of the prospectus and it was issued without his authority or consent; or

   (ii) the issue was made without his knowledge or consent and on becoming aware of the issue he gave reasonable public notice of that fact; or

   (iii) he withdrew his consent after the issue of the prospectus but before allotment and public notice was given; or

   (iv) he had reasonable ground to believe that the statements were true and believed them to be true; or

   (v) the statement was correct and fair summary or copy of an expert's report; or

   (vi) the statement was made by an official document.

Notes

Another remedy available to an allottee of shares is to file a suit for damage in case the prospectus does not include the matters required to be included in accordance with the provisions of the Act.

Remedies against expert. The allottee to the shares who has been induced to take shares on the faith of an untrue statement of an expert in the prospectus is entitled to claim from the expert: (i) damages, (ii) compensation under s.62.

An expert is liable in damages in respect of his own untrue statement, wrong report or valuation made by him and contained in the prospectus and the same principles apply as in the case of a fraudulent or an innocent statement made by the directors. An expert is also liable to pay compensation under s.62. However, he shall not be liable if he proves: (i) that having given his consent, he withdrew it in writing before delivery of a copy of the prospectus for registration; or (ii) that after delivery of prospectus for registration and before allotment, he became aware of the untrue statement, withdrew his consent in writing and gave reasonable public notice of the withdrawal and his reasons; or (iii) that he was competent to make the statement and believed on reasonable grounds that it was true.

Liability under s.56. An omission from a prospectus of a matter required to be stated under s.56 (i.e., as per Sch. II) may give rise to an action for damages at the instance of a subscriber for shares, who has suffered loss thereby, even if the omission does not make the prospectus false or misleading. But, the plaintiff must prove that he has sustained damage by reason of the omission of a matter required to be stated in the prospectus. A director or other person sued under s.56 may escape liability if he proves: (a) that he had no knowledge of the matter not disclosed; or (b) that the contravention arose out of an honest mistake of fact; or (c) in the opinion of the court, non compliance or contravention was not material or that the person sued ought reasonably to be excused, having regard to all the circumstances of the case.

11.2.3 Criminal Liability for Misstatement in Prospectus (S.63)

Where a prospectus contains an untrue statement, every person authorizing its issue is punishable: (i) with imprisonment for a term up to two years or (ii) with fine up to ₹ 50,000, or (iii) with both imprisonment and fine. However, an expert is not criminally liable in respect of misstatements in the prospectus.

Liability under s.68. Section 68 provides that any person who, either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or by any dishonest concealment of material facts, induces or attempts to induce another person to enter into or to offer to enter into any agreement for, or with a view to acquiring, disposing of, subscribing for, underwriting shares or debentures shall be punishable with imprisonment for a term which may extend to 5 years or with fine which may extend to ₹ one lakh or with both.

11.2.4 Golden Rule for Framing of Prospectus

The 'Golden Rule' for framing of a prospectus 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 representation 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.

Notes

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 profit. Held: the prospectus was false and misleading. The statement though true in itself was rendered false in the context in which it was stated.

A half truth, for instance, represented as a whole truth may tantamount to a false statement (Lord Halsbury in Aarons Reefs v. Twisa). Thus, the persons issuing the prospectus must not include in the prospectus all the relevant particulars specified in Parts I & II of Schedule II of the Act, which are required to be stated compulsorily but should also voluntarily disclose any other information within their knowledge with might in any way affect the decision of the prospective investor to invest in the company.

Notes **Allotment of Shares in Fictitious Names Prohibited (S.68A)**

Following acts are punishable with imprisonment for a term extending to five years:

(i) making an application to a company for acquiring or subscribing for, any shares therein under a fictitious name; or

(ii) making a company to allot or register any transfer of shares therein to any other person in a fictitious name.

Also this Section should be prominently reproduced both in the prospectus as well as in application forms for shares.

Initial offer of securities to be in dematerialized form i certain cases (s. 68B). Every listed company, making initial public offer of any security for a sum of spaces ten crores or more, shall issue the same only in dematerialized form by complying with the requisite provisions of the Depositories Act, 1996 and regulations made thereunder.

Self Assessment

Fill in the blanks:

4. Where a prospectus contains an untrue statement, every person authorizing its issue is punishable with imprisonment for a term up to ……years.

5. The 'Golden Rule' for framing of a prospectus is that the ……..nature of the company's venture should be disclosed.

6. The persons issuing the prospectus are bound to state everything accurately and not …….material facts.

11.3 Share and Share Capital

Section 2(46) defines a share "as a share in the share capital of a company and includes stock except where a distinction between stock and share is expressed or implied". This definition does not bring out the meaning of a share in its true perspective. A share signifies the following:

(i) The interest of a shareholder in the company; the right to receive dividend, attend meetings, vote at the meeting and share in the surplus assets of the company, if any, in the event of the company, being wound up [Bacha F. Guzdar v. Commissioner of Income Tax, Bombay, L. R. 617 (S. C.)];

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(ii) The liability of the shareholder in the company to pay calls on shares until fully paid up;

(iii) The right of the shareholder to transfer the shares subject to the articles of association (For this purpose s.82 classifies shares as movable property transferable in the manner provided in the articles);

(iv) Binding covenants on the part of the company as well as the shareholder, as given in the Articles of the company.

Thus, a share of a company in the hands of a shareholder signifies a bundle of rights and obligations.

Did u know? **A share is not a negotiable instrument**

Section 83 requires that each share in a company having a share capital must be distinguished by its appropriate number. The Companies (Amendment) Act, 1999 amended s.82 to the effect that for the word 'shares', the words 'shares and debentures' shall be substituted.

11.3.1 Share vs Share Certificate

A common man uses 'share' and 'share certificate' to mean the same. It is, therefore, important to note the exact differences between the two. Section 82, in this regard describes a share as a moveable property transferable in the manner provided by the articles of the company and s.84, on the other hand, describes a 'share certificate' to mean a certificate, under the common seal of the company, specifying any shares held by any member. Section 84 further suggests that a share certificate shall be prima facie evidence of title of the member to such shares. Thus, whereas 'share' represents property, 'share certificate' is an evidence of the title of the member to such property.

Each share bears a distinctive number and it is not the same as share certificate number, the two are different. In fact, a share certificate may be an evidence of many shares, say 50,100 or even 1 lakh. Thus, whereas there will be only one number as the share certificate number for one certificate, there will be as many distinctive numbers in respect of shares as are evidenced by the share certificate.

Thus, the share certificate being prima facie evidence of title, it gives the shareholder the facility of dealing more easily with his shares in the market. It enables him to sell his shares by showing at once marketable title.

Also, a share certificate serves as an estoppel as to payment against a bona fide purchaser of the shares from alleging that the amount stated as being paid on shares has not been paid. However, a person who knows that statements in a certificate are not true cannot claim an estoppel against the company.

11.3.2 Share vs Stock

The share capital of a company is divided into a number of indivisible units of specified amount. Each of such unit is called a 'share'. Thus, if the share capital of the company is ₹ 5,00,000 divided into 50,000 units of ₹ 10 each, unit of ₹ 10 shall be called a share of the company.

The term 'stock' may be defined as the aggregate of fully paid-up shares of a member merged into one fund of equal value. It is a set of shares put together in a bundle. The 'stock' is expressed in terms of money and not as so many shares. Stock can be divided into fractions of any amount and such fractions may be transferred like share. Such fractions, unlike the shares, bear no distinctive numbers.

Notes

Table 11.1: Share and Stock

Share	Stock
A share has a nominal value.	A stock has no nominal value.
A share has a distinctive number which distinguish it from other shares.	A stock bears no such number.
Share can be issued originally to the public.	A company cannot make an original issue of stock. Stock can be issued by existing company by converting its fully paid-up shares.
A share may either be fully paid-up or partly paid-up	A stock can never be partly paid-up it is always fully paid-up.
A share cannot be transferred in fractions. It is transferred as a whole.	A stock may be transferred in any fractions.
All the shares are of equal denomination.	Stock may be of different denominations.
Shares can be issued by any company public or private.	Stock can be issued only by a public company limited by shares.

A company cannot make an original issue of the stock. A company limited by shares may, if authorised by its Articles by a resolution passed in the general meeting, convert all or any of its fully paid-up shares into stock [s.94 (1) (c)]. On conversion into stock, the register of members must show the amount of stock held by each member instead of the number of shares. The conversion does not affect the rights of the members in any way.

11.3.3 Classes of Shares

As mentioned above, a share carries certain rights and is subject to some obligations. A company may issue all shares with same rights and obligations. However, it may issue different types of shares with different rights and liabilities attached to them so as to satisfy the needs of different types of investors. In such a case, the rights attached to the different classes of shares are called class rights. The class rights normally relate to voting, dividends, return of capital or share in the surplus assets of the company (the last two rights being available at the time of winding up) and are invariably set out in the articles of the company. The most common classes of shares are: (1) Preference; (2) Equity or Ordinary; and (3) Deferred or Founders'. A public company and a private company which is a subsidiary of a public company may not issue shares other than equity, preference and cumulative convertible preference shares (CCPS).

The Companies (Amendment) Act, 2000, substituted a new section for s. 86. It provides that the share capital of a company limited by shares shall be of two kinds only, namely: (a) equity share capital (i) with voting rights; or (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed; (b) preference share capital.

11.3.4 Preference Share

A preference share is one which carries the following two rights over holders of equity shares: (i) a preferential right in respect of dividends at a fixed amount or at a fixed rate and (ii) a preferential right in regard to repayment of capital on winding up.

The preference or priority of the preference shareholders is in relation to the rights of equity shareholders [s.85].

Participating and non-participating. If a preference share carries either one or both of the following rights then it is known as participating share: (i) to participate further in the profits

Notes

either along with, or after payment of a certain rate of dividends on equity shares, (ii) to participate in the surplus assets at the time of winding up [s.85]. Thus, if a preference share does not carry either of these rights, then it will be known as non-participating share. It should be remembered that preference shares are always presumed to be non-participating unless expressly described as participating.

Cumulative and non-cumulative. If a preference share carries the right for payment of arrears in dividend from future profits, then such a share is known as cumulative preference share. Thus, dividends not paid in any year or years accumulate and are paid out whenever profits are available. If a preference share does not carry the right to dividend in arrears, then such a preference share is known as non-cumulative or simple. Thus, if no profits are available in a year, the holders get nothing nor can they claim unpaid dividend in subsequent years. It should be remembered that preference shares are always presumed to be cumulative unless expressly described as non-cumulative.

Redeemable and irredeemable. A preference share which can be redeemed upon the resolution of the Board of Directors, if the articles so provide, is known as redeemable preference share (s.80). A company can issue redeemable preference shares if it complies with the following requirements:

(i) such shares are to be issued as redeemable preference shares; shares issued earlier cannot be converted into redeemable preference shares;

(ii) there must be authority in the articles to issue redeemable preference shares;

(iii) the shares can be redeemed only when they are fully paid up;

(iv) the shares may only be redeemed: (a) out of profits of the company which would otherwise be available for dividend, or (b) out of the proceeds of a new issue of shares – not necessarily of redeemable preference shares made for the purpose of redemption;

(v) if there is a premium payable on redemption, it must have been provided out of profits or out of the share premium account before the shares are redeemed;

(vi) where the shares are redeemed out of profits, a sum equal to the nominal amount of the shares redeemed is to be transferred out of profits to the "Capital Redemption Reserve Account."

The redeemable preference shares can be redeemed by the company either at a fixed date, or after a certain period of time, or at the option of the company. But redemption of such shares shall not be taken as reducing the nominal capital of the company.

The Companies (Amendment) Act, 1999 amended s. 80 to the effect that for the words "share premium account", the words "security premium account" shall be substituted.

Irredeemable preference shares. No company limited by shares can issue any preference shares which are irredeemable or are redeemable after the expiry of ten years from the date of issue. Also, once the company has redeemed the shares, or it is about to redeem them, it may issue new shares up to the same nominal amount and it will be presumed that the preference shares were never redeemed. In such a situation the company's capital is not deemed to be increased and, therefore, no stamp duty is to be paid. This privilege is available only if the redemption takes place within one month after the making of the fresh issue [s.80 (4)].

Non-compliance with the provisions of s.80 will render the company and every officer of the company who is in default liable to a fine up to ₹ 10,000.

Voting rights of preference shareholders. The preference shareholders will vote only on matters directly relating to preference shares. Section 87 (2) mentions the following matters which relate

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to preference shares and preference shareholders can vote on them: (i) any resolution for winding up of the company; (ii) any resolution for the reduction or repayment of share capital; (iii) any resolution at any meeting, if dividend on cumulative preference shares remains unpaid for at least two years. Holders of non-cumulative preference shares shall have a right to vote on all resolutions, if their dividends are in arrear for the two financial years during a period of six years ending with the financial year preceding the meeting. [s.87(2)].

11.3.5 Equity Share

'Equity share' means a share which is not preference share (s.85). The rate of dividend is not fixed. The Board of Directors recommend the rate of dividend which is then declared by the members at the Annual General Meeting. Before recommending dividend on equity shares, the Board of Directors have to comply with the provisions of law as regards depreciation, transfer of a minimum amount to reserves, etc.

The holders of equity shares have voting rights in proportion to the paid-up equity capital of the company [s.87(1)].

Section 86, provides that the new issues of share capital of company limited by shares shall be of two kinds only, namely: (a) equity share capital – (i) with voting rights; or (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions, as may be prescribed; (b) preference share capital prior to the amendment to the Companies Act in 2000, public companies were not allowed to issue equity shares with differential rights.

Thus, companies are now allowed to issue non-voting equity shares. However, these shares can be issued subject to the rules and conditions prescribed by the Department of Companies Affairs. The Department of Companies Affairs has notified the 'The Companies (Issue of Share Capital with Differential Voting Rights) Rules 2001' which, *inter alia,* provide for the following:

1. Share with differential voting rights, including non-voting shares, cannot exceed 25 per cent of the total issued share capital.
2. The company issuing such shares must have distributable profits in the three years preceding such issues.
3. Companies will not be allowed to convert its equity capital with regular voting rights into shares with differential voting rights and vice versa.
4. Issue of such shares must be approved by the shareholders by way of resolution in a general meeting: The notice of the general meeting to shareholders shall carry an explanatory statement detailing, inter alia, the following: (a) voting rights which shares with differential rights will carry; (b) scale or proportion to which the voting rights of such shares will vary; (c) that the members holding equity shares with differential rights will be entitled to bonus and rights shares of the same class.
5. Listed companies must obtain the shareholders' approval through postal ballot.
6. Companies which have defaulted in filing annual returns during the preceding three years or have failed to repay their deposits or interest thereon on due date or redeem debentures on due date or pay dividend after becoming due, will not be eligible to issue shares with differential rights.
7. Again, companies which have defaulted in addressing investors' grievances will not be allowed to issue such shares.
8. Issue of such shares must be authorized by Articles of Association of the company.

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9. The company should not have been convicted of any offence under SEBI Act, 1992, Securities Contract (Regulation) Act, 1956 and FEMA, 1999.

10. Members holding equity shares with differential rights shall be entitled to bonus and rights issue of the same class.

The holders of equity shares carrying voting rights shall have voting rights in proportion to the paid-up equity capital of the company [Section 87(1)].

11.3.6 Cumulative Convertible Preference Shares (CCPS)

The Government vide its guidelines dated 19th August, 1985 permitted issue of another class of shares by public limited companies, called cumulative convertible preference shares.

The Guidelines issued by the Ministry of Finance in this regard are as follows:

1. ***Applicability.*** The guidelines will apply to the issue of CCPS by public limited companies which propose to raise finance.

2. ***Objects of the issue.*** The objects of the issue of the above instruments should be for any of the following purposes: (a) Setting-up of new projects; (b) Expansion or diversification of existing projects; (c) Normal capital expenditure for modernisation; and (d) Working capital requirements.

3. ***Quantum of issue.*** The amount of CCPS cannot exceed the equity shares offered to the public for subscription. However, in case of projects assisted by financial institutions, the quantum of issue would be approved by the financial institutions/banks.

4. ***Terms of issue.*** (i) CCPS would be deemed to be equity issue for the purpose of calculation of debt equity ratio as may be applicable; (ii) The entire issue of CCP would be convertible into equity shares between the end of 3 years and 5 years as may be decided by the company and approved by the Controller of Capital Issue CCI (Now, SEBI); (iii) The conversion of the CCP shares into equity would be deemed as being one resulting from the process of redemption of the preference shares out of the proceeds of a fresh issue of shares made for the purposes of redemption; (iv) The rate of preference dividend payable on CCP would be 10%; (v) The guidelines in respect of preference shares regarding ratio of 1:3 as between preference shares and equity shares would not be applicable to this new instrument; (vi) On conversion of the preference shares into equity shares, the right to receive arrears of the dividend, if any, on the preference shares up to the date of conversion shall devolve on the holder of the equity shares on such conversion. The holder of the equity shares shall be entitled to receive the arrears of dividend as and when the company makes profit and is able to declare such dividend; (vii) The aforesaid CCP share would have voting rights as applicable to preference share under the Companies Act; (viii) The conversion of aforesaid preference shares into equity shares would be compulsory at the end of 5 years and the aforesaid preference shares would not be redeemable at any stage.

5. ***Denomination.*** The face value of CCP share will ordinarily be ₹ 100 each.

6. ***Listing.*** CCP shares shall be listed on one or more stock exchange in the country.

7. ***Articles of association of the company and resolution of the general body.*** The articles of association of the company proposing to issue CCPs should contain a provision for issue of such shares. Further, the company must submit with the application to the SEBI/a certified copy of a special resolution in this regard under s.81 (1A) of the Companies Act, duly passed in the general meeting of the company. This resolution must approve the issue of CCP shares and provide for compulsory conversion of the preference shares between the 3rd to 5th year, as the case may be.

Notes

11.3.7 Deferred or Founder's Shares

A pure private company can issue shares of a type other than those discussed above (s.90). Thus, it may issue what are known as deferred shares. As deferred shares are normally held by promoters and directors of the company, they are usually called founder's shares. They are usually of a smaller denomination, say one rupee each. However, they are generally given equal voting rights with equity share which may be of higher denomination, say ₹ 10 each. As regard payment of dividend to holders of such shares, the articles usually provide that these shares will carry a dividend fixed in relation to the profits available after dividends have been declared on the preference and equity shares. Thus, the promoters, founders and directors have a very direct interest in the success of such a company; the greater the profits of the company the higher their dividends.

It is to be remembered, however, that as and when the private company converts itself into a public company, it will have to alter its capital structure and retain only equity share capital and preference share capital (including CCPs), if any.

11.3.8 Non-voting Shares

'Non-voting shares' as the term suggests are shares which carry no voting rights. These are contemplated as altogether a different class of shares which may carry additional dividends in lieu of the voting rights. The companies (Amendment) Act, 2000 provided for issue of such type of equity shares under s. 86.

The Companies (Amendment) Act, 1999, allowed issue of sweat equity shares subject to fulfillment of certain conditions. A new Section - 79A was inserted for this purpose. The provisions are:

Notwithstanding anything contained in s.79, a company may issue sweat equity shares of a class of shares already issued if the following conditions are satisfied: (a) the issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting; (b) the resolution specifies the number of shares, current market price, consideration, if any and the class or classes of directors or employees to whom such equity shares are to be issued; (c) not less than one year has, at the date of the issue elapsed since the date on which the company was entitled to commence business; (d) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations of SEBI. In case of a company whose shares are not listed on any recognised stock exchange, the sweat equity shares may be issued in accordance with the guidelines as may be prescribed. For the purposes of this section, the expression 'a company' means company incorporated, formed and registered under this Act and includes its subsidiary company incorporated in a country outside India.

Did u know? **Sweat Equity Shares**

The expression "sweat equity shares" means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available rights in the nature of intellectual property rights or value additions, by whatever named called.

However, all the limitations, restrictions and provisions relating to equity shares shall be applicable to such sweat equity shares.

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11.3.9 Employee Stock Option Scheme/Employee Stock Purchase Plan

'Employee stock option' means the option given to the whole-time directors, officers or employees of a company which gives such directors, officers or employees the benefit or right to purchase or subscribe at a future date, the securities offered by a company at a predetermined price. SEBI issues guidelines regarding these schemes/plans.

11.3.10 Issue of Shares at Par, at Premium and at Discount

A company may issue shares at par, or at premium, or at a discount.

Issue at par. Shares are deemed to have been issued at par when subscribers are required to pay only the amount equivalent to the nominal or face value of the shares issued. For instance, if the face value of a share is ₹ 10 and the buyer is required to pay thereon ₹ 10 only – nothing more nothing less – then he will be said to be holder of a share issued at par.

Issue at a premium. In the above example, if the buyer is required to pay more than the face value of the share, e.g., ₹ 12.50 on a share of ₹ 10, then the share is said to be issued or sold at a premium.

The Companies Act, 1956 does not stipulate any conditions or restrictions regarding the issue of shares by a company at a premium. However, it does impose conditions regulating the utilisation of the amount of premium collected on shares. Firstly, the premium cannot be treated as profit and, therefore, cannot be distributed as dividend. Secondly, the amount of premium received in cash and the equivalent of it received in kind must be kept in a separate bank account known as the 'Share Premium Account'. Thirdly, the amount of share premium is to be maintained with the same sanctity as the share capital. Fourthly, the share premium account cannot be treated as free reserves as it is in the nature of capital reserve. Fifthly, the amount credited to the 'Share Premium Account' can be used only for the purposes listed in s.78(2).

In accordance with the provisions of s.78(2), the share premium can be utilised only for the following purposes: (i) to pay for unissued shares of the company to be issued to members of the company as fully paid bonus shares; (ii) to write off the preliminary expenses of the company; (iii) to write off the expenses or the commission paid or discount allowed on, any issue of shares or debentures of the company; (iv) to provide for the payment of premium payable on the redemption of redeemable preference shares or of any debentures of the company.

The issue of shares at a premium does not require the sanction of any governmental agency. The company is, however, required to ensure compliance of SEBI guidelines in this regard.

The Companies (Amendment) Act, 1999 amended s. 78 to the effect that for the word 'share' in the section, the word 'securities' shall be substituted.

Issue at a discount. If the buyer of shares is required to pay less than the face value of the share, e.g., ₹ 8.50 on a share of ₹ 10, then the share is said to be issued or sold at a discount. However, the issue of shares at a discount is regulated by law and s.79 provides for certain conditions subject to which shares can be issued at a discount. These conditions are:

1. The issue of shares at a discount is authorised by a resolution passed by the company in general meeting and sanctioned by the Company Law Board.
2. The issue must be of a class of shares already issued.
3. The maximum rate of discount must not exceed 10 per cent or such higher rate as the Central Government may permit in any special case.
4. Not less than one year has, at the date of issue, elapsed since the date on which the company was entitled to commence business.

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5. The shares to be issued at a discount must be issued within two months of the sanction by the Central Government or within such extended time as it may allow; and

6. Every prospectus at the date of its issue must mention particulars of the discount allowed on the issue of shares, or the exact amount of the discount as has not been written off. In case of default, the company and every officer of the company who is in default shall be punishable with fine which may extend to fifty rupees.

11.3.11 Bonus Shares

A company may, if the articles so provide, capitalise profits by issuing fully paid-up shares to the members thereby transferring the sums capitalised from the profit and loss account or Reserve Account to the Share Capital [s.205 (3)]. Such shares are known as bonus shares and are issued to the existing members of the company free of charge.

The issue of bonus shares is regulated not only by the Companies Act, 1956 but also by the guidelines issued by SEBI in this regard.

11.3.12 Rights Shares

The existing members of the company have a right to be offered shares, when the company wants to increase its subscribed capital. Such shares are known as "right shares" but they are not issued free of charge.

Section 81 provides that where at any time after the expiration of two years from the date of incorporation of the company or after one year from the date of the first allotment of shares, whichever is earlier, a public company limited by shares, issues further shares within the limits of the authorised capital, its directors must first offer these shares to the existing holders of equity shares in proportion, as nearly as circumstances admit, to the capital paid up on their shares at the time of the further issue. The company must give notice to each of the equity shareholders, giving him the option to buy the shares offered to him by the company. The shareholders must be informed of the number of shares he has the option to buy. He must be given at least fifteen days to decide whether he would exercise his option or not. If the shareholder does not inform the company of his decision, he shall be deemed to have declined the offer. Unless the articles of the company otherwise provide, the directors must state in the notice of offer the fact that the shareholder has also the right to renounce the offer, in whole or part, in favour of some other person who need not be member of the company. If the shareholder declines or is deemed to have declined or if the person in whose favour the renunciation is made declines to buy the shares, the company's directors may dispose of those shares in such manner as they may think fit.

Exceptions: However, the company may, by special resolution in general meeting, decide that the directors need not offer the shares in the further issue to the existing equity shareholders and that they may dispose them off in any manner whatsoever. But where, it has been possible to muster ordinary majority only, the directors may not offer the shares to the existing equity shareholders, if permission is obtained from the Central Government. Further, s.81 does not apply to a private company. Thus, a private company need not offer its further issue first to existing shareholders. Directors are free to offer them in the manner they deem fit. Further, s.81 is not applicable in the case of issue of shares against conversion of loans or debentures.

SEBI has issued guidelines regarding Rights Issues.

Duty of transferor to transferee in respect of rights shares. There may be pending transfers at the time when a rights issue takes place. This raises the question whether the transferor of an unregistered transfer is under any obligation towards his transferee to apply for the rights

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shares for the benefit of the transferee. The Supreme Court in R. Mathalone v. Bombay Life Assurance Co. Ltd. AIR 1953 SC 385 has observed that after the transfer form has been executed, the transferor cannot be held to undertake any additional financial burden in respect of the shares at the instance of the transferee where, after the transfer of shares, but before the company had registered the transfer, the company offered rights shares to its members. The transferor could not be compelled by the transferee to take up on his behalf the rights shares offered to the transferor and all that he could require the transferor to do was to renounce the rights issue in the transferee's favour.

Allotment to renouncee. As per s.81(1)(c), unless the Articles of the company otherwise provide, the letter of offer of rights shall be deemed to include a right to renounce the shares offered to a member in favour of any other person; and the notice sent to him must contain a statement to this effect. When a shareholder renounces any of the rights shares offered to him, in favour of third person, it is not in the nature of transfer of such shares. The Board of Directors, therefore, cannot refuse to allot the shares to the renouncee unless the Articles so provide - Re Simo Securities Trust Ltd. (1972) 42 Comp. Cas. 457.

However, the right to renounce shares is not available to members of a s.43A company even to the limited extent of renouncing in favour of other members. The Articles of a company may contain provisions enabling members to transfer shares to each other, but that is different from a renunciation of shares - Needle Industries' case (supra).

In the case of shares registered in joint names, any of the joint holders may lodge a letter of renunciation.

11.3.13 Conversion of Loans or Debentures into Shares

There is one more situation where the existing equity shareholders may lose the right to be offered the shares, discussed above. Sub-sections (4) to (7) of s.81 provide for such a contingency.

A company may issue shares to its lenders or debentures-holders who have been given the option to convert their loan or debentures into shares. However, the company can do so only if such conversion has been approved before the issue of debentures or raising of the loan by a special resolution and also by the Central Government. But no such special resolution is necessary where the lender or the debenture-holder is either the Government or any institution specified by the Central Government in this behalf. Moreover, the Central Government may allow a Government holder of debentures or a Government lender of money to the company to ask for shares of the company in lieu of the loan or debenture amount, even though the instrument of loan or debenture does not contain any option for conversion. A copy of every such order issued by the Central Government must be laid in draft before each House of Parliament while it is in session for a total period of thirty days.

Section 94A empowers the Central Government to administratively increase the authorised capital when conversion is ordered by it and the company does not have shares to issue and has not increased its share capital by ordinary resolution.

Self Assessment

Fill in the blanks:

7. The term ……. may be defined as the aggregate of fully paid-up shares of a member merged into one fund of equal value.
8. The issue of bonus shares is regulated not only by the Companies Act, 1956 but also by the guidelines issued by…….

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9. The Companies Act, 1956 does not stipulate any conditions or restrictions regarding the issue of shares by a company at a…….

