6

ARTICLES OF ASSOCIATION

MEANING OF ARTICLES

THE articles of association are the rules and regulations of a company framed for the purpose of internal management. The articles regulate the manner in which the company's affairs will be managed. While the memorandum lays down the objects and purposes for which the company is formed, the articles lay down rules and regulations for the attainment of those objects.

The true nature of articles can be understood from the observations made by Lord Justice Bowen: "The memorandum contains the fundamental conditions upon which alone the company is allowed to be incorporated. They are conditions introduced for the benefit of the creditors, and the outside public, as well as of the creditors. The articles of association are the internal regulations of the company and are for the benefit of share holders."[1] In the words of Lord Cairns in *Ashbury Railway Carriage Co. Ltd. v. Riche.* "The memorandum is, as it were, the area beyond which the actions of the company cannot go; inside that area the shareholders may make such regulations for their own management as they think fit in the form of articles of association."[2]

Obligation to Register Articles

A public company limited by shares may not file a separate set of articles of association. But an unlimited company, a company limited by guarantee or a private company must prepare their own articles which must be registered along with the memorandum of the company. (Sec. 26)

Articles of an unlimited company. In the case of an unlimited company, the articles shall state the number of members with which the company is to be registered and if it has a share capital, the amount of share capital

[1]*Guinness v. Land Corporation of Ireland* (1882) 22 Ch. D. 349.
[2]1875 L.R. 7H.L. 653 p.670.

with which it is to be registered. [Sec. 27 (1)]

Articles of a company limited by guarantee. In the case of a company limited by guarantee, the articles shall state the number of members with which the company is to be registered. [Sec. 27(2)]

Articles of private company. In the case of private company, the articles shall (*a*) restrict the right to transfer its shares; (*b*) limit the number of its members to fifty excluding the past and present employees of company; and (*c*) prohibit any inviation to the public to subscribe for any shares in or debentures of the company. [Sec. 27 (3)]

Adoption and application of Table A. As we already know, a public company limited by shares may not prepare its own articles. If the company does not file its own articles, the regulations contained in Table A of Schedule I shall become the articles of that company. Even when a company limited by shares has its own articles and it is silent on some points, the regulations of Table A will apply [Sec. 28]

The advantage adopting the regulations of Table A is that its provisions are legal beyond any doubt.[3]

Form and Signature of Articles

Articles shall be printed, divided into paragraphs numbered consecutively and signed by each subscriber of the memorandum of association (who shall add his address, description and occupation, if any) in the presence of at least one witness, who shall attest the signature and shall likewise add his address, description and occupation, if any. [Sec. 30]

Contents of Articles

Articles of association contain regulations for the internal management of a company. The latter may make such regulations for this purpose as it thinks fit. The only limitation is that the articles should not be against the provisions of the Companies Act or its memorandum. Any clause of the articles which violates any of the provisions of the Companies Act or the memorandum will be null and viod. Similarly, the articles must be in accordance with the principles of the general law of the country and public policy. Articles generally contain provisions relating to the following matters: (*i*) the exclusion, whole or in part, of Table A; (*ii*) share capital, different classes of shares, rights of different classes of shareholders and variations of these rights; (*iii*) execution or adoption of preliminary agreements, if any; (*iv*) allotment of shares; (*v*) lien on shares. (*vi*) calls on shares; (*vii*) forfeiture of shares; (*viii*) issue of

[3] *Lock v. Queensland Investment and Land Mortgage Co.* (1896) 1 Ch. 397 at pp. 40 6-407.

share certificates; (*ix*) issue of share warrants; (*x*) transfer of shares; (*xi*) transmission of shares; (*xii*) alteration of share capital; (*xiii*) borrowing powers of the company; (*xiv*) rules regarding meetings; (*xv*) voting rights of members; (*xvi*) notice to members; (*xvii*) dividends and reserves; (*xviii*) accounts and audit; (*xix*) arbitration provision, if any; (*xx*) directors, their appointment and remuneration; (*xxi*) the appointment and reappointment of the managing director, manager and secretary; (*xxii*) fixing limits of the number of directors. (*xxiii*) payment of interest out of capital; (*xxiv*) common seal; and (*xxv*) winding up.

Legal Effect of Memorandum and Articles

Section 36 provides that subject to the provisions of the Act, the memorandum and articles shall bind the company and its members to the same extent as if they respectively had been signed by the company and by each member and as if they had contained convenants on the part of the company and of each member to be bound by them.

Summing up the effect of Section 36, it may stated that the articles bind the company to its members, the members to the company, the members to each other, but they do not bind the company to outsiders.

Let us now make an analysis of Section 36 under different heads:

Members bound to the company. Articles constitute a contract between the company and members and therefore every member is bound by the articles as if every one of them had contracted to conform to them. Every member is bound to observe the provisions of articles.

In *Boreland Trustees v. Steel Brothers and Co. Ltd.*,[4] the articles provided that the shares of any member who became bankrupt should be sold to individuals at a price fixed by the directors. B, who was holding 73 shares, became bankrupt and his trustee in bankruptcy claimed that he was not bound by the articles and could therefore sell those shares as he wished. But it was held that the trustee in bankruptcy was bound by the articles and could not claim the shares against the company.

Similarly in *Bradford Banking Company v. Briggs*,[5] the articles of a company provided that the company shall have a first charge on shares for the debts due to it from the members. A member owing money to the company, borrowed money from a bank on the security of the shares. It was held that the company could have priority because of this provision in the articles.

Accordingly, the company is entitled to sue its members for enforcement of the articles and to restrain breach of them.

[4]1901 1 Ch. 279
[5](1886) 12 A.C. 29.

Company bound to the members. The company is also bound by the provisions of the articles to its members. Any member can sue the company to prevent any breach of the articles which would affect his rights as a member and he is entitled to an injunction to prevent the breach.[6]

In *Johnsan v. Lyttle's Iron Agency*,[7] a forfeiture of shares, irregularly effected by a company, was set aside at the instance of the aggrieved member as the company did not comply with the provisions of the articles.

In *Wood v. Odessa Water Works Co.*,[8] the articles empowered the company to declare a dividend to be paid to the shareholders with the approval in the general meeing. A resolution was passed whereby the dividend was to be paid by issue of debenture bonds and not in cash. At the instance of a member, the court granted an injunction restraining the directors from acting on the resolution.

Not binding on the company in relation to outsiders. The articles do not constitute a contract between the company and outsiders. For instance, where the articles provided for remuneration to be paid to promoters, it does not give any right of action to promoters against the company.[9] Similarly in *Brown v. La Trinidad*,[10] where B was to be appointed a director till 1888 as provided in the articles but was removed earlier, the court held that articles do not constitute a contract between company and outsider and therefore*Brown* was not entitled to bring any action against the company.

It may be noted further that even a member cannot enforce provisions of the articles in some capacity other than that of member. In *Eley v. The Positive Government Life Assurance Company*,[11] the articles provided that Eley should be the solicitor of the company. He would not be removed from his office except for misconduct. He also became a member of the company. *Eley* acted as solicitor for sometime but ultimately was removed from office without any allegation of misconduct. He sued for breach of contract but the court held that he could not bring action against the company because the right which he attempted to enforce was conferred upon him in a capacity other than that of a shareholder, and that articles do not constitute a contract between the company and outsider.

Even though memorandum and articles may not constitute a contract

[6]*Re Peveril Gold Mines Limited* (1898) 1 Ch. 122.
[7](1877) 5 Ch. D. 687.
[8](1889) 42 Ch. D. 636.
[9]*Re Rotherham Alum & Co.* (1883) 25 D. 103.
[10](1887) 37 Ch. D.1.
[11]1876 1 Ex. D. 88.

between a company and an outsider, such as a promoter or a director, an implied contract may be proved from the acts of the parties on the terms set out in the articles. This subject matter was duly considered by the Lahore High Court in *Gulab Singh v. The Punjab Zamindara Bank Ltd.*[12] In this case according to certain articles the plaintiff was appointed managing director and acted as such for eleven years and was remunerated in accordance with the terms set out in the articles. Subsequently the company removed him by special resolution at an extra-ordinary meeting. In a suit by the plaintiff for a declaration that he was still the managing director of the company, it was found that the resolution removing him from office was *ultra vires.* It was held that the articles constituted an implied contract between the company and the plaintiff and therefore the latter was entitled to maintain a suit on the basis of that contract.

Similarly, where an individiual entered into a contact with a company to serve as a director and the articles of the company required the director to have a share qualification as set out therein and fixed his remuneration, it was held that though the articles did not constitute a contract between the company and the director, yet the director was entitled to recover his remuneration against the company as fixed by the articles because the terms of the articles were deemed to have formed a part of his contract with the company.[13]

Between members inter se. Although there is no express agreement between the members of the company, yet articles regulate their rights *inter se.* But such rights can only be enforced by or against a member through the company or through the liquidator representing the company."[14]

But in *Rayfield v. Hands and others,*[15] it was held that the rights of shareholders as shareholders, and the extent to which such rights are regulated by the articles could be enforced by one member against another without joining the company as party. In this case the articles of the company provided that members wishing to transfer their shares must inform the directors of their intention and the directors must take the said shares equally between them at a fair value. The plaintiff informed the directors of his intention to transfer his shares. But the directors refused the shares and argued that the articles could impose no such obligation upon them in their capacity as directors. But it was held that the directors were obliged to take the shares since the articles imposed an

[12]A.I.R. (1942) Lahore 47.
[13]*Re New British Iron Co.* (1898) 1 Ch. 324.
[14]*Welton v. Saffrey* (1897) App. Cas. 299, p. 315.
[15](1852) 2 W.L.R. 851.

obligation upon them in their capacity as members. As such it was a personal obligation which could be enforced by one member against the other without joining the company as a party.

At the same time it must be noted that the articles constitute a contract between members only as regards matters arising out of the company relationship of members as members. They cannot regulate rights arising out of a commercial contract in which other shareholders have no interest. Hence an arbitration clause in the articles of the company could not be invoked where a member of the company had a commercial dispute of private nature with another member of the company.[16]

ALTERATION OF ARTICLES

A company has wide powers to alter its articles to suit its requirements from time to time. Section 31 lays down that a company may alter its articles by a special resolution. A copy of the special resolution authorising the alteration must be filed with the Registrar along with the explanatory statement within 30 days of the passing of the said resolution. The company is also required to file a copy of the altered articles of association with the Registrar within 3 months of the passing of the resolution. The effect of the change must be incorporated in all copies of articles of association issued after the date of alteration. The alteration will be effective from the date of registration by the Registrar.

It may be noted here that the power to alter articles of association is a statutory power and it cannot be taken away by any provision in the memorandum or articles.[17]

An alteration of articles with retrospective effect was held valid provided it was *bona fide* and for the benefit of the company as a whole.[18]

Once the alteration is made, such alteration shall be valid as if originally contained in the articles. The altered articles will bind the members just in the same way as did the original articles and such altered articles may again be altered by special resolution.

RESTRICTIONS ON ALTERATION OF ARTICLES

There are certain restrictions on the nature and extent of alterations that can be made in the articles. These are:

[16] *Khusi Ram. v. Hanut Mal* (1949) 53 C.W.N. 305.
[17] *Walker v. London Tramways Co.,* (1879) 12 Ch. D. 705.
[18] *Allen v. Gold Reefs of West Africa* (1990) 1 Ch. 656.

(*i*) *Not to be inconsistent with the Companies Act.* No such alteration which violates the provisions of the Act can be made.

(*ii*) *Not to be inconsistent with the memorandum.* The alteration cannot be such which is contrary to the conditions contained in the memorandum of association of the company. One may note that articles are subordinate to the memorandum and as such must not override.

(*iii*) *Not to be illegal.* The alterations should not sanction anything which is illegal.

(*iv*) *Special resolution.* Alterations of articles will be made only by a special resolution as defined in the Act. Articles can never be altered by an ordinary resolution even if they provide for such a procedure.

(*v*) *Not to increase liability of members.* Any alteration which seeks to impose additional liability on a member of a company to take shares more than what he has already taken or to pay any more money than what he is liable to pay on his shares, shall not be binding upon him unless he agrees in writing, either before or after the alteration. However, this restriction will not apply where the company is a club or any other association and the alteration requires the member to pay recurring or periodical subscriptions or charges at a higher rate, although he does not agree in writing to be bound by the alteration. (Sec. 38)

(*vi*) *Central Government's approval in certain cases.* The following alterations shall have not effect unless approved by the Central Government: (*a*) any alteration which has the effect of converting a public company into a private company [Sec. 31(1)]; (*b*) any alteration relating to the appointment or reappointment of a managing or whole-time director or of a director not liable to retire by rotation in the case of a public company or private company which is a subsidiary of a public company (Sec. 268); and (*c*) any alteration resulting in an increase in the remuneration of any director including a managing or whole-time director in the case of a public company or a private company which is a subsidiary of a public company. (Sec. 310)

(*vii*) *Not to constitute a fraud on minority.* The alteration shall not be valid if it constitutes a fraud on minority. An action of majority which distriminates between majority shareholders and minority shareholders would constitute a fraud on minority. A special resolution would be liable to be impeached if the effect of it were to discriminate between the majority shareholders and minority shareholders so as to give the former an advantage of which the latter were deprived. The following cases would illustrate the concept of fraud on minority:

Menier v. Hooper's Telegraph Works Ltd.[19] In this case, companies A

[19](1874) 9 Ch. App. 350.

and B were in rivalry. The majority shareholders of company A were also the shareholders of company B. Company A had filed a suit against company B. Later, shareholders of company A passed a resolution to compromise the action against company B in such manner that the terms of compromise were favourable to company B and unfavourable to company A. The minority shareholders questioned the power of the majority to make the said compromise and the court set aside the same. It observed: "It would be a shocking thing, if that could be done... then the majority have put something in their pockets at the expense of the minority."

Cook v. Deeks.[20] In this case the directors of a railway construction company obtained a contract in their own names to construct a railway line. The contract was obtained under circumstances which amounted to breach of trust by the directors who then used their voting powers to pass a resolution of the company declaring that the company had no interest in the contract. It was held that the benefit of the contract belongs in equity to the company and that the directors could not benefit themselves at the expense of the minority. If it were not checked, this would be tantamount to allowing a majority to oppress the minority.

Brown v. British Abrasive Wheel Co.[21] The majority shareholders holding ninety-eight per cent of the shares were willing to subscribe further capital which the company badly needed but only if they were able to acquire the shareholdings of the minority. They passed a special resolution to alter the articles to enable them to purchase the minority shares compulsorily on certain terms. The plaintiff refused to sell its shares and challenged the validity of the majority resolution. It was decided that the alteration was not for the benefit of the company but for the benefit of the majority and accordingly an injunction was granted against the company prohibiting it from carrying out the resolution.

(viii) *Bonafide for benefit of the company as a whole.* The alteration must be *bona fide* for the benefit of the company as a whole. The court will restrain the company from making the alteration if the effect of it were to benefit an aggressive, vindictive or fraualuent majority. Any alteration made *bona fide* , in the interests of the company as a whole, is valid and binding even though the private interests of some members may be affected adversely. For instance, in *Sidebottom v. Kershaw, Leese & Co., Ltd.*[22], the alteration of the articles empowered the directors to require any member, who carried on a business competing with that of

[20]1916 A.C. 554.
[21](1919) 1 Ch. 290.
[22](1920) 1 Ch. 154.

the company, to sell his shares at a fair price to persons nominated by the directors. The validity of the resolution was challenged on the ground that the alteration will not be for the benefit of the company as a whole.

The court held that it was in the interest of the company as a whole to be protected against competition, and upheld the resolution. The court was of the view that the company as a whole means the corporators as a general body. Individual interests might have to be sacrificed. In this case it was very much in the interest of the company as a whole to get rid of such members who were carrying on a competing business, as they always had the chance to exploit the company's secrets for their personal benefit and at its cost.

(ix) *Not to be inconsistent with the order of the Company Law Board.* The alteration must not be inconsistent with an order of the Company Law Board. Where by an order of the court (on application under Section 397 or 398 for relief in case of oppression or mismanagement) the company amends its articles, the company will then be precluded from making any further alterations which are inconsistent with the order of the Company Law Board without the leave of the Company Law Board. [Sec. 404 (1)]

(x) *Not to cause breach of contract.* The alteration should not cause a breach of contract with an outsider. Thus, where a contract between a company and an outsider clearly provided that the articles shall not be altered, the court granted an injunction restraining the company from making the alteration on the ground that it would constitute a breach of contract with an outsider. This is well illustrated by the facts of *British Murac Rubber Syndicate v. Alperton Rubber Co. Ltd.*[23] In this case, an agreement was made between Company A and Company B. Company A had the right to nominate two directors on Company B's board as long as Company A held 5,000 shares in Company B. This was incorporated in the articles. Company A nominated two persons as directors and they were disapproved by Company B. Company B also made an attempt to alter the clause of articles which provided Company A the right of nomination. The court granted on injunction restraining Company B from making the said alteration on the ground that it would constitute a breach of contract with an outsider.

But later it was held that a company may alter its articles even if it causes breach of contract with the outsider. It has statutory power to do so. Where the contract with the outsider is wholly dependent on articles, alteration would be operative, and, accordingly, the person accepting appointment purely on the terms of the articles takes the risk of those

[23](1915) 2 Ch. 186.

terms being altered, and will be bound by the altered article.[24]

But the situation will be different if apart from the articles, there is an independent contract. In *Southern Foundries Ltd. v. Shirlaw,*[25] S was appointed Managing Director in a company for ten years by an agreement dated 21.12.1933. Subsequently, the company was amalgamated with another company and new articles were adopted. The latter gave power to the company to dismiss a director and accordingly S was removed from office as director and the company treated him as having ceased to be one. He sued the company for wrongful repudiation of the contract. It was held that dismissal was breach of contract and therefore the company was liable for damages.

DISTINCTION BETWEEN MEMORANDUM AND ARTICLES

The main points of distinction between a memorandum and articles are as follows:

(i) The memorandum contains the conditions and objects for which the company is incorporated. It is the charter of the company. Articles of association contain the rules and regulations for the internal management of the company.

(ii) The memorandum is subordinate to the Companies Act whereas the articles are subordinate to the Companies Act as well as the memorandum of association. Articles should be consistent with the provisions of the Companies Act and the conditions contained in the memorandum.

(iii) Every company must have its own memorandum of association. No company can be formed unless it files its memorandum with the Registrar of Companies at the time of its registration. But it is not essential for a public company limited by shares to have its own articles. A public company limited by shares may adopt Table A.

(iv) The memorandum defines the relationship between the company and the outside world whereas the articles define the relationship between the company and members as members only and as members *inter se.*

(v) Since memorandum is the constitution of the company, it is very difficult to make any alteration in it. Sometimes the company must get the approval of the Central Government and in some cases the sanction of Company Law Board must be obtained to make an alteration in the memorandum. Articles can be altered by a special resolution. No

[24]*Chittambram Chettair v. Krishan Aiyanger* I.L.R. 30 Mad. 36.
[25](1940) A.C. 701.

sanction of the Central Government or Company Law Board is required.