11.4 Share Capital

It means the capital of a company, or the figure in terms of so many rupees divided into shares of a fixed amount, or the money raised by the issue of shares by a company.

11.4.1 Meaning of Share Capital

A public company and its subsidiary can issue only two kinds of shares, viz., preference and equity. Therefore, such a company can have only two kinds of share capital by issue of preference shares and equity shares, viz., preference share capital and equity share capital. The expression "Preference Share Capital" and "Equity Share Capital" are used in the following different senses:

Nominal, authorised or registered capital. This is the sum stated in the memorandum as the share capital of a company with which it is proposed to be registered. This is the maximum amount of capital which it is authorised to raise by issuing shares and upon which it pays stamp duty. As we shall see later, when the original amount of the authorised capital is exhausted by issue of shares, it can be increased by passing an ordinary resolution.

Issued capital. It is that part of the authorised capital which the company has issued for subscription. The amount of issued capital is either equal to or less than the authorised capital.

Subscribed capital. It is that portion of the issued capital which has been subscribed for by the purchasers of the company's shares. The amount of subscribed capital is either equal to or less than the issued capital.

Called-up capital. The company may not call up full amount of the face value of the shares. Thus, the called-up capital represents the total amount called-up on the shares subscribed. The total amount of called-up capital can be either equal to or less than the subscribed capital.

Thus, uncalled capital represents the total amount not called up on shares subscribed and the shareholders continue to be liable to pay the amounts as and when called. However, the company may reserve all or part of the uncalled capital, which can then be called in the event of the company being wound up. For this purpose, a special resolution is required to be passed and then it is known as Reserve Capital or Reserve Liability (s.99).

Paid-up capital. Paid-up capital is the amount of money paid-up on the shares subscribed.

11.4.2 Alteration of Share Capital

Section 94 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 by issuing fresh shares;
2. to consolidate and divide all or any of its share capital into shares of larger amount than its existing shares;
3. to convert all or any of its fully paid-up shares into stock and reconvert the 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 paid and unpaid on each share must remain the same;

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5. to cancel shares which, at the date of the passing of the resolution in this behalf, have not been taken or agreed to be taken by any person.

These five clauses are now explained.

1. ***Increase of authorised share capital.*** A company, limited by shares, if the articles authorise, can increase its authorised share capital by passing an ordinary resolution.

   Within 30 days of the passing of the resolution, a notice of increase in the share capital must be filed with the Registrar. On receipt of the notice, the Registrar shall record the increase and also make any alterations which may be necessary in the company's memorandum or articles or both. If default is made in filing the notice, the company and every officer of the company who is in default shall be punishable with fine up to ₹ 50 per day during which the default continues (s.97).

2. ***Consolidation and sub-division of shares.*** Consolidation is the process of combining shares of smaller denomination. For instance, 10 shares of ₹ 10 each are consolidated into one share of ₹ 100.

3. ***Sub-division of shares:*** is just the opposite of consolidation, i.e., one share of ₹ 100 is divided into 10 shares of ₹ 10 each. Once a resolution has been passed, a copy of the resolution is required to be sent within thirty days to the Registrar.

4. ***Conversion of shares into stock and vice versa.*** Stock is simply a set of fully paid-up shares put together and is transferable in any denomination or fraction. On the other hand, a share is transferable as a whole; it cannot be split into parts. For example, a share of ₹ 10 can be transferred as a whole; it cannot be transferred in parts. But if 10 shares of ₹ 10 each fully paid are converted into stock, of ₹ 100, then the stockholder can transfer stock, say, worth ₹ 17 also.

   Section 94 empowers a company to convert its fully paid-up shares into stock by passing a resolution in general meeting, if its articles authorise such conversion. A notice is to be filed with the Registrar within thirty days of the passing of the resolution specifying the shares so converted.

   It is to be noted that stock cannot be issued in the first instance. It is necessary to first issue shares and have them fully paid-up and then convert them into stock. Also, stock can be reconverted into fully paid-up shares by passing a resolution in general meeting.

   When shares are converted into stock, the shareholders are issued stock certificates. In the Register of Members, the amount of stock is written against the name of a particular member in place of number of shares. The stockholder is as much a member of the company as a shareholder.

5. ***Diminution of share capital.*** Sometimes, it so happens that shares are issued, but are not taken up by the members of the public and, therefore, not allotted. Section 94 provides that a company may, if its articles authorise, by resolution in general meeting, cancel shares which at the date of the passing of the resolution in that behalf have not been taken or agreed to be taken by any person and diminish the amount of the share capital by the amount of the shares so cancelled. This constitutes diminution of capital and should be distinguished from reduction of capital which is discussed herein below.

11.4.3 Reduction of Capital

Sections 100-105 provide for the reduction of share capital. A company limited by shares, if so authorised by its articles, may, by special resolution, which is to be confirmed by the Court reduce its share capital:

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(i) by reducing or extinguishing the liability of members for uncalled capital, e.g., where a share of ₹ 10 on which ₹ 5 are paid, is treated as a share of ₹ 5 fully paid-up. In this way the shareholder is relieved from liability on the uncalled capital;

(ii) by paying off or returning capital which is in excess of the wants of the company, e.g., where there is a share of ₹ 10 fully paid-up, reduce it to ₹ 5 and pay back ₹ 5 to the shareholder;

(iii) pay off paid-up capital on the understanding that it may be called up again, e.g., a share of ₹ 10 is fully paid-up, on which ₹ 2.50 may be returned to the shareholder on the condition that when necessary, the company may call it up again. Thus, the difference between method (i) and this method is that the uncalled liability is not extinguished in the latter;

(iv) a combination of the preceding methods;

(v) write off or cancel capital which has been lost or is not represented by available assets, e.g., a share of ₹ 10 fully paid-up is represented by ₹ 7.50 worth of assets. In such a situation, reality can be reintroduced into the balance sheet position of the company by writing off ₹ 2.50 per share. This is the most common method of reduction of capital. The assets side of the balance sheet may include useless assets, fictitious goodwill, preliminary expenses, discount on issue of shares and debentures, etc. These assets are either cancelled or their values are reduced to the extent they are useless. Correspondingly, share capital on the liability side is reduced.

11.4.4 Procedure for Reduction of Capital

After passing the special resolution for the reduction of capital, the company has to apply to the Court by way of petition to confirm the resolution under s.101. The creditors are entitled to object where the proposed reduction of share capital involves either: (1) the diminution of liability in respect of unpaid capital; or (2) the payment to any shareholder of any paid-up share capital, or in any other case, if the Tribunal so directs.

To enable the creditors to object, the Court settles a list of such people. If any creditor objects, either his consent to the proposed reduction should be obtained or he should be paid off or his payment secured. However, the Court may dispense with the consent of a creditor on the company securing payment of the debt or claim by appropriating the full amount or that fixed by the Court.

Section 102 states that if the Court is satisfied that either the creditors entitled to object have consented to the reduction, or that their debts have been paid or secured, it may confirm the reduction. It may also direct that, the words "and reduced" be added to the company's name for a specified period and that the company must publish the reasons for the reduction and the causes which led to it.

Section 103 provides for registration of the Court's order with the Registrar. The company has also to send the minutes giving details of the share capital as altered. The reduction of share capital takes effect only on registration of the Tribunal's order with the Registrar and not before. The Registrar will issue a certificate of registration which will be a conclusive evidence that both the requirements of the Act have been complied with and that the share capital is now as set out in the minutes. The registered minutes are deemed to be substituted for the corresponding capital clause in the memorandum, thereby altering the memorandum within the meaning of s. 40. The copies of the memorandum which will be issued subsequently must, therefore, be in accordance with the articles.

Section 104 provides that after the reduction of capital, the members cease to be liable for calls as regards the amount by which the nominal amount of their shares has been reduced. If,

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however, any creditor entitled to object to the reduction of share capital is not entered on the list of creditors, then every member at the time of the registration of the L.L.B. order and minutes is liable to contribute for the payment of that debt.

Section 105 provides for punishment with imprisonment extending to one year or with fine or both, if any officer of the company knowingly conceals the name of any creditor entitled to object to the reduction or misrepresents the nature or amount of claim or debt or abets such concealment or misrepresentation.

11.4.5 Reduction of Share Capital without the Sanction of the Court

There are some cases in which there is reduction of share capital and no confirmation by the Court is necessary. These are:

(i) ***Forfeiture of shares.*** A company may, in pursuance of its articles, forfeit shares for non-payment of calls.

(ii) ***Surrender of shares.*** It is a shortcut to forfeiture. It may be accepted by the company under circumstances where its forfeiture is justified. It has the effect of releasing the shareholder whose surrender is accepted from liability on shares.

(iii) ***Diminution of capital.*** This has already been explained. Section 94 clearly states that diminution of capital does not amount to reduction of capital.

(iv) ***Redemption of redeemable preference shares.*** This has already been explained as provided by s.80.

(v) ***Purchase of shares of a member by the company under s. 402.*** The Company Law Board may order the purchase of shares of any member of the company by the company, under certain circumstances.

Notes **Reduction of Capital vs Diminution of Capital**

Reduction of capital involves working off past losses against capital cancellation of the uncalled capital or repayment of surplus capital. It may involve reduction of issued capital, subscribed or paid up share capital. Diminution of capital denotes cancellation of the authorised or issued capital (but not subscribed). Diminution of capital does not constitute a reduction of capital within the meaning of the Companies Act. The distinction between reduction and diminution of capital is as follows:

1. Diminution of capital is the reduction of the issued capital. Reduction of capital involves reduction of subscribed or paid up capital; there is no reduction of issued capital.
2. Both require authorisation by Articles but whereas 'diminution' can be effected by an ordinary resolution (if so authorised by Articles), reduction of capital cannot be effected without passing a special resolution.
3. 'Reduction' requires confirmation by Court (s.100) but 'diminution' needs no confirmation by the Court (s.94).
4. In case of 'reduction', Court may order the company to add the words 'and reduced' after its name [s.102 (3) but no such order can be passed in case of 'diminution' s.94].
5. In case of 'diminution', notice is to be given to Registrar within 30 days from the date of cancellation whereupon the Registrar shall record the notice and make the

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necessary alteration in the Memorandum of Association and Articles of Association. In case of 'reduction' more detailed procedure has been prescribed though there is no time limit as in case of 'diminution'.

11.4.6 Purchase of its own Shares by a Company (s.77)

No company limited by shares and no company limited by guarantee and having a share capital, shall have power to buy its own shares, unless the consequent reduction of share capital is effected and sanctioned by the court in pursuance of s.100 to 104 or of s.402. Further, no public company and no private company which is a subsidiary of a public company can directly or indirectly (through loans or guarantee) provide financial assistance to any person to buy shares in the company or in its holding company.

If default is made in compliance of s.77, then the company and every officer of the company in default shall be punishable with a fine up to ₹ 1 lakh.

There are, however, certain exceptions to s. 77. They are: (1) A company may redeem its redeemable preference shares issued under s.80; or (2) A banking company may lend money for the purpose in the ordinary course of its business; or (3) A company in pursuance of scheme for the purchase of fully paid-up shares in the company to be held by trustees for the benefit of its employees including salaried directors, may advance loan for the purchase; or (4) A company may advance loans to its bona fide employees (excluding directors or managers) to enable them to purchase fully paid shares for amount not exceeding six months' salary or wages of each employee; or (5) An unlimited company can purchase its own shares; or (6) A private company which is not a subsidiary of a public company may advance loan or offer guarantee for purchase of its shares. However, even such a company cannot purchase its own shares.

The Companies (Amendment) Act, 1999 inserted three new sections - 77A, 77AA and 77B. The companies have been allowed to buy-back their shares subject to certain safeguards. SEBI (Buy Back of Securities) Regulations, 1998 have also been issued. These are:

1. Section 77A provides that a company may purchase its own shares or other specified securities (also known as "buy-back") out of (i) its free reserves; or (ii) the securities premium account; or (iii) the proceeds of any shares or other specified securities. However, no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

2. This buy-back is allowed only if the following conditions are satisfied: (a) the buy-back is authorised by the articles, (b) a special resolution has been passed in general meeting of the company authorising the buy-back; (c) the buy-back does not exceed 25% of the total paid-up capital and free reserves of the company; also, the buy-back of equity shares in any financial year shall not exceed 25% of the total paid-up equity capital in the financial year; (d) the ratio of the debt owed by the company must not be more than twice the capital and its free reserves after such buy-back. However, the Central Government may prescribe a higher ratio of the debt for a class or classes of companies. The term 'debt' here includes all amounts of unsecured and secured debts; (e) all the shares or other specified securities, for buyback must be fully paid-up; (f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by SEBI; (g) the buy-back in respect of unlisted shares or other specified securities is in accordance with the guidelines prescribed.

3. The notice of the meeting at which special resolution is proposed to be passed shall be accompanied by an explanatory statement stating (a) a full and complete disclosure of all

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material facts; (b) the necessity for the buy-back; (c) the class of security intended to be purchased under the buy-back, (d) the amount to be invested under the buy-back; (e) the time-limit for completion of buy-back. In any case every buy-back shall be completed within 12 months from the date of passing the special resolution.

4. The buy-back may be (a) from the existing security-holders on a proportionate basis; or (b) from the open-market; or (c) from odd lots, (i.e., where the lot of securities of a public company, whose shares are listed on a recognised stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange; or (d) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

5. Where a company has passed a special resolution to buy-back its own shares or other securities, it shall, before making such buy-back file with the Registrar of Companies and the SEBI a declaration of solvency in the prescribed form. This declaration is to be verified by an affidavit to the effect that the Board of Directors of the company has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board and signed by at least two directors of the company, one of whom shall be the managing director, if any.

   However, in case if a company whose shares are not listed on a recognised stock exchange, no such declaration need be filed with SEBI.

   Where a company buys back its own securities, it shall extinguish and physically destroy the securities so bought back within seven days of the last day of completion of buy-back.

6. Where a company completes a buy-back of its shares or other specified securities, it shall not make further issue of the same kind of shares [including allotment of further shares under s.81 (1)] or other specified securities within a period of 24 months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

7. Where a company buys-back the securities, it shall maintain a register of the securities so bought, the consideration paid for the securities bought back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

8. A company shall, after the completion of the buy-back, file with the Registrar and SEBI, a return containing such particulars relating to the buy-back within 30 days of such completion as may be prescribed. However, no such return need be filed with SEBI, in the case of a company whose shares are not listed on any recognised stock exchange.

9. If a company makes a default in complying with the above provisions, the company or any officer of the company who is in default shall be punishable with imprisonment for a term which may extend up to 2 years, or with fine which may extend up to ₹ 50,000 or with both.

10. For the purposes of this Section - (i) 'specified securities' includes employees' stock option or other securities as may be notified by the Central Government from time to time, (ii) "free reserves" shall have the meaning assigned to it in s.372A.

11. Transfer of certain sums to capital redemption reserve account (s.77AA). Where a company purchases its own shares out of free reserves, then a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the balance sheet.

12. Prohibition for buy-back in certain circumstances (s.77B). This section provides that no company shall directly or indirectly purchase its own shares or other specified securities

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(a) through any subsidiary company including its own subsidiary companies, or (b) through any investment company or group of investment companies; or (c) if a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures, or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institution or bank, is subsisting.

13. Further no company shall directly or indirectly purchase its own shares or other specified securities in case it has not complied with provisions of Ss. 159, 207 and 211.

Self Assessment

Fill in the blanks:

10. A public company and its subsidiary can issue only two kinds of shares which are …….and……

11. Sections 100-105 provide for the ……..of share capital.

12. Section 94 provides that, if the …….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 capita.

Caselet

'Buy Back' Back in Action

—by Rajesh Abraham

Buyback of shares are back in action on the bourses with several mid and small-cap companies including SRF Ltd., Revathy Equipment, Caro Info Services, Indiabulls and Essel Propack coming out with buyback offers in recent times.

Analysts said the trend showed the confidence by the managements of companies that stocks deserved better valuation on the bourses.

"Many mid and small stock prices have come down by more than 50 per cent in the recent crash. If you look at the earnings growth of these companies, clearly, these stocks deserved better valuation. Managements of companies are using buybacks to send a message that the current prices do not justify the earnings potential," said Mr Janish Shah, Head (Equity Research), Networth Stock Broking Ltd.

If stock prices remain subdued for a prolonged period of time, the market is likely to witness further offers for buybacks, he said. "I expect more companies to announce buybacks in near term," Mr Shah said.

However, there are fears that promoters may use the buyback route to increase their stake in companies. This does not augur well for investors, according to Mr Kunj Bansal, Chief Investment Officer, Religare Securities.

Companies use their cash surplus in a buyback offer and reduce equity share capital, which indirectly increases the stakes of promoters. "Promoters tend to use the buyback route to hike their holdings using the companies cash reserve instead of using funds in their personal capacity to buy shares from the market through the creeping acquisition route," Mr Bansal said.

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Though there are no set guidelines on the price, analysts said most times the price is fixed at 20-25 per cent premium over the prevailing market price. "This is mainly to ensure that share prices do not fall beyond a certain level during the buyback period," said an official in an investment bank.

For instance, the buyback price by SRF Ltd., which is for about 10 per cent of its equity capital, is fixed at ₹ 250 per share, compared to the prevailing price of ₹ 200-range. This is a premium of 25 per cent. Similarly, Caro Info Services set a price of ₹ 40 per share, compared to the prevailing price of ₹ 33, a premium of 21 per cent.

According to Mr Shah, Networth Stock Broking, the buyback offer should not be at the cost of capital expenditure plans of companies.

Source: thehindubusinessline.com

11.5 Raising of Capital/Issue of Shares

Companies limited by shares have to issue shares to raise the necessary capital for their operations. Issue of shares may be made in three ways. (i) By private placement of shares; (ii) By allotting entire shares to an issue-house, which in turn, offers the shares for sale to the public; and (iii) By inviting the public to subscribe for shares in the company through a prospectus.

Private placement of shares. A private company limited by shares is prohibited by the Act and the Articles from inviting the public for subscription of shares or debentures. It also need not file statement in lieu of prospectus. Its shares are issued privately to a small number of persons known to the promoters or related to them by family connections.

A public company can also raise its capital by placing the shares privately and without inviting the public for subscription of its shares or debentures. In this kind of arrangement, an underwriter or broker finds persons, normally his clients who wish to buy the shares. He acts merely as an agent and his function is simply to procure buyer for the shares, i.e., to place them. Since no public offer is made for shares, there is no need to issue any prospectus. However, under s.70, such a company is required to file with the Registrar a statement in lieu of prospectus at least 3 days before making allotment of any shares or debentures.

As per the guidelines issued by SEBI in June, 1992, private placement of shares should not be made by subscription of shares from unrelated investors through any kind of market intermediaries. This means promoters share should not be contributed by subscription of those shares by unrelated investors through brokers, merchant bankers, etc. However, subscription of such shares by friends, relatives and associates is allowed.

By an offer for sale: Under this arrangement, the company allots or agrees to allot shares or debentures at a price to a financial institution or an Issue-house for sale to the public. The Issue-house publishes a document called an offer for sale, with an application form attached, offering to the public shares or debentures for sale at a price higher than what is paid by it or at par. This document is deemed to be a prospectus [s.64(1)]. On receipt of applications from the public, the Issue-house renounces the allotment of the number of shares mentioned in the application in favour of the applicant purchaser who becomes a direct allottee of the shares.

By inviting public through prospectus: This is the most common method by which a company seeks to raise capital from the public. The company invites offers from members of the public to subscribe for the shares or debentures through prospectus. An investor is expected to study the prospectus and if convinced about the prospects of the company, apply for shares.

Notes

Task A company issued a prospectus advertising that the company has a great potential with turnover of a million bags of cement in a year. It is discovered later that while the company has the installed capacity of one million bags, it had never produced more than 6 lack bags of cement in a year. A buyer of shares seeks remedy against the misleading statement. Would he succeed? Also, analyse the penalties which the company may suffer for making the false statement.

Self Assessment

Fill in the blanks:

13. A ……company limited by shares is prohibited by the Act and the Articles from inviting the public for subscription of shares or debentures
14. Under ……arrangement, the company allots or agrees to allot shares or debentures at a price to a financial institution or an Issue-house for sale to the public.
15. As per the guidelines issued by SEBI in June, 1992, ……of shares should not be made by subscription of shares from unrelated investors through any kind of market intermediaries.

Case Study

Underwriting Gone Sour

Normally, underwriting a public stock offering is a highly profitable, low risk business. In the US, managers and underwriters collect a handsome fee (7% gross spread on IPO, lower on secondary offerings) but assume virtually no risk, because the deals are (usually) pre-sold via investor commitments (circles) before the deal is priced and the underwriters buy it (technically, they purchase it and then resell it to the final owners).

But there is usual, and then there are the exceptions, and the downside of a hung IPO is huge. The underwriters are stuck with a massive block of stock, and the whole world knows they need to unload it. Not a pretty place to be in.

But that's precisely the position that Morgan Stanley, Dresdner Kleinwort, and the members of the underwriting syndicate may soon find themselves with an ill-fated HBOS underwriting.

Morgan Stanley and Dresdner Kleinwort are facing a £4bn bill for underwriting HBOS's rights issue after shares in the Halifax owner collapsed below the price of the planned cash call yesterday.

HBOS shares closed at 258p, down 34 yesterday and 17p below the rights price, amid a sector rout that saw £8bn wiped from the value of banking shares. The sell-off led to rumours that a large hedge fund with long positions in UK housebuilders had gone bust and been forced to liquidate its positions.

Royal Bank of Scotland tumbled 21 to 212¼p after 60m shares were placed in a single trade, a volume large enough to raise eyebrows in the City. The fall came despite a neutral

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Notes

trading statement that chief executive Sir Fred Goodwin described as containing "no new news".

HBOS has been under pressure from short-sellers since announcing its rights issue on April 29. In the seven weeks, its shares have fallen from 495¾p. The final collapse yesterday came even though the bank stated that there had been no material change to performance, saying: "Current trading, and specifically mortgage arrears performance, is in line with the group's expectations."

Bankers said that HBOS's decision to confirm in the same statement that the "fully underwritten rights issue is proceeding according to plan" indicated that Morgan Stanley and Dresdner remained on the hook for the £4bn. UBS and Citigroup, by contrast, were released from their obligations in Bradford & Bingley's aborted £300m rights issue last week after the buy-to-let lender issued a profits warning.

At the close, Morgan Stanley and Dresdner were suffering a £250m paper loss. Their underwriting fees, to be revealed in the prospectus next week, are believed to be between £80m and £100m.

Should they be forced to prop up the issue, it would be the first time underwriters have incurred a loss since Goldman Sachs at BP's flotation in 1987, when the stock market crashed. It could also leave them with effective control of the bank, financiers noted, as the banks would then own roughly 30pc of the enlarged HBOS equity.

There are still five weeks of trading in HBOS shares before the rights issue closes, by which time both underwriters expect the stock to recover. They have already placed much with sub-underwriters. Neither would comment.

The Financial Services Authority (FSA) is also said to be confident that the fund-raising will proceed, though it declined to comment.

HBOS is Britain's biggest savings bank, with £158bn of retail customer deposits, and the largest mortgage lender with 20pc of the market and £235bn on loan.

The regulator is also said to be keenly scrutinising short-sellers for any evidence of "trash and dump", whereby short-sellers spread negative information before offloading the stock. Earlier this year, HBOS was the victim of false rumours that led to an 18pc run and statements from the FSA and Bank of England.

Question

Analyse the situation and discuss the role of underwriter in the case.

Source: nakedcapitalism.com

11.6 Summary

- A share is a share in the share capital of a company. It is a movable property transferable in the manner provided by the articles of the company.
- A share carries certain right and is subject to some obligations.
- The share capital of a company means the capital of a company, or the figure in terms of so many rupees divided into shares of a fixed amount, or the money raised by the issue of shares by a company.
- Companies limited by shares have to issue shares to raise the necessary capital for their operations.

Notes

- A copy of the prospectus duly signed by every director or proposed director must be delivered to the registrar before its publication.
- Sections 100-105 provide for the reduction of share capital. A company limited by shares, if so authorised by its articles, may, by special resolution, which is to be confirmed by the Court
- If a public company makes a private arrangement for raising its capital, then it must file a statement in lien of prospectus with the registrar at least three days before any allotment of shares of debentures can be made.
- In response to the issue of the prospectus the company receives applications for shares.

11.7 Keywords

Bonus Share: The company pays a bonus to its shareholders in the form of shares; a free share thus issued.

Deferred Shares: They are normally held by promoters and directors of the company & are of smaller denomination, say one rupee each.

'Employee Stock Option': It means the option given to the directors, officers or employees of a company to purchase or subscribe at a future by a date, the securities offered company at a predetermined price.

Preference Share: A preference share is one which carries the following two rights over holders of equity shares: (i) a preferential right in respect of dividends at a fixed amount or at a fixed rate, and (ii) a preferential right in regard to repayment of capital on dividing up.

Prospectus: It means any document described or issued as prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in or debentures of a body corporates.

Share: A share is a share in the share capital of a company and includes stock except where a distinction between stock and share is expressed or implied.

Share Certificate: It is a certificate, under the common seal of the company, specifying any shares held by any member.

Underwriting: It consists of an undertaking by a person that if the public fails to take up the issue, he will do so.

11.8 Review Questions

1. You are the managing director of the company and you wanted to alter the share capital of your company. Elucidate the procedure you will follow to do the same.
2. A company, in which the directors hold majority of the shares, altered its articles so as to give power to directors to require any shareholder, who competed with the company's business, to transfer his shares, at their full value, to any nominee of the directors. S had some shares in the company. Is S bound by the alteration?
3. Neha, due to some reason wanted to reduce the share capital of her company. She comes to you for the advice. Advise her and tell her the procedure for the same.
4. A company limited by shares intends to buy some of its own shares. Advise.

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5. "Are the public company able to increase the subscribed capital by allotment of further shares." Justify.
6. A buys from B 400 shares in a company on the faith of a share certificate issued by the company. A tenders to the company a transfer deed duly executed together with B's share certificate. The company discovers that the certificate in the name of B has been fraudulently obtained and refuses to register the transfer. Advice A.
7. Examine the restrictions and limitations on inviting and accepting deposits by companies.
8. You wanted to raise the capital from the public, so you go through the process of prospectus drafting. Analyse the liability in case of the misrepresentations and misstatements in the prospectus along with the extent of penalties for the same.
9. "A share certificate is prima facie evidence of the title of the person whose name is entered on it." Comment.
10. A company issues different shares with different rights & liabilities attached to them so as to satisfy the needs of different investors. Do you agree? Justify.
11. A shareholder approached a director and sold him shares in the company. The director had known at the time of the contract that negotiations were on foot for the purchase by an outsider of all the shares of the company at a higher figure. The shareholder sued to rescind the contract. Advise him.
12. You are the investor in the Company XYZ Ltd. You have applied for the shares of the company on the faith of the false prospectus. Now you are worried for your investment. Analyse the protection granted to you by the company in such a case.

Answers: Self Assessment

1.	prospectus	2.	Registrar
3.	directors	4.	two
5.	true	6.	omit
7.	stock	8.	SEBI
9.	premium	10.	preference, equity
11.	reduction	12.	articles
13.	private	14.	By an offer for sale
15.	private placement		

11.9 Further Reading


Book

S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.


Online links

www.legalserviceindia.com/company%20law/com_2.htm

www.vakilno1.com/bareacts/companiesact/companiesacts.htm

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Unit 12: Management of Companies

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the legal provisions regarding directors;
- Discuss the duties and types of directors;
- Explain the category of directors.

Introduction

A company, being an artificial person, acts through human agency. Accordingly, under the Act, it is necessary for every company to have a Board of Directors. In addition to this, the categories of managerial personnel may be appointed (s.197-A): (i) Managing Director; or (ii) Manager. But s.197A does not prohibit the employment of other managerial personnel, such as executives or whole-time directors, which do not come within the term "managing director" or "manager".

12.1 Directors and their Legal Position

Section 2(13) defines a director as including "any person occupying the position of director, by whatever name called." This is a definition based purely on function; a person is a director if he does whatever a director normally does. But the Act gives no further guidance on the function, duties and position of a director. In reality, directors are the persons who direct, conduct, manage

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or superintend a company's affairs. Section 291 has entrusted the management of the affairs of the company in their hands. They chalk-out the general policy of the company within the framework of the Memorandum of the Company. They appoint the company's officers and recommend the rate of dividend. The directors of company are collectively referred to as the 'Board of Directors'.