(vi) Any act comitted by the company beyond its memorandum is *ultra vires* and the company is not bound by it. Even the unanimous vote of all the shareholders cannot ratify it. But if something is done by the company beyond its articles, it is simply irregular and can subsequently be ratified by shareholders provided it is within the scope of the memorandum.

(vii) In the case of the contracts *ultra vires* the memorandum, outsiders have no remedy against the company. But in case of contracts *ultra vires* the articles, where for example internal procedures have not been complied with, outsiders can enforce the contract against the company provided they had no knowledge of irregularity.

CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES

A company's memorandum and articles of association become public documents on registration with the Registrar of Companies. These documents are available for public inspection in the Registrar's office on payment of such fees as may be prescribed.

Every person who deals with the company is deemed is to know the contents of these two documents.[26] This is known as "Doctrine of Constructive Notice" or "Constructive Notice of Memorandum and Articles." It is presumed the individuals dealing with the company have not only read these documents but that they have also understood their proper meaning.[27]

Consequently, if a person enters into a contract which is beyond the powers of the company, he cannot acquire any rights under the contract against the company. Thus for example, if the articles provide that a bill of exchange must be signed by two directors, a person dealing with the company must see that this is done. If he has a bill signed by only one director, he cannot claim under it.

A similar problem arose in *Kotla Venkatswami v. Ram Murthi.*[28] In this case, all deeds etc., were to be signed by the managing director, the secretary and a working director as per articles of the company. R accepted a deed from the company which was signed by a secretary and a working director on behalf of the company. It was held that R could not claim under this deed. If he had seen the articles, he would not have

[26]*Earnest v. Nicholls* (1857) 6 H.L.C. 401.

[27]*Griffith v. Paget* (No. 2) (1877) 6 Ch. D. 517; *Oak Bank Oil Co. v. Crum* (1882) 8 A.C. 65.

[28]A.I.R. (1934) Mad. 579.

accepted such a deed as it was not signed by the required persons and hence was invalid.

DOCTRINE OF INDOOR MANAGEMENT

The "doctrine of indoor management" imposes an important limitation on the "doctrine of constructive notice." Persons dealing with the company are presumed to have read these documents. Once they are satisfied that the company has power to enter into the proposed transaction, they are required to do no more. They are not bound to enquire into the regularity of any internal proceedings. They are entitled to assume that provisions of articles have been complied with by the company in its internal working. If the proposed contract is within the scope of the company as indicated by these two documents, the company will be bound to the outsider and the claims of the outsider will not be affected in any way by the internal irregularity of the company. This is known as the "Doctrine of Indoor Management" or rule in *Royal British Bank v. Turquand.*[29]

In the above case, the articles empowered the directors to borrow money provided they were authorised by a resolution passed at the general meeting of the company. The directors borrowed money from T and issued a bond to him without the authority of resolution passed at the general meeting. It was held that the company was liable for the money to T, because once the articles authorised the directors to borrow money subject to a resolution of the general meeting of the company, T was entitled to assume that the directors were borrowing on the authority of the resolution passed at a general meeting of the company. T is not required to enquire into the regularity of the company's internal proceedings.

The rule was followed in *Premier Industrial Bank Ltd. v. Carlton Mfg. Co. Ltd.,*[30] where it was stated: "If the directors have power and authority to bind the company, but certain preliminaries are required to be gone through on the part of the company before that power can be duly exercised, then the person contracting with the directors is not bound to see that all these preliminaries have been observed. He is entitled to presume that the directors are acting lawfully in what they do."

The rule is of great utility in the world of commerce. But for this rule, the form of company organisation would not have been that popular. It is based on the principles of justice and public convenience. Firstly, as we

[29](1856) 6 E. & B. 327.
[30](1909) 1 K.B. 107,

already know the office of the Registrar is a public office and hence any person dealing with the company must ensure that the proposed contract with the company is within its powers. He cannot be expected to know more about what is happening inside the company office. "An outsider is presumed to know the constitution of a company; but not what may or may not have taken place within the doors that are closed to him."[31] No one would like to deal with the company if he is also required to ascertain the regularity of the internal proceedings in respect of the proposed transaction. Secondly, the person would be unwilling to deal with the company if the company could escape the liability by denying the authority of officials to act on its behalf in the absence of this rule.

Exceptions to the Doctrine of Indoor Management

The doctrine of indoor management is subject to certain limitations. They are as follows:

(1) **Knowledge of irregularity.** A person dealing with the company will not be entitled to protection under this rule if he has notice, actual or constructive, that the prescribed procedure has not been complied with by the company.

Thus where *Company A* lends money to *Company B* on a mortgage of its assets and the procedure laid down in the articles for such a transaction was not complied with and the directors of the two companies were the same, it was held that the mortgage is not binding. It may be presumed that *Company A* had notice of irregularity through its directors.[32]

Similarly in *Howard v. Patent Ivory Co.*,[33] the directors were empowered to borrow up to £1,000 and such further sums as the company in general meeting might authorise. Without such consent, they issued to themselves debentures for sums in excess of £1,000. It was held that as they had knowledge of irregularity in the intgernal proceedings of the company, the company would be liable for £1,000 only. Sums borrowed in excess of this were held to be invalid.

(2) **Forgery.** It may be noted here that the rule in the *Turquand* case does not protect a person where forgery is involved. A company cannot be held liable for forgeries committed by its officers.

In Ruben v. Great Fingall Ltd.,[34] the secretary of the company issued a share certificate by forging the signatures of two directors under the seal

[31]*Pacific Coast Coal Mines Ltd., v. Arbuthnot* (1971) A.C. 607.
[32]*Pratt Ltd. v. Sasoon & Co. Ltd.* 40 Bomb. L.R. 1109 P.C.
[33](1888) 38 Ch. D. 156.
[34](1906) A.C. 439.

of the company. It was contended by the plaintiff that it was not his duty to verify the signatures. Whether the signatures were genuine or not was a part of internal management. But the court held that the certificate is not binding on the company as the rule in *Turquand's* case does not protect forgery. In this connection Lord Loreburn observed as follows: "It is quite true that persons dealing with limited liability companies are not bound to inquire into their indoor management and will not be affected by irregularities of which they have no notice. But this doctrine, which is well established, applies only to irregularities that otherwise might affect a genuine transaction. It cannot apply to a forgery."

(3) **Negligence on the part of the outsider.** If an individual is put upon enquiry, he cannot claim the benefit under the *Turquand* case in the circumstances under which he would have discovered irregularity if he had made the proper inquiries. In *Underwood v. Bank of Liverpool*,[35] the sole director paid cheques drawn in the name of the company in his own account. It was held that the bank was put upon inquiry before crediting the cheques drawn in favour of the company in the account of the director. The bank was not entitled to rely upon the ostensible authority of the director.

Similarly a bank was put upon inquiry where the directors of the company secured their indebtedness by a charge upon the assets of the company. It was held that the bank was not entitled to the benefit of the charge which had not in fact been authorised.[36]

It was further held that even the unusual magnitude of the transaction may put a person dealing with the company upon inquiry as to its being authorised.[37]

In *Anand Bihari Lal v. Dinshaw & Co.*,[38] the plaintiff accepted transfer of the company's property from its accountant.The transfer was held to be void because such a transaction is apparently beyond the scope of the accountant's power. It puts the person dealing with the company into inquiry. The plaintiff should have insisted on seeing the power of attorney executed in favour of the accountant by the company. Even a delegation clause is not enough to make the transaction valid unless the accountant is in fact authorised.

(4) **No knowledge of articles.** In order to claim protection, under the rule of "indoor management", knowledge of articles is essential. The doctrine of indoor management is based on the principle of estoppel and

[35](1924) 1 k.B. 775.
[36]*E.B.M. Co. v. Dominion Bank* (1937) 3 All. E.R. 555.
[37]*Houghton & Co. v. Nothard, Lowe & Wills (1927)* 1 K.B. 246.
[38]A.I.R. (1942) Oudh. 417.

a person who did not consult the company's memorandum and articles and consequently did not act in reliance on those documents, cannot be protected under the rule in *Turquand's* case.

(5) **Acts ordinarily beyond the apparent authority.** An outsider will not be protected by the rule in *Turquand's* case if the act of the agent is one which would not ordinarily be within his powers simply because under the articles the power of making such a contract might have been entrusted to him. The outsider can hold the company liable only where the power had in fact been delegated, notwithstanding a delegation clause to that effect in the articles. The facts of *Anand Bihar Lal v. Dinshaw & Co.*,[39] provide a clear illustration to support this point.

Similarly where the branch manager of a bank drew and endorsed bills on behalf of his company without having received any authority from the company, it was held that drawing of bills was not within the ordinary ambit of power of this branch manager and the company was not bound unless the authority was in fact delegated to him to this effect.[40]

QUESTIONS

1. Define articles of association. What are the usual contents of articles of association? Is it necessary for every company to have articles of asociation of its own?

2. The articles of a company are subordinate to and are controlled by the memorandum of association. *[Delhi, B.Com. (Hons.), 1979]*

3. Distinguish between articles of association and memorandum of association. *[Delhi, B.Com. (Hons.), 1978]*

4. How can the articles of association be altered? Discuss the limits on the powers of a company to alter or to add to the articles. *[Delhi, B.Com. (Hons.), 1990]*

5. What do you know about the legal effect of the articles of association? Indicate the limitations on the power of the company to alter its articles of association. *[Delhi, B.Com. (Hons.), 1977]*

6. "General articles dealing with the rights of members as such should be treated as statutory agreement between them and the company as well as between shareholders interse." Discuss. *[C.A. (Final), May, 1977]*

7. What are the legal effects of the articles of association of a company? Examine the validity of the provisions in the articles of association depriving a company of its powers to amend articles. *[Company Secretary (Inter), April 1976]*

8. Discuss the extent to which the memorandum of association and articles of association bind: (a) the member to the company, (b) the company to the

[39] A.I.R. (1942) Oudh. 417.

[40] *Kredit Bank Cassel v. Schenkers* (1927) 1 K.B. 826.

members; (c) the members inter se; and (d) the company to outsiders.

[Company Secretary, (Inter), April 1973; Meerut, M.Com., 1975]

9. "Articles of Association of a company constitute a contract between the members *inter-se* and between the company and the members *qua* members." Explain. *[Delhi, B. Com. (Hons.), 1988]*

10. How far do you agree with the statement that the power to alter the articles conferred by the Companies Act is very wide, yet it is subject to a large number of limitations? *[Delhi, M.Com., 1976]*

11. "Every person dealing with the company is deemed to have notice of the contents of its memorandum." Comment. *[Delhi, B. Com.((Hons), 1985]*

12. What do you understand by the 'doctrine of indoor management?' Are there any exceptions to this doctrine? *[I.C.W.A., Jan. 1970]*

13. Enunciate the doctrines of constructive notice and indoor management. What are the exceptions if any to the doctrine of indoor management.

[C.A. (Final), Nov. 1978]

14. What do you understand by the 'doctrine of indoor management'? What are its exceptions? *[Delhi B. Com. (Hons.), 1986]*

PRACTICAL PROBLEMS

1. The secretary of a company issued a share certificate in favour of R which apparently complied with the company's Articles as it purported to be signed by two Directors and the Secretary and it had the company's seal affixed to it. In the fact, the Secretary had forged the signatures of the Directors and affixed the seal without authority. It the certificate binding on the company?

[Delhi, M. Com., 1979]

2. The Articles gave the company a lien on all shares 'not fully paid-up' for calls due to the company. S is the only member holding some fully paid-up shares, but he owes money to the company for calls due on other shares. S dies. The company, thereafter, alters its Articles by striking out the words "not fully paid-up". Can the company exercise lien on all the shares of S including those fully paid-up? Give reason for your answer. *(Delhi, M. Com., 1967)*

3. The majority of the shareholders of a company passed a special resolution to alter its Articles of Association and give the directors a power to require any shareholder who competed with the company's business to transfer his shares. The plaintiff who carried on a competing business challenged the validity of the alteration. Give your decision on this point. *(I.C.W.A. Dec. 1976)*

4. A company was in great need of further capital. The majority representing 98 per cent of the shares were willing to provide the capital if they could buy up 2 per cent minority. The majority passed a resolution altering the Articles and enabling them to purchase the minority shares. Examine the legality of alteration.

(Delhi, M. Com., 1959)

5. The Articles of Association of a company contained a clause in which it was stated that A should be the solicitor to the company and that he should not be removed from office except for misconduct. A acted as the solicitor for the company for some time. But ultimately the company ceased to employ him and

engaged another solicitor. A sued the company for breach of contract Decide.
(I.C.W.A., Dec. 1974)

6. The managing director of a company accepts a bill on behalf of the company. In fact the Articles provide that he can do so only with the prior approval of the Board of Directors in a meeting. He did not take any such approval. B. who got this bill for supply of goods to the company, presents it on the date. The company refuses payment. Advise B. *(Delhi, M. Com., 1973)*

7. The articles of a company provided that the directors could allot shares only to the existing members and the shares could be allotted to outsiders only after the approval of shareholders in a general meeting. The directors allotted shares to outsiders without the approval of shareholders in a general meeting. Is the company bound by the said allotment?

8. The memorandum of a company stated that the nominal capital of the company was Rs1,00,000 divided into 1,000 shares of Rs100 each. Neither in the memorandum nor in the original articles was there any provision as to preference shares. A special resolution passsed at a general meeting of the company altered the articles of association authorising the directors to issue shares bearing a preferential dividend. It the alteration valid?

9. Can the power to alter articles be taken away by any provision in the memorandum or articles or by a contract?

10. The directors of a company had the power to borrow upto Rs. 50,000. Any amount exceeding this sum required the sanction of the shareholders in a general meeting. The directors themselved lent Rs 75,000 to the company without general meeting sanction. Discuss the liability of the company.

11. Company A lends money to company B on a mortgage of its assets and the procedure laid down in the articles for such a transaction was not complied with and the directors of the two companies were the same. Is the above mortgage binding upon company B?

7

PROSPECTUS

AFTER obtaining the certificate of incorporation, the promoters will take steps to raise the necessary capital for the company. A public company may invite the general public to subscribe to the capital of the company and for this purpose a prospectus has to be issued. The basic objective of issuing a prospectus is to arouse public interest in the proposed company and induce the general public to buy its shares and debentures. However, it is not essential for a public company to issue a prospectus. If the promoters are confident of raising the required capital privately from their relatives and friends, they need not issue a prospectus. In such a case, a statement in lieu of prospectus must be filed with the Registrar of companies.

A private company, by its articles, prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company. It is also not required to file a statement in lieu of prospectus.

DEFINITION OF PROSPECTUS

Section 2(36) defines a prospectus as "any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate." In simple words a prospectus may be defined as an invitation to the public to subscribe to a company's shares or debentures. By virtue of the Amendment Act of 1974, any document inviting deposits from the public shall also come within the definition of prospectus. In essence, therefore, the word "prospectus" means a document which invites deposits from the public or invites offers from the public to buy shares or debentures of the company.

Invitation to public. It may be noted here that a document will be treated as a prospectus only when it invites offers from the public. Section 67 defines the term "public" as follows: "It includes 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." It further provides that no offer of invitation shall be treated as made to the public if, (a) the same is not calculated to result in the shares or debentures becoming available other than those receiving the offer or invitation; (b) it appears to be a domestic concern of the person making and receiving the offer or invitation.

The 'public' is of course a general word. No particular numbers are prescribed. Anything from two to infinity, perhaps even one, may serve to indicate public. The point is that the offer makes the shares and debentures available for subscription to any one who brings his money and applies in due form, whether the prospectus was addressed to him on behalf of the company or not. A private communication does not satisfy the above point.

Where directors make an offer to a few of their friends, relatives or customers by sending them a copy of the prospectus marked "not for publication," it is not considered an offer to the public.[1]

In another case it was held that the offering of shares to the kith and kin of a director is not an invitation of the public.[2]

It was held that the provisions of the Act relating to prospectus are not attracted unless the prospectus is issued to the public. The term 'issued' is not satisfied by a single private communication. The leading case on this point is *Nash v. Lynde.*[3] In this case the managing director of a company prepared a document that was marked "strictly private and confidential" and it did not contain the particulars required to be disclosed in a prospectus. A copy of the document along with application forms was sent to a solicitor who in turn sent it to the plaintiff. The document was held not be prospectus and as such the claim of the plaintiff for compensation was dismissed.

On the other hand, the distribution of 3,000 copies of a prospectus among the members of certain gas companies was held to be an offer to the public because persons other than those receiving the offer could also accept it.[4] One may note here that under Section 67 an offer or invitation to any section of the public, whether selected as members or debenture holders of the company or as clients of the person making the invitation, will be deemed to be an invitation to the public.

Similarly, where in an advertisement it was stated, "some shares are still available for sale according to terms of the prospectus of the

[1] *Sherwell v. Combined Incandescent Syndicate* (1970) W.N. 110.

[2] *Rattan Singh v. Moga Transport* A.I.R. 1959 Punj. 196.

[3] (1929) A.C. 158.

[4] *Re South of Englang Natural Gas and Petroleum Co. Ltd.* (1911) 1 Ch. 573.

company which may be obtained on application, it was held to be a prospectus as it amounted to an invitation to the public to subscribe to the shares of the company.[5]

Meaning of the term subscription or purchase of shares. The term "subscription or purchase of shares" means taking or agreeing to take shares for cash. In *Government Stock and Other Securities Investment Co. Ltd. v. Christopher,*[6] an offer was made by *Company A* to the members of *Companies B* and *C* to acquire all their shares in these companies in exchange for allotment of shares in the company. The offer cannot be held to be an offer made to the public because it does not invite subscription for shares since subscription means taking shares for cash. Moreover, the offer cannot be said to have been made to the public as it can be accepted only by members to who it is made. The shares were not open for subscription by the public.

Offer of Shares through Issuing Houses-Deemed Prospectus

It was found that some companies tried to avoid stringent provisions regarding prospectus. The company instead of offering its shaes or debentures for sale to the public allotted the whole of its capital to an intermediary called "Issuing House." Thereafter the "Issuing House" offered these shares to the public by an advertisement or circular of its own, which obviously could not be taken as prospectus and thus the company could evade the provisions of the Act relating to prospectus.

But now the Companies Act contains provisions in Section 64 to deal with such cases. The objective of these provisions is to prevent the companies from evading the provisions of the Act relating to prospectus.

Section 64 provides that where the company allots shares or debentures to issuing house and others with a view to such shares being offered to public for sale, any document by which the offer to public is made should be treated as prospectus. All provisions relating to prospectus must also be complied with. An allotment or an agreement to allot shares or debentures to the issuing houses was made with a view to offer them to public for sale will be presumed if it is shown (a) that the shares were offered to the public for sale within six months after they were allotted or agreed to be allotted to issuing house; or (b) that where the offer was made to the public, the whole of the consideration in respect of the shares or debentures had not been received by the company.