The exact position of 'director' is hard to define, as no formal definition, either statutory or judicial, of the term has been given. However, judicial pronouncements have described them as (i) agents, (ii) trustees, or (iii) managing partners.

The directors act as agents of the company and the ordinary rules of agency apply. They exercise the powers and are subject to duties within the framework of the company's Articles, and the Act. For instance, they may make contracts on behalf of the company and they will not be personally liable as long as they act within the scope of their authority. But if they contract in their own name, or fail to exclude personal liability, they also will be liable. If the directors exceed their authority, the same act may be ratified by the company. But if they do something beyond the objects clause of the company, then the act is ultra vires and the company cannot ratify the same. But directors are not agents for the individual shareholders; they are the agents of the company – the artificial person.

The directors have also been described as trustees. But they are not trustees in the full sense of the term in as much as no proprietary rights of the company's property are transferred to them and, therefore, they enter into contracts on behalf of the company and in the name of the company. On the other hand, in the case of a trust, the legal ownership of the trust property is transferred to the trustee and therefore, he can enter into contract in his own name, but whatever he does, he does for the benefit of the beneficiaries.

Although directors are not trustees in the real sense of the term, they occupy an office of the trust and are in certain respects in the position of trustees for the company. Such cases are:

(i) They are trustees of money which comes to their hands or which is actually under their control. If they misapply company's money, they have to make good the same as if they were trustees.

(ii) They are trustees for exercising powers conferred on them for the benefit of the company. For instance, powers to allot shares, to make calls, forfeit shares should be exercised *bona fide* in the interests of the company.

(iii) They stand in a fiduciary relationship to the company and, therefore, whenever there is clash of his personal interests with that of the company, he should keep in mind the company's interests.

A director is in no way a trustee for individual shareholders except when the former induces the latter by misrepresentation to sell the shares to him.

The directors are also sometimes described as managing partners. They manage the affairs of the company on their own behalf and on behalf of other shareholders who elect them.

Did u know? **Are the directors employees of the company?**

They are not employees of the company or employed by the company, nor are they servants of the company, or members of "Company's staff". A director can, however, hold a salaried employment or an office in addition to that of his directorship which may, for these purposes, make him an employee or servant and in such a case he would enjoy rights given to employees as such; but his directorship and his rights through that directorship are quite separate from his rights as employee.

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12.1.1 Legal Provisions as Regards Directors

Some of the important legal provisions as regards directors are summarised as follows:

1. ***Number of Directors.*** Every public company must have at least three directors. Every private company must have at least two directors (s.252). However, a public company having: (a) a paid-up capital of ₹ 5 crore or more; (b) 1000 or more small shareholders may have a director elected by such small shareholders in the manner as may be prescribed. The phrase 'small shareholders' means a shareholder holding shares of nominal value of ₹ 20,000 or less in a public company to which this section applies. This is the minimum legal requirement of the number of directors. The Articles of a company may and usually do, fix the minimum and maximum number of directors of its Board. For instance, the articles may fix 5 as the minimum and 9 as the maximum number of directors of the Board. Also, the articles may fix, within these limits, the number which will constitute the Board for the time being. For instance, in the above example, the number of directors constituting a Board may be fixed at 7.

2. ***Increase in Number of Directors.*** A company in general meetings may, by ordinary resolution, increase or reduce the number of its directors within the limits fixed in that behalf by its articles (s.258).

   In certain cases, the increase in number of directors also requires the approval of the Central Government. Section 259 provides that if a public company, or a private company which is subsidiary a public company wishes to increase the number of its directors beyond the maximum fixed by its articles, the increase even though decided upon by resolution of the company in general meeting will not have any effect unless approved by the Central Government and shall become void if and in so far as it is disapproved by the Central Government. But if the increase in the number will not make the total number of directors more than twelve, no approval of the Central Government is necessary. However, independent private companies and Government companies are exempted from the provisions of s.259.

3. ***Individuals to be directors.*** No body corporate, association or firm shall be appointed director of any company. Only an individual can be a director (s.253).

   Director Identification Number etc.

   The Companies (Amendment) Act, 2006 has amended s.253, and inserted new sections 266A, 266B, 266C, 266D, 266E, 266F and 266G. These are summarised below:

   (a) *Amendment of s.253.* A proviso to s.253 now provides that no company shall appoint or reappoint any individual as director of the company unless he has been allotted a Director Identification Number (DIN) under s. 266B.

   (b) *Application for allotment of DIN (s.266A).* An application for allotment of DIN has to be made to the Central Government for allotment of DIN by the following:

      (i) an individual, intending to be appointed as director of a company; or

      (ii) the director of a company appointed before the commencement of the Companies (Amendment) Act, 2006.

   In (ii) case, the application to the Central Government for the allotment of DIN has to be made within 60 days of the commencement of the Act.

   Further every applicant, who has made an application under this section for allotment of DIN may be appointed as a director in a company or, hold office as director in a company till such time such applicant has been allotted DIN.

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(c) *Allotment of DIN (s.266B).* The Central Government shall, within one month from the receipt of the application under s.266A, allot a DIN to an applicant.

(d) *Prohibition to obtain more than one DIN.* No individual, who had already been allotted a DIN under s.266B, shall apply, obtain or possess another DIN.

(e) *Obligation of director to intimate DIN to concerned Company or Companies (s.266D).* Every existing director shall, within one month of the receipt of DIN from the Central Government, intimate his DIN to the company or all companies wherein he is a director.

(f) *Obligation of company to inform DIN to Registrar (s.266E).* This section provides that every company shall, within one week of the receipt of intimation under s.266D, furnish the DIN of all its directors to the Registrar or any other officer or authority, as may be specified by the Central Government.

(g) *Obligation to indicate DIN (s.266F).* This section provides that every person or company, while furnishing any return, information or particulars as are required to be furnished under the Act, shall quote the DIN in such return, information or particulars in case such return, information or particulars relate to the director or contain any reference of the director.

(h) *Penalty for contravention of provisions of sections 266A, 266C, 266D or 266E, (s.266G).* If any individual or director, referred to in s.266A or 266C or 266D or a company referred to in s.266E, contravenes any of the provisions of those sections, every such individual or director or the company, as the case may be, who or which, is in default, shall be punishable with fine which may extend to ₹ 5000 and where the contravention is continuing one with a further fine which may extend to ₹ 500 for every day after the first during which the contravention continues.

4. ***Appointment of Directors.*** The appointment of directors rests in the following hands: (a) Subscribers to the Memorandum- s.254; Clause 64 (Table A); (b) Company in general meeting - Ss. 255-57; 263-265; (c) Board of Directors - Ss.260, 262, 313; (d) Central Government- s.408; (e) Third parties - s.255.

Appointment of First Directors. The first directors are usually named in the articles of a company. The Articles may, however, instead of naming the first directors confer power on the subscribers, or majority of them to appoint the directors. Where the appointment is to be made by the majority of subscribers, the majority of them (and not only the quorum fixed by the Articles) should be present if the appointment is to be valid. Where there are no Articles or the Articles neither name them nor confer any such power on the subscribers, then Clause 64 of Table A in Schedule I to the Act confers powers on the subscribers or a majority of them to make the appointment of first directors. Furthermore, if the Articles neither name them, nor do they contain a provision for their appointment by the subscribers and Table A is excluded, then the subscribers to the memorandum who are individuals are deemed to be the first directors of the company until the directors are duly appointed at a general-meeting of the company in accordance with the provisions of s.255.

Appointment of Subsequent Directors. Sections 255 and 265 provide for three schemes for the constitution of the Board of Directors of a public company or a private company which is subsidiary of a public company. These are: (i) All the directors retire at every Annual General Meeting [s.255]; or (ii) At least two-thirds of the total number of directors must be persons whose period of office is liable to determination by retirement by rotation (s.255); or (iii) At least two-thirds of the directors may be appointed by the principles of proportional representation, by a single transferable vote by a system of cumulative voting or otherwise and shall be directors for a period of three years at a time (s.265). The

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remaining directors in (ii) and (iii) and the directors generally of a pure private company, unless otherwise provided in the Articles, must also be appointed by the company in general meeting.

Thus, every company should have a duly constituted Board appointed in accordance with the provisions of s.255. A general meeting is called by the 'first' directors after the allotment of shares in the case of a company limited by shares and in the case of any other company, after its incorporation, for the specific purpose of appointment of directors.

Appointment in General Meeting. Section 256 provides that at the first AGM after the general meeting at which the first directors are appointed in accordance with s.255, the number nearest to one-third of the directors liable to retire by rotation must retire from office. The rotation for retirement shall be determined by the length of office of directors, or in case all were appointed on the same day, by lot. At every subsequent AGM, one-third of the directors must retire. This is known as retirement by rotation. The retiring directors are, however, eligible for re-election.

Deemed Reappointment of a Retiring Director. Section 256 also provides for automatic reappointment of directors in certain cases. The company may fill the vacancy caused by the retirement of a director at the AGM by appointment of the same person or someone else, or decide not to fill the vacancy. If the vacancy is not filled up and the company has not expressly decided not to fill it up, the meeting shall stand adjourned till the same day in the next week, at the same time and place and if at that meeting also the vacancy is not filled up and that meeting also does not decide not to fill it up, the retiring director shall be deemed to have been elected at the adjourned meeting except where: (i) at that meeting or at the previous meeting a resolution for the reappointment of such director had been put to vote but was lost; or (ii) the retiring director has, in writing, expressed his unwillingness to continue; or (iii) he has been rendered disqualified; or (iv) a special or ordinary resolution is necessary for his appointment by virtue of any provisions of this Act; or (v) it is resolved not to fill the vacancy.

In respect of an independent private company s.256 does not provide for retirement of any director periodically. Therefore, in the absence of any provisions in the Articles, directors are entitled to continue until removed under s.284 [S. Labh Singh v. Panaser Mech. Works (P) Ltd. (1987)].

Appointment of a director other than a retiring director. Section 257 provides for the procedure of appointment of a person other than the retiring director. If any person, other than the retiring director wishes to stand for directorship, he must signify his intention to do so by giving 14 days' notice to the company before the meeting and the company must inform the members not later than seven days before the meeting either by individual notices or by advertisement of this fact in at least two newspapers circulating in the place where its registered office is situated, of which one must be in English and the other in the regional language of the place. Also the candidate or the member who intends to propose him as director has to deposit a sum or ₹ 500 which shall be refunded to such person or as the case may be, to such other member, if the candidate succeeds in being elected. In case such person is not elected as director, he or the member, as the case may be, will not be entitled to the refund of ₹ 500 and the amount deposited shall stand forfeited by the company. Also s.264 requires every person proposed as a candidate for the office of a director to sign and file first with the company his consent to act as a director, if appointed and then with Registrar within 30 days of his appointment.

Section 263 prescribes the mode of voting on appointment of directors. No motion can be made at a general meeting of a public company or a private company which is a subsidiary of a public company for the appointment of two or more persons as directors by a single

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resolution, unless a resolution is first unanimously passed that it shall be so made. Any resolution moved in contravention of this provision shall be void.

Appointment by Board of Directors. The Board of Directors can exercise the power to appoint directors in the following three cases: (i) Additional directors (s.260). (ii) Filling up the casual vacancies (s.262). (iii) Alternate directors (s.313).

If the Articles authorise, the Board may appoint additional directors. Such additional directors together with the directors constituting the Board should not exceed the maximum number fixed by the Articles. Also, the additional directors are entitled to hold office only up to the date of the next AGM of the company (s.260).

Section 262 empowers the Board to fill casual vacancies in the case of a public company or a private company which is subsidiary of a public company. Thus, if the office of any directors appointed by the company in general meeting is vacated before his term of office expires in the normal course, the resulting casual vacancy, may, subject to any regulations in the Articles of the company, be filled by the Board of Directors at a meeting of the board. Any person so appointed shall hold office only up to the date to which the original director would have continued if it had not been vacated.

By virtue of s.313, alternate director, in place of a director who is absent from the State in which Board meetings are held for not less than three months, may be appointed by the Board, if so authorised by the Articles or by a resolution passed by the company in general meeting. The alternate director shall not hold office for a period longer than that permissible to original director and shall vacate office when the original director returns to such State. Also, if the term of office of the original director is determined before he so returns, any provision for the automatic reappointment (under s.256) of retiring directors in default of another appointment shall apply to the original director and not to the alternate director.

The Articles of a company may authorise a director to appoint by will or otherwise his successor in office. This appointment is not hit by s.312 which prohibits assignment of office by director.

Appointment by Central Government. Section 408 empowers the Central Government to appoint directors on the Board of a company on the recommendation of Tribunal that it is necessary to appoint government directors to effectively safeguard the interests of the company or its shareholders or the public interest. On the application of not less than 100 members of the company or of members holding not less than one-tenth of the total voting power therein, the Company Law Board may, if satisfied after making any inquiry it deems fit that it is necessary to prevent oppression and mismanagement and that the affairs of the company are being carried on in a manner which is prejudicial to the interest of the members or the company or the public, direct the appointment of as many persons (whether members of the company or not) as directors as it thinks fit to hold office for such period not exceeding three years on any one occasion. The Company Law Board, however, instead of passing the above order direct the company to alter its Articles so as to arrange for the election of its directors on the principle of a proportional representation under S.265.

A person appointed by the Central Government in pursuance of the above provisions shall not be: (a) considered for the purpose of reckoning 2/3rds or any other proportion of the total number of directors of the company [s.408(3)]; (b) required to hold qualification shares [s.408(4)]; (c) required to retire by rotation [s.408(4)]; and (d) required to file written consent with the company under s.264(1).

The Central Government may remove any such director from his office at any time and appoint another person to hold office in his place the provisions of this section are applicable to both public and private companies.

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Appointment by third parties. Under s.255, there cannot be more than one-third of the total number of directors, which are not subjected to retirement by rotation. The third parties may be empowered by the Articles to nominate directors. Such third parties may be lenders of money - i.e., financial institutions, debenture holders.

5. ***Number of Directorships.*** A person cannot hold office at the same time as a director in more than twenty companies (s.275). In computing this number of 20 directorships, the directorships of (i) private companies (other than subsidiaries) (ii) unlimited companies (iii) non-profit association and (iv) alternated directorships will be omitted (s.278).

   If a person, who is already a director of 20 companies, is appointed a director in any other company, the appointment will not be effective unless within 15 days thereafter, the director so has vacated his office in any of the companies in which he was already a director as to keep the number within the maximum allowed. None of the new appointments of director shall take effect until such choice is made and all the new appointments will become void if the choice is not made within 15 days of the day on which the least of them were made (s.277). Any person who holds office of, or acts as a director of more than 20 companies in contravention of the foregoing provisions is liable to be fined up to ₹ 5,000 in respect of each of those companies after the first 20 companies (s.279).

Example: If a person is already a director of 20 public companies and if a private company of which he is a director has become a public company under s.43-A, then, he will have to give up the directorships of one of those companies.

6. ***Qualifications and Disqualifications of Directors.*** The Act has not prescribed any academic or professional qualifications for the directors. Also, the Act imposes no share qualification on the directors. So, unless the company's Articles contain a provision to that effect, a director need not be a shareholder unless he wishes to be one voluntarily. But the Articles usually provide for a minimum share qualification. Where a share qualification is fixed by the Articles of a company, the Act provides (s.270) that: (i) it must be disclosed in the prospectus; (ii) each director must take his qualification shares within two months after his appointment; (iii) the notional value of the qualification shares must not exceed ₹ 5,000 or the nominal value of the one share where it exceeds ₹ 5,000; (iv) share warrants will not count for purposes of share qualification.

   If a director fails to obtain his share qualification within two months, he vacates office automatically on the expiry of two months from the date of his appointment and if he acts as director after the expiry of two months without taking the qualification shares, he is liable to a fine up to ₹ 50 for every day until he stops acting as such (s.272).

   However, the articles of a company cannot compel a person to hold qualification shares before he is elected a director nor can they require him to obtain qualification shares within a shorter period than two months after his appointment and if any provisions to this effect is made in the Articles, it shall be void.

   The effect of this provision is that, if the company is wound up during this period of two months, the director cannot be placed in the list of contributories, in as much as there is no express or implied contract under which he would be bound to take the qualification shares, since his name cannot be put on the register of members unless he has applied for shares and these are allotted to him.

   However, a private company which is not a subsidiary of a public company may, by its Articles, provide additional qualifications for a director, such as, a person must be a B. Com. or holding a fixed deposit receipt in his own name issued by the company.

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Section 274 has laid down certain disqualifications and therefore, the following persons are incapable of being appointed directors of any company: (i) a person found by the court to be of unsound mind; (ii) an undischarged insolvent; (iii) a person who has applied to be adjudged an insolvent; (iv) a person who has been convicted anywhere in the world for an offence involving moral turpitude and sentenced in respect thereof to imprisonment for not less than six months and a period of five years has not elapsed from the date of the expiry of the sentence; (v) a person who has failed to pay calls on shares for six months from the date fixed for the payment; (vi) a person who has been disqualified by court under s.203 which empowers the court to restrain fraudulent persons from managing companies; (vii) such person is already a director of a public company which, (a) has not filed the annual accounts and annual returns for any continuous three financial years; or (b) has failed to repay its depositor interest there on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more. Further such person shall not be eligible to be appointed as a director of any other public company for a period of 5 years from the date on which such public company, in which he is a director, failed to file annual accounts and annual returns under (a) above or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in (b).

The disqualifications mentioned under (iv) and (v) above may be removed by the Central Government by a notification in the Official Gazette. On the other hand, a private company may provide in its Articles that a person shall be disqualified for appointment as director on any other additional ground. However, a subsidiary private company or a public company cannot, by its Articles, provide for any additional disqualifications.

Notes **Minor as a Director**

In the case of a minor, though there is no provision in the Act, expressly disqualifying him, as he is not competent to contract, he cannot file either with the company or with the Registrar any valid consent to act as director, as required by s.264. But as s.264 applies only to public companies there is nothing prohibiting a minor being a director of a private companies. However, from a practical point of view a minor can be an ornamental director as he cannot be party to any transaction which requires competency to contract - nor, for the same reason, can he be delegated any powers of the Board. He may possibly vote on all resolutions at Board meetings.

7. ***Vacation of Office of a Director.*** Section 283 provides for the office of the director becoming vacant on the happening of certain contingencies. It provides that the office of a director shall become vacant if: (i) he is found to be of unsound mind by a competent court; (ii) he is adjudged insolvent; (iii) he fails to obtain within two months of his appointment, or ceases to hold at any time thereafter his share qualification, if any; (iv) he is convicted of any offence involving moral turpitude and sentenced to imprisonment for not less than six months; (v) he fails to pay any call within six months from the last date fixed for the payment; (vi) he absents himself from three consecutive meetings of the Board of Directors, or from all meetings of the board for a continuous period of three months, whichever is longer, without obtaining leave of absence from the Board; (vii) he becomes disqualified by an order of the court under s.203 which restrains fraudulent persons from managing companies; (viii) he is removed in pursuance of s.284 by an ordinary resolution of which special notice was given; (ix) he accepts a loan from the company in contravention of s.295; (x) he fails to disclose to the Board his interest in any contract entered into by the company as required by s.299; (xi) if he became the director by virtue of an office, on coming to an end of that office. A private company may provide additional grounds in its Articles for vacation of office of a director. If a person functions as a director after the office has

become vacant on account of any of the disqualifications specified in (i) to (xi), he shall be punishable with fine up to ₹ 500 for every day during the period he so functions.

8. ***Removal of Directors.*** A director may be removed under S.284, or 388B-E.

Removal by shareholders. Section 284 provides that company may by ordinary resolution passed in general meeting after special notice, remove a director before the expiry of his term of office. But the following directors cannot be removed by the company in general meeting: (i) a director appointed by the Central Government under s.408; (ii) a director of a private company holding office for life on April 1, 1952; (iii) director elected by the principle of proportional representation under s.265.

On receipt of the special notice, the company must forthwith send a copy thereof to the director concerned to enable him to make a representation. If he makes a representation in writing and requests the company to notify it to the members, the company must, unless it is received by it too late for it to send to the members, state the fact of the representation in any notice of the resolution given to the members. It should also send a copy of the representation to every member of the company to whom notice of the meeting is sent. If the representation is not sent as aforesaid the company must at the instance of the director concerned read it out at the meeting. The director is also entitled to be heard on the resolution at the meeting.

The vacancy caused by the removal of a director may be filled at the same meeting and if so filled, person appointed thereto will only hold office for the residue period of the removed director. If the vacancy is not filled by the company in general meeting, the Board of Directors may fill it as if it were a casual vacancy in accordance with s.262, but the Board cannot appoint the removed director.

Removal by Central Government. The provisions of Ss.203 and 204 prohibit certain persons from acting or being appointed as directors and provide for their removal only if they were convicted for offences involving moral turpitude. In all those cases conviction or finding of guilt by the court is the prerequisite for bringing about vacation of office. Strict proof of guilt in a criminal case is essential and very often such persons may go scot-free in spite of malpractices. The finding of the Tribunal will enable the Central Government to take quick action against persons involved in cases of fraud, etc. For this purpose a Chapter IV-A and Ss.388B to 388E have been inserted in the Act.

Under s.388B, the Central Government has the power to make a reference to the Company Law Board against any managerial personnel. The power can be exercised where, in the opinion of the Central Government, there are circumstance suggesting:

(a) the any person concerned in the conduct and management of the affairs of a company is or has been guilty of fraud, misfeasance, persistent negligence of default in carrying out his obligations and functions under the law, or breach of trust in connection therewith; or

(b) that the business of the company is not or has not been conducted and managed by such person in accordance with sound business principles or prudent commercial practices; or

(c) that the business of the company is or has been conducted or managed by such person in a manner which is likely to cause or has in fact caused, serious injury or damage to the interest of trade, industry or business to which such company pertains; or

(d) that the business of the company is or has been conducted and managed by such person with an intent to defraud its creditors, members, or any other person or

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otherwise for a fraudulent or unlawful purpose or in a manner prejudicial to public interest.

9. ***Resignation by a Director.*** There is nothing in the Act as to whether and by what procedure, a director can resign. The Act, however, indirectly recognises resignation through the provisions in s.318 one of which is that no director is entitled to compensation if he resigns his office. In S.S. Lakshmana Pillai v. Registrar of Companies (1977) 47 Comp. Cas. 652 (Mad), it was held, that if there is a provision in the articles, resignation will take effect in accordance with such provision and if there is no provision, resignation will take effect in accordance with its terms. Notice may be written or oral.

10. ***Directors not to Hold Office or Place of Profit.*** Section 314 imposes certain restrictions on the holding of office or place of profit in a company by the directors and their associates. Following is the summary of restrictions so provided:

    (a) No director of a company shall hold any office or place of profit (carrying any remuneration) under the company or its subsidiary except with the consent of the company by a special resolution. It shall, however, be sufficient if the special resolution is passed at the first general meeting held after such appointment.

    A director shall be deemed to hold an office or place of profit under the company if the director holding an office obtains from the company anything by way of remuneration over and above the remuneration to which he is entitled as such director. Such remuneration may be by way of salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence or otherwise.

    (b) Except by passing a special resolution, partner or relative of such director, no firm in which such director or a relative of such director, is a partner, no private company of which such director is a director or member and no director, or manager of such a private company shall hold any office or place of profit carrying a total monthly remuneration of such sum as may be prescribed (presently ₹ 3,000 per month). Again, special resolution may be passed at the first general meeting after the appointment made. Where, however, the aforesaid appointment made without the knowledge of the director, the consent of the company may be obtained either in the general meeting aforesaid or within 3 months from the date of the appointment, whichever is later.

    However, a director or any of his associates may be appointed as managing director, manager, banker or trustee for the debenture holders of the company without sanction of special resolution, if the remuneration received from such subsidiary in respect of such office or place of profit is paid over to the company or its holding company.

    For the aforesaid appointment of a director or his associates, special resolution shall not only be necessary at the time of first appointment but also for every subsequent appointment on a higher remuneration not covered by the special resolution except where an appointment on a time-scale has already been approved by the special resolution.

    It may be noted that the aforesaid restrictions do not apply where a relative of a director or a firm in which such relative is a partner holds any office or place of profit under the company or a subsidiary thereof having been appointed to such office or place before such director became a director of this company.

    (c) (i) No partner or relative of a director or manger, (ii) no firm in which such director or manger, or relative of either is a partner, (iii) no private company of which such a director or manager, or relative of either, is a director member, shall hold an office or place of profit in the company carrying a total monthly remuneration of not less

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than such sum as may be prescribed (Presently, ₹ 6,000 per month). The aforesaid appointment may, however, be made by passing a special resolution and the approval of the Central Government.

If any director or his associate holds an office or place of profit in contravention of the aforesaid provisions, then: (i) he shall be deemed to have vacated such office or place of profits as such on and from the date next following the date of the general meeting. (ii) he shall be liable to refund to the company any remuneration received or the monetary equivalent of the perquisites or advantage enjoyed by him. The company cannot waive the recovery any sum refundable to it as above unless permitted to do so by the Central Government.

The aforesaid restrictions do not apply to a person who being the holder of any office of profit in the company is appointed by the Central Government, under s.408, as a director of the company.

Meaning of 'office or place of profit'. Any office or place shall be deemed to be an office or place profit under the company: (a) in case the office or place is held by a director, if the director holding it obtains from the company anything by way of remuneration over and above the remuneration to which he is entitled as such director, whether as salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence, or otherwise; (b) in case the office or place is held by an individual other than a director or by any firm, private company or other body corporate holding it obtains from the company anything by way of remuneration whether as salary, fees, commission, perquisite, the right to occupy free of rent any premises as a place of residence or otherwise.

Self Assessment

Fill in the blanks:

1. Every public company must have at least ……..directors.
2. A company in general meetings may, by……, increase or reduce the number of its directors within the limits fixed in that behalf by its articles.
3. A person cannot hold office at the same time as a director in more than ……companies

12.2 Managing Director and Manager

Section 2(26) defines 'managing director' as a 'director' who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board of directors or, by virtue of its memorandum or articles of association, is entrusted with substantial powers of management which would not otherwise be exercisable by him. The expression includes a director occupying the position of a managing director, by whatever name called.

However, the power to do administrative acts of routine nature when so authorised by the Board such as the power to affix the common seal of the company to any document or to draw and endorse any cheque on the account of the company in any bank or to draw and endorse any negotiable instrument or to sign any certificate of share or to direct registration of transfer of any share, shall not be deemed to be included within substantial powers of management. Further, a managing director of a company shall exercise his powers subject to the superintendence, control and direction of its Board of Directors.

Some of the more important legal provisions about managing directors are summarised as: (i) He, being a director, must be an individual. (ii) He is appointed, usually to perform such functions and carry out such duties as may be assigned to him by the Board of directors to whom he is responsible or subject. The Board can revoke the authority of the managing director.

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(iii) He must be entrusted with substantial powers of management. (iv) There can be two or more than two managing directors in a company. (v) A person cannot be appointed as managing director of more than two companies unless so permitted by the Central Government.

His appointment is subject to the approval by the Central Government. The Central Government upon application for permission to appoint a person as managing director of the company has power to impose conditions. Ss. 268, 269, 316 and 317 are applicable to a public company or a private company which is subsidiary of a public company.

Caution Section 268 states that an amendment of any provision relating to appointment or reappointment of a managing director (or a whole-time director) shall not be effective unless approved by the Central Government and shall be become void if and in so far as, it is disapproved by the Central Government.

Appointment of managing or whole-time director or manager to require government approval only in certain cases (s.269). Every public company and/or private company which is subsidiary of a public company having a paid-up share capital of not less than ₹ 5 crore must appoint either a managing or a whole-time director or Manager. Also no approval of the Central Government to the appointment of managerial personnel is required on fulfillment of certain conditions laid down in Schedule XIII [including the minimum remuneration under s.198(4) as also increase in the remuneration under Ss. 310 and 311].

For appointment of a managing, whole-time director or a manager, approval of the Central Government would not be required if the following conditions were satisfied:

(i) he had not been sentenced to imprisonment for any period or to fine exceeding ₹ 1,000 for conviction of an offence under any of the fourteen acts mentioned in Schedule XIII;

(ii) he had not been detained for any period under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act 1974;

(iii) he has completed the age of 25 years but has not attained the age of 70 years;

(iv) he is not a managing or whole-time director or manager or in any way in whole-time employment elsewhere;

(v) he is citizen of India and is resident in India;

(vi) the company had neither suffered loss nor had inadequate profits: (a) during the preceding financial year immediate to the financial year in which appointment is made, or (b) in any of the three financial years out of the four financial years immediately preceding.

In case any of the above conditions are not complied with, an application must be made to the Central Government within 90 days of the appointment. If the appointment is not approved by the Central Government the appointee shall vacate the office immediately on communication of the decision by the Central Government.

Section 316 states that a person, who is either the managing director or the manager of any other company (including a pure private company), cannot be appointed a managing director of a public company or a private company which is a subsidiary of a public company. But such an appointment can be made if the board of such company approves of the appointment by a unanimous resolution passed at the Board meeting specific notice of which had been given to all the directors then in India. Also the Central Government is empowered to permit, by order, the same person to be managing director of more than one companies, if it is satisfied and it is necessary for their proper working that the companies should function as a single unit and have a common managing director.

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Section 317 states that the term of office of a managing director cannot exceed five years at a time. Also re-appointments or extension can be made on the basis of 5 years tenure on each occasion, provided each time the re-appointment or extension is made by the company during two years of the existing term.

It may be emphasized that Ss.268, 269 and 317 relating to restrictions on appointment of managing directors (as noted above) do not apply to pure private companies.

Disqualification of a managing director. Section 267 prohibits the appointment or employment or the continuance of the appointment or employment of any person by a company as its managing director or whole-time director, if the said person: (i) is an undischarged insolvent or has at any time been adjudged an insolvent; (ii) suspends, or has at any time suspended payment to his creditors, or makes or has at any time made a composition with them; or (iii) is or has at any time, been convicted by a court of an offence involving moral turpitude.

It may be noted that these disqualifications are in addition to the ones mentioned in s.272 (i.e., disqualifications of a director).

Did u know? **Whole Time Director**

In many sections of the Companies Act, the term 'Whole time director' has been used side by side with that of the 'managing director'. While the term 'managing director' has been specifically defined under Section 2(26), no such definition of a whole time director is available. Explanation to Section 269, however, states that the expression 'whole time director' includes a director in the whole time employment of the company.

Regarding appointment/re-appointment and remuneration of whole time director, same provisions as are applicable to a managing director, are applicable. Under section 269, every public company and a private company which is a subsidiary of a public company must have a managing director a whole-time director if its paid-up share capital is ₹ 5 crores or more. Similarly Sections 267 and 268 providing for disqualifications of managing directors and approval of Central Government for their appointment/re-appointment also make the provisions applicable to whole time directors. Also, the provisions of Sections 309, 310 and 311 dealing with remuneration of directors and other managerial personnel are applicable to whole time directors.

Caution The following points of distinction between a managing director and a whole time director must be noted:

1. A managing director may be appointed in that capacity in two or more companies at the same time but a whole-time director, by virtue of his whole time employee cannot act as such in more than one company.
2. The tenure of a managing director of a public company or a private company which is the subsidiary of a public company cannot be more than five years at a time. There is no such restriction in the case of a whole-time director.

12.2.1 Manager

Section 2(24) states that "manager means an individual who, subject to the superintendence, control and direction of the Board of Directors, has the management of the whole, or substantially the whole of the affairs of the company and includes a director or any other person occupying the position of a manager, by whatever name called and whether under a contract of service or not".

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Thus, an individual must be in charge of the whole or substantially the whole of the business of the company, in order to be called a manager in accordance with the Act. A person who is one of the departmental managers or a branch manager is not deemed to be a manager in this sense. Some of the more important legal provisions about managers are summarised as follows:

1. Only an individual can be appointed a manager of a company (s.384)
2. Section 385 lays down the disqualifications of a Manager. No company shall appoint or continue the appointment or employment of any person as its manager, who (a) is an undischarged insolvent; or (b) has at any time within the preceding five years been adjudged an insolvent; or (c) suspends, or has suspended payment to his creditors; or (d) make, or has at any time, within the preceding five years made a composition with his creditors; or (e) is, or has at any time within preceding five years been convicted of an offence involving moral turpitude.
3. Person may not be appointed manager of more than 2 companies.
4. The provision of the following sections relating to managing directors have been made applicable to Manager also (s.388); (a) s.269: Appointment or re-appointment requires Government approval except in cases specified under Schedule XIII; (b) Ss. 310-311: Provisions for increase in remuneration requires Government approval; (c) s.312: Prohibition of assignment of office by a director; (d) s.317: Term of appointment to be not more than five years at a time.

Notes **Distinction between a Managing Director and a Manager**

The following points of distinction between the two are worth noting:

1. A managing director is entrusted with substantial powers of management. A 'manager', on the other hand, has the management of the whole or substantially the whole of the affairs of a company.
2. A company may have more than one managing director but it cannot have more than one manager.
3. A managing director is appointed either under an agreement or by a resolution of the Board or general meeting or under the provisions of the Memorandum or Articles. A manager, on the other hand, is usually appointed either under a contract of service of by the Board of directors though the Articles may also provide for his appointment.
4. A managing director must be a director whereas a manager may or may not be a director.
5. A managing director, on his ceasing to be a director, shall automatically cease to be the managing director as well. A manager-director, however, can continue as a manager even though he ceases to be a director.
6. The grounds of disqualifications of a managing director as given in Section 267 remain effective for whole life and cannot be waived by the Central Government. Most of the grounds of disqualification of a manager as given in section 385 are only for five years and can also be waived by the Central Government.

Self Assessment

Notes

Fill in the blanks:

4. A person cannot be appointed as managing director of more than two companies unless so permitted by the……...
5. In order to be called a manager in accordance with the Act, an individual must be ……of the whole or substantially the whole of the business of the company.
6. Section 385 lays down the …….....of a Manager.

12.3 Compensation to Directors

12.3.1 Compensation to Directors for Loss of Office

Section 318 provides that no compensation for loss of office may be paid by a company to any director other than the managing director, or whole-time director, or a director holding the office of manager. Even in their cases, no such payment must be made: (i) when he resigns his office on reconstruction or amalgamation of the company; (ii) where the office is vacated under s.203 or s.283; (iii) where he has to give up directorship beyond 20 directorships; (iv) where the winding up of the company takes place due to his negligence and mismanagement; (v) where he has been guilty of fraud or breach of trust in relation to, or of gross negligence in or gross mismanagement of the conduct of the affairs of the company or any subsidiary or holding company thereof; (vi) where he has instigated or has taken part directly or indirectly in bringing about the termination of his office.

Where, however, the compensation is payable, it must not exceed the remuneration which would have been earned by the director for the unexpired residue of the term or for three years whichever is shorter. The calculation of this amount should be based on the average remuneration actually earned by him during a period of three years immediately prior to the date on which he ceased to hold the office, or where he held the office for a shorter period than three years, during such period. No such payment can be made to him if the winding up has commenced either before or at any time within 12 months after the date of his ceasing to hold office, if the assets of the company are not sufficient to repay to the shareholders the share capital including the premium, if any, contributed by them.

12.3.2 Remuneration of Managerial Personnel

Section 198 provides that the total managerial remuneration payable by a public company or a private company which to its directors or manager in respect of any financial year must not exceed 11 per cent of the net profit of that company for that financial year, in computing the above ceiling of 11 per cent computed in the manner laid down in sections 349 and 359. The fees payable to directors for attending Board meetings is not included.

What is included in managerial remuneration? Explanation to s.198 describes the term remuneration. According to it, for the purposes of Ss. 309, 310, 311, 381 and 387, 'remuneration' includes the following: (a) any expenditure incurred by the company in providing rent-free accommodation, or any other benefit or amenity in respect of accommodation free of charge, to any of its directors or manager; (b) any expenditure incurred by the company in providing any other benefit or amenity free of charge or at a concessional rate to any of the persons aforesaid; (c) any expenditure incurred by the company in respect of any obligation or service, which, but for such expenditure by the company, would have been incurred by any of the persons aforesaid;

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and (d) any expenditure incurred by the company to effect any insurance on the life of, or to provide any pension, annuity or gratuity for, any of the persons aforesaid or his spouse or child.

Self Assessment

Fill in the blanks:

7. The total managerial remuneration payable by a public company or a private company which to its directors or manager in respect of any financial year must not exceed ……...of the net profit.
8. Section 318 provides that no compensation for loss of office may be paid by a company to any director other than the……., or wholetime director, or a director holding the office of manager.
9. Explanation to s.198 describes the term…….

12.4 Powers of the Board of Directors

Section 291 provides for general powers of the Board of directors. It provides:

Subject to the provisions of the Act, the Board of Directors of a company shall be entitled to exercise all such powers and to do all such acts and things, as the company is authorised to exercise and do.

However, the board cannot exercise any power or do any act or thing which is directed or required, whether by this or any other Act or by the memorandum or articles of the company or otherwise, to be exercised or done by the company in general meeting. In exercising any such power or doing any such act or thing, the Board will be subject to the provisions contained in that behalf in this or any other Act, or in the memorandum or articles of the company, or in any regulations not inconsistent therewith and duly made thereunder, including regulations made by the company in general meeting.

Thus, the Board may exercise all powers of the company and can do all such acts and things that the company can do. But the exercise of such powers of the Board shall be in conformity with the provisions of the Companies Act or any other Act and Memorandum, Articles and resolutions of the company in general meetings. Thus, a general meeting may, by amending the articles, restrict the powers of the Board. But the meeting cannot invalidate any act validly done by the Board except in the cases: (1) where the directors are either unable or unwilling to act [Barron v. Potter (1914) 1 Ch. 895]; (2) when the directors act for their own personal interests in complete disregard to the company [Marshall's Value Gear Co. Ltd. v. Manning Wardle & Co. Ltd (1909) Ch. 267]; (3) when the Board has become incompetent to act e.g. where all the directors constituting the Board are interested in a dealing or where none of the directors was validly appointed [B.N. Vishwanathan v. Tiffins B.A. and Ltd. AIR (1953) Mad 510].

The mode or manner of exercise of board's powers. Section 292 provides that the Board of directors of a company shall exercise the following powers on behalf of the company and it shall do so only by means of resolutions passed at meeting of the Board: (i) the power to make calls on shareholders in respect of money unpaid on their shares; (ii) the power to issue debentures; (iii) the power to borrow money otherwise than on debentures; (iv) the power to invest funds of the company; and (v) the power to make loans.

The Board may, however, by a resolution passed at a meeting delegate to any committee of directors, the managing directors, the manager or any other principal officer of the company, the powers specified in clauses (iii), (iv) and (v) on such conditions as the Board may prescribe.

Notes

Besides the powers specified in s.292, there are certain other powers also which can be exercised only at the meeting of the board. These are: (i) The power of filling casual vacancies in the Board (s.262); to appoint additional directors (s.260); and to appoint alternate directors (s.313) (ii) sanctioning of a contract in which a director is interested [s.297]. (iii) the power to recommend the rate of dividend to be declared by the company at the Annual General Meeting, subject to the approval by the shareholders.

In the following cases, not only that the powers be exercised at the Board's meeting but also that every director present and entitled to vote must consent thereto: (1) The power to appoint a person as managing director or manager, who is already managing director or manager of another company (Ss.316 and 386). (2) The power to invest in any shares and debentures of any other body corporate (s.372).

Restrictions on powers of directors. Section 293 provides that the Board of Directors of a public company or a private company which is a subsidiary of a public company cannot exercise the following powers without the consent of the shareholders in general meeting:

1. Sell, lease or otherwise dispose of the whole, substantially the whole, of the undertaking of the company, or where the company owns more than one undertaking, of the whole or substantially the whole, of any such undertaking.

   However, this restriction does not apply to the case of a company whose ordinary business is to sell or lease properly.

2. Remit or give time for the repayment of any debt due by a director except in the case of renewal or of continuance of an advance made by a banking company to its director in the ordinary course of business.

3. Invest, otherwise than in trust securities, the amount of compensation received by the company in respect of compulsory acquisition of any fixed assets of the company.

4. Borrow money exceeding the aggregate of the paid-up capital of the company and its free reserves. "Borrowing' does not include temporary loans obtained from the company's bankers in the ordinary course of business.

5. Contribute in any year, to charitable and other funds not directly relating to the business of the company or the welfare of its employees, any amount exceeding ₹ 50,000 or 5% of its average net profit for the last three financial years, whichever is greater.

However, contributions of National Defence Fund or any other fund approved by the Central Government for the purpose of national defence are exempted from the above provisions. Any amount may be contributed without obtaining the sanction of the company is general meeting.

Did u know? The Companies Act does not expressly empower companies to borrow money. Therefore, most of the companies expressly provide for such borrowing powers in the memorandum.

In such a case, where memorandum authorises the company to borrow, the Articles provide as to how and by whom these powers shall be exercised. It may also fix up the maximum which can be borrowed by the company.

Self Assessment

Fill in the blanks:

10. The Board may exercise all powers of the company and can do all such acts and things that the ……. can do.

Notes

11. The exercise of powers of the Board shall be in conformity with the provisions of the ……..or any other Act and Memorandum, Articles and resolutions of the company in general meetings.

12. Section 291 provides for ……powers of the Board of directors.

Caselet

SPH Limited

Ken Fennell and Richard McGuire as joint liquidators of SPH Limited (in voluntary liquidation) v Sean Shanahan, Marie Shanahan, Declan Fitzpatrick and Padraic Cullen, 25 May 2005, High Court Facts: This Section 150 application concerned the first and second named respondents of the company. The first named respondent was described as the "prime mover" in the company and in day to day control. The second named respondent was a non-executive director. The company operated under significant financial pressure in its last six months of trading and the liquidator expressed the view that the company may have lacked the necessary measurement controls to trade successfully or profitably resulting in constant cash flow issues. Shortly before the company was wound up it received a demand from the Revenue Commissioners for 277,569.54. The Directors estimated in their statement of affairs that the deficit facing the company was in the order of 1.7 million. The issue facing the court was whether the respondents acted responsibly in relation to the control and supervision of the financial affairs of the company, having regard in particular to the amount of liability to the Revenue Commissioners, and the manner and period of which this had been allowed to accumulate. The question is whether directors acted responsibly in relation to financial affairs of company? The Judge stated that the first and second named respondents either knowingly permitted significant sums due to the Revenue Commissioners to accrue without providing for the payment thereof, or alternatively, if they were unaware of the liabilities accruing that they failed to have in place appropriate systems to inform themselves of the financial position of the company to allow them properly control and manage the affairs of the company.

The Judge said that whilst the company employed an accountant, even if the day to day management of the finances were delegated to him, it could not relieve the first and second named respondents of their obligations to inform themselves about the financial affairs of the company and with their fellow directors to supervise and control the delegated functions.

The Judge concluded that the court was not satisfied that either the first or second named respondents had acted responsibly in relation to the conduct of the affairs of the company whilst a director and therefore made directors of restriction orders against both directors.

Source: http://www.hg.org/articles/article_1162.html.... Published July 11, 2005 ..By: A&L Goodbody

12.5 Duties and Liabilities of Directors and Audit Committee

Duties of directors may be divided under two heads: (1) Statutory duties; and (2) Duties of a general nature. The statutory duties are the duties and obligations imposed by the Companies Act. These have been discussed at appropriate places. Important among them are:

(a) ***To file return of allotments.*** Section 75 charges a company to file with the registrar, within a period of 30 days, a return of the allotments stating the specified particulars. Failure to file such return shall make directors liable as 'officer in default'. A fine up to ₹ 500 per day till the default continues may be levied.

Notes

(b) ***Not to issue irredeemable preferences shares or shares redeemable after 10 years.*** Section 80, forbids a company to issue irredeemable preference shares or preference shares redeemable beyond 10 years. Directors making any such issue may be held liable as 'officer in default' and may be subject to fine up to ₹ 1,000.

(c) ***To disclose interest (Ss.299-300).*** A director who is interested in a transaction of the company must disclose his interest, to the Board. The disclosure must be made at the first meeting of the Board held after he has become interested. This is because a director stands in a fiduciary capacity with the company and therefore, he must not place himself in a position in which his personal interest conflicts with his duty. Interest should be such which conflicts with the duties of the director towards the company.

Notice, however, that the Companies Act does not debar a company from entering into a contract in which a director is interested. It only requires that such interest be disclosed. An interested director should not take part in the discussion on the matter of his interest. His presence shall not be counted for the purpose of quorum. He shall not vote on that matter. If he does vote, his vote shall be void. Non-disclosure of interest makes the contract voidable and not void. Where the whole body of directors is aware of the facts, a formal disclosure is not necessary (Venkatachalapathi v. Guntur Mills). In this case a loan was advanced by the wife of a director creating a mortgage on the property of the company. The director did not disclose his interest and he even voted on the matter. The company later sued to have mortgage set aside. Held, the fact was known to all directors and a formal disclosure was not necessary. As regards voting by the interested director, it was held that the voting would not render the contract void or voidable unless in the absence of that vote, there would have been no quorum qualified to contract.

(d) ***To disclose receipt from transferee of property.*** Section 319 provides that any money received by the directors from the transferee in connection with the transfer of the company's property or undertaking must be disclosed to the members of the company and approved by the company in general meeting. Otherwise the amount shall be held by the directors in trust for the company. This money may be in the name of compensation for loss of office but in essence may be on account of transfer of control of the company. But if it is bona fide payment of damages of the breach of contract, then it is protected by s.321(3).

(e) ***To disclose receipt of compensation from transferee of shares.*** If the loss of office results from the transfer (under certain conditions) of all of the shares of the company, its directors would not receive any compensation from the transferee unless the same has been approved by the company in general meeting before the transfer takes place (s.320). If the approval is not sought or the proposal is not approved, any money received by the directors shall be held in trust for the shareholders who have sold their shares.

Section 320 further provides that in pursuance of any agreement relating to any of the above transfers, if the directors receive any payment from the transferee within one year before or within 2 years after the transfer, it shall be accounted for to the company unless the director proves that it is not by way of compensation for loss of office.

Section 321 further provides that if the price paid to a retiring director for his shares in the company is in excess of the price paid to other shareholders or any other valuable consideration has been given to him, it shall also be regarded as compensation and should be disclosed to the shareholders.

Some other statutory duties are: to attend Board meetings; to convene and hold general meetings; to prepare and place before AGM financial accounts; to make declaration of solvency.

Notes

The general duties of directors are as follows:

(a) ***Duty of good faith.*** The directors must act in the best interest of the company. Interest of the company implies the interests of present and future members of the company on the footing that the company would be continued as a going concern.

A director should not make any secret profits. He should also not exploit to his own use the corporate opportunities. In Cook v. Deeks (1916) AC 554, it was observed that "Men who assume complete control of a company's business must remember that they are not at liberty to sacrifice the interest which they are bound to protect and while ostensibly acting for the company, direct in their own favour business which should properly belong to the company they represent." In this case there was an offer of a contract to the company. Directors who were the holders of shares of 3/4 of the votes resolved that the company had no interest in the contract and later entered the contract by themselves. Held, the benefit of the contract belonged in equity to the company.

(b) ***Duty of care.*** A director must display care in performance of the work assigned to him. He is, however, not expected to display an extraordinary care but that much care only which an ordinary prudent man would take in his own case. Justice Romer in Re City Equitable Fire Insurance Company observed, "His (director's) duties will depend upon the nature of the company's business, the manner in which the work of the company is distributed between the directors and other officials of the company. In discharging these duties a director must exercise some degree of skill and diligence. But he does not owe to his company the duty to take all possible care or to act with best care. Indeed, he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. It is, therefore, perhaps, another way of stating the same proposition that directors are not liable for mere errors of judgement."

Similar view was expressed in Langunas Nitrate Co. v. Lagunas Nitrate Syndicate (1899) 2 Chi. 392, in the following words: "If directors act within their powers, if they act with such care as is to be reasonably expected of them having regard to their knowledge and experience and if they act honestly for the benefit of the company they discharge both their equitable as well as legal duty to the company."

Section 201 states that a provision in the company's Articles or in any agreement that excludes the liability of the directors for negligence, default, misfeasance, breach of duty or breach of duty or breach of trust, is void. The company cannot even indemnify the directors against such liability. But if a director has been acquitted against such charges, the company may indemnify him against costs incurred in defense. Section 633 further states that where a director may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust but if he has acted honestly and reasonably and having regard to all the circumstances of the case, he ought fairly to be excused, the court may relieve him either wholly or partly from his liability on such terms as it may think fit.

(c) ***Duty to attend board meetings.*** A number of powers of the company are exercised by the Board of Directors in their meetings held from time to time. Although a director is not expected to attend all the meetings but if he fails to attend three consecutive meetings or all meetings for a period of three months, whichever is longer, without permission, his office shall automatically fall vacant.

(d) ***Duty not to delegate.*** Director being an agent is bound by maxim 'delegatus non protest delegate' which means a delegate cannot further delegate. Thus, a director must perform his functions personally. A director may, however, delegate in the following cases: (a) Where permitted by the Companies Act or articles of the company; (b) Having regard to the exigencies of business certain functions may delegated to other officials of the company.

Notes

Some other duties are: to convene statutory, annual general meeting and also extraordinary general meeting general meeting when required by the shareholders of the company; to prepare and place at the AGM along with the balance sheet and profit and loss account a report on the company's affairs; to make a declaration of solvency in the case of a Member's voluntary winding up.

The duties of the directors are usually regulated by the company's articles. While performing their duties, they must display reasonable care, honesty, good faith, skill and diligence. As they stand in a fiduciary relationship to the company and they are agents and trustees in certain respects, they are bound to exercise in the performance of their duties a reasonable degree of skill and care.

12.5.1 Liabilities of Directors

The liabilities of directors may be considered under the heads: (1) Liability to the company. (2) Liability to third parties. (3) Liability for breach of statutory duties. (4) Liability for acts of co-directors. (5) Criminal Liability.

Liability to the company. The liability to the company may arise from: (a) breach of fiduciary duty; (b) ultra-vires acts; (c) negligence; and (d) breach of trust and misfeasance.

(a) ***Breach of fiduciary duty.*** Where a director acts dishonestly in disregard to the interests of the company, he will be held liable for breach of fiduciary duty. Most of the powers of directors are 'powers in trust' and therefore, should be exercised in the interest of the company and not in the interest of the directors or any section of members. Thus, where the directors, in order to forestall a takeover bid, transferred the unissued shares of the company to trustees to be held for the benefit of the employees and an interest-free loan from the company was advanced to the trustees to enable them to pay for the shares, it was held to be a wrongful exercise of the fiduciary powers of the directors [Hogg v. Cramphorn Ltd. (1966) 3 All ER 420].

(b) ***Ultra-vires acts.*** Directors are supposed to act within the parameters of the provisions of the Companies Act, Memorandum and Articles of Association since these lay down the limits to the activities of the company and accordingly to the powers of the Board of Directors. The directors shall be held personally liable for acts beyond the aforesaid limits, being ultra-vires. Thus, where the directors pay dividends or interest out of capital, they will be liable to indemnify the company for any loss or damage suffered due to such act.

(c) ***Negligence.*** The directors shall be deemed to have acted negligently in discharge of their duties and consequently liable for any loss or damage resulting therefrom where they fail to exercise reasonable care, skill and diligence. However, error of judgement will not be deemed as negligence. It may be noted that the directors cannot be absolved of the liability for negligence by any provision in the Articles (s.201). The court may award relief to directors against such liability under s.633.

(d) ***Breach of trust and misfeasance.*** Directors are the trustees for the money and property of the company handled by them, as well as the exercise of the powers vested in them. If they act dishonestly or mala fide in the exercise of their powers and performance of their duties, they will be liable for breach of trust and may be required to make good the loss or damage suffered by the company by reason of such mala fide acts. They are also accountable to the company for any secret profits they might have made in transactions on behalf of the company.

Directors can also be held liable for their acts of 'misfeasance', i.e., misconduct or willful misuse of powers. However, misconduct which is not willful shall not amount to 'misfeasance'. Moreover, the directors are entitled to relief against liability for breach of trust or misfeasance under s.633.

Notes

Where a director has misapplied or misappropriated money or property of the company or has been guilty of breach of trust or misfeasance, the court may order him to repay the money or restore the property or to pay compensation [P.K. Nedungadi v. Malayalee Bank Ltd., AIR (1971) S.C. 829].

Liability to third parties. The discussion on liability of directors towards third parties may be grouped as under: (a) Liability under the provisions of the Act. (b) Liability for breach of warranty of authority.

(a) ***Liability under the Act.*** The following provisions make directors personally liable to third parties:

(i) *With regard to prospectus.* Failure to state any particulars as per the requirements of s.56 or misstatement of facts in a prospectus renders a director personality liable of damage to the third party. Section 62 provides that a directors shall be liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus for any loss or damage he may have sustained by reason of any untrue statement included therein. He may, however, escape liability where he proves his innocence.

(ii) *With regard to allotment.* Directors may also incur personal liability for: irregular allotment, i.e., allotment before minimum subscription is raised or without filing a copy of the statement in lieu of prospectus [s.71(3)]. - for failure to repay application money in case of minimum subscription having not been received [s.69(5)]. - for failure to repay application money when application for listing of securities is not made or is refused (s.73).

(iii) *Unlimited liability.* Directors will also be held personally liable to the third parties where their liability is made unlimited in pursuance of s.322 (i.e., vide memorandum) or s.323 (i.e., vide alteration of memorandum by passing special resolution).

(iv) *Fraudulent trading.* Directors may also be made personally liable for the debts or liability of a company by an order of the court under s.542. Such an order shall be made by the Court where directors have been found guilty of fraudulent trading.

(b) ***Liability for breach of warranty.*** Directors are supposed to function within the scope of their authority. Thus, where they transact business in respect of matters ultra-vires the company or ultra-vires the Articles, they may be proceeded against personally for any loss sustained by the third party.

Liability for Breach of Statutory Duties. The Act, imposes numerous statutory duties on the directors under its various sections. Default in compliance of these duties attracts penal consequences. For instance, they are liable as 'officer-in-default' for default in filing return of allotments (s.75); for failure to comply with the provisions of the Act relating to issue of redeemable preference shares or redemption of irredeemable preference shares, etc. (Ss.80, 80A).

Liability for acts of co-directors. A director is the agent of the company and not of the other members of the Board. Accordingly, nothing done by the Board can impose liability on a director who did not participate in their action or did not know it. His liability shall not arise even where he attends the subsequent Board meeting at which minutes recording the wrongful action of the earlier meeting are confirmed. To incur liability he must either be a party to the wrongful act or later acquiesce (consent) to it. Thus, the absence of a director from Board meetings does not make him liable for the fraudulent acts of a co-director on the ground that he ought to have discovered the fraud.

Where a director is made liable for the acts of co-director he is entitled to contribution from the other director or co-director who were a party to the wrongful act [Ramskil v. Edwards (1885)

Notes

31 Ch.D.100]. However, where the director seeking contribution alone benefited from the wrongful act, he is not entitled to contribution.

Criminal liability. Apart from civil liability under the Act or under the general law, directors of a company may also incur criminal liability under common law, as well as under the Companies Act and other statutes. Some of the provisions of the Companies Act which make directors criminally liable (fine or/and imprisonment) are:

S. 44(4) - Filing of prospectus or statement in lieu of prospectus (to be filed by private company on ceasing to be private company) containing untrue statement.

S. 58A(5) - Failure to repay deposits within the prescribed time limits.

S. 58A(6) - Accepting deposits or inviting deposits in excess of the prescribed limits.

S. 63 - Issuing a prospectus containing untrue statement.

S. 68 - Knowingly making a false, deceptive or misleading statement and thereby inducing persons to invest money.

S. 84(3) - Fraudulently renewing a share certificate or issuing a duplicate certificate.

S. 210(5) - Failure to lay balance-sheet, profit & loss accounts, etc. at the annual general meeting.

S. 240(3) - Failure or refusal to produce books to inspector or furnish information or to appear before inspector conducting investigation.