In addition to the usual contents of a prospectus, a prospectus issued

[5]*Pramatha Nath Sanyal v. Kali Kumar Dutt* A.I.R. 1925 Cal. 714.
[6](1956) 1 All. E.R. 490.

by an issuing house shall state the net amount of consideration received or to be received by the company in respect of those shares and the place and time at which the contract of allotment may be inspected.

RULES REGARDING ISSUE OF PROSPECTUS

The relevant rules and regulations as to the issue of prospectus are given below:

(1) **Dating of prospecuts.** A prospectus issued by a company shall be dated and that date shall be taken as the date of publication of the prospectus. (Sec. 55)

(2) **Registration of prospectus.** No prospectus shall be issued unless a copy of such prospectus has been delivered to the Registrar for registration. This is to preserve an authentic record of the terms and conditions of issue of shares and debentures made by the companies. Registration must be made on or before the date of its publication. The copy sent for registration must be signed by every person who is named in the prospectus as a director or proposed director of the company or by his agent authorised in writing. Where the prospectus is issued in more than one language, a copy of its as issued in each language should be delivered to the Registrar.[7] The copy for registration must be accompanied by the following documents:

(*a*) consent of the expert if his report is to be published in the prospectus;

(*b*) a copy of every contract relating to the appointment and remuneration of managerial personnel;

(*c*) a copy of every material contract unless it is entered in the ordinary course of business or two years before the date of the prospectus;

(*d*) a written statement relating to adjustments, if any, made by the auditors or accountants in their reports relating to profits and losses, assets and liabilities or the rates of dividends, etc.; and

(*e*) written consent of auditors, legal adviser, attorney, solicitor, banker or broker of the company to act in that capacity.

It must be stated on the face of the prospectus that a copy of the prospectus along with specified documents have been filed with the Registrar.

The prospectus must be issued within ninety days of its registration. A prospectus issued after the said period shall be deemed to be a prospectus, a copy of which has not been delivered to the Registrar for registration.

[7]*Emperor v. Bengal Salt Co.*, A.I.R. (1936) Cal. 33.

The company and every person who is knowingly a party to the issue of prospectus without registration shall be punishable with fine which may extend to five thousand rupees. (Sec. 60)

(3) **Expert's consent.** A prospectus shall not include any statement made by an expert, if he is connected with the formation or management of the company issuing the prospectus. (Sec. 57)

A statement of an expert cannot be included in the prospectus without his written consent and this fact should be mentioned in the prospectus. Further, this consent should not be withdrawn before delivery of the prospectus for registration. (Sec. 58)

These provisions intend to protect an intending investor by making the expert a party to the issue of prospectus and making him liable for untrue statements.

Section 59 provides that the expression expert includes an engineer, a valuer, an accoutant and any other person whose profession gives him authority to a statement made by him.

It further provides that every person who is knowingly a party to the issue of prospectus in contravention of the above provisions shall be punishable with fine which may extend to rupees five thousand.

(4) **Terms of the contracts mentioned in the prospectus not to be varied.** The terms and conditions of the contracts stated in a prospectus or a statement in lieu of prospectus shall not be altered except with the approval of the members in general meeting. (Sec. 61)

(5) **Application forms for shares to be accompanied by an abridged form of prospectus.** No one shall issue any form of application for shares and debentures of a company unless it is accompanied by an abridged form of prospectus containing, such salient features of a prospectus as may be prescribed by the Central Government. However, a copy of the full prospectus shall be furnished on a request being made by any person before the closing of the subscription list.

However, an application form need not be accompained by a copy of the prospectus if the application is given to a person to enter into an underwriting agreement or in relation to shares or debentures not offered to the public. [Sec. 56(3)]

Similarly, the prospectus need not contain all the details required by the Act where the offer is made to existing members or debenture holders of the company or if such shares or debentures are in all respect uniform with shares or debentures already issued and quoted on a recognised stock exchange. [Sec. 56(5)]

(6) **Personation for acquisition, etc., of shares,** A person who makes an application in a fictitious name to a company for acquiring shares or subscribing any shares shall be liable to imprisonment which may extend

to five years. Similarly a person who induces a company to allot any shares or to register any transfer of shares in a fictitious name is also liable to the same punishment.

These provisions shall be permanently stated in every prospectus and every application form issued by the company to an person. (Sec. 68A)

CONTENTS OF PROSPECTUS

A prospectus is the only window through which a prospective investor can look into the soundness of a company's venture.[8] This may tempt the promoters and directors of a company to present a rosy picture by giving all possible prospects and good points of the company and concealing its weak points and limitations. In oder to protect the interests of prospective investors, the Companies Act requires every company issuing a prospectus to observe a large number of regulations. Failure to observe them is made punishable with fine or imprisonment or both. As such great care must be taken in preparing a prospectus.

Every prospectus shall state the matters specified in Part I of Schedule II and set out reports specified in Part II of the Schedule, and the said Part I and II shall have effect subject to the provisions contained in Part III of the Schedule.

Part I of Schedule II--Matters to be Specified

According to Part I of Schedule II, the following matters must be stated in the prospectus:

(i) The main objects of the company, with the names, occupations and addresses of the signatories to the memorandum and number of shares subscribed by them.

(ii) The number and classes of shares, and the nature and extent of the interests of the shareholders in the property and profits of the company.

(iii) The number of redeemable shares intended to be issued, the date of their redemption and the proposed method of redemption.

(iv) The number of qualification shares fixed for directors.

(v) The names, addresses, description and occupation of directors, managing director or manager or any of those proposed persons.

(vi) Any provisions in the articles or any contract relating to appointment, remuneration and compensation for loss of office of directors, managing director or manager.

(vii) The amount of minimum subscription.

(viii) The time of opening the subscription list.

(ix) The amount payable on application and allotment of each shares.

(x) Particulars about any option or preferential right to be given to any

persons to subscribe for shares or debentures of the company.

(xi) the number, description and amount of shares and debentures which within two preceding years have been issued for consideration other than cash.

(xii) Particulars about premium received on shares within two preceding years or to be received.

(xiii) The names of the underwriters and the opinion of the directors that the resources of the underwiters are sufficient to discharge their obligations.

(xiv) The names, addresses, descriptions and occupations of vendors from whom the property has been purchased or is to be purchased, and the amount paid or payable in cash, shares or debentures respectively.

(xv) The amount of underwriting commission paid within two preceding years or payable to any person for subscribing or procuring subscription for any shares or debentures of the company.

(xvi) The estimated amount of prelimianary expenses and the presons to whom any of these expenses have been paid or are payable.

(xvii) Any amount or benefit paid or given within two preceding years or intended to be paid or given to any promoter or officer of the company.

(xviii) Particulars as to the date, parties and general nature of every contract appointing or fixing the remuneration of managing director or manager, whenever entered into.

(xix) Particulars of every material contract, not being a contract entered into in the ordinary course of business carried on by the company or a contract entered into more than two years before the date of the prospectus.

(xx) The names and addresses of the auditors of the company.

(xxi) The particulars of the interest, if any, of every director or promoter in the promotion of the company or in any property acquired by the company within two preceding years.

(xxii) If the share capital of the company is divided into different classes of shares, the rights of voting at meeting of the company and the rights in respect of capital and dividends attached to several classes of shares respectively.

(xxiii) Where the articles of the company impose any restriction upon the members of the company in respect of the right to attend, speak or vote at meetings of the company or the right to transfer shares or on the directors of the company in respect of their powers of management, the nature and extent of these restrictions.

(xxiv) In the case of a company which has been carrying on business, the length of time during which the business of the company has been

carried on. If the company proposes to acquire a business which has been carried on for less than three years, the length of time during which the business had been conducted.

(xxv) Particulars of reserves including reserves capitalised.

(xxvi) A reasonable time and place at which copies of all balance sheets and profit and loss accounts on which report of the auditor are based, may be inspected.

Part II Schedule II--Reports to be Set out

The following are the reports required to be set out in the prospectus:

(1) A report by the auditors of the company as regards (a) profits and losses and assets and liabilities of the company; (b) the rates of dividends (if any) paid by the company in respect of each class of shares for each of five financial years immediately preceding the issue of the prospectus; and (*c*) if no account has been made up for any part of the five year period ending three months before issue of the prospectus, a statement to that effect. The report of the auditors shall also state separately the profits and losses of the company's subsidiaries and also their combined profits and losses.

(2) If the proceeds or any part of the proceeds of the issue of shares or debentures are to be applied directly or indirectly in the purchase of a business or an interest therein (exceeding fifty per cent in the capital or profits and losses or both), the prospectus shall contain a report made by an accountant (whose name should be disclosed in the in the prospectus upon (*a*) the ,profits and losses of the business for the five immediately preceding financial years; and (*b*) the assets and liabilities of the business on the last date up to which the accounts of the business were made up.

(3) A similar report has to be made by the accountant if the proceeds of the issue of shares or debentures are to be applied directly or indirectly in any manner resulting in acquisition by the company of shares in any other body corporate and if by reason of that acquisition that body corporate will become a subsidiary of the acquiring company.

Newspaper Advertisements of a Prospectus

Where any prospectus is published as a newspaper advertisement, it shall not be necessary in the advertisement to specify the contents of the memorandum or the signatories thereto or the number of shares subscribed by them. (Sec 66)

This section is intended to reduce advertisement costs. However, in order to secure uniform information from all the companies releasing newspaper advertisements of their prospectus, the following form as recommended by the Company Law Department is generally followed:

The annuoucement regarding the proposed issue of capital must mention (*a*) the name of the company; (*b*) the address of the registered office of the company; (*c*) its existing and proposed activities; (*d*) location of the industry; (*e*) its board of directors; (*f*) managing director/manager/ secretary; (*g*) (*i*) authorised capital, (*ii*) subscribed capital, and (*iii*) proposed issue to the public (whether at par, discount or premium; (*h*) opening and closing dates of the subscription list; and (*i*) that the application forms along with copies of the prospectus can be had from the registered office of the company or from the underwriters, bankers or brokers whose names and addresss are given below:

Underwriters .... (Address)
Bankers .... (Address)
Brokers .... (Address)

This form of newspaper advertisement of a prospectus is not obligatory, yet most companies follow it.

Statement in Lieu of Prospectus

It has already been mentioned that a public company may invite the general public to subscribe to the capital of the company, and for this purpose it must issue a prospectus. However, if the promoters are confident of raising the required capital privately from relatives and friends, it need not issue a prospectus. In such a case a statement in lieu of prospectus may be filed with the Registrar of Companies.

Section 70 provides that a company having a share capital which does not issue a prospectus is required to deliver to the Registrar a statement in lieu of prospectus at least three days before the allotment of shares. It shall be signed by each director or proposed director of the company or by his agent authorised in writing. The statement shall include the particulars set out in Schedule III. It is intended to preserve an authoritative record of the terms and conditions of issue of shares. A private company is required neither to issue a prospectus nor to file a statement in lieu of prospectus.

If these provisions are not complied with, the company and every director who wilfully authorises or permits the contravention shall be punishable with fine which may extend to rupees one thousand.

The liability for any misstatement in a statement in lieu of prospectus is the same as in the case of a prospectus.

MISSTATEMENT IN THE PROSPECTUS

A prospectus is an invitation to the public to subscribe to the shares or debentures of a company. It is on the basis of the contents of a prospectus

that prospective investors decide to invest money in the company. As such a prospectus must give a full, accurate and a fair picture of the state of affairs and prospects of the company and a heavy responsibility therefore rests on those who issue it.

This means that a prospectus should not only state everything correctly and accurately but that it should not only omit any relevant facts which are likely to influence the mind of the prospective investor. If a prospectus is issued in breach of any of the two conditions, it shall be deemed to be a misleading prospectus or a prospectus containing an untrue statement.

Section 65 provides that 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 or if because of omission of any matter the statement made is calculated to mislead. A prospectus may be false if due to suppression of facts, it conveys a false impression.

Thus, the term 'untrue statement' or 'mis-statement' is used in a broader sense. It includes not only false statements but also statements which produce a wrong impression of actual facts. Concealment of a material fact also comes within the category of mis-statement.

Remedies for Misstatements

If a prospectus includes untrue statements, it shall give rise to several rights which may be grouped in two categories: (*i*) rights of the aggrieved shareholder against the company, and (*ii*) rights of the aggrieved shareholder against the directors, promoters and experts.

(1) **Remedies against the company.** The aggrieved shareholder has two remedies against the company: (*a*) rescission of the contract, and (*b*) damages for fraud.

(A) **Rescission of the contract.** When the prospectus contains misstatement, whether innocent or fraudulent, the person who is induced by such misstatements to subscribe for shares or debentures, is entitled to rescind the contract and to ask that his name be removed from the register of members. In other words, where a prospectus contains mis-statements whether innocent or fraudulent, the contract to buy shares becomes voidable at the option of the aggrieved shareholder. When he decides to rescind the contract to take shares, he will have to surrender the shares allotted to him, his name will be taken off the register of members and the money paid by him to the company shall be returned.

The right of rescission of contract can be exercised when the following conditions are fulfilled:

(*i*) It must the established that the prospectus was issued by te company or by someone authorised by the company in this behalf. If the

prospectus was issued by the promoters and has been ratified and adopted by the board of directors, the company will be responsible for it.

(*ii*) There must be an untrue statement in the prospectus. Section 65 provides that 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 or if because of omission of any matter the statement made is calculated to mislead.

A statement in the prospectus that share capital has been subscribed when it has only been allotted in fully paid shares to the company's contractor,[8] or that the company has contracted for purchase of property when, in fact, there is only negotiation[9] are instances of untrue statements.

A prospectus shall be deemed to include an untrue statement if it omits certain facts which are calculated to mislead even if all other statements given in the prospectus are true. The case of *Rex v. Kylsant*[10] proves this point.

In the case *Kylsant* issued a prospectus where it was stated that the company had paid dividend varying from five to eight per cent every year between 1911 to 1927 except in one or two years where a lower rate of dividend or no dividend was paid. The prospectus thus reflected that the company was financially strong and stable. But the facts were that during the last seven years, the company had incurred heavy losses, and dividends were paid only out of the accumulated profits which had been stored up during the war period. The prospectus was held to be misleading not because of what is stated but because of what it concealed or omitted.

Further, if a statement was true when in was made but subsequently became untrue when shares were allotted, the contract to take shares can be rescinded.[11]

The misrepresentation in the prospectus must be of fact and not of law. Where the prospectus stated that the shares will be issued at half of their nominal price, whereas Section 79 restricts the rate of discount to ten per cent, it is a misrepresentation of law and this will not entitle the aggrieved party to rescind the contract.

Again the misrepresentation must be one of fact and not merely an expression of opinion or expectation.

(*iii*) The misrepresentation contained in the prospectus must be material to the contract of taking shares. A fact will be material if it is

[8]*Arnison v. Smith* (1889) 40 Ch. D. 567.

[9]*Ross v. Estates Investments Co.* (1868) L.R. 3 Ch. App. 682.

[10](1932) 1 K.B. 442.

[11]*Re Scottish Petroleum Co.* (1823) 23 Ch. D. 413.

likely to influence the judgement of a prospective investor in deciding whether he should purchase shares in the company or refrain from doing so. The following are examples of misrepresentation of material facts to the contract of taking shares: (*a*) the prospectus stating that *B* and *M*, two leading businessmen of repute have agreed to become directors of the company, when they had only expressed their willingness to help the comapny;[12] (*b*) the prospectus stating that directors and their friends have subscribed a large protion of the capital of the company and that they now offer the remaining shares to the public, whereas the fact was that they had only subscribed ten shares each;[13] and (*c*) a prospectus stating that the proceeds of issue of debentures were to be utilised for improving and developing the business, whereas the real object of issuing debentures was to pay off past liabilities.[14]

In all these cases the aggrieved party was entitled to rescind the contract.

(*iv*) The aggrieved party must have relied upon the prospectus while applying for shares. He must have taken shares directly from the company. A purchaser of shares in the open market has no remedy against the company or promoters though he might have bought on the faith of misrepresentation in the prospectus.[14a]

"Even when a person purchases shares from the company on the basis of a misleading prospectus and sells them in the market and then repurchases them he will not have any right to rescind the contract."[15]

(*v*) The aggrieved party must exercise the right to rescind the contract within a reasonable time of becoming aware of a misstatement in the prospectus and before the company goes into liquidation.[16]

Loss of right to rescind the contract. (*i*) If the subscriber affirms his contract for purchase of shares after becoming aware of misrepresentation in the prospectus, he cannot afterwards rescind the contract. Affirmation will be deemed to have taken place in the following cases: (*a*) where he receives dividend or pays calls;[17] (*b*) where he attends and votes at general meetings;[18] and (*c*) where he executes a transfer of his shares.[19] But a

[12] *Karberg's Case, Re Metropolitan Coal Consumers' Association;* (1892) 3 Ch. 1.

[13] *Handerson v. Lacon* (1867) 5 Eq. 249.

[14] *Edington v. Fitzmaurice* (1885) 29 Ch. D. 459.

[14a] *Peek v. Gurney* (1870) L.R. 6 H.L. 377.

[15] *Croom's Case* 16 Eq. 431.

[16] *Shiromani Sugar Mills Ltd. v. Debi Prasad* A.I.R. (1950) All. 508.

[17] *Scholey v. Central Railway* (1868) L.R. 9 Eq. 266; *Re Dunlop Truffault Cycle, Co.* (1896) 66 L.J. Ch. 25.

[18] *Sharpley v. Louth Etc. Co.* (1876) 2 Ch. D. 663.

[19] *Crawley's Case* (1869) L.R. 4 Ch. App. 322.

transfer of part of shares before discovery of misrepresentation does not affect his right as to the rest.[20]

(*ii*) The right to rescind the contract is also lost if the subscriber does not start the proceedings within a reasonable time after he has come to know the misrepresentations in the prospectus.[21] In one case even a lapse of fifteen days after he became aware of an untrue statement in the prospectus deprived the shareholder of his right to rescind the contract.[22]

(*iii*) The right to rescind is also lost on the commencement of winding up of the company. However, if a subscriber has started active proceedings for the rescission of the contract before the commencement of winding up, the case would be different.

(B) **Damages for fraud.** Under this right the subscriber can recover damages from the company but it shall be necessary to establish that there is fraudulent misrepresentation in the prospectus. If the aggrieved shareholder can prove it, he can claim full compensation for the loss sustained by him as a result of fraudulent statement in the prospectus. "To support an action for deceit, fraud must be proved and nothing less than fraud will do. Fraud is proved when it is shown that a false statement has been made (*a*) knowingly; or (*b*) without belief in its truth; or (*c*) recklessly, carelessly whether it be false or true."[23]

The fraudulent statement must be releated to facts which were material to the contract of purchasing shares and the aggrieved party must have actually relied on the misstatements and taken shares directly from the company.

It may be noted here that for the right of rescission of contract, misstatement in the prospectus was sufficient even if made innocently but for claiming damages for fraud, it must be established that a misstatement was made fraudulently or knowingly. A director will not be liable in damages for a false statement in the prospectus, if he honestly believed it to be true, though there was no reasonable ground for the belief.[24]

It may further be noted that the right to claim damages may be exercised either against the company or against the directors or promoters or others who authorised the issue of a prospectus. If the action is directed against the directors or promoters, the subscriber need not rescind the contract. Generally actions for damages against the company are rare.

If a shareholder wants to take action for damages against the company,

[20]*Re Mount Morgan Etc. Ltd.* (1887) 56 L.T. 622.

[21]*Shiromani Sugar Mills Ltd. v. Debi Prasad* A.I.R. (1950) All. 508.

[22]*Re Scottish Petroleum Co.* 23 Ch. D. 413.

[23]*Derry v. Peek* (1889) 14 A.C. 337.

[24]*Derry v. Peek* (1889) 14 A.C. 337.

he must rescind the contract. He cannot sue the company for damages while he remains a shareholder.[25]

2. **Remedies against directors, promoters and experts.** The following persons shall be liable to pay compensation to every person who subscribes for shares or debentures on the faith of the prospectus for any loss or damage he may have sustained by reason of an untrue statement therein: (*a*) every person who is a director of a company at the time of the issue of prospectus; (*b*) every person who has authorised himself to be named and is named in the prospectus either as a director or as having agreed to become a director; (*c*) every person who is a promoter of the company; and (*d*) every person who has authorised the issue of the prospectus. Experts will be covered under this clause only in respect of their untrue statements.

The liability of the above-mentioned persons may be studied under the following heads:

(A) Damages for misrepresentation under Section 62. Under this section, once the statement in the prospectus is proved to be untrue the directors or the promoters are liable to compensate the allottees who took shares on the faith of the prospectus and sustained damages. The subscriber need not prove fraud to claim compensation. Section 62 thus removes the hardship caused by the decision of *Derry v. Peek.*[26]

Defences available to directors, etc. No person shall be liable under this section, if he proves:

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

(*ii*) that the prospectus was issued without his knowledge or consent and that on becoming aware of its issue, he immediately gave reasonable public notice to that effect; or

(*iii*) that after the issue of the prospectus and before allotment, he, on becoming aware of any untrue statement in it, withdrew his consent to the prospectus and gave reasonable public notice of the withdrawal and his reasons for doing so; or

(*iv*) that he had reasonable ground to believe and did up to the time of the allotment of shares or debentures, as the case may be, believe that the statement was true; or

(*v*) that the statement was a correct and fair representation of the statement made by an expert and he had reasonable ground to believe and did up to the time of the issue of the prospectus believe, that the

[25]*Houldsworth v. City Glasgow Bank* (1880) 5 A.C. 317.
[26](1889) 14 A.C. 337.

person making the statement was competent to make it and that the expert had given his consent required under the Act and had not withdrawn that consent before delivery of a copy of the prospectus for registration or to the defendant's knowledge, before allotment; or

(*vi*) that if the statement is a copy of or extract from an official document or is made by an official person, it was a correct and fair copy of the document or a fair representation of the statement. [Sec. 62(2)]

Defences available to an expert. It has already been noted that an expert may also be held liable under this section in respect of an untrue statement, if any, purporting to be made by him as an expert. However, such an expert shall not be liable if he proves: (*a*) that, having consented to the issue of the prospectus, he withdrew his consent in writing before delivery of a copy of the prospectus for registration; or (*b*) that, after delivery of a copy of the prospectus for registration and before allotment thereunder, he, on becoming aware of the untrue statement, withdrew his consent in writing and gave reasonable public notice of the withdrawal and of the reasons therefor; or (*c*) that, he was competent to make the statement and that he had reasonable ground to believe, and did up to the time of allotment of shares of debentures, believe, that the statement was true. [Sec. 62(3)]

Measure of damages. The measure of damages is the loss suffered by reason of the false statement, that is to say, the difference between the value which the shares would have had if the company had possessed the advantages stated in the prospectus (but not exceeding the price paid) and the true value of the shares at the time of allotment in the circumstances which in fact existed.[27]

Right of indemnity. Every such director or expert who has escaped liability on the above grounds is entitled to be indemnified by other directors or experts who continue to be liable against all damages, costs and expenses which he may incur in defending himself against any legal proceedings brounght against him. [Sec. 62(4)]

Right of contribution. If any subscriber realises any damages from any director or officer of the company for untrue statement in the prospectus, the directors and officers who authorised the issue of untrue prospectus shall contribute and pay their share of damages to the director who has made the payment.[28]

(B) Damages under Section 56. Section 56 provides that the prospectus shall set out the particulars as required by Schedule II of the Act. However, if it omits certain items, it shall have the following

[27]*McConnel v. Wright* (1903) 1 Ch. 546; *Clark v. Urquhart* (1930) A.C. 28.
[28]*Gerson v. Simpson* (1903) 2 K.B. 197.

consequences:

(*i*) Persons responsible for the issue of the prospectus shall be liable to a fine which may extend to five thousand rupees.

(*ii*) The subscriber will also be entitled to recover damages from persons responsible for the issue of the prospectus if he can show that (*a*) he would not have purchased shares if there had been no such omissions; and (*b*) he has actually sustained a loss.

It is important to note that this section does not entitle the shareholder to rescind the contract to take shares by reason merely of the omission of any of the facts required to be disclosed by this section. However, if the omission amounts to fraud or misrepresentation, the contract may also be rescinded.[29]

However, a director or any other person sued under this section shall not be liable, if (*a*) he proves that he had no knowledge of any matter not disclosed; or (*b*) he proves that the non-compliance or contravention arose from an honest mistake of fact; or (*c*) in the opinion of the court, the matter not disclosed was immaterial; or (*d*) that the non-compliance or contravention ought to be excused with regard to all the circumstances of the case. [Sec. 56(4)]

(C) Damages for fraud under general law. Under this right the subscriber can recover damages from all or any of the persons responsible for the issue of the prospectus but it shall be necessary to establish that there is fraudulent misrepresentation in the same. If the aggrieved shareholder can prove this, he can claim full compensation for the loss sustained by him as a result of fraudulent statement in the prospectus. Not only this, the aggrieved shareholder must prove that the fraudulent statement was made in respect of facts material to the contract of purchasing shares and that he actually relied on the misstatement and was actually deceived. It is also essential that he must have taken shares directly from the company and not on the open market.

It has already been pointed out that this right is an elective one and that the shareholder may bring action against the company for damages and not against the directors or promoters. Generally action is brought against directors or promoters because in this case he need not rescind the contract.

This remedy is of considerable significance as it is open even where the right of rescission is lost either through laches or negligence against the company and even where the company goes into liquidation.

(D) Criminal liability for misstatement in a prospectus. Section 63 provides that where a prospectus contains any untrue statement, every

[29]*Shiromani Sugar Mills v. Debi Prasad* A.I.R. (1950) All. 508.

person who authorised the issue of the prospectus shall be punishable with imprisonment for a term which may extend to two years or with a fine which may extend to five thousand rupees, or with both. However, he will not be liable if he can prove that: (*a*) the statement was immaterial; or (*b*) he had reasonable ground to believe, and did believe up to the time of the issue of the prospectus that the statement was true.

An expert, an auditor, legal adviser, attorney, solicitor, banker or broker shall not be deemed to have authorised the issue of a prospectus by merely giving his consent (*a*) for inclusion of statement made by him as an expert or (*b*) to act in any of the above capacities. These persons are not liable for untrue statement in the prospectus unless their own statement is incorrect.

Under Section 68, any person guilty of fraudulently inducing persons to invest money shall be punishable with imprisonment for a term which may extend to five years or with a fine which may extend to ten thousand rupees, or with both. This section attempts at preventing frauds in connection with obtaining capital from the public.

QUESTIONS

1. Define a prospectus. Explain its contents. What are the provisons of the Act regarding the issue of a prospectus?

2. What is a prospectus? Explain its contents. [*Kerala, B. Com., 1973*]

3. What is a prospectus? When should a statement in lieu of prospectus be issued? Do you notice any substantial difference between a prospectus and a statement in lieu of a prospectus? [*Company Secretary (Inter), April 1962*]

4. Define a prospectus. Discuss the liability of a company for untrue statements in its prospectus. [*Delhi B. Com. (Hons.), 1978*]

5. State the importance of a prospectus. Discuss the consequences of misstatements in a prospectus. [*Delhi B. Com. (Hons.), 1971, 76*]

6. Define 'Prospectus'. What are the remedies open to an allottee who has subscribed for the shares on the faith of a false and misleading prospectus? [*Delhi, B. Com. (Hons.), 1988*]

7. State the remedies available to a person who has been induced to take shares by mis-statement in a prospectus, specifying the conditions under which and the persons against whom such remedies are available. [*Delhi, M. Com., 1976*]

8. What is a prospectus? Discuss the consequences of mis-statements in a prospectus. [*Allahabad, B. Com. (Part II) 1978*]

9. Explain the civil and criminal liabilities for mis-statements in prospectus. Who are liable for such mis-statements? [*Company Secretary (Final), Oct. 1974*]

10. Who is deemed to be an expert in relation to the prospectus of a company? What conditons must be satisfied before a report by an expert can be published therein? Is there any remedy available to the allottee of the shares who has been

induced to take shares on the faith of an untrue statement of an expert in the prospectus? [*I.C.W.A., Dec. 1973*]

PRACTICAL PROBLEMS

1. A company issued a prospectus containing mis-statements on which action could be taken against the company. Ram purchased shares in the market relying on the prospectus and filed a suit against the company for damages for mis-statements. Will he succeed? [*Delhi B. Com., (Hons.), 1976*]

2. A deceitful prospectus containing an untrue statement was issued by the defendant on behalf of a company. The plaintiff received a copy of it but did not take any shares originally in the company. The allotment was completed and several months afterwards the plaintiff bought 200 shares in the open market. The plaintiff sues the defendant for rescission on the ground of untrue statement in the prospectus. Decide stating reasons. [*C.A. (Inter), May 1977*]

3. *A* applies for some shares on the basis of a prospectus which contains a mis-statement and the shares are allotted to *A*, who thereafter transfers them to *B*. Can *B* bring an action for rescission on the ground of mis-statement.

[*Delhi M. Com., 1962*]

4. In a prospectus issued by the managing director of a company it was stated that the company had paid dividend every year during 1921-27 (years of depression), thus implying that the company had been prospering. As a matter of fact the company had sustained loss during the relevant period and had paid in dividends only out of reserves accumulated in the past. Can this observation be construed as a mis-statement so as to render the matter criminally liable and if so, on what ground? If not, why not? [*C.A., May 1967*]

5. *A* had applied for shares in a company on the basis of a prospectus containing the name of several persons as directors. Before the allotment took place, some of the directors had retired. The plaintiff files a suit against the company for rescission on the ground of mis-statement in the prospectus. Will he succeed?

6. Printed in red ink on the cover of a prospectus was the following statement, "the managing agents with their friends, promoters and directors have already promised to subscribe shares worth six lakh rupees." But these persons took shares much less than those stated. *A* purchased shares from the company relying on the above statement. Can *A* rescind the contract?

7. *A* company issued a prospectus containing a statement that company's fully paid shares will be offered at half of their nominal price. Later on the company refused to offer the stated discount to allottees. Would the above statement amount to mis-statement in the prospectus and entitle the allottees to rescind the contract?

8. *A* applies for some shares on the basis of a prospectus which contains some mis-statement. The shares are allotted to him, who afterwards transfers them to *B* and then re-purchases the same shares from *B* after sometime and gets them registered in his name. Can *A* bring an action for a rescission on the ground of mis-statement?

8

SHARES

ALLOTMENT OF SHARES

THE prospectus is an invitation to the public to purchase shares. Persons intending to purchase shares have to apply in a form prescribed in the prospectus for the purpose. The application for shares by intending shareholders is an offer for the purchase of shares and, when accepted by the company, is known as an allotment of shares. When the directors have made an allotment to a particular person, he becomes a shareholder of the company. Allotment is thus an appropriation by the board of directors of a certain number of shares to a specified person in response to his application. In *Nicol's* case it was held that an allotment is generally neither more nor less than the acceptance by the company of the offer to take shares.[1]

A valid allotment must be in accordance with provisions of the Companies Act, 1956 and the Indian Contract Act, 1972 relating to acceptance of offers.

Provisions of the Companies Act

Let us first study the provisions of the Companies Act, 1956 regarding the allotment of shares by public companies.

(1) **Registration and issue of prospectus.** Where a public company offers shares and debentures to the public for subcription, a copy of prospectus must be duly filed with the Registrar for registration. Registration must be made on or before the date of publication of the prospectus. The prospectus must be issued within ninety days of its registration. (Sec. 60)

(2) **Minimum subscription.** No allotment shall be made of any share capital offered to the public for subscription, unless the amount stated in the prospectus as the minimum subscription has been subscribed and the sum payable on application on such subscribed share capital has been

[1](1885) 29 Ch. D. 421.

received in cash. [Sec. 69(1)]

As per SEBI Guidelines for Disclosure and Investor Protection, a company making any public issue of shares or debentures must receive a minimum of 90 per cent subscription against the entire issue before making an allotment of shares or debentures to the public.

The object of this provision is to ensure that the company has at least the minimum amount needed to conduct its business smoothly. In the words of Gower: "Object of these provisions is to prevent the company getting under way until it has raised the capital needed to carry out the objects in which it has invited the public to participate."[2]

(3) **Application money.** The amount payable on application on each share shall not be less than five per cent of the nominal amount of the share. [Sec.69(3)]

It has been held that the directors will be guilty of misfeasance if they proposed to allot shares without having received the application money.[3]

(4) **Moneys to be deposited in a scheduled bank.** All moneys received from applicants for shares shall be deposited and kept deposited in a scheduled bank *(a)* until the certificate to commence business is obtained; or *(b)* where such a certificate has been obtained, until the entire amount payable on application for shares in respect of minimum subscription has been received by the company. [Sec. 69(4)]

(5) **Refund to application money in specific cases.** If the minimum subscriptions is not raised within one hundred and twenty days of the issue of the prospectus, all moneys received from applicants of shares shall be forthwith repaid to them without interest. If any such money is not so repaid within one hundred and thirty days after the issue of the prospectus, the directors of the company shall be jointly and severally liable to repay that money with interest at the rate of six per cent per annum from the expiry of the hundred and thirtieth day. [Sec. 69(5)]

As per SEBI Guidelines for Disclosure and Investor Protection, if a company does not receive minimum subscription of 90 per cent of the issued amount, including devolvement of underwriters within 60 days from the date of closure of the issue, the company shall forthwith refund the entire subscription amount received. For any delay beyond 78 days, if any in refund of such subscription, the company shall pay interest at the rate of 15 per cent per annum.

(6) **Opening of subscription list.** No allotment can be made until the beginning of the fifth day after the publication of the prospectus or such later time as may be prescribed for the purpose in the prospectus. This is known as the time of opening of the subscription list. The fifth day is

[2] L.C.B. Gower, *Principles of Modern Company Law*, London, Stevens and Sons, 1969 (3rd Edn.), p. 300.

[3] *Indian State Bank Ltd. v. Kanwar Sardar Singh*, A.I.R. (1934) All. 855.

to be counted from the day when the prospectus was published in a newspaper or was otherwise notified to the public. The object of this section is to provide sufficient time to the public to go through the prospectus and digest its contents before deciding to invest money in the company. [Sec. 72(1)(2)]

The validity of an allotment shall not affected by any contravention of the above rules but in that event, the company and every officer of the company who is in default shall be punishable with a fine which may extend to five thousand rupees. [Sec. 72(3)]

It may be noted here that the Companies Act is silent about the time for which the subscription list must be kept open. Ordinarily, the company may keep the subscription list open for any length of time. But in the case of quoted shares, the subscription list must be kept open for at least three days under the rules of recognised stock exchanges.

Further an application for shares is not revocable until the end of the fifth day from the opening of the subscription list. [Sec. 72(5)]

(7) **Statement in lieu of a prospectus to be delivered to the Registrar.** A company with a share capital which has not issued a prospectus, shall not allot any of its shares or debentures unless a statement in lieu of prospectus has been filed with the Registrar at least three days before the first allotment of either shares or debentures. This is not applicable to a private company. (Sec. 70)

(8) **Compulsory listing of all public issues.** Section 73, as amended by the Amendment Act of 1988, provides that every company intending to offer shares or debentures to the public by the issue of a prospectus has to make an application to one or more of the recognised stock exchanges for permission for the shares or debentures to be dealt with in the stock exchange or each such stock exchange. Prior to this amendment, application to a stock exchange was optional with the company. It is further provided that the prospectus shall specify the name of the stock exchange or, as the case may be, each such stock exchange where an application has been made for permission. Any allotment made in pursuance of such a prospectus shall be void if any such stock exchange does not grant its permission within ten weeks from the closing of the subscription list.

The company has the right to make an appeal against the decision of any recognised stock exchange refusing permission for shares or debentures to be dealt in on that stock exchange under Section 22 of the Securities Contracts (Regulation) Act, 1956. Where the appeal has been preferred as above, such allotment shall not become void until the dismissal of the appeal. [Sec. 73(1)]

Where the permission has not been applied for, or it is not granted as aforesaid, the company shall forthwith repay all moneys received from

applicants. If any such money is not repaid within eight days after the company becomes liable to pay it, the company and every director of the company who is an offcer in default shall be jointly and severally liable to repay it with interest at the rate of four percent to fifteen per cent per annum, depending upon the period of delay in making the repayment of such money from the expiry of eighth day. [Sec. 73(2)]

Where permission has been granted by the recognised stock exchange or stock exchanges and the issue is oversubscribed, the company shall forthwith repay the excess application moneys standing to the credit of allottees after adjustment against allotment moneys due from them. If any such money is not repaid within eight days from the completion of the allotment, the company and its directors shall be liable to repay it with interest as stated above. [Sec. 73(2-A)]

It may be noted here that the above restrictions are not applicable to a private company.

General Provisions

Let us now study the general principles of law of contract relating to allotment of shares.

(1) **Allotment must be in accordance with the provisions of the articles.** Generally allotment is made by a resolution of the board of directors. However, power may be delegated to someone else if the articles provide for it. Where allotment was made by the general manager under improper delegation by the directors, it was held to be void.[4] But where the articles included a delegation clause, the allotment by secretaries and treasurers was regular.[5]

(2) **Allotment must be communicated.** It was pointed out in *Pellat's* case that there must be a response by the company, without which there is no contract.[6] A mere entry in the name of applicant on the register of members is not sufficient for the purpose.[7] The allotment may be communicated to the applicant either in writing or verbally or by contract.[8] Generally notice of allotment is given by post and in such case the contract is complete when the letter is posted even though it is never received.[9]

[4]*Bank of Peshawar Ltd. v. Madho Ram,* A.I.R. 1919 Lah. 351.

[5]*Pusarala Sanyasi and Others v. Guntur Cotton, Jute and Paper Mills Co.,* A.I.R. 1915 Mad. 325.