S. 295(4) - Granting loan to directors without approval of the Central Government.

Criminal liability under SEBI. The directors of a company may also be held criminally liable for contravention of the provision of SEBI.

Criminal liability under economic legislations. Directors are also made criminally liable for various lapses and non-compliances under MRTP Act, I(D&R) Act, FEMA, Income-tax Act, etc.

12.5.2 Audit Committee

Section 292A provides that every public company having paid up capital of ₹ 5 crore or more shall constitute a committee of the board of directors known as Audit Committee. It will consist of three or more directors as decided by the board. Two- thirds of the members shall be other than managing or whole time director. Its members shall elect a chairman from amongst themselves. It shall act in accordance with the terms of reference as specified in writing by the board.

The meetings of the audit committee still also be attended and participated by auditors, internal auditors and director-in-charge of finance with no voting right. The committee shall discuss the company's internal control system, scope of audit, auditors' observations and review the half-yearly and annual financial statements before submission to the board. The committee shall also have authority to investigate into the terms specified or referred to and for this purpose it shall have access to the company's records and external professional advice.

The recommendations of the committee relating to financial management including the audit report shall be binding on the board and if not accepted, the board shall record the reasons therefore and communicate the same to the shareholders through its report.

The chairman of the Audit Committee shall attend every annual general meeting of the company to provide classification on matters relating to audit.

For non-compliance of the provisions of s. 292A, the company and every officer in default shall be punishable with imprisonment up to one year or fine up to ₹ 50,000. The offence is compoundable.

Notes

Task The Board of Directors of a public company met on three times in the previous year, the fourth meeting though called, but not held for want of quorum on two occasions successively. Discuss whether any provisions of the Companies Act have been contravened.

Self Assessment

Fill in the blanks:

13. Duties of directors may be divided under two heads which are……; and Duties of a general nature.
14. Every public company having paid up capital of ……or more shall constitute a committee of the board of directors known as Audit Committee.
15. Where a director acts dishonestly in disregard to the interests of the company, he will be held liable for breach of ……duty.

Case Study

Key Executives Pay Packages

—by Vishwanath Kulkarni and Adith Charlie

Compensation packages of key non-promoter executives at the country's top three IT firms - TCS, Infosys and Wipro - grew faster than the companies' net revenues for fiscal 2009 over previous year. Their pays were also more than the industry wage inflation of 12-15 per cent. The remuneration for top executives at Infosys grew faster than that of their counterparts at TCS and Wipro. The net revenues of these three firms grew an average of 17.5 per cent.

Interestingly, much of the growth in the compensation packages was driven by an increase in incentives and commissions, even as stock options or restricted stock units lost their charm.

For Infosys promoters such as the Co-chairman, Mr Nandan Nilekani, CEO Mr S. Gopalakrishnan, COO, Mr S. D. Shibulal and Director, Mr K. Dinesh, the compensation grew by about 11 per cent each. However, the CFO, Mr V. Balakrishnan's package saw a dramatic increase of 274 per cent at ₹ 2.36 crore, followed by Director's Mr Srinath Batni at 47 per cent and Mr T.V. Mohandas Pai's at 44 per cent.

The TCS Chief Executive and Managing Director, Mr S. Ramadorai's total compensation grew 21 per cent to ₹ 4.09 crore, while the CFO, Mr S. Mahalingam's remuneration rose 30 per cent to ₹ 1.70 crore. The COO and CEO-designate, Mr N. Chandrasekaran's package increased 36 per cent to ₹ 1.92 crore over fiscal 2008, while the Executive Director, Mr Phiroz Vandrevala's remuneration saw the highest increase of 41 per cent at ₹ 1.41crore.

Though the Wipro Chairman, Mr Azim Premji, took a cut of eight per cent in his package, the compensation of other key executives went up. The Joint CEO, Mr Girish Paranjpe's package saw the highest rise of 38.6 per cent to $363,000, while the other Joint CEO, Mr Suresh Vaswani's remuneration grew 35.4 per cent to $384,000. The CFO, Mr Suresh Senapaty, and the Head of HR, Mr Pratik Kumar, got jumps of 26 per cent each at $364,000 and $270,000, respectively.

Contd...

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Key Parameters

"The CEO and top management salaries are generally benchmarked against key parameters which may differ from company to company," said Mr E. Balaji, CEO, Ma Foi Management Consultants. The target set could be anything from improving market capitalisation, earnings, profit after tax or a combination of all the above.

"In the case of IT companies, one would not be surprised if key performance indicators are related to bringing down day sales outstanding, maintaining key customers, doing well in specific geographies or controlling costs," he said.

The trend of offering big incentives as part of overall compensation package is likely to continue, said Ms Priya Chetty Rajagopal, Vice-President, Stanton Chase.

Satyam Effect

The fall of Satyam Computer Services may also have contributed to the swelling wallets of IT company's executives. Major IT firms lay lot of impetus on winning new clients especially at a time when firms are shrinking their IT budgets.

"It is a known fact that all companies were busy making sales pitches to Satyam's customers soon after the fraud came to light. Invariably, the ones who were able to attract most of Satyam's customers were the top tier IT firms. As a result, key officials with those IT firms would have been appropriately rewarded by the management," said a senior official of Mumbai-based IT solutions firm.

Questions

1. Elaborate the role of Satyam in context of the case.
2. Analyse the compensation trend in IT industry of last few years.

Source: thehindubusinessline.com

12.6 Summary

- A company, being an artificial person, acts through human agency.
- Every company is required to have a Board of Director for managing the affairs of the company.
- The Act has made provision for the appointment of a managing director or a manager.
- The Act has regulated the remuneration which can he paid to the managerial personnel.
- A meeting of the Board of Directors of every company must be held at least once in every three months and at least four such meetings must be held in every calendar year.
- It has provides for liabilities and duties of directors.
- It provides that every public company, having a paid up share capital of ₹ 5 crore or more shall constitute a committee of the Board of Directors known as Audit Committee.
- Act has made provision for the appointment of a Company Secretary.

12.7 Keywords

Compensation: It is the remuneration provided to the directors for their services.

Director: A director is any person occupying the position of director, by whatever name called.

Notes

Manager: He is an individual who, subject to the superintendence, control and direction of the board of director, has the management of the affairs of the company.

Managing Director: He is 'director' who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board of Directors.

Office or Place of Profit: A director is deemed to hold an office or place of profit under the company if the director holding an office obtains from the company anything by way of remuneration.

Secretary: A secretary is defined as a company secretary within the meaning of the Company Secretaries Act, 1980 and includes any other individual possessing the prescribed qualifications and appointed to perform the duties which may be performed by a secretary.

Ultra Vires: It is a Latin phrase means "beyond the powers".

12.8 Review Questions

1. Are company directors' trustees or agents of the company? Comment.
2. X Co. Ltd. wants to make a contract with a partnership. Four of the five directors of the company are partners of such partnership. How can the contract be executed?
3. Examine the criteria for the disqualifications of a person for appointment as the director of a company.
4. In conducting the affairs of the company, the directors are found guilty of delay, bungling and faulty planning, which have resulted in losses and fall in the prices of the shares of the company. Members holding 1/10th of the voting power in the company apply to the central government for investigation on the ground that the circumstances establish fraud on the part of the directors. Is the appointment of an inspector justified under the circumstances?
5. Examine the critical situation under which a director would vacate office.
6. Total strength of the Board of Directors of a company is ten. How many directors are liable to retire by rotation at the next annual general meeting?
7. Elucidate the requirements of the Companies Act with respect to contracts in which particular directors are interested.
8. You are the managing director of the company. You are been asked by one of the director about the meetings to be held in a year for the company. State how many meetings of a Board of Directors of a company must be held in a year and at what intervals.
9. Do you think Government also plays an important role in removal of the managerial personnel on a reference made to the CLB? Justify.
10. Can a director be paid compensation for loss of office? Comment.
11. The directors of a company borrow ₹ 50000/- from A on a transaction which is ultra vires the company. Discuss the rights of A against the company and its directors.
12. You are interested in getting appointed as the secretary of a company. Elucidate the qualifications you must possess for appointment as a company secretary.

Notes

Answers: Self Assessment

1. three
2. ordinary resolution
3. twenty
4. Central Government
5. incharge
6. disqualifications
7. 11 per cent
8. managing director
9. remuneration
10. company
11. Companies Act
12. general
13. Statutory duties
14. ₹ 5 crore
15. fiduciary

12.9 Further Reading

Book S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.

Online links isid.org.in/pdf/concept.PDF

www.investopedia.com/articles/02/062602.asp

Notes

Unit 13: Meeting of Directors and Shareholders

CONTENTS

Objectives

After studying this unit, you will be able to:

- Describe the need for meetings of the shareholders;
- Discuss about the different kinds of meetings;
- Recognize the type of business transacted at different meetings;
- Explain the procedure and legal provisions for conducting meetings properly.

Introduction

A company is an artificial person and therefore, cannot act itself. It must act through some human intermediary. The various provisions of law empower shareholders to do certain things. They are specifically reserved for them to be done in company's general meetings. Section 291

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empowers the Board of Directors to manage the affairs of the company. In this context meetings of shareholders and of directors becomes necessary. The Act has made provisions for different types of meetings of shareholders: (i) Statutory Meeting; (ii) Annual General Meeting; (iii) Extraordinary General Meeting; and (iv) Class Meetings.

13.1 Statutory Meeting (S.165)

Some of the most important legal provisions regarding the statutory meeting are:

(i) It is required to be held only by a public company having a share capital. A private company or a public company registered without share capital is under no obligation to hold such a meeting.

(ii) It must be held within a period of not less than one month and not more than six months from the date at which the company is entitled to commence business.

(iii) At least 21 days before the day of meeting, a notice of the meeting is to be sent to every member stating it to be a Statutory Meeting.

(iv) The Board of Directors should also get a report, called the Statutory Report, sent to each member along with the notice of the meeting. If the statutory report is forwarded later, it shall be deemed to have been duly forwarded if it is so agreed to by all the members entitled to attend and vote at the meeting. A copy of the Statutory Report should also be sent to the Registrar after the same is sent to the members.

The Statutory Report contains (a) the total number of shares allotted - fully paid-up and partly paid-up; allotted for cash and for consideration other than cash; (b) the total cash received by the company in respect of all allotments; (c) an abstract of receipts and payments up to a date within seven days of the date of the Report and the balance of cash in hand; (d) any commission or discount paid on the issue of shares or debentures; (e) the names, addresses and occupations of directors, auditors, managers and the secretary of the company; (f) the extent to which any underwriting contract has not been carried out; (g) the arrears due on calls from every director; (h) the particulars of any commission or brokerage paid to any director or manager on the issue of shares and debentures.

The Statutory Report is required to be certified as correct by at least two directors, one of whom shall be the managing director, where there is one. Also, the auditors of the company shall certify that part of the Statutory Report which relates to the shares allotted, each received thereon and the receipts and payments and the balance of cash in hand.

(v) The members present at the meeting may discuss any matter relating to the formation of the company or arising out of the statutory report without previous notice having been given.

(vi) The meeting may adjourn and the adjourned meeting has the same powers as the original meeting. The adjourned meeting, therefore, may do anything which could have been done by the original meeting.

(vii) If default is made in complying with the provisions of s.165, the following consequences may follow: (a) Every director or other officer of the company who is in default shall be punishable with fine up to ₹ 5,000; (b) The Registrar or a contributory may apply to the Court for the winding up of the company [s.439]. However, the Court may, instead of passing an order for winding up, give directions for the holding of the meeting or filing of the Statutory Report.

(viii) It should be remembered that this meeting is required to be held only once in the life time of a public company, having a share capital.

Notes

Self Assessment

Fill in the blanks:

1. Statutory meeting is required to be held only by a ……company having a share capital.
2. Statutory meeting must be held within a period of not less than one month and not more than ……..months from the date at which the company is entitled to commence business.
3. A private company or a public company registered without share capital is under no obligation to hold a ……..meeting.
4. Statutory meeting may adjourn and the adjourned meeting has the …….powers as the original meeting.

13.2 Annual General Meeting (AGM) (Ss. 166-168)

As the name signifies, this is an annual meeting of a company. The provisions relating to this meeting are:

1. Every company, whether public or private, having a share capital or not, limited or unlimited must hold this meeting.
2. The meeting must be held in each calendar year and not more than fifteen months shall elapse between two meetings. However, the first AGM may be held within eighteen months from the date of its incorporation and if such general meeting is held within that period, it need not hold any such meeting in the year of its incorporation or in the following year. The maximum gap between two such meetings may be extended by three months by taking permission of the Registrar, who may so allow for any special reason.

Notes The Company Law Department has expressed the view that the Registrar can grant extension of time, for special reasons, up to a maximum period of 3 months, even if such extension allows the company to hold its AGM beyond the calendar year. However, the said extension shall be granted only if the application therefor is made to the Registrar before the expiry of the period as per s.166 (1).

3. The meeting must be held (i) on a day which is not a public holiday, (ii) during business hours, (iii) at the registered office of the company or at some other place within the city, town or village in which the registered office is situated. [s.166(2)].
4. The business to be transacted (s.173) at such a meeting may comprise of: (i) Ordinary business which relates to the following matters: (a) consideration of accounts, balance sheet and the reports of the Board of Directors and Auditors; (b) declaration of dividend; (c) appointment of directors in the place of those retiring; and (d) appointment of auditors and fixation of their remuneration. (ii) Any business other than ordinary business transacted at the meeting will be deemed to be special business. With regard to all special business, an Explanatory Statement is required to be annexed to the notice.
5. What about a situation where annual accounts are not ready for being placed before the AGM? In case annual accounts are not ready for laying at the appropriate AGM, it is open to the company concerned to adjourn the said AGM to a subsequent date when the annual accounts are expected to be ready for laying. Since consideration of annual accounts is only one of the matters to be dealt with at an AGM, directors are under a statutory

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obligation to hold the meeting. The proper course shall be to hold the meeting and then adjourn it to a suitable date for considering the accounts. The adjourned meeting must, however, be held within the maximum time limit allowed under s.166.

6. The combined reading of Ss.166 and 210 requires compliance with the following: (a) There must be one meeting held in each calendar year. (b) Not more than 15 months must elapse between one general meeting and another. (c) The period of 15 months may be extended to 18 months by the Registrar. (d) Except in the case of the first AGM, the accounts must relate to a period beginning with the day immediately after the period for which they were submitted and ending with a day which must not precede the day of the meeting by more than 6 months; or 6 months and the extension granted by the Registrar, i.e., a maximum period of 9 months.

7. The company must give twenty-one days notice to all the members of the company and the auditor. A shorter notice may be held valid if consent is accorded to by all the members entitled to vote at the meeting (s.171). Such a consent may be given before the meeting is held or after the resolutions are passed. A copy of directors' report on the company's position for the year together with copy of the audited accounts and auditors' report must accompany the notice. Also a proxy form must be attached with the notice, on which it shall be specifically mentioned that a member entitled to vote is entitled to appoint Proxy, and Proxy need not be a member of the company.

   The notice must specify the place and the day and hour of the meeting and shall contain a statement of the business to be transacted thereat [s.172(1)].

   If the time of holding the meeting and other essential particulars required by the section are not specified in the notice, the meeting will be invalid and all resolutions passed thereat will be of no effect.

   The notice must be given to every member, legal representative of a deceased member or assignee of an insolvent member and to auditor or auditors [s.172(2)].

8. If default is made in holding the meeting, the Central Government may, on the application of any member of the company, call or direct the calling of the meeting. If the company fails to hold the meeting either originally or when directed to do so by the Central Government, then the company and every officer of the company who is default shall be punishable with fine up to ₹ 50,000; and in the case of a continuing default, with a further fine of ₹ 2500 per day during the continuance of default (s.168).

13.2.1 Certain Typical Issues in Respect of AGM

1. Whether AGM can be called on a public holiday. Section 166(2), *inter alia,* provides that every AGM shall be called on a day that is not a public holiday. The Department of Company Affairs has opined that it is a mandatory provision.

Caution Bank holidays (for purposes of closing) though declared as public holidays under the Negotiable Instruments Act, 1881 shall not be treated as public holidays for the aforesaid purpose. Thus, 31st March and 30th Sept. shall not be considered as public holidays.

   In the following cases, however, AGM may be held on a public holiday: (i) Section 2(38) provides that if any day is declared by the Central Government to be a public holiday after the issue of the notice convening such a meeting, it shall not be deemed to be a public holiday in relation to the meeting. (ii) Where a public company or its subsidiary has by its articles fixed the time of its AGM and the day turns out to be a public holiday [Proviso (a)

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to s.166(2)]. (iii) Where a public company or its subsidiary has, by a resolution passed in one AGM fixed the time for its subsequent AGM and the day turns out to be a public holiday [Proviso (a) to s.166(2)]. (iv) A private company which is not a subsidiary of a public company may also [like a public company or its subsidiary under (ii) and (iii) above] by a resolution agreed to all the members thereof fix the time as well as the place of its AGM and the same shall be valid if the day happens to be a public holiday [Proviso (b) to s.166(2)]. (v) A company to whom a licence is granted under s.25 is exempted from the provisions of s.166(2). (vi) Where the AGM is adjourned because of lack of quorum, it is to be held on the same day in the next week at the same time and place (s.174). In case the day comes to be accidentally a public holiday, it shall not amount to contravention of s.166(2).

2. It is not obligatory to advertise notice of meetings in the newspapers.

Caution As an abundant precaution, the company advertises the notice of meetings in the newspapers to avoid objection from such of the shareholders as reside outside India and who incidentally may not receive the notices served through post.

3. Voting rights of members shall be determined as at the date of the meeting and not as they would/have been if the meeting had been held within the prescribed time.

4. A meeting beyond statutory time cannot be said to be void or illegal. If the Tribunal does not extend the date of holding the AGM u/s 167, the Directors shall be subjected to increasing penalty but the meeting shall be a valid meeting. Otherwise, the position in law would become impossible.

5. The Board of Directors has the power to cancel or postpone a meeting convened, though it cannot be exercised except for bona fide and proper reasons.

Self Assessment

Fill in the blanks:

5. The Annual general meeting must be held in each calendar year and not more than …….months shall elapse between two meetings.

6. The Annual general meeting must be held on a day which is not a public holiday during ……hours.

7. The company must give ……days notice to all the members of the company and the auditor regarding the annual general meeting.

13.3 Extraordinary Meeting (EGM) (S.169)

Clause 47 of Table A (Schedule I) provides that all general meetings other than AGMs shall be called the EGMs. The legal provisions as regards such meetings are:

1. EGM is convened for transacting some special or urgent business that may arise in between two AGMs, for instance, change in the objects or shift of registered office or alteration of capital. All business transacted at such meetings is called special business. Therefore, every item on the agenda must be accompanied by an 'Explanatory Statement'.

2. An EGM may be called: (i) by the Directors of their own accord; (ii) by the Directors on requisition; (iii) by the requisitionists themselves; (iv) by the CLB. The Board of Directors

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may call a general meeting of the members at any time by giving not less than 21 days notice. A shorter notice may, however, be held valid if consent is accorded thereto by members of the company holding 95% or more of the voting rights (s.171). The Board of Directors must convene a general meeting upon request or requisition if the following conditions are satisfied (s.169):

The requisitionists must be such number of members who, at the date of the deposit of the requisition, are the holders of 1/10th of total voting power. Thus, in case of a company having share-capital they should hold at least 1/10th of such of the paid-up capital that carries right to vote in regard to that matter. Preference shareholders have voting power only as regards matters relating to the preference shareholders. They have no voting right and therefore, no right to requisition in respect of other matters. If the company does not have a share capital, they should at least hold 1/10th of the total voting power of the company in regard to that matter. The requisition must state the objects of the meeting, i.e., it must set out the matters for the consideration of which the meeting is to be called. Further, requisition must have been deposited at the registered office of the company. The requisition must be signed by the requisitionists. In case all the aforesaid conditions are satisfied, the Board of Directors must within 21 days of the receipt of the requisition call the meeting giving at least 21 days notice fixing the meeting within 45 days of the receipt of the requisition.

Where the resolution proposed is a special resolution then the requirements of s.189(2) must be complied with, viz., it should be so described and explanatory statement be annexed.

If the Board of Directors does not or fails to call the meeting as aforesaid (i.e., within 21 days fixing the date of the meeting within 45 days of the deposit of a valid requisition), the meeting may be called: by the requisitionists themselves: (a) In case of a company having share capital, by one or more requisitionists as represent: (i) a majority in value of the paid-up share capital held all the requisitionists, or (ii) at least 1/10th of the paid-up share capital carrying voting rights in respect of that matter, whichever is less; or (b) in case of a company not having share capital, by one or more requisitionists who represent at least 1/10th of the total voting power of the company in regard to the matter of the requisition.

Where the Articles, in accordance with the provisions of s.180, provide that members who have not paid calls on their shares would not be entitled to vote, them they can not requisition a meeting, nor vote it and if they do so the proceedings would be invalid.

The requisitioned meeting must be held within 3 months of the date of the deposit of the requisition. Further, where two or more persons hold any shares or interest in an company jointly, a requisition, or a notice calling a meeting, signed by one or some only of them shall, for the purposes of this section, have the same force and effect as if it had been signed by all of them.

Any reasonable expenses incurred by the requisitionists, as aforesaid, shall be repaid to them by the company and the same shall be recouped from directors at fault.

Meeting by the requisitionists must be held in the same manner as nearly as possible, in which the meetings are to be called by the Board. However, where the registered office is not made available to them for holding the meeting, they may hold the meeting elsewhere [R. Chettair v. M. Chettair (1951) 21 Comp. Cas. 93].

Powers of the Company Law Board (s.186). If for any reason it is impracticable to call a meeting of the company, other than an AGM, the Company Law Board may direct the calling of the meeting: (a) on its own motion; (b) on an application of any director; (c) on an application of any member entitled to vote at that meeting.

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For the aforesaid meeting, the Company Law Board may give directions in respect of the place, date and the manner in which the meeting be held and conducted. It may also give such ancillary or consequential directions as it thinks expedient, including a direction that one member present in person or proxy shall be deemed to constitute a meeting.

Example: Superclean Industries Pvt Ltd. is a company in which there are three shareholders and all of them are directors of the company. Mr Superman holds 60 percent of the paid up share capital while the balance 40 percent of shares is held equally by the remaining two directors. Because of some rift among them, the two directors holding 40 percent share capital have aligned and started preventing the holding of any meetings of the company. The articles of the company provide for a minimum of two directors/members as quorum for board meetings as well as general meetings.

Mr Superman is a majority shareholder, but he is helpless, as no meeting can be held because of no quorum. He would apply to CLB under s. 186 for convening of the general meeting. The CLB, if satisfied, will order a meeting to be held with the presence of one member as sufficient quorum. Mr Superman, being the majority shareholder is entitled to exercise his statutory right to participate in the decision-making process, which cannot be frustrated by the quorum requirement. [Opera Photography Ltd. Re, 1989 B CLC 763 CLD].

Did u know? **Class Meetings**

When it is proposed to alter, vary or affect the rights of particular class of shareholders (e.g., where accumulated dividends on cumulative preference shares is to be cancelled) and it is not possible to obtain the consent in writing, of the holders of 3/4ths of the issued shares of that class, a meeting of the holders of those shares may be called. Such a meeting is commonly known as a 'class meeting'. It should be noted that all resolutions in a class meeting must be passed as special resolutions. The holders of at least 10 per cent of the issued shares of that class who did not consent in favour of the resolution may apply to the Court within 21 days to have the resolution cancelled and where such application is made, the resolution shall not have effect unless and until it is confirmed by the Court.

Self Assessment

Fill in the blanks:

8. EGM is convened for transacting some ……business that may arise in between two AGMs.
9. All business transacted at extra ordinary meetings is called ……..business.

13.4 Matters Relating to General Meetings

Notice of the meeting (s.171). Every member of the company is entitled to a notice of every general meeting. A notice of not less than 21 days must be given in writing to every member. However, a shorter notice for AGM will be valid if all members entitled to vote give their consent. In case of other meetings, a shorter notice will be valid if consent is given by members holding at least 95 per cent of the paid-up capital carrying voting rights, or representing at least 95 per cent of the voting power.

The notice may be given to members either personally, or sending by post to him at his registered address. A notice of a meeting may also be given by advertising the same in a newspaper circulating in the neighborhood of the registered office of the company.

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The secretary should see that proper notice of meeting must be given to all persons who are entitled to receive it. An improper or insufficient notice, as well as absence of notice, may affect the validity of a meeting and render the resolutions passed at the meeting ineffective. Also the notice should make a full and frank disclosure to the members of the fact on which they would be expected to vote.

Agenda of the meeting. The word 'agenda' indicates the business to be transacted at a meeting. It is prepared for all kinds of meetings in order that the meeting may be conducted systematically. The agenda is generally prepared by the secretary in consultation with the chairman. It is drafted in such a manner as to help the chairman to conduct the meeting smoothly. In drafting the agenda, the secretary should bear in mind the following: (i) the agenda should be clear and explicit; (ii) it should be drafted in a summary manner; (iii) all items of routine business should be put down first and the contentious matters later; and (iv) all items of similar nature should be placed in a continuous order.

The foregoing points are important because when a copy of the agenda is sent to a member, he is in a position to form a definite opinion of the subject matter to be discussed at the meeting. While preparing the agenda, care should be taken for the order of the matters to be discussed, as the order of the agenda cannot be altered except with consent of the meeting. Sometimes, the agenda is drafted in such a manner that it can serve the purpose of minutes later on. Some space is left opposite each agenda item and the secretary writes it up during the meeting; this practice is very common in the preparation of agenda for Board meetings.

Sometimes, companies maintain an Agenda Book, wherein the agenda items are entered. It is placed before the chairman of the meeting and is regarded as the agenda. Those placed before the members or other directors are copies only. Later, the Agenda book becomes a permanent record for future reference.

Proxy (s.176). In the case of a company, every member of a company entitled to attend and vote at a meeting has the right to appoint another person, whether a member or not, to attend and vote for him. The term proxy is applied to the person so appointed. Also, it refers to the instrument by which a member of a company appoints another person to attend the meeting and vote on his behalf. However, the proper term for this document is proxy form or proxy paper. The following points about proxies are to be noted: (i) A proxy has no right to speak at the meeting. (ii) A proxy need not be a member of the company. (iii) The instrument appointing a proxy must be in writing and signed by the appointed. (iv) The proxy form must bear the date of the meeting. (v) No company can make it compulsory for any one to lodge proxies earlier than 48 hours before the meeting. (vi) A proxy may be revoked before the person appointed has voted. (vii) A proxy can demand a poll. (viii) A proxy cannot vote against the wishes of his appointer.

Secretarial work as regards proxies. (a) Scrutinise the proxy forms to see whether they comply with the provisions the Act, and the bye-laws and rules of the organisation. (b) Any proxies received after the stipulated time limit must be returned with a note that they cannot be accepted. (c) Any irregularities in proxy forms should be reported to Chairman of the meeting, as he is the final authority to accept or reject them. (d) Each correct proxy form is countersigned by the Secretary. (e) Enter the correct proxy forms in Register of proxies. (f) Return the proxy form to the member together with an Admission card in the name of the proxy.

13.4.1 Quorum for Meeting

A number of members of any body sufficient to transact business at a meeting is a quorum. Stated differently, a quorum is the minimum number of persons whose presence is necessary for the transaction of business. The quorum for meetings is generally fixed by the Articles of the company, or bye-laws and the rules of the association or society. Any resolution passed without a quorum is invalid. In fact, if no quorum is present, then there is no meeting and the proceedings are invalid.

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Section 174 provides that unless otherwise so provided in the Articles, in the case of a public company, the quorum is five members personally present and in the case of a private company, it is two members personally present. If Quorum is not present within ½ hour, the meeting shall be adjourned to the same day next week at the same time and place. The Board may determine some other time, day and place but it should be within the town, city or village of the registered office.

Notes **Quorum - Certain Typical Issues**

1. Can a single member present constitute a valid quorum? A single member present cannot by himself constitute a valid quorum except where the Act expressly so provides (vide Ss.167 and 186). Thus, where the meeting is convened by Central Government/Tribunal/s 167 or 186, it may give any directions including a direction that a single member present in person or proxy shall constitute a valid meeting.
2. Presence of Preference Shareholders - whether to be counted for quorum. If business proposed to be transacted at a general meeting does not include any item or resolution proposed to be passed, which directly affect the rights of the preference shareholders, their presence should not be taken into account for purpose of determining the quorum, but where the subject matter includes any resolution in which the rights of preference shareholders are directly affected, their presence should be taken into account for the purpose of the quorum.

13.4.2 Voting (Ascertaining the Sense of the House)

Unanimity on all matters before a meeting is always not obtained. In the absence of unanimity, the chairman wants to know the wishes of the persons present therein. This is known as ascertaining the sense of the house and for this purpose; he has to put the matter before the house to the members. There are various methods which can be adopted by the chairman to put the matter to vote in order to ascertain the wishes of the members. They are as follows: (1) By acclamation, (2) By voice vote, (3) By division, (4) By show of hands, (5) By ballot and (6) By poll.

1. ***By acclamation.*** When persons present in a meeting indicate their approval or disapproval of the motion by clapping of hands, cheering or applause, it is known as voting by acclamation. This method is adopted where there is a unanimous approval or disapproval.

Example: the motion of thanks to the chair is generally adopted by this method. But this method should not be adopted if there is a sharp difference of opinion among the members on the issue before them.

2. ***By voice vote.*** In this case, the Chairman puts the proposition before the meeting and persons who are in favour of the proposition say 'yes' and those who are against it say 'no'. The Chairman hears both the voices 'yes' and 'no' and gives his decision after ascertaining the numbers of 'yes' and 'no'. At this stage, a member who is dissatisfied with the Chairman's decision on the basis of voice vote may demand a vote by show of hands.
3. ***By division.*** Under this method, the Chairman requests the members present in the meeting to divide themselves into two blocks-one in favour of the proposal and another against it. The Chairman, with the help of the Secretary, counts the number of persons in favour and against the proposal and gives his verdict.
4. ***By show of hands.*** Under this method, the Chairman asks all those in favour of the resolution to raise their right hand and when that number is noted, asks all those against

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to do likewise. The Chairman then declares the result of the voting indicating whether the proposal has been carried or lost.

5. ***By ballot.*** Under this method, every person present records his vote on a ballot paper and deposits it in the ballot box provided for that purpose. The counting of ballots cast for and against the motion reveals the results. This method ensures secrecy in casting votes.

6. ***By poll.*** In company meetings, voting by poll is according to the number of shares held by a member. The voting by show of hands may not always reflect the opinion of members upon a value basis. Also, there may be a number of proxies who can vote only by poll and not by show of hands.

Rules in respect of voting. As per the provisions of the Act, rules regarding voting may be noted as follows:

(i) Every holder of equity shares shall have a right to vote [s.87(1)].

(ii) Right of an equity shareholder to vote cannot be prohibited on the ground that he has not held his shares for any specified period before the meeting or on any other ground (s.182). In Ananthalakshmi v. H. I. & F. Trust, AIR 1951 Mad. 927, a provision in the articles of a company that only those shareholders would be entitled to vote whose names have been there on the register for two months before the date of the meeting was held to be in contravention of the Act.

The only ground on which the right to vote may be excluded is non-payment of calls by a member or other sums due against a member or where the company has exercised the right of lien on his shares (s.181).

(iii) A preference shareholder shall have the right to vote only on resolutions which directly affect the rights attached to his preference shares [s.87(2)].

Where the directors proposed to increase the shares of the company by issue of further equity shares, by capitalizing an amount standing to the credit of the company's reserve account and applying the same in paying-up the new equity shares and distributing the same as fully paid among the equity shareholders, the proposed resolution was held to affect the rights of the preference shareholders and could, therefore, be only carried out with their sanction [Re John Smith's Tadcaster Brewery Co. Ltd. (1952) 2 All ER 751].

However, rights of preference shareholders are not 'affected' by the issue of additional ordinary shares, though their voting rights are thereby weakened [White v. Bristol Aeroplane Co. Ltd. (1953) I All ER 40 (CA)].

(iv) Voting rights of a member are not affected by the fact that his shares have been attached or pledged or a receiver has been appointed.

(v) Voting to be by show of hands in the first instance. Section 177 provides that at any general meeting, a resolution put to vote shall, unless a poll is demanded under s.179, be decided on a show of hands. A declaration by the chairman that on a show of hands, a resolution has or has not been carried either unanimously or by a particular majority and an entry to that effect in the Minutes Book of the company, shall be conclusive evidence of the fact. No proof of the number or proportion of the votes cast in favour of or against such resolution shall be required (s.178).

Demand for poll. Section 179 provides that before or on declaration of the result of the voting on any resolution on a show of hands, a poll may be ordered to be taken by the Chairman of the meeting of his own motion and shall be ordered to be taken by him on a demand made in that behalf by the person or persons specified below:

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(a) in the case of a public company having a share capital, by any member or members present in person or by proxy and holding shares in the company: (i) which confer a power to vote on the resolution not being less than 1/10th of the total voting power in respect of the resolution; or (ii) on which an aggregate sum of not less than fifty thousand rupees has been paid-up;

(b) in the case of a private company having a share capital, by one member, present in person or by proxy if not more than seven members are personally present and by two members present in person or by proxy, if more than seven members are personally present;

(c) in the case of any other company, by any member or members present in person or by proxy and having not less than 1/10th of the total voting power in respect of the resolution.

The chairman of the meeting may regulate the manner in which the poll should be taken. He must appoint two scrutinizers to scrutinize the votes given on the poll and to report thereon to him. Then the chairman will declare the result.

Voting by companies and government as members (Ss. 187-187-A). Where a company or a corporation is a member of another company, it may attend the meetings of the other company through a representative. The representative must be appointed by a resolution of the Board of Directors or the other governing body. Where the Central Government or a State Government is a member, the President or the Governor of the State, as the case may be, has the power to appoint representatives to attend meetings of the company. The person nominated shall hold the position of a proxy.

Self Assessment

Fill in the blanks:

10. Every member of the company is entitled to a ……..of every general meeting.

11. A number of members of any body sufficient to transact business at a meeting is a……..

12. When persons present in a meeting indicate their approval or disapproval of the motion by clapping of hands, cheering or applause, it is known as voting by……...

13.5 Motions, Resolutions and Amendments

Decisions of a company are taken by resolution of its members, passed at their meetings. Also, the Board of Directors takes certain decisions at its meeting by passing certain resolutions after due deliberations.

The term 'motion' indicates a proposition made at a meeting by any member. Such a motion may be passed without any change or modification. But if some members feel that the motion in the form proposed needs some change or modification, they may move an amendment. A motion when passed with or without amendment is called a resolution.

A motion should always be in writing and before it is brought before the meeting, the necessary notice must be given.

Did u know? **Who is a mover?**

A person proposing a motion is called the mover and the motion should be signed by him.

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Once the motion has been put to the members and they have voted in favour of it, it becomes a resolution. In the case of a company, there are three kinds of resolutions: (i) ordinary resolution; (ii) special resolution; (iii) resolution requiring special notice.

13.5.1 Ordinary Resolution (s.189(1))

When a motion is passed by simple majority of the members voting at a general meeting, it is said to have been passed by an ordinary resolution. In other words, votes in favour of the resolution are more than 50 per cent. Still in other words, a resolution shall be an ordinary resolution where the votes cast in favour of the resolution are more than the votes cast against the resolution. According to s.189(1), "A resolution shall be an ordinary resolution when at a general meeting of which the notice required under the Act has been duly given, the votes cast (whether on show of hands, or on poll, as the case may be), in favour of the resolution (including the casting vote, if any, of the chairman) by members who, being entitled to do so, vote in person or where proxies are allowed, by proxy, exceed the votes, if any, cast against the resolution by members so entitled and voting."

All matters which are not required either by the Act or the company's articles to be done by a special resolution can be done by means of an ordinary resolution. Some of the cases in which only ordinary resolution is required are: alteration of authorised capital, declaration of dividend, appointment of auditors, election of directors.

13.5.2 Special Resolution (s.189 (2))

A resolution is a special resolution in regard to which: (a) the intention to propose the resolution as a special resolution has been specifically mentioned in the notice calling the general meeting; (b) 21 days notice has been duly given for calling the meeting; (c) the number of votes cast in favour of the resolution is three times the number cast against it.

Some of the cases in which a special resolution is necessary: alteration of objects clause; change of registered office from one State to another; alteration of the Articles; changes in the name of the company; reduction of share capital.

13.5.3 Resolution requiring Special Notice (s.190)

Some resolutions require special notice. The object of special notice is to give the members sufficient time to consider the proposed resolution and also to give the Board of directors an opportunity to indicate views, on the resolution if it is not proposed by them but by some other shareholders. Under this, a notice of intention to move the resolution should be given to the company not less than 14 days before the date of the meeting at which it is proposed to be moved. The company in turn must immediately give notice by advertisement in a newspaper or in any other mode allowed by the Articles, but not less than seven days before the meeting. Some of the cases in which a special notice is necessary are: appointing an auditor, a person other than a retiring auditor; moving a resolution that a retiring auditor will not be re-appointed; removing a director before his term expires.

Section 192 requires that a printed or a type written copy of each special resolution should be sent to the Registrar within 30 days thereof.

13.5.4 Passing of Resolutions by Postal Ballot (s. 192A)

Section 192A contains following provisions for passing of resolution by postal ballot:

1. A listed company may and in the case of resolution relating to such business as the Central Government may, by notification, declare to be conducted only by postal ballot, shall, get

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any resolution passed by means of a postal ballot, instead of transacting the business in general meeting of the company.

2. Where a company decides to pass any resolution by resorting to postal ballot, it shall send a notice to all the shareholders, along with a draft resolution explaining the reasons therefore and requesting them to send their assent or dissent in writing on a postal ballot within a period of 30 days from the date of posting of the letter.

3. The notice shall be sent by registered post acknowledgement due, or by any other method as may be prescribed by the Central Government in this behalf and shall include with the notice, a postage prepaid envelope for facilitating the communication of the assent or dissent of the shareholder to the resolution within the said period.

4. If a resolution is assented to by a requisite majority of the shareholders by means of postal ballot, it shall be deemed to have been duly passed at a general meeting covered in that behalf.

5. If a shareholder sends under (2) above his assent or dissent in writing on a postal ballot and thereafter any person fraudulently defaces or destroys the ballot paper or declaration of identify of the shareholder, such person shall be punishable with imprisonment for a term which may extend to 6 months or with fine or with both.

6. If a default is made in complying with provisions in (1) to (4), the company and every officer of the company, who is in default shall be punishable with fine which may extend to ₹ 50,000 in respect of each such default.

13.5.5 Circulation of Members' Resolution (s.188)

When some members of a company want (i) to propose a resolution at the company's next AGM; or (ii) desire to circulate to members any statement with respect to the matter referred to in any proposed resolution or any business to be dealt with at any general meeting, the Act allows them to use the administrative machinery of the company for the purpose.

If the requisite number of members make a requisition as aforesaid, the company shall be bound to: (i) give a notice of the resolution intended to be moved at the next AGM; (ii) circulate the statement among the members entitled to notice of any general meeting. However, before the obligation of the company, in respect of the above may arise, the following conditions shall have to be satisfied:

1. The requisition must have been signed by at least: (a) members having 1/20th is to be at one place of the total voting rights of all the members having the right to vote on the resolution; or (b) members, numbering 100 (having the right to vote at the resolution) and commanding a paid-up share capital of ₹ 1 lakh or more.

2. The requisition must have been deposited at the registered office of the company: (a) at least 6 weeks before the meeting in case of a requisition requiring notice of a resolution; and (b) at least 2 weeks before the meeting in case of any other requisition.

3. The statement to be circulated does not contain more than 1000 words.

4. The requisitions must have deposited with the company a sum reasonably sufficient to meet the expense of the requisition.

Exceptions. Section 188 authorises a company not to circulate a resolution or statement of the requisition in the following cases: (a) The CLB, on the application of the company or any other aggrieved party, is satisfied that the rights so conferred are being abused to secure needless publicity for defamatory matters. (b) The Board of Directors of a banking company considers that the circulation of the statement would injure the interests of the company.

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Registration of certain resolution and agreements (s.192). A copy of the resolutions or agreements as enumerated in this section must within 30 days after their passing or making be forwarded to the Registrar of Companies who shall record the same.

13.5.6 Point of Order

A point of order deals with the conduct or procedure of the meeting. The chairman has to give his ruling or decision on a point of order at once. His ruling on any matter of procedure is final.

13.5.7 Minutes of Proceedings of Meeting

Minutes are a record of business transacted at meetings. Every organisation must keep minutes containing a fair and correct summary of all proceedings of general meetings of members and of Management Committee. It is the duty of the secretary to make this record.

After the meeting is over or as soon thereafter as possible, whilst the proceedings are still fresh in mind, the secretary should proceed to draft the minutes of the meeting. Each minute entered on the minute book should be consecutively numbered, abbreviated in the margin and indexed. They must be written in the order in which the business was transacted at the meeting. Minutes may be recorded either in the form of narration or conclusions. In the latter case, only conclusions in the form of resolutions passed are recorded. The practice is to have conclusions only. Details of the actual discussion and irrelevant talks should be omitted. The minutes should be clear, compact, unambiguous and definite. Minutes of each meeting must begin on a fresh page and should be headed with the number, date and nature of the meeting. The wording of resolutions and amendments must be recorded in full and the name of the proposer and secondary given, whether they are eventually carried or not.

Section 193 provides that every company must keep minutes containing a fair and correct summary of all proceedings of general meetings in books kept for that purpose. The minutes book must have their pages consecutively numbered and minutes must be recorded within 30 days of the meeting.

Task DJA Co. Ltd. held its AGM for the financial year ending 31 March, 2005, on 30 September, 2005. The meeting was adjourned without placing the balance sheet of the company as at 31 March, 2005 before the meeting. The balance sheet as at 31 March, 2005 was placed at the adjourned AGM held on 31 March, 2006 and the same was filed with the Registrar on 20 April, 2006.

Examine, whether placing of the balance sheet at the adjourned AGM and filing with the Registrar on 20 April, 2006 are in order.

Self Assessment

Fill in the blanks:

13. The term …….. indicates a proposition made at a meeting by any member.
14. A ……deals with the conduct or procedure of the meeting.
15. When a motion is passed by simple majority of the members voting at a general meeting, it is said to have been passed by ……..resolution.

Notes

Case Study

LIC Dissents Pfizer AGM

—by Jyothi Datta

It would have been business as usual at multinational drugmaker Pfizer's annual shareholder meeting, but for a dissenting LIC representative who opposed two enabling proposals to increase the salary of the managing director and the commission of two Indian non-executive directors, respectively.

LIC totally holds 14.38 per cent in Pfizer, and the LIC representative told that he was communicating the decision taken by the corporation. He was, however, unable to give reasons behind the decision. Market observers indicated that LIC could push for a poll on the proposal, given its equity holding.

One of the enabling resolutions was regarding Pfizer's Managing Director in India, Mr. Kewal Handa's salary, proposing that it be increased from its 2007-level of ₹ 1.80 crore to a maximum of ₹ 2.50 crore a year.

The other enabling resolution was with reference to resident non-executive directors Mr. R.A. Shah and Mr. Pradip Shah, seeking to raise their commission, at the rate of one per cent of the company's profit, up to ₹ 50 lakh a year.

The company explained that the commission for non-executive directors was upped to ₹ 20 lakh a year in 2004, effective for a five-year period starting December 2003.

Shareholders should be part of the good and bad times of the company, said a shareholder who has been holding a Pfizer share since the beginning, when the multinational sent letters to shareholders inviting them into their fold.

He, along with some other shareholders, were expressing their unhappiness over the dividend. The dividend for the year ended 2008 was ₹ 12.50 per share, as compared with the previous year's ₹ 27.50 per share. However, Pfizer's Chairman, Mr. R.A. Shah, clarified that there were no motives behind the company's actions and dividends were generous when the circumstances warranted it.

On Pfizer Inc.'s recently announced plan to raise stake in its Indian subsidiary to 75 per cent, from the present 41 per cent, he said, that there was no intention to delist, "at this time".

Unlike info-tech companies, he said, the applicable milestone for Pfizer for reverse book-building was 75 per cent. Creeping acquisition and buy-back was allowed only till 75 per cent, he clarified. Also, he said, Pfizer was also evaluating the possibility of merging Duchem (that has pharma and animal health businesses) with itself.

Detailing Pfizer's plans to expand its domestic reach, Mr. Handa said that they would increase the product portfolio and value offerings from the company. The company was planning to increase its field force by 300 people, including 100 for just retail sales.

Question

Discuss LIC's role in Pfizer.

Source: thehindubusinesline.com

Notes

13.6 Summary

- The different provisions of the Companies Act empower shareholders to exercise their rights therein at general meetings consequently, the act provides for calling and conducting meetings of members.
- A statutory meeting is required to be held once in the life of a company, which is a public company having a share capital.
- Statutory meeting must be held within a period of not less than one month and not more than six months from the date the company is entitled to commence business. The Bond of Directors should get a report, called the statutory report, sent to each member with the notice of the meeting.
- An Annual General Meeting (AGM) is to be held by every type of company.
- An extraordinary general meeting is convened for transacting some special or urgent business that may arise in between two annual general meetings.
- A number of members of any body sufficient to transact business at a meeting is a quorum.
- A point of order deals with the conduct or procedure of the meeting.
- Minutes are a record of business transacted at meetings.

13.7 Keywords

Agenda: The word agenda indicates the business to be transacted at a meeting.

Ordinary Resolution: When a motion is passed by simple majority of the members voting at a general meeting, it is said to have been passed by an ordinary resolution.

Proxy: Every member of a company entitled to attend and vote at a meeting has the right to appoint another person, whether a member or not, to attend and vote for him. The term proxy is applied to the person so appointed.

Quorum: A quorum is the minimum number of persons whose presence is necessary for the transaction of business at a meeting.

Special Resolution: A resolution is a special resolution when the number of votes cast in favour of the resolution is three times the number cast against it.

13.8 Review Questions

1. A meeting was properly convened and was subsequently adjourned by the Chairman. No fresh notice was given for the adjourned meeting which has held subsequently. Discuss whether the adjourned meeting is a valid meeting.
2. Elucidate the provisions of the Companies Act, 1956 in respect of an extraordinary general meeting to be held on requisition.
3. The secretary of the company while sending out to the members of the company notice of a special resolution to be proposed at the annual general meeting inadvertently omitted out to send the notice to one member. The resolution was passed at the meeting. Discuss whether the resolution is valid or not. Justify.

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4. A company served a notice of a general meeting upon its members. The notice stated that a resolution to increase the share capital of the company would be considered at such a meeting. A shareholder complains that the amount of the proposed increase was not specified in the notice. Is the notice valid? Justify.
5. A company is entitled to commence business from May, 1994. Which is the earliest date on which the company may hold its statutory meeting?
6. You are the director of the company. Analyse the ways in which you will ascertain the wishes of the members present in meeting.
7. Give the contents of a statutory report.
8. Summarise the provisions as regards Annual General Meeting.
9. What are the provisions of the Companies Act, 1956 in respect of an Extraordinary General Meeting to be held on requisition?
10. Write a short note on the powers of Company Law Board to call meetings.

Answers: Self Assessment

1.	public	2.	six
3.	statutory	4.	same
5.	fifteen	6.	business
7.	twenty-one	8.	special or urgent
9.	special	10.	notice
11.	quorum	12.	acclamation
13.	'motion'	14.	point of order
15.	ordinary		

13.9 Further Reading


Book

S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.


Online links

http://www.hg.org/articles/article_1162.html

www.vakilno1.com/bareacts/companiesact/companiesacts

Unit 14: Winding up and Dissolution of a Company

Notes

CONTENTS

Objectives

After studying this unit, you will be able to:

- Recognize the various modes of winding up;
- Describe the concept of preferential payments;
- Discuss about the liquidators;
- Explain the dissolution of a company.

Introduction

Winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator, called a 'liquidator', is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights. In simple words, winding up means applying the assets of a company in the discharge of its liabilities and returning any surplus to those entitled to it, subject to the cost of doing so. The statutory process by which this is achieved is called 'liquidation'. Winding up of a company differs from insolvency of an

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individual in as much as a company cannot be made insolvent under the insolvency law. Besides, even a solvent company may be wound up.

14.1 Provisions as Regards Contributories

Definition of contributory: The term contributory means every person liable to contribute to the assets of a company in the event of its being wound up, and includes the holder of fully-paid up shares.

Persons liable as contributories: The person who are contributories are mentioned in different sections. These are:

(a) ***Present and past members (s. 426):*** The present members shall be liable up to the amount remaining unpaid on the shares held by them. In case of a company limited by guarantee, the liability shall be up to the amount guaranteed by each member. In case of a guarantee company having a share capital, the members shall be liable up to the amount remaining unpaid on the shares plus the amount guaranteed.

The past members shall be liable only if the following conditions are satisfied:

(i) If he ceases to be a member within one year before commencement of winding up.

(ii) The debts and liability relates to the period when he was the member.

(iii) If the present members fail to meet the liabilities in full.

(b) ***The directors/manager whose liability is unlimited (s. 427):*** Section 427 provides for an unlimited liability for a present or past director or manager, in addition to his liability if any to contribute as an ordinary member. Thus, if his liability has been made unlimited under s. 322 or s. 323, the director or manager is liable to make further contribution as if he were, at the commencement of the winding up, a member of an unlimited company.

However, a past director or manager shall not be liable to make such further contribution:

(i) If he has ceased to hold office for a year or upwards before the commencement of winding up;

(ii) In respect of any debt or liability of the company contracted after he ceased to hold office;

(iii) Unless the court deems it necessary to require the contribution in order to satisfy the debts and liabilities of the company, and the costs, charges and expenses of the winding up.

(c) ***Contributories in case of death of member (s. 430):*** If a contributory dies either before or after he has been placed on the list of contributories, his legal representatives shall be liable in due course of administration, to contribute to the assets of the company in discharge of his liability.

If the legal representatives make default in paying any money ordered to be paid by them, then it will be paid out of the estate of the deceased member.

(d) ***Contributories in case of insolvency of member (s. 431):*** If a contributory is adjudged insolvent, either before or after he has been placed on the list of contributories, then his assignees in insolvency shall be contributories.

(e) ***Contributories in case of winding up of a body corporate which is a member (s. 432):*** If a body corporate which is a contributory is ordered to be wound up, either before or after it has been placed on the list of contributories, then the liquidator of the body corporate shall be a contributory.

Nature of Liability of Contributory (s. 429)

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The liability of a contributory shall create a debt accruing due from him at the time when his liability commences but is payable at times specified in calls made on him.

The nature of the liability of a contributory is *ex lege* and not *ex contractu*. It means that the liability of a contributory arises by the fact that his name appears in the register of members; and it does not arise as a result of the contract of membership with the company. Thus, where a member's calls are in arrears for more than three years, the debt is time-barred and the company cannot recover the amount of the call from him. But once the winding up commences, the liquidator can recover the same amount from the member, though the company could not do so under the Limitation Act. The liquidator has a fresh cause of action as time, it is said, does not run against the liquidator. Thus, once winding up commences, s. 429 imposes a new liability on the members.

Example: A Ltd. was wound up with effect from 15 March, 2008 by an order of the court. Mr. B, who ceased to be a member of the company from 1 June, 2007, has received a notice from the liquidator that he should deposit a sum of ₹ 5,000 as his contribution towards the liability on the shares previously held by him.

Mr. B is a past member since one year has not elapsed before the commencement of the winding up. Therefore he is a contributory. He will be liable provided the other two conditions given in s. 426 are satisfied.

Self Assessment

Fill in the blanks:

1. ……means every person liable to contribute to the assets of a company in the event of its being wound up.
2. The liability of a contributory arises by the fact that his name appears in the register of members; and it does not arise as a result of the ……with the company.
3. If a contributory dies either before or after he has been placed on the list of contributories, his …….shall be liable in due course of administration, to contribute to the assets.

14.2 Modes of Winding up (S. 425)

A company may be wound up in any of the following three ways:

(a) Compulsory winding up under an order of the court.

(b) Voluntary winding up.

(c) Voluntary winding up under the supervision of the court.

14.2.1 Winding up by the Court

Grounds for Compulsory Winding up [s.433(3)]

A company may be wound up by the court on the following grounds:

1. ***Special resolution:*** The company may, by special resolution, resolve that it be wound up by the court. The resolution may be passed for any cause whatsoever. However, the court

Notes

may not order winding up if it finds it to be opposed to public interest or the interest of the company as a whole.

2. ***Default in holding statutory meeting:*** If default is made in delivering the statutory report to the Registrar or in holding the statutory meeting, the company may be ordered to be wound up. Petition on this ground can be presented either by the Registrar or by a contributory. If it has to be filed by any other person, it should be filed before the expiration of 14 days after the last day on which the statutory meeting ought to have been held [s.439 (7)].

3. ***Failure to commence business:*** If a company does not commence business within a year from incorporation or suspends business for a whole year, it may be ordered to be wound up. Failure to commence or to carry on business is not treated as a ground for compulsory winding up unless the company has no intention of carrying on business or it has become impossible to do so.

4. ***Reduction in membership:*** If the number of members is reduced below the statutory minimum of 7 in a public company or 2 in a private company, the company may be ordered to be wound up.

5. ***Inability to pay debts:*** The Court may order a company to be wound up if it is unable to pay its debts. According to s.434, a company shall be deemed to be unable to pay its debts if: (a) a creditor for more than one lakh rupees has served on the company at its registered office a demand under his hand requiring payment and the company has for three weeks thereafter neglected to pay or secure or compound the sum to the reasonable satisfaction of the creditor; or (b) execution or other process issued on a judgement or order of any court or court in favour of a creditor of the company is returned unsatisfied in whole or in part; or (c) it is proved to the satisfaction of the court that, the company is unable to pay its debts, taking into account its contingent and prospective liabilities.

Caution Though a contingent and prospective liability is not a debt, the provision that, the court is to take into account the company's contingent and prospective liabilities is important.

A company which has to date paid all its debts as they fell due may still be ordered to be wound up if a consideration of its assets and liabilities shows that, it will or may shortly be unable to do so. Inability is to be seen in the commercial sense of a running enterprise and not in the sense of liquidation, i.e., if the company cannot meet its current demand, even though its assets, when realised, would exceed its liabilities, it will be deemed to be unable to pay its debt and may be wound up.

But the important condition to be fulfilled is that, the creditor should have a complete title to the debt and the debt – a determined or definite sum of money – must have become payable immediately. Where there is a bona fide dispute regarding the debt, the company cannot be charged to have neglected to pay it.

The application money due to be refunded to an applicant who applied for shares, but his application was not accepted, is not a debt. Also, the interest due on such an amount is not a debt.

Also wages or salary which is due by the company to an employee is not a debt.

The petition on the ground of a company's inability to pay its debts can be made by a creditor (including a secured creditor) a debentureholder, and a trustee for debenture holders. Even a contingent creditor, such as a holder of bill of exchange may make a

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petition. The company itself can file a petition. The registrar has a limited right to file a petition for winding up of a company.

6. ***Just and equitable:*** The court may also order for the winding up of a company if it is of the opinion that, it is just and equitable that, the company should be wound up. In exercising its power on this ground, the court shall give due weight to the interest of the company, its employees, creditors and shareholders and the interest of the general public. The relief based on the just and equitable clause is in the nature of a last resort when other remedies are not efficacious enough to protect the general interests of the company. While in the above five cases definite conditions should be fulfilled but in the 'just and equitable' clause the entire matter is left to the 'wide and wise' direction of the court. The winding up must be just and equitable not only to the persons applying but also to the company and to all its shareholders. [Hind Overseas Pvt. Ltd. vs. R.P. Jhunjhunwala (1977) ASIL. XIII] A few of the examples of 'just and equitable' grounds on the basis of which the court may order the winding up are given below:

   (i) *When the substratum of the company has gone:* The substratum of a company is deemed to be gone where its objects have failed or become impossible of achievement.