[6](1867) L.R. 2 Ch. App. 527.

[7]*Radhesham v. Prabh Dayal,* A.I.R. 1936 Lah. 16.

[8]*Gunn's Case* (1867) L.R. 3 Ch. App. 40.

[9]*Household Fire Insurance Co. v. Grant* (1879) 4 Ex. D. 216; *Burner v. Moore* (1904) 1 Ch. 305.

(3) **Allotment must be made within reasonable time.** Otherwise the offer to take shares lapses and the applicant can refuse to accept them. It may be noted here that in a number of decided cases, an interval of about six months or more between application and allotment was held to be unreasonable and therefore the applicant was not bound to accept shares.[10]

(4) **Allotment must be absolute and unconditional.** Sometimes the application for shares may be conditional, i.e., subject to a condition precedent. If the conditions are not satisfied the applicant is entitled to repudiate the shares even though allotment has been made to him.[11]

Thus where a person applied for 400 shares on the condition that he would be appointed cashier in the company, it was held that he was not bound by the allotment until he was appointed cashier.[12]

But the applicant must reject the shares immediately when the shares have been allotted to him without his condition being fulfilled. Thus where the applicant accepted or pledged his shares, he lost his right to insist on the condition.[13]

However, the position will be different in case of an application with collateral agreement or a condition subsequent. In such a case the applicant will be deemed to have agreed absolutely to become a member, with only a right to enforce (if valid) the collateral agreement or condition subsequent against the company.[14]

Thus where an applicant was allotted certain shares in a company on the condition that he would pay for them only when the company paid dividends, it was held that he was bound by the allotment even though the company went into liquidation before paying any dividend.[15]

Irregular Allotment

An allotment is irregular (*a*) when it has been made by a public company which has issued a prospectus without receiving at least five per cent of the nominal value of shares as application money or without receiving the minimum subscription or without depositing the application money in a scheduled bank; and (*b*) when it has been made by a

[10] *Indian Co-operative Navigation and Trading Co. Ltd. v. Padamsey Premjit* (1933) 36 Bombay L.R. 32; *Ramsgate Victoria Hotel v. Montefiore* (1866) L.R. 1, Ex. 109; *Ramlalsao Gupta v. M.E.R. Malak*, A.I.R. 1989 Nag. 225.

[11] *Roger's Case and Horrison's Case* (1868) L.R. 3 Ch. App. 633;*Simpson's Case* (1869) 4 Ch. App. 184.

[12] *Ramanbhai v. Ghasi Ram* (1918) 42 Bom. I.L.R. 595.

[13] *Hargopal v. People's Bank of Northern India Ltd.* A.I.R. 1935 Lah. 691.

[14] *Elkington's Case* (1876) L.R. 2 Ch. App. 511.

[15] *Motilal Chunilal v. Thakorlal* (1912) 14 Bom. L.R. 648.

public company which has not issued any prospectus without filing a statement in lieu of prospectus at least three days before the first allotment of shares.

Effects of irregular allotment. The effects of irregular allotment are stated below:

(1) *Allotment voidable.* An irregular allotment is *voidable* at the option of the applicant within two months of the statutory meeting of the company or in case where the company is not required to hold a statutory meeting or where the allotment is made after holding such a meeting, within two months of the date of the allotment. [Sec. 71(1)]

The allottee must inform the company that he avoids the allotment within two months. It is not necessary that the allottee should commence legal proceedings within the said period provided he has given notice of avoidance within two months. But legal proceedings should be reasonably prompt thereafter if they are to be brought.[16]

If the applicant takes steps for avoiding the allotment within this period, it does not matter that winding up proceeding has intervened during this period.[17]

(2) *Suit for compensation against directors.* If any director of a company knowingly contravenes or wilfully authorises or permits the contravention of any of the rules for valid allotment of shares as discussed above, he shall be laible to compensate the company and allottee respectively for any loss, damages or costs which the company or the allottee may have sustained or incurred thereby. The suit for compensation must be brought within two years of the date of allotment.

(3) *Fine.* All directors who are knowingly responsible for the default shall be punishable with fine. [Section 69(4) and 70(4)]

Return As to Allotment

Whenever a company with a share capital makes any allotment of its shares, it must file with the Registrar a return as to allotment within thirty days of the allotment of shares. The return must contain the following particulars:

(*i*) The number and nominal amount of shares allotted, the names, addresses and occupations of the allottees and the amount paid or due and payable on each share.

(*ii*) In case the shares (not being bonus shares) are allotted as fully or partly paid-up for consid tion other than in cash, the original contract constituting the title of t allottee to the allotment must be produced to

[16]*Re National Motor Ma Coach Co.* (1908) 2 Ch. 228.

[17]*Blanche Fonseca v. Jupiter Airways Ltd.*, A.I.R. (1953) Bom. 417.

the Registrar of Companies for inspection and examination. Such contract must be duly stamped. The company shall file with the Registrar copies verified the prescribed manner of all such contracts and a return stating the number and nominal amount of shares so allotted, the extent to which they are to be treated as paid up and the consideration for which they have been allotted.

(*iii*) In the case of bonus shares, a return stating the number and nominal amount of shares comprised in the allotment, and the names, addresses and occupations of allottees and a copy of the resolution authorising the issue of such shares shall be filed.

(*iv*) When the shares have been issued at a discount, the return must include a copy of the resolution passed by the company authorising such issue together with a copy of the order of the Company Law Board sanctioning the issue, and where the maximum rate of discount exceeds ten per cent, a copy of the order of the Central Government permitting the issue at the higher percentage.

Default. If default is made in complying with this section, every officer of the company who is in default shall be punishable with a fine which may extend to five hundred rupees for every day that the default countries.

No return for reissue of forfeited shares. No return as to allotment shall be filed for the reissue of forfeited shares since reissue of forefeited shares does not amount to allotment. Similarly, in case of allotment of debentures no such return is to be filled. (Sec. 75)

It has been held that the Registrar has no power to refuse to register a return of allotment on the ground that some of the shares have been allotted to a minor.[18]

Issue of Shares at a Discount

Section 79 of the Companies Act lays down that a company may issue shares at a discount, if the following conditions are satisfied:

(*i*) The issue of shares at a discount must be of a class of shares already issued.

(*ii*) At least one year should have elapsed at the the date of issue from the date of commencement of business by the company.

(*iii*) The issue is authorised by a resolution in the general meeting, which must state the maximum rate of discount.

(*iv*) It is sanctioned by the Company Law Board.

(*v*) Shares are issued within two months of the date on which the issue is sanctioned by the Company Law Board or within such extended time

[18]*Golcanda Industries v. Registrar of Companies,* A.I.R. (1968), Delhi 170.

as the Company Law Board may allow.

(vi) The resolution must specify the rate of discount which must not exceed ten per cent, except with the approval of the Company Law Board.

Where a company issues shares at a discount in contravention of the above conditions, the allottees who have been put on the register of members become bound to pay the full value of their shares.[19]

Issues of Sweat Equity Shares

The expression "sweat equity shares" means equity shares issued by a company to its 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 name called. The shares should be of a class of shares already issued and the issue should be authorised by a special resolution. The resolution should specify the number of shares, their current market price, considerations, if any and the class or classes of directors or employees to whom such sweat equity shares are to be issued. At least one year must have elapsed between the date of commencement of business by the company and the date of such issue. Further, such shares shall be issued in accordance with regulations made by SEBI. All the limitations, restrictions and provisions relating to equity shares will be applicable to them. [Sec. 79-A inserted by the Companies (Amendment) Act, 1999]

Issues of Shares at a Premium

Section 78 of the Companies Act empowers a company to issue shares at a premium, i.e., at a price higher than the face value of shares. The total premium amount shall be transferred to the "Share Premium Account" and the provisions of the Act relating to reduction of capital shall also apply to this account. However, the share premium may be utilized for the following purposes:

(i) to issue fully paid bonus shares to members;

(ii) to write off preliminary expenses of the company;

(iii) to write off expenses or commissions paid or discounts allowed on an issue of shares or debentures; and

(iv) to provide for the premium payable on redemption of any redeemable preference shares or debentures.

Even when the shares are issued at a premium for consideration other than cash, a sum equal to the amount of the premium must be transferred to the share premium account.[20]

Underwriting Commission and Brokerage

An underwriting agreement is an agreement between the company and an individual, a firm or an institution, known as an underwriter, whereby the latter agrees to take up the whole or part of the shares which may not be subscribed by the pubic in consideration of a commission. Thus we

[19] *Ooregum Gold Mining Co. v. Roper* (1882) A.C. 125.

[20] *Head (Henry) & Co. Ltd. v. Ropher* (1951) 2 All. E.R. 994.

can say that the object of an underwriting agreement is to prevent the failure of an issue of shares. It is in the nature of an insurance against risk. An underwriting agreement is enforceable against executors of deceased underwriter.[21]

Conditions for payment of commission. Under Section 76, a company may pay a commission to any person in consideration of (*a*) his subscribing or agreeing to subscribe; or (*b*) his procuring or agreeing to procure subscription for any shares or debentures of a company subject to the following conditions:

(*i*) The payment of the commission is authorised by the articles of the company.

(*ii*) The rate of commission does not exceed five per cent of the price at which shares are issued or the rate authorised by the articles, whichever is less. In the case of debentures, it shall not exceed two and a half per cent of the price at which debentures are issued or the rate authorised by the articles, whichever is less.

(*iii*) The rate per cent of the commission must be disclosed in the prospectus or in the statement in lieu of prospectus.

(*iv*) The number of shares or debentures which has been underwritten must be indicated in the prospectus.

(*v*) A copy of the contract for the payment of commission is delivered to the Registrar along with the prospectus or the statement in lieu of prospectus.

It must be noted here that no commission shall be paid by the company in respect of shares or debentures which are not offered to the public for subscription.

Payment of brokerage. It may be stated that Section 76 does not in any way affect the power of any company to pay lawful brokerage. Lawful brokerage means reasonable brokerage payable to a person carrying on the business of a broker and not to a person who has casually induced others to subscribe.[22]

Default. If any default is made in complying with the provisions of Section 76, the company and every officer of the company who is in default shall be punishable with a five which may extend to five hundred rupees.

SHARE CERTIFICATE

A share certificate is a certificate issued by the company under its

[21]*Warner Engineering Co. v. Bennan* (1913) 30 T.L.R. 191.

[22]*Andreae v. Zinc Mines of Great Britain Ltd.*, (1918) 2 K.B. 454.

common seal, specifying the number of shares held by any member and the amount paid on each share. It is *prima facie* evidence of the title of the member to such shares. A share certificate is a declaration by the company that the person in whose name the certificate is made out and to whom it is given, is a shareholder in the company and the certificate is given by the company with the intention that it shall be used by the person to whom it is given and acted upon in the sale and transfer of shares.[23]

Every person whose name is entered as a member in the register of members shall be entitled to receive one certificate for all his shares without payment. If he requires more than one certificate for his shares, he will pay one rupee for every additional certificate after the first. In respect of any share or shares held jointly by several persons, the company shall not be bound to issue more than one certificate and delivery of a certificate for a share to one of several joint-holders shall be sufficient delivery to all such holders. (Regn. 7 of Table A)

Contents of a Share Certificate

The Companies Act, 1956 does not prescribe the form or contents of a share certificate. Section 84 simply requires that is should state the number of shares held by the member named therein. It will, however, be found to contain the following information:

(*a*) Name and address of the registered office of the company.
(*b*) Serial number of the share certificate.
(*c*) Date of issue of the certificate.
(*d*) Name and address of the shareholder.
(*e*) Number and class of shares.
(*f*) Distinctive numbers of shares included in the share certificate.
(*g*) Nominal value of each share.
(*h*) Amount paid on each share.
(*i*) A revenue stamp of 30 Paise.
(*j*) Impression of the common seal of the company.
(*k*) Space for the signatures of two directors and the secretary.

The share certificate form consists of three parts: (*a*) the counterfoil for reference, (*b*) the certificate proper, and (*c*) the receipt to be signed by the shareholder on receiving the certificate. Each part bears the same serial number and is separated from the other parts by perforations. The certificate forms are consecutively numbered and invariably bound in a book form.

[23] *Re Bahia Etc.* (1868) L.R. 3 Q.B. 595.

Time Limit for Issue of Certificates

Section 113(1), as amended by the Companies (Amendment) Act, 1988, makes it obligatory on the part of companies to deliver the certificates of shares and debentures within three months of allotment or within two months after the application for registration of transfer is made. The Company Law Board has been empowered to grant an extended period of not more than nine months in appropriate cases. Prior to the amendment, the obligation of the company was to keep ready for delivery, and not to deliver, the certificates. Under the Securities Contracts (Regulation) Rules, 1957 a listed company is required to issue share certificate to the transferee within one month of the making of the application for the registration of the transfer.

In case of default, a notice may be served upon the company be the person entitled to the certificate requiring it to make good the default. If the company fails to comply with the notice within ten days of the services of the notice, the allottee may make an application to the Company Law Board. The Company Law Board may make an order directing the company and any of its officers to issue such certificate and to pay all costs and incidental costs to the applicant. [Sec. 113]

Besides, the company and every officer of the company who is an default shall be punishable with a five which may extent to five hundred rupees for every day that the default countries. [Sec. 113(2)]

Legal Effects of Share Certificate

The legal effects of a share certificate may be studied under two heads:

1. **Estoppel as to title to the shares.** A share certificate under common seal of the company, specifying any shares held by any member, shall be *prima facie* evidence of the title of the member to such shares [Sec. 84(1)]. After the issue of a share certificate, the company cannot contend that the holder is not entitled to those shares.

The case of *Dixon v. Kennaway & Co.*,[24] may be mentioned here to illustrate the above point. In this case the plaintiff applied for 300 shares in the company and paid for them. A clerk of the company who owned no shares executed a transfer in favour of the plaintiff. The company registered the transfer and issued a share certificate to the plaintiff without requiring the clerk to produce his certificate. The company was estopped from denying the accuracy of the plaintiff's certificate and was held liable to the plaintiff in damages.

However, if the certificate is issued by an officer of the company who has no authority to do so, the company will not be estopped. This was the

[24](1900) 1 Ch. 833.

case in *Ruben v. Great Fingall Consolidated,*[25] where the secretary of the company had forged the signature of the directors and, putting his own signatures, had issued the share certificate. It was held that the company was not bound by it.

But if a *bona fide* purchaser for value acquires shares relying on a share certificate, the company will be estopped from denying the validity of the certificate on the ground that it is a forged one and it shall be liable to compensate the purchaser.[26] The reason is that the share certificate is a declaration by the company to the world that the person who is named therein is the shareholder in the company.

2. Estoppel as to payment. A company is estopped from denying the fact of payment certified on a certificate. If the certificate describes the shares as fully paid, the company cannot afterwards contend that they are not. In *Bloomenthal v. Ford,*[27] *B* lent £1,000 to the company which promised to give him as security fully paid-up shares. The certificate issued to *B* stated that he was the registered holder of 10,000 fully paid shares. In fact, nothing had been paid on them. The company was wound up and *B* was placed on the list of contributories in respect of the whole amount of shares. The court held that the doctrine of estoppel applied and the company and the liquidator were estopped from denying that the shares were fully paid-up and, therefore, *B* could not be placed on the list of contributories.

Issue of Duplicate Share Certificate

A certificate may be renewed or a duplicate of a certificate may be issued if such a certificate (*a*) is proved to have been lost or destroyed; or (*b*) having been defaced or mutilated or torn, is surrendered to the company. [Sec. 84(2)]

When original certificate is defaced or mutilated. Where the original certificate is defaced, mutilated or torn, the procedure for issuing a duplicate is very simple. The shareholder will surrender the original certificate and request for a duplicate. The secretary must see that the appplication for duplicate certificate is in proper form and it is accompained by the requisite fee decided by the Board but not exceeding Rs 2. The company will cancel the original certificate and a duplicate of the same will be issued in due course.

When original certificate is lost or destroyed. The procedure becomes complicated when the original certificate is lost or destroyed. Before

[25] 1906 A.C. 439.
[26] *Re Bahia & San Francisco Rly. Co.,* (1868) L.R. 3 Q.B. 584.
[27] (1897) A.C. 156.

issuing a duplicate in such a case, tne company will have a satisfactory proof of the loss or destruction. For this purpose, the shareholder concerned is required to give a statutory declaration (affidavit) stating the fact of the loss of the certificate. He is also required to give a letter of indemneity in favour of the company to protect it against any claim that may be made by any person on the original certificate. Where the original certificate was for a considerable number of shares, the shareholder may be required to give a supporting guarantee from his banker or other person of known financial standing. Before issuing the duplicate certificate, the company shall give a public notice of the loss or destruction of the certificate in some leading newspaper at the cost of the shareholder. The shareholder has also to pay the prescribed fee of not more than Rs 2 for the issue of a duplicate certificate.

SHARE WARRANT

A share warrant is a document issued under the common seal of the company stating that the bearer is entitled to the specified number of shares. Being a bearer document, it can be transferred by mere delivery without the transfer being registered by the company. Share warrants, unlike share certificates, are negotiable instruments and a *bona fide* holder will get a good title provided he obtained it in good faith and for value.[28]

Conditions of Issue of Share Warrants

Under Section 114, the share warrants may be issued subject to the following conditions:

(*i*) The articles must empower the company to issue share warrants.

(*ii*) The shares must be fully paid up. Share warrants cannot be issued for party paid shares.

(*iii*) The company must obtain the approval of the Central Government before it can issue warrants.

(*iv*) Only public companies limited by shares can issue share warrants.

Efffect of the Issue of Share Warrants

On the issue of a share warrant, the company shall strike out of its register of members, the name of the member to whom the warrant is issued. The company shall enter in that register the following particulars, namely (*a*) the fact of the issue of the warrant; (*b*) a statement of the shares specified in the warrant, distinguishing each share by its number;

[28]*Webb, Hale and Co. v. Alexandria Water Co.* (1905) 21 T.L.R. 572.

and (*c*) the date of issue of the warrant. [Sec. 115(1)]

Any holder of the warrant may surrender the warrant for cancellation and take a share certificate, whereupon his name will be recorded in the register of members. [Sec. 115(2)]

Ordinarily, the holder of the warrant does not enjoy the right of a member of the company. But if the articles permit and to the extent they permit, the bearer of a warrant may be deemed to be a member of the company for all or any purposes defined in the articles. [Sec. 115(5)]

The bearer of a share warrant shall not be deemed to be the holder of shares specified in the warrant so as to fulfil the condition of qualification shares for the directors. [Sec. 270(4)]

Issue of Duplicate Share Warrants

The procedure for the issue of duplicate share warrants is almost the same as explained earlier in this chapter in relation to the issue of duplicate share certificates. Where the original share warrant is defaced, mutilated or torn, it can be surrendered by the shareholder with a request for a duplicate. The company will cancel the original and issue a duplicate of the same in due course. Where the original share warrant is lost or destroyed, the holder may apply to the company for a duplicate. Since the share warrants are negotiable, there is a great risk in issuing a duplicate warrant unless the company has taken steps to protect itself. For this the applicant advertises the loss in the newspaper and also gives an indemnity bond as well as a guarantee, before a duplicate warrant is issued to him. Moreover, companies postpone the issue of a duplicate warrant for some years and continue paying dividends against indemnity bonds.