   Some tests to ascertain whether the substratum of the company is gone were laid down in In re Kaithal and General Mills Co. Ltd. (1951.) 31 Comp Cas 46 These are:

   (a) Where the only subject matter of the company is gone; or

   (b) The object for which it had been incorporated has substantially failed; or

   (c) It is impossible for the company to continue except at a loss; or

   (d) The existing liabilities are far in excess of existing and possible assets.

   (ii) *When there is a complete deadlock in the management:* A company will be wound up on this ground even though it is making good profits. In re Yenidje Tobacco Co. Ltd. [1916]2 Ch 426. A and B, the only shareholders and directors of a Private Limited company became so hostile to each other that neither of them would speak to the other except through the secretary. Held: There was a complete deadlock and consequently the company was ordered to be wound up.

   (iii) *Where the company was formed for fraudulent or illegal purposes:* For this purpose, fraud in the prospectus or in the manner of conducting company's business is not sufficient. It must be shown that, the original object of creating the company was fraudulent or illegal [re T.E. Brismead & Sons Ltd. (1897)1 Ch.45].

   (iv) *Where the principal shareholders have adopted an aggressive or oppressive policy towards the minority [R. Sabapathy Rao vs. Sabapathy Press Ltd. AIR (1925) Mad. 489]:* However, the court will order winding up only when it is satisfied that it is impossible for the business of the company to be carried on for the benefit of the company as a whole because of the way in which voting power is held and used.

   (v) When the company is a 'bubble', i.e., it never had any real business [re London and Country Coal Co. (1867) L.R. 3 Eq. 365].

   (vi) *Where the business of the company cannot be carried except at loss. But, mere apprehension on the part of some shareholders that loss instead of gain will result has been held to be no ground [Re Mahamandal Shastra Prakashik Samiti Ltd. (1917) 15 All L.T. 193]:* Similarly, in re Shah Steamship Navigation Co. [(1901) 10 Bom. L.R. 107], it was held that, 'the Court will not be justified in making winding up order merely on the ground that the company has made losses and it was likely to make further losses.

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(vii) *Where a private company is in essence or substance a partnership:* It may be ordered to be wound up if such circumstances exist under which it would be just and equitable for the Court to order for the dissolution of the partnership firm. In Re Davis & Coltett Ltd. [(1935) Ch. 693] one member improperly excluded the other, who held half the shares, from taking part in the company's business. Held, the company be wound up.

In this context, some guiding principles for the application of just and equitable ground for winding up were laid down in Ebrahimi v. Westbourne Galleries Ltd. [1972] 2 All ER 492. These are:

(a) The company was formed based on personal relationship and mutual confidence;

(b) An agreement or understanding that all or some of the shareholders will participate in the conduct of the business as in the case of a partnership concern; and

(c) Restrictions on the transfer of a members' interest in the private company.

However, the fact that an existing partnership firm was converted into a private company does not necessarily imply that the company retains the features of a partnership firm [Official Liquidator v. Ram Swarup (1997) Cas 569.]

(viii) *Requirements for Investigation:* Where Directors were making allegations of dishonesty against each other in respect of defalcations of the funds of the company, the company was ordered to be wound up on the ground that, it was a case in which the conduct of some of the officers of the company required an investigation which could only be obtained in a winding up by the Court [Re Varieties Ltd. (1893) 2 Ch. 235].

Who may Petition (s.439)

A petition for the compulsory winding up of a company may be presented by: (1) the company itself by the passing of a special resolution; or (2) any creditor or creditors, including any contingent or prospective creditor or creditors; or (3) a contributory or contributories; or (4) any combination of creditors, company or contributories acting jointly or separately; or (5) the Registrar; or (6) any person authorized by the Central Government, as per s.243. (7) the official liquidator (s.440).

1. ***The company [s.439(1) (a)]:*** A company may make a petition for its winding up, when the members of the company have so resolved by passing a special resolution. However, it is not very common for companies to apply for winding up orders since, if desired, they have only to pass a special resolution for voluntary winding up under s.484 of the Act. But, where the Directors find the company to be insolvent due to circumstances which ought to be investigated by the Tribunal, they may file a petition for winding up order on behalf of the company.

2. ***Creditor's petition [s.439 (1) (b)]:*** A creditor has a right to a winding up if he can prove that, he claims an undisputed debt and that the company has failed to discharge it. The word 'creditor' includes secured creditor, debenture holder and a trustee for debenture holders. It is not even necessary that, the secured creditor should give up his security [In Re-India Electric Works (1969) 2 Comp. L.T. 169]. A contingent or prospective creditor (such as the holder of a bill of exchange not yet matured or of debentures not yet payable) is also entitled to petition for winding up the company. But, he must give a reasonable security for costs and establish a prima facie case for winding up [s.439 (8)].

Notes

Sometimes a creditor's petition is opposed by other creditors. In such cases the court may ascertain the wishes of the majority of the creditors. However, the opinion of the majority of creditors does not bind the court. The question will ultimately depend upon the state of the company. If the company is commercially insolvent and the object of trading at a profit cannot be attained, winding up order will follow as a matter of course.

A creditors' petition is generally based on the ground that, the company is unable to pay its debts. He will not ordinarily be heard to urge that a winding up order should be made because the substratum of the company is gone, which is usually the proper concern of the company's shareholders [Bukhtiarpur Bihar Light Rly. Co. Ltd. vs. Union of India, AIR (1954) Cal.499]. However, if the debt of a petitioning creditor is disputed, no order for winding up can be made [Md. Amin Bros vs. Dominion of India, AIR (1952) Cal. 323].

3. ***Contributory's petition [s.439(1) (c)]:*** A 'contributory' means any person liable to contribute to the assets of a company in the event of its being wound up. But for this purpose the term 'contributory' includes a holder of fully paid shares. A 'contributory', however, may petition only: (i) on the ground that, the number of members is reduced below the statutory minimum of seven members in case of public company and two in case of a private company; (ii) on any other ground if the shares in respect of which he is a contributory or some of them were originally allotted to him, or/have been held by him and registered in his name for at least six out of the eighteen months preceding the commencement of the winding up, or/have devolved upon him through the death of the former holder.

Example: A transfer though executed and stamped in June, 2006, was registered in October, 2007. The shareholder presented a winding up petition in December, 2007.

Held: The petition was not valid since she had not held shares for 6 months as required by the Act.

A holder of fully paid shares is a contributory for the purpose of a petition not because he is liable to contribute but because he may have an interest in the assets in a winding up. The section provides: "A contributory shall be entitled to present a petition for winding up a company notwithstanding that, he may be the holder of fully paid-up shares, or that the company may have no assets at all or may have no surplus assets left for distribution among the shareholders after the satisfaction of its liabilities."

The legal representative of a deceased shareholder may petition. Even an insolvent shareholder, whose name is still there on the register, may, at the instance of the assignee, petition.

Did u know? **What is joint petition?**

Joint petition [s.439(1) (d)]: This means that, any combination of the company, the creditors and the contributories can present a petition for winding up.

4. ***The registrar [s.439(1) (e)]:*** The Registrar may file a petition where: (i) a default is made in delivering the statutory report to him or in holding the statutory meeting; or (ii) the company has not commenced its business within a year from its incorporation; or (iii) the number of its members has fallen below the statutory minimum; or (iv) the financial condition of the company, as disclosed in its balance-sheet or from the report of a special auditor appointed under s.233A or any inspector appointed under Ss.235 to 237 it appears that, it is unable to pay its debts; or (v) it is just and equitable that, the company be wound up.

Notes

Caution The petition on the ground of default in delivering the statutory report or holding the statutory meeting cannot be presented before the expiration of 14 days after the last day on which the statutory meeting ought to have been held. In any case, the Registrar cannot present the petition unless sanctioned by the Central Government.

The Central Government shall not grant the permission to the registrar unless the company has been given the opportunity of making its representation against the petition of the registrar for winding up.

5. ***Central government petition (s.243):*** The Central Government may petition for winding up where it appears from the report of inspectors appointed to investigate the affairs of a company under s.237 that, the business of the company has been conducted for fraudulent or unlawful purposes. The Government may authorise any person to act on its behalf for the purpose. [s.439 (1) (b)].

6. ***Official liquidator's petition (s.440):*** An official liquidator may present a petition for winding up by the court where a company is being wound up voluntarily. The court, however, shall not make a winding up order unless it is satisfied that, the voluntary winding up cannot be continued with due regard to the interest of the creditors or contributories or both.

7. ***Company's workers union Petition:*** Section 439 does not give a right to workers or their union, as such, to file a petition for winding up. However, if a winding up petition is properly filed by those who are entitled to do so under s. 439, the workers may appear and be heard in support of or in opposition to the winding up petition [National Textiles Workers Union V. R. P. Ramakrishnan (1983)53 Comp Cas 184].

Commencement of winding up (s.441): The winding up of a company by the court shall be deemed to commence at the time of the presentation of the petition for the winding up. If no order for winding up is made and the winding up petition is dismissed, the date of presentation of the winding up petition has no relevance. As such, until winding up order is made, the company will have to comply with the requirements of the Companies Act, as are required if the company was not wound up. Also the words 'shall be deemed to commence' indicate that although the winding up of a company does not in fact commence at the time of the presentation of the petition, it nevertheless shall be taken to commence from that time if and when the winding up order is made. However, where before the presentation of a petition for the winding up of a company by the court, a resolution has been passed by the company for voluntary winding up, the winding up of the company is deemed to have commenced at the time of the passing of the resolution.

Arrangement when binding on company and creditors (s. 517): During the liquidation proceedings, a company can enter into a scheme of arrangement with its creditors. The scheme will be binding on the company and its creditors provided:

(a) It has been approved by a special resolution of the company, and

(b) Agreed to by three-fourths in number and value of the creditors.

Any creditor or contributory may, however, within three weeks from the completion of the arrangement, appeal to the court. The court may amend, vary, confirm or set aside the arrangement.

Notes

14.2.2 Procedure for Winding up Order

1. The winding up petition must be presented to the court.
2. After the presentation of the petition but before the hearing, application may be made to the court by either the company, creditor or contributories: to appoint a provisional liquidator to safeguard the assets pending the hearing. Before making such appointment, however, the court must give notice to the company so as to enable it to make its representation in the matter unless, for reasons to be recorded in writing, it thinks fit to dispense with such notice. The powers of the provisional liquidator are the same as those of a liquidator unless limited by the court (s.450).
3. On hearing a winding up petition, the court may [s.443(1)]: (i) dismiss it, with or without costs; or (ii) adjourn the hearing conditionally or unconditionally; or (iii) make any interim order that it thinks fit; or (iv) make an order for winding up the company with or without costs, or any other order that it thinks fit.

The court cannot, however, refuse to make a winding up order on the ground only that, the assets of the company have been mortgaged to an amount equal to or in excess of those assets or that the company has no assets. "Where the petition is presented on the ground that, it is just and equitable that the company should be wound up, the court may refuse to make an order of winding up if it is of the opinion that, some other remedy is available to the petitioners and that they are acting unreasonably in seeking to have the company wound up instead of pursuing that other remedy." [s.443 (2)].

Where the petition is presented on the ground of default in delivering the statutory report to the Registrar or in holding the statutory meeting, the court may: (a) instead of making a winding up order, direct that the statutory report shall be delivered or that a meeting shall be held; and (b) order the costs to be paid by persons who, in the opinion of the Court, are responsible for the default [s.443 (3)].

In all matters relating to the winding up of a company, the court may have regard to the wishes of creditors or contributories of the company as proved to it by any sufficient evidence and for the purpose may direct that their meetings may be held or conducted as directed by the Court (s.557).

14.2.3 Consequence of Winding up Order

The consequence of the winding up order by the court are as follows:

1. The court must, as soon as the winding up order is made, cause intimation thereof to be sent to the official liquidator and the Registrar (s.444).
2. The petitioner and the company must also file with the Registrar within 30 days a certified copy of the order [s.445(1)]. The Registrar should file with himself a certified copy of the winding up order of the court when he himself is a petitioner under s.439. If default is made in filing the certified copy of the order, the petitioner, or the company and every officer of the company who is in default, shall be punishable with fine upto ₹ 1,000 for every day during which the default continues (s.445).
3. The Registrar should then make a minute of the order in his books relating to the company and notify in the official gazette that such an order has been made [s.445(2)].
4. The order for winding up is deemed to be a notice of discharge to the officers and employees of the company, except when the business of the company is continued [s.445(3)].

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5. The order operates in the interests of all the creditors and all the contributories, no matter who in fact asked for it (s.447).
6. The official liquidator, by virtue of his office becomes the liquidator of the company and takes possession and control of the assets of the company (s.449).
7. All actions and suits against the company are stayed, unless the court gives leave to continue or commence proceedings (s.446).
8. All the powers of the Board of directors cease and the same are then exercised by the liquidator [Ss.491 & 505].
9. On the commencement of winding up, the limitation ceases to run in favour of the company.
10. Any disposition of the property of the company and any transfer of shares in the company or alteration in the status of members made after the commencement of winding up shall, unless the court otherwise orders, be void [s.536(2)].
11. Any attachment, distress or execution put in force, without leave of the court, against the estate or effects of the company after the commencement of the winding up shall be void [s.537 (a)] but not for dues payable to Government [s.537(2)].
12. Any sale held, without leave of the court, of any of the properties or effects of the company after the commencement of winding up shall be void [s.537(b)].
13. Any floating charge created within 12 months preceding the commencement of winding up is void unless it is proved that, the company after the creation of the charge was solvent, except as to, any cash advanced at the time of or subsequent to the creation of the charge or to any interest on that amount @ 5% or such other rate notified by the Central Government (s.534).

Example: A company created a floating charge of its current assets in favour of a bank to secure a current account, which was in debit of ₹ 5 lakhs and also to secure further working capital facilities provided by the bank. The charge created on January 1, 2007 was duly registered with ROC. The bank advanced ₹ 10 lakh subsequent to the creation of the charge. The company has gone into creditors voluntary liquidation pursuant to a resolution passed on September 1, 2007. There is no case of a fraudulent preference.

As it is a creditors voluntary winding up, the floating charge is void being made within 12 months of winding up resolution, unless the charge is against cash advanced at the specified rate of interest (s. 534).

Example: If in the above example, if it was a members' voluntary winding up, then the floating charge is valid.

Did u know? The secured creditor is outside the winding up and can realise his security without the leave of the court.

Statement of affairs to be made to the liquidator (s.454): When a winding up order is made by the court, the directors of the company must make to the liquidator a statement as to the affairs of the company, stating the following particulars: (i) the debts and liabilities of the company; (ii) the assets of the company, showing separately the cash in hand and in bank, if any; (iii) the name, residence and occupation of each creditor stating separately the amount of secured debts and unsecured debts; (iv) the debts due to the company and the name, residence and occupation of each person from whom the sum is due and the amount likely to be realised therefrom.

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The object of such a statement is to give the liquidator an idea as to the financial affairs and liabilities of the company. The creditors and contributories of the company can inspect the statement. The statement should be made within 21 days (or such extended time not exceeding 3 months as the official liquidator or Tribunal may for special reasons allow) after the relevant date. The relevant date is the date of the winding up order by the court or where a provisional liquidator is appointed, the date of his appointment. The statement must be submitted and verified by affidavit by one or more of the persons who, at the relevant date are the directors and by the person who at that time is the manager, secretary or other chief officer of the company. Defaulter shall be punishable with imprisonment up to 2 years or with fine up to ₹ 1,000 for every day during which default continues or with both.

Committee of inspection: The court may, at the time of making an order of winding of a company or at any time thereafter, direct that there shall be appointed a committee of inspection to act with the liquidator. In such a case the liquidator must, within 2 months from the date of such direction convene a meeting of the creditors of the company for the purpose of determining who are to be members of the committee. Within 14 days from the date of the creditors meeting (or such further time as the Court in its direction may grant for the purpose), the liquidator should convene a meeting of the contributories to consider the decision of the creditors' meeting with respect to the membership of the committee. It is open to the meeting of the contributories to accept the decision of the creditors' meeting with or without modifications or to reject it. The liquidator must apply to the court for directions as to what the composition of the committee shall be and who shall be members thereof. However, it will not be necessary to seek directions in this regard where the meeting of the contributories accept the decision of the creditors' meeting in its entirety.

Section 465 provides: (i) a committee of inspection cannot have more than 12 members; (ii) the committee shall have the right to inspect the accounts of the liquidator at all reasonable times; (iii) it must meet at such times as it may from time to time appoint and the liquidator or any member of the committee may also call a meeting of the committee as and when he thinks necessary; (iv) the quorum for the meeting of the committee shall be 1/3rd of the total number or two whichever is higher; (v) a member of the committee may resign by notice in writing. But where a member of the committee is adjudged an insolvent or compounds or arranges with his creditors, or is absent from five consecutive meetings of the committee without the leave of the members, he shall cease to remain a member.

14.2.4 General Powers of the Court

1. ***Power of court to stay winding up (s.446):*** The court may at any time after making a winding up order (on the application either of the official liquidator of any creditor or contributor and on proof to the satisfaction of the court that, all proceedings in relation to the winding up order be stayed) make an order staying the proceedings either altogether or for a limited time, on such terms and conditions as the court thinks fit.

2. ***Settlement of the list of contributories (s.467):*** The court has the power to cause the assets of the company to be collected and applied in discharge of its liabilities. For this purpose the court has the power to make a list of contributories. In settling the list of contributories the court shall distinguish between those who are contributories in their own right and those who are contributories as being representatives of, or liable for the debts of others.

3. ***The power to make calls (s.470):*** The court is empowered to make call on all or any of the contributories to the extent of their liability. It should be noted that, no statutory liability for an unpaid call can be set off against a credit except in the following cases: (a) in the case of an unlimited company, a contributory may set off his debt against any money due to him from the company on any independent dealing or contract with the company. But no

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set off is allowed for any money due to him as a member of the company in respect of any dividend or profit; (b) if, in the case of a limited company, there is any director or manager whose liability is unlimited, he shall have the same right of set off as described in (a) above; (c) in the case of any company, whether limited or unlimited when all the creditors have been paid in full, any money due on any account whether to a contributory from the company may be allowed to him by way of set off against any subsequent call.

4. ***Payment into bank of moneys due to company (s.471):*** The court may order any contributory, purchaser or other person from whom any money is due to the company to pay the money into the public account of India in the Reserve Bank of India instead of to the liquidator.

5. ***Power to exclude creditors not proving in time (s.474):*** The court may fix a time or times within which creditors are to prove their debts or claims. In such a case, if the creditors fail to establish their claims in time, they may be excluded from the benefit of any distribution made.

6. ***Adjustment of rights of contributories (s.475):*** The court is empowered to adjust the right of the contributories among themselves and distribute any surplus among the person entitled thereto.

7. ***Power to order costs (s.476):*** The court may, in the event of assets being insufficient to satisfy the liabilities, make an order for the payment out of the assets, of the costs, charges and expenses incurred in the winding up, in such order of priority inter se as the Court thinks just.

8. ***Power to summon persons suspected of having property of company, etc. (s.477):*** The court may summon before it any officer of the company or person known or suspected to have in his possession any property or books or papers of the company or known or suspected to be indebted to the company. Any such person may be examined on oath. The court may also require him to produce any books and papers in his custody or power relating to the company; but where he claims any lien on books or papers produced by him, the production must be without prejudice to that lien.

   If any officer or person summoned, after being paid or tendered a reasonable sum for his expenses, fails to appear before the court at the time appointed without any valid reason, the court may cause him to be apprehended and brought before the court for examination.

9. ***Power to order public examination of promoter, directors etc. (s.478):*** Where the Official Liquidator has made a report to the court, stating that in his opinion a fraud has been committed by any person in the promotion or formation of the company, or by any officer of the company since its formation, the court may direct that person or officer may appear before the court and be publicly examined. Examination shall relate to the promotion or formation or the conduct of the business of the company, or as to his conduct and dealings as an officer thereof. Official liquidator, any creditor or contributory may take part in such examination. The court may put such questions to the person examined as it thinks fit. The person shall be examined on oath and must answer all such questions as the Tribunal may put or allow to be put, to him. Notes of the examination must be taken in writing and must be read over to or by and signed by the person examined and may thereafter be used in evidence against him. Statement so recorded shall be open to the inspection of any creditor or contributory at all reasonable times.

10. To order the appointment of a committee of inspection: (already discussed)

11. ***Power to arrest a contributory intending to abscond (s.479):*** At any time (either before or after making a winding up order), the court may, on proof of probable cause for believing that a contributory is about to quit India or otherwise to abscond or is about to remove or

cancel any of his property, for the purpose of evading payment of calls or of avoiding examination in respect of the affairs of the company, cause: (a) the contributory to be arrested and safely kept until such time as the Tribunal may order; and (b) his books and papers and movable property be seized and safely kept until such time as the Court may order.

12. ***Power to order for dissolution of the company (s.481):*** When the affairs of a company have been completely wound up or when the court is of the opinion that, the liquidator cannot proceed with the winding up of a company for want of funds and assets or for any other reason whatsoever and it is just and reasonable in the circumstances of the case that an order of dissolution of the company should be made, the court shall make an order that the company be dissolved from the date of the order. The liquidator must, within 30 days, send a copy of the order to the Registrar who shall make in his books a minute of the dissolution of the company. If he makes a default in forwarding a copy as aforesaid, he shall be punishable with fine which may extend to ₹ 500 for every day during which the default continues.

On the expiry of 5 years from the date of dissolution, the name of the company should be struck off the register. But within 2 years of the date of the dissolution on application by the liquidator of the company or by any other person who appears to the court to be interested, the court may make an order, upon such terms as the court thinks fit, declaring the dissolution to have been void. After such an order is passed, such proceedings may be taken as might have been taken if the company had not been dissolved (s.559).

14.2.5 Voluntary Winding up

Winding up by the creditors or members without any intervention of the court is called 'voluntary winding up'. In voluntary winding up, the company and its creditors are left to settle their affairs without going to the court for directions or orders if and when necessary. Winding up should not be confused with insolvency. Company may be solvent and running a prosperous business yet it may decide to be wound up voluntarily, e.g., in pursuance of a scheme of reconstruction or amalgamation.

A company may be wound up voluntarily: (1) if the company in general meeting passes an ordinary resolution for voluntary winding up where the period fixed by the Articles for the duration of the company has expired or the event has occurred on which under the Articles the company is to be dissolved; (2) if the company resolves by special resolution that it shall be wound up voluntarily (s.484).

When a company has passed a resolution for voluntary winding up, it must within 14 days of the passing of the resolution, give notice of the resolution by advertisement in official gazette and also in some newspaper circulating in the district where the registered office of the company is situated. In case of default, the company and every officer of the company who is in default shall be punishable with fine which may extend up to ₹ 500 for every day during which the default continues (s.485).

Notes **Consequences of voluntary winding up**

The consequences of voluntary winding up are as follows:

1. A voluntary winding up is deemed to commence at the time when the resolution for voluntary winding up is passed (s.486). This will be so even when after passing a

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resolution for voluntary winding up, a petition is presented for winding up by the court (s.441).

2. The company, from the commencement of winding up, must cease to carry on its business except so far as may be required to secure a beneficial winding up, although the corporate state and powers of the company continue until final dissolution (s.487).

3. All transfer of shares and alterations in the status of members, made after the commencement, are void unless sanctioned by the liquidator (s.536).

4. A resolution to wind up voluntarily operates as notice of discharge to the employees of the company [Fowler vs. Commercial Times Co.] except: (a) when the liquidation is only with a view to 'reconstruction' [Midland Counties Bank Ltd. vs. Attwood (1905) 1 Ch. 357] or (b) when business is continued by the liquidator for the beneficial winding up of the company.

5. On the appointment of the liquidator, all the powers of the Board of directors, managing director or 'manager' shall cease except (s.491): (a) for the purpose of giving notice to the Registrar about the name of the liquidator appointed, or (b) insofar as the company in general meeting or the liquidator may sanction the continuance of their powers.

14.2.6 Types of Voluntary Winding up

Voluntary winding up may be of three types: (a) Members' Voluntary winding up; (b) Creditors' Voluntary winding up; (c) Voluntary winding up under supervision of court.

Members' Voluntary Winding up

Members' Voluntary winding up is possible only when the company is solvent and is able to pay its liabilities in full. Following are the important provisions regarding members' voluntary winding up.

1. ***Declaration of solvency (s.488):*** Where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full enquiry into the affairs of the company and that having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding 3 years from the commencement of the winding up as may be specified in the declaration. In order to be effective, this declaration must be: (i) made within five weeks immediately preceding the date of passing of the winding up resolution by the members; (ii) delivered to the Registrar for filing before the said date; (iii) accompanied by a copy of the report of the auditors of the company on the profit and loss account prepared since the date of the last account and the balance-sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at that date.

   Any director of a company making a declaration under this section without having reasonable grounds for the opinion that the company will be able to pay its debts in full within the period specified in the declaration, shall be punishable with imprisonment for a term which may extend to six-months, or with fine up to ₹ 5,000 or with both. If the company is wound up in pursuance of a resolution passed within the period of five weeks after making the declaration, but its debts are not paid or provided for in full within the

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period specified in the declaration, it shall be presumed, until the contrary is shown, that the director did not have reasonable grounds for his opinion.

If the above provisions are not complied with, the winding up shall not be a members' voluntary winding up [Vosica vs. Janda Rubber Works AIR (1950) East Punjab 180] and in such case provisions (s.490 and 498) relating to members voluntary winding up cannot apply and if liquidator is appointed in pursuance of s. 490 or 498 such appointment would be bad in law. In such a case, the provisions relating to creditor's voluntary winding up (Ss. 500-509) should be followed and the violation of these provisions will make the winding up proceedings void ab initio (M. Kakshmiah vs. Registrar of Companies, Trivandrum-unreported case decided by the Kerala High Court) and if default is made in calling a meeting of the creditors then the company and the Directors' as the case may be, shall be punishable with fine which may extend to ₹ 10,000 and in the case of default by the company, every officer of the company who is in default, shall be liable to the like punishment [s.500 (6)]. The Court may, if moved by the company or its shareholders, instead of treating the winding up proceedings as invalid, direct the company to convene the creditors meeting [Light of Asia Insurance Company, I.L.R. 1940 (2) Cal.325]. The above rules will be applicable even where a declaration of solvency has been filed but in accordance with the provisions of s.488(2).

The company, however, may pass a fresh resolution for its winding up after complying with the requirements of s.488 (Declaration of Solvency).

2. ***Appointment and remuneration of liquidators (s.490):*** The company in general meeting must: (a) appoint one or more liquidators for the purpose of winding up the affairs and distributing the assets of the company; and (b) fix the remuneration, if any, to be paid to the liquidator or liquidators.

   Any remuneration so fixed cannot be increased in any circumstances whatever, whether with or without the sanction of the Court. No liquidator shall take charge of his office unless his remuneration is fixed. Further, if a vacancy occurs by death, resignation or otherwise in the office of the liquidator appointed by the company, the company in general meeting may, subject to any arrangement with its creditors, fill the vacancy. For this purpose a meeting may be convened by any contributory or the continuing liquidator or by the Court on the application of any of them (s.492).

3. ***Board's power to cease:*** On the appointment of a liquidator, all the powers of the Board of directors and of the managing director or whole-time directors or manager shall cease except for purpose of giving a notice of such appointment to the Registrar. But their powers may continue if sanctioned by the general body or by the liquidator so far as the sanction applies (s.491).

4. ***Notice of appointment of liquidator to be given to the Registrar (s.493):*** The company must give notice to the Registrar regarding the appointment of liquidator within 10 days of his appointment. In case of default, the company and every officer of the company (including liquidator) who is in default, shall be punishable with fine which may extend to ₹ 1,000 for every day during which the default continues.

5. ***Power of liquidator to accept shares, etc., as consideration of sale of property of the company (s.497):*** The liquidator may accept shares, policies or like interests in consideration of the sale of the company's undertaking to another company, with an object to distribute them amongst the members of transferor company, provided: (a) a special resolution is passed by the company to that effect; and (b) he purchases the interest of any dissenting member at a price to be determined by agreement or by arbitration.

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The money to the dissenting members should be paid before the company is dissolved and should be raised in such manner as may be determined by special resolution.