Payment of Dividends on Share Warrants

A share warrant may have attached coupons on the production of which the dividends due on the shares specified in the warrant will be paid. The share warrant has also a talon or voucher for demanding a new set of dividend coupons when those attached to the warrant have been exhausted. The usual practice with companies is to advertise the declaration of dividend in leading newspapers and to request the holders of share warrants to deposit their coupons with the company's bankers for examination. The holder of share warrant enters his name, address and serial number of the coupon on a form supplied by the bank for that purpose. The coupon is carefully scrutinised and checked by the bank with the list previously supplied to the bank by the company. If the coupon is found in order, the bank issues a cheque or cash warrant in favour of the holder and a note of this fact is made against the number of the warrant. The coupon is then destroyed by means of a perforator.

Distinctions between a Share Certificate and a Share Warrant

1. A share certificate can be issued by private as well as public companies while a share warrant can be issued only by public limited companies.

2. Share certificates can be issued in respect of fully paid up as well as partly paid up shares whereas a share warrant can be issued only in respect of fully paid up shares.

3. The issue of share certificates does not require the approval of the Central Government. But share warrants can be issued only with the approval of the Central Government.

4. Nominal stamp duty is required in the case of share certificates whereas with share warrants, heavy stamp duty is required.

5. A holder of a share certificate is a member of the company whereas a holder of a share warrant may not be, unless the articles permit.

6. The holder of a share certificate can present a petition for winding up of the company. But the holder of a share warrant cannot do so, unless the articles of association permit.

7. A share certificate is not a negotiable instrument whereas the share warrant is a negotiable instrument and a *bona fide* holder will get a good title provided he obtained it in good faith and for value, even if the immediate transferor had defective title.

8. A share certificate can be transferred by a transfer deed or by an instrument in writing duly executed and stamped. It also involves registration of transfer by the company through a resolution of the board of directors. Upon registration, necessary changes are made in the register of members. But a share warrant can be transferred by mere delivery by one holder to another.

9. A share certificate forms the share qualification for directors, whereas the share warrant cannot constitute the share qualification for directors.

10. In the case of share certificates the dividend is paid to the shareholder through a dividend warrant which is sent to him on his registered address, whereas the dividend is paid through bearer dividend coupons in the case of share warrants. The coupons are attached to the warrant.

STOCK

Stock is the aggregate of fully paid up shares legally consolidated. The issue of partly paid-up stock is invalid.[29] It can be split into fractions of any amount without regard to the original nominal value of shares. The

[29]*Re Home and Foreign Investment Co.*, (1912) 1 Ch. 72.

advantage of stock is that the shareholder may transfer any portion of it as he likes. Moreover the distinctive number of shares also need not be mentioned.

"The use of the term 'stock' merely denotes that a company has recognised the fact of complete payment of the shares and that the time has come when these shares may be assigned in fragments, which for obvious could not be permitted before.[30]

Statutory conditions for creating stock. Section 94(1) of the Act empowers the company to convert its fully paid up shares into stock by a resolution in the general meeting, if its articles authorise such conversion. The company shall give notice to the Registrar of such conversion within thirty days of doing so. [Sec. 95(1)]

Effect of conversion of shares into stock. Section 96 lays down that where a company with share capital has converted any of its shares into stock and given notice of the conversion to the Registrar, all the provisions of this Act which are applicable to shares only shall not apply to so much of the share capital as is converted into stock.

Where the company has converted any of its shares into stock and given notice of the conversion to the Registrar, the register of members shall show the amount of stock held by each of members concerned instead of the shares so converted which were previously held by him. [Sec. 150(1)]

Reconversion of stock into shares. Stock can be reconverted into shares of any denomination by an ordinary resolution, if the articles so provide. [Sec. 94(1)]

Rights and privileges of holders of stock. Regulation 38 of Table A lays down that the holders of the stock shall have the same rights, privileges and advantages as regards dividends, voting at meetings of the company and other matters, as if they held the shares from which the stock arose.

Difference between Share and Stock

(1) Shares may be partly paid up or fully paid up. But they can be converted into stock only when fully paid up. This means that stock must always be fully paid up.

(2) Shares can be issued originally or at any time but stock cannot be issued originally direct to the public. Only fully paid up shares can be converted into stock.

(3) A share had nominal value while stock has none.

(4) Shares are of equal denomination while stock may be spilt into any fractions of any amount.

[30] *Morrice v. Aylmer* (1874) 10 Ch. App. 148.

117

(5) Shares are numbered consecutively. Stocks are not numbered but the names of stock-holders are recorded in the books of the company.

(6) Shares cannot be issued or transferred in fragments or fractions, whereas stock may be transferred in any fractions. However, the articles usually restrict transfer of stocks to certain definite amounts or multiples thereof.

(7) Stock may be registered or unregistered by shares are always registered. They are not transferable by delivery.

CALLS ON SHARES

Generally, companies do not require applicants to pay the full value of shares to the company at the time of issue. They collect a certian percentage of the nominal value of shares on application and allotment, and the balance is called in one or more instalments as and when the company requires. Such instalments are known as calls. A call may be defined as a demand by the company, in pursuance of a resolution of the board of directors and in accordance with the regulations of the articles upon its shareholders, to pay the whole or part of the balance remaining unpaid on their shares during the lifetime of the company. It may be made by the liquidator in the course of winding up of the company.

It may be noted here that "all money payable by any member to the company under the memorandum or articles shall be a debt due from him to the company" [Sec. 36(2)]. But the liability to pay will arise when a valid call has been made.[31]

It is also important to note that it is only the registered shareholder who can be made liable in respect of share calls and it makes no difference whether he is a benamidar or the beneficial owner of the shares or a mere trustee.[32]

Requisites of a Valid Call

A valid call must be made in accordance with the provisions of the Act and the articles of the company. The following are the important requisties of a valid call:

(1) **Resolution of the board of directors.** In order for the call to be valid it must be made under a resolution of the board of directors. "In making a call care must be taken that the directors making it are duly appointed and duly qualified and that the meeting of directors has been duly convened, that the proper quorum is present and that the resolution

[31]*Pabna Dhanabhandar Co. v. Foyezuddin,* A.I.R. (1932) Cal. 716.

[32]*Murshidabad Loan Office v. Satish Chandra,* A.I.R. (1943) Cal. 440.

making the call is duly passed."[33] In order that any irregularity in making the call may not invalidate it, the articles of the company generally contain a clause that all acts of the directors shall be valid even if any defect in the appointment or qualifications of directors is discovered later on.

Section 292 lays down that the power to make calls on shareholders in respect of money unpaid on their shares can be exercised by the board of directors only by means of resolutions passed at duly constituted meetings of the board and not by circulation.

However, the directors cannot exercise their power to make a call in the course of the winding up of the company in the case of 'reserve capital'. After the winding up proceedings have started, the power to demand payment of the amount remaining unpaid on shares or to call up the reserve capital vests only with the liquidator.

(2) **The amount and time of payment.** The resolution must state the time and place of payment along with the amount of the call. Thus, where the directors passed a resolution fixing the amount of a call, but omitted to fix the date of payment, this call was held to be invalid.[34]

Moreover, to legally enforce the payment of the call, a proper notice must be given to the shareholders in accordance with the provisions of the articles.

(3) **Calls on shares of the same class to be made on a uniform basis.** Section 91 lays down that calls shall be made on a uniform basis on all shares falling under the same class. Shares of the same nominal value on which different amounts have been paid up shall not be deemed to fall under the same class.

This means that if a call is made on some shareholders and not others, the call is void. In *Galloway v. Halley Concerts Society,*[35] a shareholder paid the first two calls after a great delay and neglected to pay the third call. The directors got annoyed and called upon him to pay the whole amount on his shares without making a similar call on other shareholders. The court held that the call was invalid is it did not require all the members to pay the full amount due on their shares.

(4) **Bona fide and for the benefit of the company.** The power to make calls is a power in the nature of a trust and it must be exercised for the general benefit of the company.[36] The amount uncalled should be called

[33]*Palmer's Company Law,* Stevens and Sons, Ltd., London, 1959, (20th Ed.), p. 318.

[34]*Re Cawley and Co. (1889)* 42 Ch. 209; *E. & W. Insurance Co. Ltd. v. Mrs Kamla Mehta* A.I.R. (1966) Bom. 537.

[35](1915) 2 Ch. 233.

[36]*Alexander v, Automatic Telephone Co* (1900) 2 Ch. 56.

only when it is necessary for the promotion of the objects of the company.

However, if the call is made by the directors to serve their personal ends and not for the benefit of the company, shareholders can prevent its enforcement by an injuction.[37]

A shareholder complaining against the director must establish *mala fide* in such a case. The court will not interfere with the discretion of the directors in making a call in the absence of proof of *mala fide.*[38]

(5) **In accordance with the provisions of the articles of the company.** The call must also conform to the provisions of the articles of association of the company. If the articles are silent, then Regulations 13-18 of Table A shall apply. These regulations are stated below:

(*i*) No call shall exceed one-fourth the nominal value of shares.

(*ii*) The minimum interval between two calls must be at least one month.

(*iii*) At least fourteen days' notice must be given to each member.

(*iv*) A call may be revoked or postponed at the discretion of the board.

(*v*) The joint holders of a share shall be jointly and severally liable to pay all calls in respect thereof.

Calls in Arrears

If a sum called in respect of a share is not paid before or on the day fixed for payment the person from whom the sum is due shall pay interest thereon from the day fixed for payment to the day of actual payment at five per cent per annum or at such lower rate as the board may determine. The board shall be at liberty to waive payment of any such interest, wholly or in part. (Reg. 16 of Table A)

Section 274 lays down that non-payment of a call by a person for six months will disqualify him from holding the office of a director of the company.

Calls in Advance

The board may receive from any member willing to advance the same, all or any part of moneys uncalled and unpaid upon any shares held by him and that it may pay interest at such rate not exceeding six per cent per annum unless the company in general meeting otherwise directs. (Reg. 18 of Table A)

The power of the directors to accept calls in advance must be exercised *bona fide.* Thus where the directors knew that the company was insolvent

[37]*Lamb v. Sambas Rubber, Etc. Co* (1908) 1 Ch. 845.
[38]*Odessa Tramways Co. v. Mendel* (1878) 8 Ch. D. 235.

and paid up the amount unpaid on their own shares in advance and at once applied it in payment of their own fees, they were still liable for the amount unpaid on their shares.[39]

It may be noted here that the member shall not however be entitled to any extra voting rights in respect of the money so paid by him until the same becomes presently payable. {Sec. 92(2)]

A company may, if so authorised by its articles, pay dividends in proportion to the amount paid up on each share where a larger amount is paid upon some shares than others. (Sec. 93)

The amount paid in advance is not refundable except in the event of winding up, when the shareholder making the advance payment will be entitled to refund of the amount with interest before the other shareholders are paid off.

FORFEITURE OF SHARES

Forfeiture of shares by a company means the compulsory termination of membership and the taking away the shares from a member by way of penalty for non-payment of any call, instalment or premium on shares. If a shareholder does not pay the call made on him, a company may file a suit against him to recover the amount due. But the articles of association provide that in such a case the company may forfeit the shares of such a member.

The directors have no right to forfeit shares unless this power is expressly conferred on them by the articles of the company. Where the power is given by the articles, it must be exercised in accordance with the provisions regarding notice, procedure and manner stated therein.

The right to forfeit must be pursued with the greatest exactness, it must be exercised by proper parties, that is by directors properly appointed, and by the requisite number of them and in the proper manner and for the proper cause. The right must be exercised *bona fide* for the purpose for which it is conferred. The power of expulsion is a trust, the execution of which will be narrowly scanned by the courts... It cannot, for example, be exercised surreptitiously for the purpose of expelling a shareholder, nor by connivance for the purpose of assisting him in getting rid of his shares."[40]

Essentials of Valid Forfeiture

Forfeiture for non-payment of calls. Shares can be forfeited only for

[39]*Re European Central Rail Co.,* (1872) L.R. 13 Eq. 255.
[40]*Kanshiram v. Kishore Chander.* A.I.R. (1915) Lah. 109.

non-payment of calls. A forfeiture on any other ground is invalid.[41] But the Supreme Court has held that a forfeiture is perfectly valid even on other ground if the articles provide for it. The Supreme Court established firmly that there is no provision in the Companies Act restricting the exercise of the right to forfeit shares for non-payment of a call only.[42]

Notice precedent to forfeiture. Regulation 30 of Table A provides that when a member fails to pay any call within the stipulated time, the board of directors shall serve a notice on him requiring payment together with interest. The notice must specify a date, not earlier than fourteen days from the date of service of the notice on or before which the payment is to be made and must also state that failure to pay within that date will make the shares liable for forfeiture. The exact amount to be paid by the defaulter must be clearly mentioned in the notice. Where the notice of forfeiture was inaccurate because it required payment of interest from a wrong date (e.g., the date of call instead of the date appointed for payment), the forfeiture was held to be invalid.[43] Even a slight defect in the notice will render the notice invalid and will be fatal to forfeiture.[44]

Resolution of forfeiture. A proper resolution of forfeiture must be passed at a duly convened and constituted meeting of the board. Resolution 31 of Table A lays down that if no payment is made as notified in the notice sent to the defaulter, the shares in respect of which the notice was given may be forfeited by a resolution of the borad to that effect.

Bona fide. The power to forfeit is a power of trust and the directors must exercise this power in good faith and in the best interest of the company. It should not be used to relieve an individual from liability or to expel a member or to get rid of him.

Certain directors had taken shares merely to qualify themselves for appointment and in fact had paid nothing on their shares. Later on when the company was in difficulties, they wanted their shares to be forfeited and cancelled, and this was done. It was held that the forfeiture was invalid as it was not for the benefit of the company, and therefore the directors continued as shareholders.[45]

Effect of forfeiture

When shares have been forfeited, the defaulting shareholder ceases to

[41] *Hopkinson v. Mortimer Harley and Co.* (1917) 1 Ch. 646.

[42] *Naresh Chandra Sanyal v. The Calcutta Stock Exchange Assn. Ltd.* (1971) 41 Comp. Cas. 51.

[43] *Johnson v. Lytlle's Iron Agency* (1877) 5 Ch. D. 687.

[44] *Public Passenger Service Ltd. v. Khadar* A.I.R. (1966) S.C. 489.

[45] *Re Esparto Trading Co.* (1879) 12 Ch. D. 191.

be a member of the company and he loses all rights or interest in his shares. He also loses the money he has paid on them. But the articles may provide that the member shall be liable for payment of calls owing upon the shares at the time of the forfeiture, which can be enforced against him as a debtor of the company and not as a contributory.[46] But the company cannot recover more than the difference between the amount payable on shares and the amount received from the subsequent holder of the forfeited shares.[47]

However, the forfeiture of a share does not relieve the forfeiting member from liability to be placed on the B List of contributories and to contribute in respect of any debt or liability of the company contracted before he ceased to be a member. But he will be so liable as a past member only when the company is wound up within a year of the forfeiture and the present members are unable to satisfy the contributions required to be made. (Sec. 426)

Re-issue of Forfeited Shares

A forfeited share may be sold or otherwise disposed of on such terms and in such manner as the board thinks fit, but the amount of discount cannot exceed the actual amount forfeited on these shares.

No return of allotment is required to be filed for the reissue of forfeited shares. [Sec. 75(5)]

The purchaser of the forfeited shares shall not be bound to see to the application of the purchase money, if any, nor shall his title to the shares be affected by any irregularity or invalidity in proceedings with reference to the forfeiture, sale or disposal of the shares.

Annulment of Forfeiture

At any time before sale or disposal as aforesaid, the board may cancel the forfeiture on such terms as it thinks fit. This power cannot be exercised without the consent of the forfeiting member.[48]

SURRENDER OF SHARES

When a shareholder abandons his shares in favour of the company, it is known as surrender of shares. Whereas the Companies Act and Table A recognise forfeiture of shares, they have no provision regarding the surrender of shares. But the articles of a company may provide for the

[46] *Ladies Dress Association v. Pulbrook* (1900) 2 Q.B. 376.
[47] *Re Bolton* (1930) 2 Ch. 48.
[48] *Larkworthy's Case* (1903) 1 Ch. 711.

acceptance of a surrender of shares under circumstances which would justify forfeiture. Any provision in the articles for acceptance of surrender in other circumstances is invalid.[49]

Director's powers to accept surrender of shares. The power of directors to accept surrender is in the nature if trust to be exercised in good faith for the benefit of the company. A valid call and default must exist. Surrender should not be used as a device to relieve any member from his liability.

It was held that surrender of shares is *ultra vires* if the shares are not liable to forfeiture, and hence the shareholder is not relieved from his liability to pay the amount remaining unpaid on his shares. The reason is that such a surrender involves reduction of capital or purchase by the company of its own shares, which is invalid.[50]

But surrender of shares in exchange for other shares of the same nominal value involves no reduction of capital and therefore is not invalid.[51]

Effect of surrender of shares. On a valid surrender of shares, the member ceases to be a member of the company. However, he remains liable as a contributory as a past member of the company if the latter is wound up within twelve months of his surrendering his shares. Partly paid up shares which are surrendered may be reissued in the same manner as forfeited shares.

Where the surrender of shares was illegal, null and void, the shareholder is justified in applying to have the register of members rectified by placing his name thereon even after a lapse of some years provided the company has not reissued or otherwise dealt with the shares in the meantime.[52]

LIEN ON SHARES

Lien means the right to retain property belonging to another until some debt or calim is paid. The articles of the company generally provide that the company shall have a first and paramount lien on all shares of its members either in respect of amounts payable on shares or on any amounts due from the members to the company. The company's lien on shares shall also extend to all dividends payable on those shares. "It is eminently fair for a company to provide by its articles that the shareholders who are indebted to the company should not be permitted

[49]*Madras Native Permanent Fund v. Natessa Sastri* 52 Mad. 915.
[50]*Bellerby v. Rowland and Marwood's Steamship Co.* (1902) 2 Ch. 14.
[51]*Rowell v. Rowell and Sons* (1912) 2 Ch. 609.
[52]*Bellery v. Rowland and Marwood's Steamship Co.* (1902) 2 Ch. 14.

to dispose of their shares without paying their debts and that the company should have a lien of the shares for the debts."[53]

It may be noted here that the right of lien is not statutory right provided by the Act but must be expressly conferred on the company by its articles. The right of lien conferred on the company by its articles empowers it to prevent the transfer of shares until the amount due to it from its shareholders is paid.