6. ***Duty of liquidator to call creditor's meeting in case of insolvency (s.495):*** If the liquidator is at any time of opinion that the company will not be able to pay its debts in full within the period stated in the declaration of solvency, or that period has expired without the debts having been paid in full, he must forthwith summon a meeting of the creditors and must lay before the meeting a statement of the assets and liabilities of the company. If he fails to comply with the above requirements, he shall be punishable with fine which may extend to ₹ 5,000.

7. ***Duty of the liquidator to call general meeting at the end of each year (s.496):*** In case winding up continues for more than one year the liquidator must: (a) call a general meeting of the company at the end of the first year from the commencement of winding up and at the end of each succeeding year, or as soon thereafter as may be convenient within 3 months from the end of the year or such longer period as the Central Government may allow; and (b) lay before the meeting an account of his acts and dealing and of the conduct of the winding up during the preceding year.

8. ***Final meeting and dissolution [s.497]:*** As soon as the affairs of the company are fully wound up, the liquidator must: (a) make up an account of the winding up showing how the winding up has been conducted and the property of the company has been disposed of; and (b) call a general meeting of the company for the purpose of laying the account before it, and giving any explanation thereof.

The meeting must be called by advertisement specifying the time, place and object of the meeting and must be published at least one month before the meeting in the official gazette and also in some newspaper circulating in the district where the registered office of the company is situated.

Within one week after the meeting, the liquidator must send to the Registrar and the official liquidator each, a copy of the account and the return regarding holding of the meeting. In case quorum was not present at the meeting called, he must report accordingly.

On receipt of the above documents, the Registrar will register them and the official liquidator shall make a scrutiny of the books and papers of the company and report to the court, the result of his scrutiny. If the report of the official liquidator shows that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest, then, from the date of submission of report of the court, the company shall be deemed to be dissolved. In the case of an unfavourable report, the court shall direct the official liquidator to make a further investigation of the affairs of the company. On receipt of the report of the official liquidator on such further investigation, the court may either make an order that the company stands dissolved with effect from the date specified in the order or make such order as the circumstances of the case brought out in the report permit.

Creditors' Voluntary Winding up

The procedure in a creditors' voluntary winding up is based upon the assumption that the company is insolvent. From the beginning, meetings of creditors are held in addition to those of the members. The chief power to appoint the liquidator is in the hands of the creditors and there is provision for the appointment of a committee of inspection, if desired, to which is left the fixing of the liquidator's remuneration. The detailed provisions as enlisted in Ss.500 to 509 are given below:

Meeting of creditors (s.500): When no statutory declaration of solvency has been made and filed as required by the Act, the Board of directors, acting on behalf of the company must summon a meeting of the creditors, for the same day or the next day after the meeting at which the resolution

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for voluntary winding up is to be proposed. Notice of this meeting has to be sent by post to the creditors simultaneously with the sending of the notices of the meeting of the company. Notice of the meeting should also be advertised in the official gazette and in two newspapers circulating in the district of the registered office or principal place of business of the company.

The Board of directors must prepare and lay before the meeting a statement of the position of the company's affairs, together with a list of its creditors and the estimated amounts of their claims. Violation of s.500 is punishable with fine which may extend to ₹ 10,000.

Notice to the registrar: A copy of any resolution passed at the creditors' meeting must be filed with the Registrar within 10 days of the passing thereof. If default is made, then the company and every guilty officer shall be punishable with fine which may extend to ₹ 500 for every day of the default (s.501).

Appointment of liquidator (s.502): The creditors and the members at their respective first meetings may nominate a person to be liquidator for the purpose of winding up the affairs and distributing the assets of the company. If the creditor and the members nominate different persons, the creditor's nominee will as a rule be the liquidator. But any Director, member or creditor may apply to the Court for an order that the company's nominee or the official liquidator or some other person should be appointed. If no person is nominated by the creditors, the members' nominee shall be the liquidator. Vacancies in the office caused by death, resignation or otherwise may be filled by creditors, except where the liquidator was originally appointed by or by the direction of the Court, when the Court will on application fill the vacancy.

Committee of inspection (s.503): The creditors at their first or any subsequent meeting may, if they think fit, appoint a committee of inspection of not more than five members. If such committee is appointed, the company may, either at the meeting at which the winding up resolution is passed, or at a later meeting, appoint five persons to serve on the committee. If the creditors object against the persons appointed by the company, then the matter will be referred to the Court for the final decision. The powers of such committee are the same, as those of a committee of inspection appointed in a compulsory winding up.

Fixing of liquidator's remuneration (s.504): The remuneration to be paid to the liquidator or liquidators has to be fixed by the committee of inspection or if there is no much committee, by the creditors. Where the remuneration is not so fixed, it must be determined by the Court. Any remuneration once fixed shall not be increased in any circumstances, whatever, whether with or without sanction of the court.

Board's powers to cease on appointment of liquidator (s.505): On the appointment of liquidator, all the powers of the Board of directors shall cease, except in so far as the committee of inspection, or if there is no such committee, the creditors in general meeting, may sanction the continuance thereof.

Duty of liquidator to call meeting of company and of creditors at the end of each year [s.508]: In the event of the winding up continuing for more than one year, the liquidator must call a general meeting of the company and a meeting of the creditors at the end of the first year, from the commencement of the winding up and at the end of each succeeding year, or as soon thereafter as may be convenient within 3 months from the end of the year or such longer period as the Central Government may allow. Further, he may lay before the meeting an account of his acts and dealings and of the conduct of winding up during the preceding year, together with a statement in the prescribed form and containing the prescribed particulars with respect to the proceedings and position of the winding up.

Final meeting and dissolution (s.509): As soon as the affairs of the company are fully wound up, the liquidator must: (a) make up an account of the winding up, showing how the winding up has been conducted and the property of the company has been disposed of; and (b) call a general

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meeting of the company and a meeting of the creditors for the purpose of laying the account before the meeting and giving any explanation thereof.

Each such meeting must be called by advertisement and must specify the time, place and objects thereof and must be published at least one month before the meeting in the official gazette and also in some newspaper circulating in the district where the registered office of the company is situated.

Within one week after the date of the meetings, the liquidator shall send to the Registrar and the official liquidator a copy of the account and a return of the meeting held [s.509 (3)].

The official liquidator, after scrutiny of the books and papers of the company, shall make a report to the court. If this report states that the affairs of the company have not been conducted in a manner prejudicial to the interest of the company or public then from the date of the submission of the report the company shall be deemed to be dissolved; otherwise the court will ask official liquidator to make further investigation and may, after that report, order that the company shall stand dissolved from the specified date [s. 509 (6)].

Notes Distinction between Members' Voluntary Winding up and Creditor's Voluntary Winding up:

1. Members' voluntary winding up can be resorted to by solvent companies and thus requires the filing of a 'declaration of solvency' by the directors of the company with the Registrar; creditors' winding up, on the other hand, is resorted to by insolvent companies.
2. In members' voluntary winding up there is no need to have creditor's meeting. But in the case of creditors' voluntary winding up, a meeting of the creditors must be called immediately after the meeting of the members.
3. Liquidator, in the case of members' winding up is appointed by the members. But in the case of creditors' voluntary winding up, if the members and creditors nominate two different persons as liquidators, creditors' nominee shall become the liquidator.
4. In the case of creditor's voluntary winding up, if the creditors so wish a 'Committee of Inspection' may be appointed. In the case of members' voluntary winding up, there is no provision for any such committee.

Voluntary Winding up under Supervision of the Court

At any time after a company has passed a resolution for voluntary winding up, the court may make an order that the voluntary winding up should continue subject to the supervision of the court (Section 522). Application for such supervision order may be made either by a creditor, a contributory, the company, or the liquidator.

One advantage of having a supervision order is that the liquidator is allowed to occupy the same position and exercise the same power (subject to restrictions where necessary) as a voluntary liquidator. At the same time the advantage of a compulsory winding up as regards stay of suits and other proceedings and making and enforcing calls etc. are also secured and the court is empowered to exercise all the powers which it can exercise in a compulsory winding up. In truth, a supervision order is an amalgam of both—a voluntary winding up and a winding up by court as it is made on such terms and conditions as the court thinks just. Such an order is passed by the court under the following circumstances:

1. The resolution for winding up was obtained by fraud, or

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2. The rules relating to winding up order are not being observed, or

3. The liquidator is prejudicial or is negligent in collecting the assets.

The court, in such a case, gets the same powers as it has in the case of compulsory winding up under order of the court. The court may also appoint an additional liquidator or liquidators. It may also remove any liquidator and fill any vacancy occasioned by the removal or by death or by resignation [Section 524]. A liquidator so appointed shall have the same powers, be subject to the same obligations and in all respects stand in the same position as if he had been appointed in accordance with the provisions of the Act relating to the appointment of liquidator in voluntary winding up, subject, however, to any restrictions the court may impose (Section 525).

Unless the court imposes restrictions on the exercise of any powers by the liquidator, he will have all the powers conferred on a liquidator in voluntary winding up [Section 526(1)]. The court will have as wide powers as in compulsory winding up. The court may stay suits or legal proceedings. It can make or enforce calls and all other orders necessary for beneficial winding up of the company [Section 526(2)].

Powers of court to order compulsory winding up [Section 527]: The court may pass an order for compulsory winding up superseding the order of winding up under its supervision. The court may then appoint a person who is the liquidator, either provisionally or permanently to be liquidator in winding up by the court in addition to and subject to the control of official liquidator.

Dissolution of the company: In the case of winding up under the supervision of the court, the company is deemed to be dissolved from the date the order of the court is issued to that effect. The court will issue such an order when the affairs of the company have been completely wound up and the liquidator has made an application to the court requesting it to order for the dissolution of the company.

Where a company has been dissolved according to the due process of law, (except under Section 560—defunct companies) on the expiry of 5 years from the date of dissolution of the company, the name of the company should be struck off the Register after noting against its name that it has been dissolved.

Task A company was incorporated for the purpose of manufacturing machinery tools, implements etc. It spents a substantial part of its subscribed capital on fixed assets. It borrowed a sum of ₹ 30 Lakhs from a bank for providing working capital. As the company was unable to pay back this loan, the bank obtained a decree from a court. The stock-in-trade, plant and machinery and all the fixed assets of the company were sold out in execution of the decree, leaving no surplus for the company.

Would it be just and equitable to wind up the company in the circumstances?

Self Assessment

Fill in the blanks:

4. The company by …….resolution, resolve that it be wound up by the court.

5. The procedure in a creditors' voluntary winding up is based upon the assumption that the company is……...

6. The ……shall not grant the permission to the registrar unless the company has been given the opportunity of making its representation against the petition of the registrar for winding up.

Notes

14.3 Preferential Payments

In the event of winding up, certain payments are to rank in priority to others. The payments to be so made first are called preferential payments. Section 529 A and 530 contain such payments.

Overriding Preferential Payments (s. 529A)

This section provides that notwithstanding anything contained in any other provision of this Act or any other law for the time being in force, the following amounts shall be paid in priority to all other debts:

(a) Workmen's dues; and

(b) Debts due to secured creditors, to the extent such debts rank pari passu with workmen's dues.

Section 529 provides an illustration to show as to how to assess workmen's due as against secured creditors. This is as follows:

(a) The value of the security of a secured creditor is ₹ one lakh.

(b) The total amount of the workmen's due is ₹ one lakh.

(c) The amount of the debts due from the company to its secured creditors is ₹ 3 lakh.

(d) The aggregate of the amount of workmen's dues and of the amounts of debts due to secured creditors is ₹ 4 lakh.

(e) The workmen's portion of the security is, therefore, one-fourth of the value of the security, i.e. ₹ 25000. In other words, the pari passu share will be 1 : 3 for workmen and secured creditors respectively in the amount of ₹ 1 lakh, the value of the security. This comes to ₹ 25,000 and 75,000 for the workers and the secured creditors respectively.

The aforesaid debts mentioned in s. 529A shall be paid in preference to all other debts in the winding up of a company and shall be paid in full unless the assets of the company are not sufficient to meet them, in which case they shall be reduced in equal proportions.

Preferential Payments (s. 530): The provisions of s. 530 are summarized as follows:

1. In a winding up (subject to the provisions of s. 529A), there shall be paid in priority to all other debts:

   (a) All revenues, taxes, ceases and rates due to the Central or State Government or to a local authority. The amount should have become due and payable within 12 months before the winding up order;

   (b) All wages or salary of any employee, in respect of services rendered to the company and due for a period not exceeding four months during the twelve months preceding the winding up. The amount shall not exceed such sum as may be notified by the central government [presently, ₹ 20,000] for any one claimant;

   (c) All secured holiday remuneration becoming payable to an employee on the termination of his employment before, or by the effect of the winding up;

   (d) All amount due in respect of contributions payable during the 12 months before the winding up under the Employees State Insurance Act, 1948 or any other law;

   (e) All amounts due in respect of any compensation or liability for compensation under the Workmen's Compensation Act, 1923 in respect of death or disablement of any employee of the company;

(f) All sums due to any employee from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the employees maintained by the company;

(g) The expenses of any investigation held in pursuance of s. 235 or s. 237 insofar as they are payable by the company.

2. The advances made by a third person to pay wages or salary of an employee or holiday remuneration to him or to any other person on his death, shall have the same right of priority in winding up, up to the amount by which the employee or other person in his own right would have been entitled to.

3. The foregoing debts shall rank pari passu, i.e., equally among themselves. In case assets are not sufficient to meet them, they shall abate (i.e., be reduced) in equal proportion.

4. Where the assets of the company available for payment of general creditors are insufficient to meet them, the aforesaid debts shall have priority over the claims of holders of debentures under any floating charge created by the company, and be paid accordingly out of any property comprised in or subject to that charge.

The order of priority in paying off debts in a winding up shall be as follows:

(i) Workmen's dues and debts due to secured creditors (s. 529A)

(ii) Costs and expenses of winding up

(iii) Preferential debts (s. 530).

(iv) Floating charge; and

(v) Unsecured creditors.

Example: A Ltd. is being wound up by the court. The official liquidator, after realization of the assets, has an amount of ₹ 28 lakh at his disposal towards the payment to the creditors of the company. The list of creditors is given below:

(i) Dues to secured creditors: ₹ 20 lakh

(ii) Dues to workers: ₹ 15 lakh

(iii) Taxes, etc. due to the government authorities: ₹ 2 lakh

(iv) Unsecured creditors: ₹ 40 lakh.

The company has created a charge on all the assets of the company in favour of the secured creditors.

The amount payable under s. 529A to workers is ₹ 15 lakhs; and to the secured creditors is ₹ 20 lakhs. This comes to ₹ 35 lakhs. The amount available is ₹ 28 lakhs. As it is insufficient to pay these two debts in full, they shall abate in equal proportion. The workers and the secured creditors will get ₹ 12 lakh and ₹ 16 lakh respectively. The question of payment of tax due to the government authorities and to the unsecured creditors does not arise.

Self Assessment

Fill in the blanks:

7. In the event of winding up, certain payments are to rank in priority to others, they are called …… payments.

8. All secured holiday remuneration becoming payable to an employee on the ……of his employment before, or by the effect of the winding up

Notes

9. ……dues and debts due to secured creditors come first in the order of priority in paying off debts in a winding up.

14.4 Liquidators

The commencement of winding up of a company does not put an end to the existence of the company. Its assets are to be realised and distributed among the debenture holders, creditors, shareholders etc. For the purpose, somebody has to act as an agent of the company. Such agent is called liquidator. For the purpose of filing Income Tax Return for the income earned during the winding up it has been held that the liquidator will be regarded as principal officer of the company (Mysore Spun Silk Mills Ltd.).

Rules relating to their appointment, rights, powers and duties can be discussed under the following heads: (1) In compulsory winding up. (2) In voluntary winding up.

Liquidators in compulsory winding up: On a winding up order being made in respect of company, the official liquidator, by virtue of his office becomes the liquidator of the company (s.449). Note that, the court has no power to appoint private persons as liquidators.

An official liquidator is attached to each High Court and is appointed by the central government. The Official Receiver attached to District Court for insolvency purposes shall be the official liquidator attached to the District Court (s. 448).

Provisional liquidator: After presentation of the petition but before the hearing, application may be made to the court by the company or creditors or contributories to appoint a provisional liquidator to safeguard the assets pending the hearing. The powers of a provisional liquidator are the same as those of a liquidator unless limited by the court. As soon as winding up order is made, the provisional liquidator becomes the liquidator of the company (s.450).

Committee of inspection to act with Liquidator (already explained): Liquidators in voluntary winding up:

1. In member's voluntary winding up the following points have already been explained: (a) Appointment and remuneration; (b) Notice of his appointment to Registrar; (c) Duty to call creditors' meeting in case of insolvency; (d) Duty to call general meeting every year; (e) Duty to call final meeting.
2. In Creditors' Voluntary Winding up the following points have already been explained: (a) Appointment; (b) Remuneration; (c) Duty to call meeting of the creditors at the end of each year; (d) Duty to call final meeting.

Common Points as Regards Liquidators in Voluntary Winding up

Restriction on appointment. A Body Corporate cannot be appointed as a voluntary liquidator and any such appointment would be void. If a body corporate acts as a liquidator, that body corporate, its director or manager shall be punishable with fine up to ₹ 10,000 (s.513).

Further, any person who gives or agrees to give or offers to any member or creditor of a company any gratification whatever with a view to: (a) securing his own appointment or nomination as the company's liquidator, (b) securing or preventing the appointment or nomination of some person other than himself, as a liquidator of the company, shall be punishable with fine up to ₹ 1,000 (s.514).

Power of court to appoint and remove a liquidator (s.515): (1) If for any cause whatever, there is no liquidator acting, the court may appoint an official liquidator or any other person as a liquidator; (2) The court may, on cause shown, remove a liquidator and appoint an official liquidator or any other person as a liquidator in place of the removed liquidator; (3) The court may also appoint or remove a liquidator on the application made by the Registrar in this behalf;

Notes

(4) If the official liquidator is appointed as liquidator, the remuneration to be paid to him shall be fixed by the court and shall be credited to the Central Government.

Notice by liquidator (s.516): Within 30 days after his appointment, the liquidator must publish in the official gazette and deliver to the Registrar a notice of his appointment in the prescribed form, otherwise a punishment of ₹ 500 for every day of default shall be attracted.

Self Assessment

Fill in the blanks:

10. For the purpose of filing Income Tax Return for the income earned during the winding up it has been held that the …….will be regarded as principal officer of the company.
11. A Body Corporate cannot be appointed as a voluntary liquidator and any such appointment would be ……..
12. The Official Receiver attached to District Court for insolvency purposes shall be the …… attached to the District Court.

14.5 Dissolution of Companies

A company is said to be dissolved when it ceases to exist as a corporate entity for all practical purposes but it is not the extinction of the company. The company is kept, after dissolution, in 'suspended animation' for 2 years. The dissolution of a company may be declared by the court, under s.559, within a period of two years from the date of dissolution. Thus, within a period of 2 years from the date of dissolution, the company can be revived by the court by declaring the dissolution void. The court will do so at the application by the liquidator of the company or by any other person who appears to the court to be interested in this [s.559 (1)]. It will be the duty of the applicant to file a copy of the above order of the court, with the registrar, within 30 days after the making of the order [s.559(2)].

Modes of Dissolution

Dissolution of a company may be brought about in any of the following three ways:

(1) ***In case of defunct companies:*** By removal of its name from the register of companies (s.560): If the registrar has reason to believe that a company is not carrying on business, he is empowered to adopt the procedure prescribed by s.560 and strike out the company's name from the register as being 'defunct'. This may be done whether the company is a going concern or in liquidation.

(2) ***In pursuance of amalgamation or reconstruction:*** By order of the Court without winding up, i.e., where a reconstruction or amalgamation is being carried under s.394(b)(iv).

(3) In pursuance of the winding up of the company.

Dissolution of Defunct Companies (s.560)

A defunct company means a company which has never commenced business or which is not carrying on business. Section 560 lays down the procedure for the dissolution of defunct companies, without resorting to the winding up machinery. The procedure is as follows:

1. Where the registrar has reasonable cause to believe that a company is not carrying on business or is not in operation, he shall send to the company by post a letter inquiring whether the company is carrying on business or is in operation.

Notes

2. If the registrar does not within one month of sending the letter receive any answer thereto, he shall, within 14 days after expiry of the month, send to the company by post a registered letter referring to the first letter and stating that no answer thereto has been received and that, if an answer is not received to the second letter within one month from the date thereof, a notice will be published in the official gazette, with a view to striking the name of the company off the register.

3. If the registrar either receives an answer from the company to the effect that it is not carrying on business or is not in operation, or does not within one month after sending the second letter receive any answer, he may publish in the official gazette and send to the company by registered post a notice that, at the expiration of 3 months from the date of that notice, the name of the company, unless cause is shown the contrary, be struck off the register and the company will be dissolved.

The dissolution of the company in the above stated manner, shall not, however, affect: (a) The liability, if any, of every director, manager or other officer who was exercising any power of management and of every member of the company. In other words, such persons shall be liable as if the company had not been dissolved; and (b) the power of the court to wind up a company.

Restoration of the Name of the Company

If a company or any member or any creditor feels aggrieved by the removal of the company's name from the register of companies, the court may, on an application by the aggrieved party, any time within 20 years from the publication in the official gazette of the notice of striking off the name of the company, order that the name of the company should be restored in the register. Power of the court to order for restoration of company's name is discretionary and will be given when the court is satisfied that: (1) after restoration, the company will be in a position to carry on its business; or (2) at the time of striking off, the company was carrying on business or was in operation; or (3) it is just and equitable that the company's name be restored.

The court may also, on passing such an order, give such directions and make such provisions as seem just for placing the company and all other persons in the same position, as nearly as may be, as if the name of the company had not been struck off.

A certified copy of the court's order must be delivered to the registrar and upon such delivery the company shall be deemed to have continued in existence as if its name had not been struck off.

Dissolution in Pursuance of Amalgamation [s.394(1)]

The court may, either by the order sanctioning the compromise or arrangement or by a subsequent order, make provision for the dissolution, without winding up, of the company whose undertaking, property or liabilities, either wholly or in part, under the scheme of amalgamation or construction, is transferred to another company.

But no such order shall be made by the court unless the official liquidators has, on scrutiny of the books and papers of the company, made report to the court that, the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest. The court can, however, within 2 years declare the dissolution void.

Dissolution in Pursuance of Winding up

The corporate existence of a company continues through winding up till it is dissolved. It may be dissolved as follows:

1. ***In case of compulsory winding up (s.481):*** The court will make an order dissolving a company if: (i) the affairs of the company have been completely wound up (i.e. assets

Notes

collected and liabilities paid as far as practicable); or (ii) the liquidator cannot proceed with the winding up for want of funds and assets or for any other reasons whatever; or (iii) it is just and reasonable in the circumstance of the case that an order of dissolution of the company should be made.

On making of the order of dissolution, the company shall be dissolved from the date of the order [s. 48 (1)]. The official liquidator shall file a copy of the order of dissolution within 30 days of making of the order (s.497).

2. ***In case of members' voluntary winding up (s.497):*** As soon as the official liquidator, after scrutinizing the books, accounts and papers of the company, makes a report to the court that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest, then from the date of the submission of the report to the court, the company shall be deemed to be dissolved. Where the liquidator reports that, the affairs have not been so conducted, the court shall direct him to make further investigation and submit his second report to the court and may order that the company shall stand dissolved from a date specified in that order [s.497(b)].

3. ***In case of creditors voluntary winding up (s.509):*** Same as above [s.509(6)]. The court can, however, declare the dissolution void within 2 years.

When a company has been dissolved according to due process of law, except when such dissolution is under s.560, on the expiry of 5 years from the date of dissolution of the company, the name of the company should be struck off the register of companies after noting against its name that it has been dissolved. Thus in case of defunct companies, dissolution and extinction takes place at the same time but in other cases extinction follows 5 years after.

Self Assessment

Fill in the blanks:

13. A ……..company means a company which has never commenced business or which is not carrying on business.

14. The company is kept, after dissolution, in 'suspended animation' for …….years.

15. The official liquidator shall file a copy of the order of dissolution within …….days of making of the order

Case Study

David Hughes v Seamus Duffy and Eugene Hanratty, 19 April 2005, High Court

Facts: This case was taken under Section 150 of the Companies Act 1990, by the Official Liquidator of the Supreme Oil Company Limited. Section 150 provides for a prohibition or restriction of persons acting as company directors for a period of five years.

The respondents sought to have the application dismissed or refused by reason of the delay in bringing the application. The order winding the company up was made in November 1991 but the application under Section 150 was not made until December 2003. The High Court applied the principles set down by the Supreme Court in Duignan v Carway [2001] 4 IR 550 in deciding whether to dismiss the application on grounds of delay.

Contd...

Notes

Ms. Justice Finlay Geoghan stated that there were two separate circumstances in which the court might determine that the balance of justice was against proceeding with an application under Section 150, namely:

1. where the delay would put a just hearing at risk; and
2. where the delay would represent a breach of the respondent's constitutional right to fair procedures.

In examining the latter ground, the Judge gave consideration to the mandatory five year restriction period under Section 150 and the shift in the onus of proof onto the respondent directors.

Question

Do you agree to the justice of the court? Justify.

Source: http://www.hg.org/articles/article_1162.html, Published July 11, 2005 By: A&L Goodbody

14.6 Summary

- The winding up or liquidation of a company is the process whereby its life is ended and its property administrated for the benefit of its creditors and members.
- The term contributory means every person liable to contribute to the assets of a company in the event of its being wound up, and includes the holder of fully-paid up shares.
- A company may be wound up in three ways which are Compulsory winding up under an order of the court, Voluntary winding up and Voluntary winding up under the supervision of the court.
- In the event of winding up, certain payments are to rank in priority to others. The payments to be so made first are called preferential payments.
- The order of priority in paying off debts in a winding up shall be: (i) Workmen's dues and debts due to secured creditors, (ii) Costs and expenses of winding up, (iii) Preferential debts, (iv) Floating charge; and (v) Unsecured creditors
- In case of winding up of a company for realising and distributing assets among the debenture holders, creditors, shareholders etc. somebody has to act as agent of company which is called liquidator.
- After the winding up procedure is completed, the company is dissolved.
- A company is said to be dissolved when it ceases to exist as a corporate body.

14.7 Keywords

Contributory: It means any person who is liable to contribute to the assets of a company in the event of its being would up.

Dissolution: A company is said to be dissolved when it ceases to exist as a corporate body for all practical purposes.

Liquidator: In case of winding up of a company for realising and distributing assets among the debenture holders, creditors, shareholders etc. somebody has to act as agent of company which is called liquidator.

Notes

Preferential Payments: In the event of winding up, certain payments are to rank in priority to others, they are called preferential payments.

Special Resolution: A resolution is a special resolution when the number of votes cast in favour of the resolution is three times the number cast against it.

14.8 Review Questions

1. Elucidate the circumstances in which a company may be wound up by the Company Law Board.
2. "There is no difference between winding up and dissolution". Do you agree? Comment.
3. Analyse the powers and discretion of the court in case of winding up of the company.
4. If you have to wind up your company voluntarily, what procedure will you follow for the same?
5. Examine the liability of members of a company in the event of its being wound up.
6. Your friend wants to wind up his company due to frequent loss he is suffering in his business. He is very confused. He wanted your advice on the winding up procedure. What suggestion you will give to him?
7. Define the term 'contributory.' Discuss the liability of members of a company in the event of its being wound up.
8. State the liabilities of contributories as present and past members.
9. Explain – "The liability of contributory is ex lege and not ex contractu".
10. What are the circumstances in which a company may be wound up on the ground that it is just and equitable to wind it up?

Answers: Self Assessment

1.	Contributory	2.	contract of membership
3.	legal representatives	4.	special
5.	insolvent	6.	Central Government
7.	preferential	8.	termination
9.	Workmen's	10.	liquidator
11.	void.	12.	official liquidator
13.	defunct	14.	2
15.	30		

14.9 Further Reading


Book

S.S. Gulshan, *Business Law*, Excel Books, New Delhi, 2006.


Online links

www.legalserviceindia.com/article/details.asp?id=62

www.secp.gov.pk/SECGuideSeries/pdf/Guide_WindingUp.pdf

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