Transferability of lien. The lien is not a possessory lien, but creates an equitable charge which is assignable.[54]

Postponement of lien. If shares are mortgaged and the mortgagee gives notice of his claim to the company and then the shareholder becomes indebted to it, the company's lien will be postponed to the claims of the mortgagee.[55]

It has been held that notice of pledge of shares to the managing director, even in his private capacity, shall be deemed to be a notice to the company.[56]

Where the liability of the shareholder towards the company is disputed by him, it does not deprive the company of its right of lien on his shares.[57]

Mode of enforcing lien. Articles generally empower the company to enforce the lien by sale of shares. Regulation 10 of Table A also empowers the company to sell any shares on which the company has lien if (*a*) the sum in respect of which lien exists is presently payable, and (*b*) fourteen days' clear notice in writing and stating and demanding payment of such amount has been given to the reigistered shareholder or his legal representative on death or insolvency. Lien cannot be enforced by forfeiture. Even if the shares are forfeited in exercise of any such power given by the article for non-payment of an ordinary debt, the forfeiture would be invalid as a reduction of capital without court order.[58]

To give effect to any such sale, the board may authorise some person to transfer the shares sold to the purchaser. The purchaser of such shares shall be registered as the holder of the shares. The purchaser shall not be bound to see to the application of purchase money and his title of the shares is not affected by an irregulaity or invalidity in the preceedings in reference to the sale. (Regn. 11 of Table A)

Where the shares held under lien are sold, the sale proceeds will be received by the company and will be applied in payment of the amount

[53]*Allen v. Gold Reefs of West Africa* (1900) 1 Ch. 656.
[54]*Everitt v. Automatic Weighining Machine Co.* (1892) 3 Ch. 506.
[55]*Bradford Banking Co. v. Briggs* (1886) 12 App. Cas. 29.
[56]*Re Union Sugar Mills Ltd.* A.I.R. (1933) All. 607.
[57]*Amar Nath v. Karnal Electric Supply Co.* A.I.R. 1962 Punj. 411.
[58]*Hopkinson v. Mortimer Harley and Co.* (1917) 1 Ch. 646.

in respect of which the lien exists. The residue or balance, if any, will be paid to the person entitled to the shares at the date of the sale. (Regn. 12 of Table A)

Differences between Lien and Forfeiture

The differences between lien and forfeiture of shares are as follows:

1. A company may have lien on shares of its members in respect of amounts payable on shares or any amounts due from members to the company. But forfeiture of shares can be effected only in respect amounts payable on shares.

2. A lien is kind of security for a debt and it is retained until the payment of debt in full, whereas forfeiture is effected as a penal proceeding on non-payment of call amount by the member on his shares.

3. A lien is enforced by sale, but forfeiture is effected by compulsory termination of membership and taking away the shares from a member by way of penalty.

4. Lein never leads to reduction of capital since lien is enforced by sale of shares. Forfeiture may involve reduction of capital if the forfeited shares are not reissued.

5. When the shares held under lien are sold, the proceeds of sale are applied for repayment of debts and the balance, if any, will be given to the defaulting member. But in the case of forfeiture, nothing is payable to the defaulting member and he loses the entire amount he has already paid on the shares.

QUESTIONS

1. (*a*) What is allotment of shares?

(*b*) Explain the situations when, under the Companies Act, 1956, allotment of shares is void, voidable and valid. [*Delhi, B. Com. (Hons.), 1984*]

2. Discuss the restrictions on the allotment of shares under the Companies Act. What is the effect of irregular allotment? [*C.A. (Final), Nov. 1975*]

3. What are the provisions of the Companies Act regarding allotment of shares? Discuss the effect of irregular allotment. [*Allahabad, B. Com. (Part II), 1978*]

4. Explain the consequences of a public limited company alloting its shares to the public even when the stock exchange had declined permission for the shares of the public company to be dealt with in that stock exchange as had been mentioned in the prospectus. [*C.A. (Final), Nov. 1978*]

5. What do you understand by irregular allotment? What is the effect of such an allotment? What are the rights of an allottee in such a situation? [*Delhi, B. Com. (Hons.), 1978*]

6. What are the conditions under which a company can be empowered to issue shares at a discount? [*Delhi, B. Com. (Hons.), 1990*]

7. (*a*) How is the amount of the premium on shares to be applied by a company?

(*b*) What are the conditions under which a company is empowered to issue shares at a discount? [*Agra, M. Com., 1976*]

8. Write short notes on the following:

(*a*) Share Certificate. [*Delhi, B. Com. (Hons.), 1973*]

(*b*) Share Warrant. [*Delhi, B. Com. (Hons.), 1974, 77*]

9. When can share warants be issued? What is the effect of the issue of share warrant? Can a private company issue it? [*I.C.W.A., June 1976*]

10. Distinguish between the following:

(*a*) Share and Stock.

(*b*) Share warrant and Dividend warrant. [*Delhi, B. Com. (Hons.), 1978*]

11. Diffferentiate between share certificate and share warrant.

[*Delhi, B. Com. (Hons.), 1985*]

12. What is meant by calls on shares of a joint stock company? What are the conditions of a valid call on shares? [*Poona, M. Com., 1975*]

13. How can the shares of a company be forfeited? What is the effect of forfeiture of shares? [*Delhi, B. Com. (Hons.), 1976*]

14. Distinguish between forfeiture and surrender of shares. State the essentials of a valid forfeiture.

15. "Surrender is short cut to process of forfeiture of shares." Discuss.

16. Write a short note on lien on shares. How does it differ from forfeiture of shares?

PRACTICAL PROBLEMS

1. A public company forfeited 100 shares, re-issued them, and thereby earned a surplus of Rs 2,500. The company did not file a Return of Allotment to the Registrar in respect of these shares. Has the company contravened any provision of the Companies Act? [*Delhi, B. Com. (Hons.), 1973*]

2. A company was heavily losing and its shares were partly paid-up. Harish,a member of the company, surrenders his ten shares to the company and the Board of Directors of the company accept the surrender. Is the surrender valid?

[*Delhi, B. Com., (Hons.), 1976*]

3. *A* buys 200 shares in a company from *B* on the faith of a share certificate issued by the company. *A* tenders to the company a transfer to himself from *B* 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 transfer. Advise *A*. Is he entitled to get the registration of transfer?

[*C.A. (Inter), May, 1974*]

4. The Secretary of a company issued a share certificate in favour of *R*, which apparently complied with the company's Articles as it purported to be signed by two Directors and the Secretary and it had the company's seal affixed to it. In fact, the Secretary had forged the signatures of the Directors and affixed the seal without authority. Is the certificate binding on the company? [*Delhi, M. Com., 1979*]

5. *A* lent money to a company on the security of 10,000 shares which were issued to him as fully paid. In fact, nothing had been paid on them. The company was wound up and *A* was placed on the list of contributories in respect of the whole amount of shares. Is the company right?

6. The directors of a public company passed a resolution to make a call. Subsequently, in transpired that one of the directors present at the meeting had not been validly appointed. Could the call be enforced?

[*Delhi, B. Com. (Hons.), 1973*]

7. A company had no money to pay directors' fees. The directors paid into the company's account the amount due on their shares and immediately thereafter withdrew the amount as their fees. Do the directors become free from their liability to pay on their shares?

8. The Memorandum of Association and the Articles of Association of a company were delivered to the Registrar on 10 June for registration. On 15 June the Registrar issued the Certificate of Incorporation but dated 10 June. The company made allotment of its share on 12 June. The allotment is challenged on the ground that it was made before the actual date of incorporation. Is the allotment of shares invalid? [*Delhi, B. Com. (Hons.), 1973*]

9. The directors of *B. Ltd.* made a call on the shareholders but the resolution for making the call was defective inasmuch as it did not mention the amount of the call or the time and place for its payment. On the failure of *M*, a shareholder, to pay the call, the directors subsequently discovered their mistake and rescind their previous resolution as to forfeiture. They then made a proper fresh call on the shareholder and on *M*'s failure to pay the call money, filed suit against him to recover the amount due. *M* contended that his shares having been already forfeited, he had ceased tobe a shareholder and was, therefore, not liable on the call made. How would you decide the suit? [*Delhi, B. Com. (Hons.), 1958*]

10. *A* paid the first two calls after a great delay and neglected to pay the third call and the directors, being annoyed, called upon him to pay the whole amount on his shares without making a similar call on other shareholders. Is the call valid?

11. Certain directors had taken shares merely to qualify themselves for appointment. They paid nothing on their shares. Later on when the company was in difficulties, they requested the company to forfeit and cancel their shares and this was done by the company. Is the above forfeiture valid?

12. A company offered debentures to the public at a discount of 20 per cent. Debenture holders were also given the right to get their debentures converted into shares. Is the above arrangement legal?

13. *S* agreed to take three hundred shares in a hotel company if the contract for alterations to the hotel was given to him. His offer was accepted and three hundred shares were allotted to him. However, such contract for the alterations was never made and the company went into liquidation. Can *S* be held liable as a contributory?

14. Shares were alloted to *X* on the condition that he would pay for them only when the company paid dividends. However the company went into liquidation before paying any dividend. Is *X* bound to pay for the shares?

9

SHARE CAPITAL

NATURE OF CAPITAL

IN simple words the term "capital" denotes a particular amount of money with which a business is started. In the case of a company, the term "share capital" referes to the amount of money reaised by the issue of shares. Under the Companies Act, the capital of a company refers to the following:

(1) **Nominal or registered capital.** This is the maximum amount which a company is authorised to raise by issue of shares and upon which it pays the stamp duty and registration fee. Either the full amount or a part of it can be issued for subscription and the balance can be issued whenever the need arises. The amount of registered capital is mentioned in the capital clause of the memorandum of the company along with the division thereof into shares of a fixed amount. This is also known as the company's authorised capital whose limit may not be exceeded, unless the authorised capital itself in increased.

(2) **Issued Capital.** Such part of the registered capital that is offered to the public for subscription is called the "issued capital" of the company. It may be noted that it is not obligatory for the company to issue the whole of the registered capital for subscription and it may offer only a part of the nominal capital, retaining the balance for future requirements.

(3) **Subscribed capital.** This refers to that part of the company's issued capital which has been take up or subscribed by the public. In the case of reputed companies with a lot of goodwill, the entire issued capital may be subscribed by the public, but in unsound companies the subscribed capital may be less than the issued capital.

(4) **Called-up capital.** Companies do not generally call the full amount of shares at once, only such amount as they need being called. "Called-up capital" therefore refers to that part of issued capital which has been called up.

(5) **Paid-up capital.** This is the amount that has actually been paid up

by shareholders or which is credited as paid up on the shares. Often, some shareholders fail to pay the calls made on them and the amount thus owing is known as "calls in arrears" or "calls unpaid."

(6) **Reserve capital.** Under Section 99, a limited company may, by a special resolution, determine that any portion of its share capital which has not been already called up shall not be capable of being called up except in the event and for the purposes of the company being wound up. Such uncalled capital is known as "reserve capital".

DEFINITION OF A SHARE

The capital of a company is divided into small parts and each part is known as a "share." Section 2(46) of the Companies Act, 1956 has defined a "share" as follows: "Share means share in the share capital of the company and includes stock, except when a distinction between stock and share is expressed or implied." The best description of a share is given in *Boreland Trustees v. Steel Bros. Co. Ltd.,*[1] in these words: "A share is the interest of a shareholder in the company measured by a sum of money for the purpose, of liability in the first place, and of interest in the second, but also consisting of a series of convenants entered into by all the shareholders *inter se.*" A share has also been defined as an interest measured by a sum of money and made of various rights contained in the articles of association.[2] In another case it has been held that a share is merely a bundle of rights and obligation which are regulated by the articles.[3] The holder of a share has a right to participate in the profits made by a company while it is a going concern and in the assets of the company when it is wound up.[4]

Nature of share. The shares of any member in a company are movable property and they can be transferred in the manner provided in the articles of the company(Sec. 82). The term"goods" as defined under Section 2(7) of the Sale of Goods Act includes shares also. But it is important to note that shares are not ordinary but a peculiar kind of movable property or goods. The shares cannot be transferred by mere delivery like ordinary goods. The property in shares belongs to the registered shareholder and it cannot be transferred to another person except according to the articles of the company which may place certain restrictions in this respect.

[1](1901) 1 Ch. 297.

[2]*Commissioner of Income Tax v. Standard Vacuum Oil Co. Ltd.,* A.I.R. (1966) S.C. 1393.

[3]*Vishwanathan v. East India Distilleries* (1857) 27 Comp. Cas. 175.

[4]*Bacha F. Guzdar v. Commissioner of Income Tax, Bombay* (1955) S.C. 74.

Numbering of shares. The shares must be numbered so as to distinguish them from one another. (Sec.83)

KINDS OF SHARES

Before the Companies Act, 1956 was passed, a company could issue three types of shares: (a) equity shares; (b) preference shares; and (c) deferred shares. But the Companies Act, 1956 now permits only two types of shares to be issued. Section 86 clearly provides that a company limited by shares can issue only two types of shares, namely (a) equity shares and (b) preference shares. However, a private company (not being a subsidiary of a public company) is exempted from the provisions of Section 86. This means that an independent private company may issue shares other than equity and preference shares, while a public company is prohibited to issue shares other than equity and preference shares. (Sec. 90)

Preference Shares

Preference shares have the following characteristics: (a) the dividend on them is fixed by the articles of the company: (b) preference shareholders will get their fixed rate of dividend before any dividend is distributed among the other class of shareholders. They will have the first charge on the distributable amount of annual net profits: and (c) at the time of winding up the company these shareholders must be paid back their capital before anything is paid to ordinary shareholders. Thus it can be said that preference shares enjoy preferential rights both with respect to repayment of capital on winding up the company and with respect to payment of dividends.

Kinds of Preference Shares

Cumulative and non-cumulative preference shares. Preference shares may be cumulative and non-cumulative. In the former, if in any year the profits are not enough, their right to dividend does not lapse but is carried over and continues accumulatig and the same may be claimed from the divisible profits of next year. In the latter, if no profits are available for distribution as dividend in a particular year, holders of those shares receive nothing and cannot claim the unpaid dividend in subsequent years either.

One can learn from the terms of issue of shares or provisions in the articles whether the preference shares are cumulative or non-cumulative. All preference shares are presumed to be cumulative in the absence of a clear provision to the contary. In *Foster v. Coles, Foster and Sons Ltd.,*[5] the

[5](1906) 22 T.L.R. 555.

articles of the company provided for cumulative preferential dividend for preference shares. The company altered its articles and the word "cumulative" before "preference" was dropped. This was done obviously with the intention of converting the cumulative preference shares into non-cumulative preference shares. But still the shares were held to be cumulative as there was no clear provision to the contrary.

However, preference share may be made non-cumulative by inserting a clear provision to this effect in the articles of the company. As for example, in *Staples v. Eastman Photographic Material Co.,* [6] the articles of the company provided that the holders of preference shares shall be entitled out of the net profit of each year to a preference divided at the rate of ten per cent per annun. The shares were held to be non-cumulative as the provision in the articles clearly prevented payment of arrears of dividend out of the profits of subsequent years. The provision meant that the profits of each year only were to be paid in that way.

Participating and non-participating preference shares. In participating preference shares, shareholders carry a fixed rate of dividend in priority to ordinary shares and further, the right to participate in the balance of profits in an agreed proportion along with ordinary shareholders whose claims are first met on reasonable grounds. Thus it can be said that in these shares they have two kinds of dividends-one fixed and the other changing, depending on the magnitude of excess profits. It is necessary that there be a special provision in the articles giving powers to such shareholders to participate in surplus profits. In the case of non-participating shares, they are entitled only to the fixed rate of dividend in preference to any other class of shares and no claim exists in surplus profits which will belong to ordinary shareholders. It may be noted that in the absence of any specific right to participate in the surplus profits, preference shares are presumed to be non-participating.

Further on winding up the company, if the preference shareholders are entitled to participate in the distribution of surplus assets found after paying both the preference and equity shareholders they will be known as participating preference shares. But the preference shareholders have no right to participate in the surplus in the winding up unless they have been given such a right by a clear provision in the memorandum or articles of the company. There cannot be any presumption that they have the right to participate.[7]

It may also be noted here that the right to participate in the surplus profits does not automatically entitle the preference shareholders to

[6](1896) 2 Ch. 303.

[7]*Scottish Insurance Co. Ltd. v. Wilson and Clycde Coal Co. Ltd.* (1949) A.C. 462.

participate in the surplus assets on the winding up of the company.[8]

Convertible and non-convertible preference shares. When the holders of preference shares are given a right to get their shares converted into equity shares within a certain period, the preference shares are known as convertible preference shares. In case of non-convertible preference shares, the holders are not given the right to convert their shares into equity shares. Unless the articles or terms of issue provide otherwise, all preference shares are deemed to be non-convertible.

Redeemable preference shares. Generally, the capital that is raised by issue of shares has to be returned by the company only on its winding up. But under section 80, a company limited by shares may, if authorised by its articles, issue redeemable preference shares. In case of such shares, capital has to be returned during the life-time of the company as per terms of issue of such shares, or whenever the company so chooses after giving notice. Paying back of capital is known as redemption. Section 80(5A), amended by the Companies (Amendment) Act of 1996, provides that no company can now issue preference shares which are redeemable after the expiry of a period of 20 years from the date of issue.

Conditions. The following conditions must be complied with in relation to the issue and redemption of such shares:

(i) The articles must authorise the issue of such shares.

(ii) No such shares shall be redeemed except out of the profits of the company which would otherwise be available for dividend, or out of proceeds of a fresh issue of shares made for the purpose of redemption.

(iii) No such shares shall be redeemed unless they are fully paid up.

(iv) The premium, if any, payable on redemption shall be provided for out of the profits of the company or out of the company's share premium account.

(v) If such shares are redeemed from the profits of the company, the company shall create a reserve fund to be called "Capital Redemption Reserve Account" out of its divisible profits which should be equal to the nominal value of shares so redeemed.

(vi) The redemption shall be according to the terms and conditions of the articles of the company and provisions of the Act.

(vii) The redemption of preference shares shall not be taken as reduction of the company's authorised share capital.

(viii) The company shall have power to issue shares up to the nominal amount of the shares redeemed as if those shares had never been issued.

(ix) The Capital Redemption Reserve Account may be applied by the company in paying up its unissued shares to be issued to members of the

[8] *Re Isle of Thanet Electric Supply Co.*, (1949) 2 All. E.R. 1060.

company as fully paid bonus shares.

Notice of redemption. Under Section 95, notice of redemption must be sent to the Registrar within one month of the date of redemption.

Irredeemable preference shares. In the case of irredeemable preference shares the capital is to be returned on the winding up of the company. After the commencement of the Companies (Amendment) Act, 1988, no company can issue any preference shares which are irredeemable. [Sec. 80(5A)]

Redemption of existing irredeemable preference shares, etc. Section 80-A, inserted by the Companies (Amendment) Act, 1988, provides that all existing irredeemable preference shares shall be redeemed within a period of five years from the commencement of the Amendment Act of 1988, i.e., 15 th June, 1988. It further provides that all existing preference shares redeemable after ten years from the date of issue shall be redeemed within ten years from the date of commencement of the Amendment Act of 1988, unless the same are due for redemption earlier.

Where a company is not in a position to redeem any such shares within the aforesaid period, it may, with the approval of the Company Law Board, issue further redeemable preference shares of an equal amount and thereupon the unredeemed preference shares shall be deemed to have been redeemed by operation of law.

Ordinary or Equity Shares

All shares other than preference shares will be ordinary or equity shares. The holders of these shares are entitled to dividend from the net profits of the company after the fixed dividend on preference shares has been paid up. If, after paying the dividend on preference shares, no profits remain, equity shareholders will receive no dividends. Similarly, at the time of winding up the company equity shareholders will get back their capital only after the capital of preference shareholders has been paid back. Unlike preference shares, equity shares do not have a fixed rate of dividend. The dividend to equity shareholders will change with the magnitude of available profits for distribution in the form of dividends. However, equity shareholders have normal voting rights. At the same time equity shares are always irredeemable. A major portion of the authorised capital of a company is usually in the form of equity shares.

Deferred Shares

These shares are also known as founders' shares or management shares because they are issued mainly to the promoters or founders of the company in consideration of the services rendered by them in forming the company. In the case of deferred shares the right to participate in the

distributable amount of the net profits of a company arises only after all other classes of shares have received their shares according to the terms of the articles. These shares carry extraordinary voting rights through their face value is generally very low. Under the Companies Act, 1956, these shares cannot be issued by either a public company, a companby deemed to be a public company or a subsidiary private company. Independent private companies may still issue such shares.

VOTING RIGHTS

Under the 1913 Act, a company with a share capital could issue different classes of shares conferring different rights as to dividends, voting, return of capital on winding up and rights to receive notices and attendance at meetings. The present Act of 1956 has made revolutionary changes in the scheme of the capital structure of companies. Section 86 clearly provides that a company limited by shares can issue only two types of shares, namely, (a) equity shares, and (b) preference shares. The voting rights both in respect of equity shares and preference shares are governed by Sections 87 to 89 of the Act.

Voting rights of equity shareholders. Every equity shareholder of a company will have the right to vote on every resolution placed before the company. His voting rights on a poll will be in proportion to his share of the paid-up equity capital of the company. [Sec. 87(1)]

Voting rights of preference shareholders. A preference shareholder of a company will have the right to vote on resoultions which directly affect his rights. Any resolution for winding up the company or for repayment or reduction of share capital will be deemed to affect the rights attached to preference shares. However, a preference shareholder is also entitled to vote on every resolution before the company at any meeting if dividend has not been paid in the case of cumulative preference shares for an aggregate period of not less than two years preceding the commencement of the meeting. In the case of non-cumulative preference shares, they will have a right to vote on all resolutions if their dividends remained unpaid for two financial years immediately preceding the meeting or for any three years during a period of six years ending with the financial year preceding the meeting. The voting rights of preference shareholders will be in proportion to the paid-up value of preference capital to the total paid-up equity capital of the company. It can be seen that the total paid-up capital (equity) is the basis for determining the voting rights of equity shareholders and preference shareholders. [Sec. 87(2)]

Section 87 thus removes inequality in voting rights not only between members holding equity capital *inter se* but also as between equity

shareholders and preference shareholders.[9]

Prohibition of issue of shares with disproportionate rights. Section 88 further provides that no company shall issue any shares (not being preference share) which carry voting rights or rights in the company as to dividend, capital or otherwise, which are disproportionate to the rights attaching to holders of other shares(not being preference shares). In other words, the section prohibits the issue of shares with disproportionate rights not only as regards voting rights but also as regards dividend or capital. Obviously this prohibition does not apply to preference shares which may carry different rights as to dividend, capital or otherwise depending upon the terms of issue of such shares. However, the voting rights granted to preference shares must conform to the provisions of Section 87 as already stated.

Exception. The rules regarding voting rights stated above, do not apply to a private company unless it is a subsidiary of a public company. (Sec. 90)

Restrictions on exercise of voting rights. The articles of a company may provide that a member shall not exercise any voting right in respect of any shares on which any calls or other sums presently payable by him have not been paid, or where the company has exercised the right of lien on his shares. (Sec. 181)

Any other restrictions on the right of voting of a member will be void even though such provisions are contained in articles of association. (Sec. 182)

ALTERATION OF CAPITAL CLAUSE

Alteration in the capital clause of the memorandum may be of the following types:

(1) Alteration of share capital. (Sections 94-97)
(2) Reduction of capital. (Sections 100-105)
(3) Reserve share capital or reserve liability. (Sec. 99)
(4) Variation of the rights of shareholders. (Sections 106-107)
(5) Reorganisation of capital. (Sections 390-391)

These alterations are discussed below:

(1) **Alteration of share capital.** A limited company with share capital can, if permitted by its articles of association, alter the capital clause of its memorandum in any of the following ways:

(i) it may increase its share capital by issue of new shares;
(ii) it may consolidate and divide all or part of its share capital into

[9] *Jeevan Singhji v. Balbhadra Singhji* A.I.R. (1963) Guj. 209.

shares of larger amount;

(iii) it may convert all or any of its fully paid up shares into stock or reconvert that stock into fully paid up shares;

(iv) it may subdivide the existing shares into shares of lower denomination; and

(v) it may cancel those shares which have not been taken up and reduce its capital accordingly. [Sec. 94 (1)]

Cancellation of shares under this section [Item (v) above] is not deemed to be reduction of share capital. [Sec. 94 (3)]

Ordinary resolution required. Alteration can be affected in the capital clause in any of the above ways by passing an ordinary resolution in the general meeting. Confirmation of the court is not required. [Sec. 94 (2)]

Notice to Registrar. The company shall give notice of the above alterations to the Registrar within thirty days of doing so, and he will record the same and make necessary alterations in the company's memorandum and articles. If a default is made in complying with the above provisions, the company and every officer of the company who is in default is punishable with a fine which may extend to fifty rupees for every day the default continues. (Sec. 95)

Where a company has converted any of its shares into stock, such provisions of the Act as are applicable only to shares shall cease to apply to such shares which have been converted into stock. (Sec. 96)

Similarly under Section 97, the Registrar must be informed if the company has increased its authorised capital, or in the case of company not limited by shares, if the number of members has been increased beyond the registered number. Notice of the increase must given to the registrar even when the new shares may not have been issued to any shareholder.[10]

(2) **Reduction of Capital.** The issued capital reprsents a fund available to meet the debts and obligations of the company. Companies do not generally calle the full value of shares at one time. The uncalled capital acts as a future security for the compan's creditors. Therefore any reduction of capital, called up or uncalled, reduces the security of the creditors. It is for exactly these reasons that a company is not allowed to buy its own shares as this would amount to reduction of capital. Similarly there are a number of restrictions on the powr of the company to forfeit shares or to accept surrender of shares, as this would also reduce its capital. Thus all safeguards have been provided for in the Companies Act to conserve the capital of a company.

Modes of reduction of capital. It is thus clear from the above

[10]*Mahalaxmi Mills Co. Ltd. v. State* (1969) Comp. Cas. 347.

discussion that conservation of the capital is one of the fundamental priciples of company law. However in genuine cases, a company limited by shares or a guarantee company with a share capital is premitted to reduce its capital by Section 100 in any of the following ways:

(i) by extinguishing or reducing the liability on any of its shares in respect of share capital not paid up;

(ii) by cancelling any paid up capital which is lost or unrepresented by available assets;

(iii) by paying off any paid up capital which is in excess of the wants of the company; and

(iv) by any other method approved by the court.

Procedure for reducing share capital. The procedure for effecting reduction of capital is given below:

(i) *Authorised by articles.* Reduction of capital cannot be affected unless it is authorised by the company's articles. However, if the articles do not give this power to the company, they may be altered by special resolution to enable the company to reduce its share capital. [Sec. 100 (1)]

In this connection it is important to note that the authority to reduce capital must be in the articles. Where this authority is contained in the memorandum only, it is of no avail.[11]

(ii) *Special resolution.* The company must pass a special resolution for reduction of capital. [Sec. 100 (2)]

(iii) *Confirmation by court.* The company must apply to the court for an order confirmation the reduction. The court must look after the interests of creditor and shareholders.

Interest of creditors. It may be noted that creditors are entitled to object if the reduction of share capital involves (a) reduction of liability in respect of uncalled capital or (b) payment to any shareholder of any paid up capital and(c) in any other case if the court so directs. However, if reduction of capital does not involve reduction of liability in respect of uncalled capital or payment to any shareholder of any paid up capital, creditors are not entitled to object as their rights are not affected. Again, only such creditors are entitled to object, to whom the company owes a debt which would have been provable in the winding up of the company.

The court should settle a list of creditors who are entitled to object to the reduction of share capital and it may dispense with the consent of the dissentient creditors provided that their debts are paid off or secured to the satisfaction of the court.

Interest of shareholders. The court must also look after the interst of shareholders before sanctioning a scheme of reduction of capital. It is the

[11]*Re Daxine Patent Packing and Rubber Co.,* (1903) W.N. 82.

duty of the court to see that the scheme for reduction of capital is fair and equitable to all kinds of shareholders, considering the circumstances of each individual case. (Sec. 101)

The court may make an order confirming the reduction of capital on such terms and conditions as it thinks fit, if it is satisfied that every creditor of the company entitled to object has consented to the reduction or that his debt has been discharged or secured by the company. The court may also order the company to add the words "and reduced" to the name of the company for such period as may be specified in the order, and these words will be deemed to be part of the company's name for such specified time. The court may also order the company to publish reasons for reduction and all other information in regard thereto for public information. (Sec. 102)

(iv) *Registration of order of court with the Registrar.* The order of the court confirming the reduction must be produced before the Registrar and a certified copy of the order and of the minutes of reduction should be filed with him for registration. On such registration by the Registrar, the resolution for reduction of share capital as confirmed by the order of the court takes effect. Notice of the registration shall be published in such manner as the court may direct. the Registrar shall certify registration of the order and minutes in hand. His certificate is conclusive evidence that all the requirements of the Act with regard to reduction of share capital have been complied with and that the share capial is such as is stated in the minutes. (Sec. 103)

Liability of members in respect of reduced shares. Section 104 provides for liability of the members in respect of reduced shares. A member shall be liable to pay the amount deemed to have been unpaid on his shares, which would be equal to the amount deemed to have been paid up on his shares and the reduced value of shares as fixed by the minutes of reduction. However, in one case the members may be made liable to pay the original nominal value of shares. This will happen when a creditor entitled to object to the reduction has been left out of the list of such creditors by reason of his ignorance of the proceedings, and the company is unable to pay the amount of his debt. In these circumstances the court may order the members to pay upto the original nominal value of the shares held by them.

Moreover, officers of the company, who cancel the name of any creditor entitled to object, are punishable with imprisonment upto one year or with fine or with both. (Sec. 105)

(3) **Reserve share capital or reserve liability.** Section 99 provides that by passing a special resolution, a company may determine that any portion of its share capital which has not already been called up shall not

be capable of being called up except in the event of the company's winding up. Such uncalled capital is called reserve share capital. Once this is created, its character cannot be changed, i.e., it cannot be called up except in winding up. This reserve share capital is intended to be a protection for the creditors in the event of the winding up of the company.

It cannot be dealt with in any manner under a power in its memorandum or articles nor can it be converted or changed into ordinary capital without the permission of the court.[12] A company cannot charge the reserve capital for raising a loan.

(4) **Variation of the rights of shareholders.** The share capital of a company is divided into different classes of shares which may have different rights attached to them, generally provided for in the articles. If the company intends to change the rights of any class of shareholders, the following procedure has to be followed:

(i) *Variation not prohibited.* There should be provision in the memorandum or articles with respect to variation of the rights of shareholders or, in the absence of any such provision, there should be nothing in the terms of issue of the shares of that class which prohibits such a variation.

(ii) *Special resolution.* The written consent of the holders of not less than three-fourths of the issued shares of that class should be obtained or the variation should be sanctioned by special resolution at a separate meeting of the holders of shares of that class. (Sec. 106)

Variation may be challenged before court. Where the rights of shareholders have been varied in pursuance of the above provisions, those who did not consent, or vote in favour of the resolution for the variation may apply to the court to have the variation cancelled. Such application can be made only by persons who held at least ten per cent of the issued shares of that class. The application shall be made to the court within twenty-one days of the date on which the consent was given or the resolution passed.

Court's powers. If the court, after hearing the applicant and any other person interested in the application, is satisfied that the variation would unfairly prejudice the shareholders of the class represented by the applicant, it may disallow the variation. But if the variation appears to be fair, it will confirm the variation. The decision of the court on any such application shall be final.

Registration of court's order with the Registrar. The company shall send a copy of the court's order to the Registrar within thirty days. If default

[12] *Bartlett v. Mayfair Property Co.* (1898) 2 Ch. 28.

duty of the court to see that the scheme for reduction of capital is fair and equitable to all kinds of shareholders, considering the circumstances of each individual case. (Sec. 101)

The court may make an order confirming the reduction of capital on such terms and conditions as it thinks fit, if it is satisfied that every creditor of the company entitled to object has consented to the reduction or that his debt has been discharged or secured by the company. The court may also order the company to add the words "and reduced" to the name of the company for such period as may be specified in the order, and these words will be deemed to be part of the company's name for such specified time. The court may also order the company to publish reasons for reduction and all other information in regard thereto for public information. (Sec. 102)

(iv) *Registration of order of court with the Registrar.* The order of the court confirming the reduction must be produced before the Registrar and a certified copy of the order and of the minutes of reduction should be filed with him for registration. On such registration by the Registrar, the resolution for reduction of share capital as confirmed by the order of the court takes effect. Notice of the registration shall be published in such manner as the court may direct. the Registrar shall certify registration of the order and minutes in hand. His certificate is conclusive evidence that all the requirements of the Act with regard to reduction of share capital have been complied with and that the share capial is such as is stated in the minutes. (Sec. 103)

Liability of members in respect of reduced shares. Section 104 provides for liability of the members in respect of reduced shares. A member shall be liable to pay the amount deemed to have been unpaid on his shares, which would be equal to the amount deemed to have been paid up on his shares and the reduced value of shares as fixed by the minutes of reduction. However, in one case the members may be madė liable to pay the original nominal value of shares. This will happen when a creditor entitled to object to the reduction has been left out of the list of such creditors by reason of his ignorance of the proceedings, and the company is unable to pay the amount of his debt. In these circumstances the court may order the members to pay upto the original nominal value of the shares held by them.

Moreover, officers of the company, who cancel the name of any creditor entitled to object, are punishable with imprisonment upto one year or with fine or with both. (Sec. 105)

(3) **Reserve share capital or reserve liability.** Section 99 provides that by passing a special resolution, a company may determine that any portion of its share capital which has not already been called up shall not

allotment of shares:

(i) *Offer to the existing shareholders.* Such shares shall be offered to the existing holders of equity shares of the company in proportion to the capital paid up on those shares.

(ii) *Offer to be made by notice.* The offer shall be made by notice specifying the number of shares offered and the time within which it should be accepted. Such time shall not be less than fifteen days from the date of the offer. The notice must also state that if the offer is not accepted within the specified time, it will be deemed to have been declined.

(iii) *Shareholder's right of renunciation.* Unless the articles otherwise provide, the offer shall be deemed to include a right to renounce all or any of the shares in favour of any other person and the notice must contain a statement of the right.

(iv) *Director's powers in case of shareholder's refusal.* After the expirty of the time specified in the notice or on receipt of earlier notice from the person declining to accept the shares, the board of directors may dispose of them in such manner as they think most beneficial to the company.

(v) *Offier of further shares to outsiders.* Further shares may be offered to outsiders to the total exclusion of the existing shareholders (a) if a special resolution to that effect is passed by the company in general meeting or (b) if an ordinary resolution is passed to that effect and the Central Government is satisfied on an application made by the board of directors in this behalf that the proposal is most beneficial to the company.

(vi) *Exceptions.* These provisions do not apply (a) to a private company or (b) to the increase of the subscribed capital of a public company caused by the exercise of an option attached to debentures or loans raised by the company to convert such debentures or loans into share of the company or to subscribe for shares in the company. The terms of issue of such debentures or loans must provide for the option to convert such debentures or loans into share of the company. Again, such terms must either have been approved by the Central Government or be in conformity with rules made by the Central Government. It is also necessary that the terms should have been approved by a special resolution of the company except when the loan is from the Government or any other institution specified by it.

Purchase by a Company of its Own Shares

Buy-back of shares. Prior to the Companies (Amendment) Act, 1999, companies were not permitted to purchase their own shares unless the consequent reduction of capital was effected and sanctioned in pursuance of Sections 100 to 104 or Section 402 (Sec. 77). Section 77-A, introduced by the

is made a fine of upto fifty rupees may be imposed. (Sec. 107)

It should be noted that variation which may affected the enjoyment of a right without modifying the right itself does not amount to a variation within the meaining of this section.[13] Similarly, a proposed issue of new preference and ordinary capital to the ordinary stock-holders does not affect the rights or privileges of the existing preference stock-holders though, in fact, it lessens the latters' voting power.[14]

(5) **Reorgination of capital.** A company may also reorganise its share capital by the consolidation of shares of different classes, or by division of shares into different classes, or by both these methods. [Sec. 390 (b)]

Where a reorganisation of share capital is proposed: (a) between a company and its creditors or any class of them; or (b) between a company and its members or any class of them, the court may order a meeting of creditors or members of the company on an applciation by the company or by any creditor or member of the company or by a liquidator (in case the company is being wound up). The reorganisation of capital shall be binding if the scheme is approved by a majority in number representing three-fourths in value of creditors or members, who are present and voting in person or proxy. The scheme should also be sanctioned by the court. (Sec. 391)

Further Issue of Capital-Rights Issue

Section 81 lays down the procedure for further issue of shares after the first issue so as not to disturbe the established equilibrium of share-holding in the company. This section shall apply whenever the directors wish to increase the subscribed capital within the limit of the authorised capital by allotment of further shares after one year of the first allotment of shares or after two years from the formation of the company, whichever is earlier. It is required that such further shares shall be offered to the existing equity shareholders in proportion to the capital paid up on these shares. Such shares are called "right shares." Thus Section 81 gives pre-emptive rights to the holders of equity shares in case of further issue of shares.

The object of this section is to prevent discrimination amongst shareholders and ensure an equitable distribution of shares. It is also intended that the holding of shares by each shareholder is not affected by the issue of new shares.[15]

Section 81 lays down the following conditions in regard to further

[13] *In ré Hindustan General Electric Corporation* A.I.R. (1959) Cal. 672.

[14] *White v. Bristol Aeroplane Co. Ltd.,* (1953) 1 All E.R. 40.

[15] *Nanalal Zaver v. The Bombay Life Ass. Co.* A.I.R. (1949), Bom. 56.

allotment of shares:

(i) *Offer to the existing shareholders.* Such shares shall be offered to the existing holders of equity shares of the company in proportion to the capital paid up on those shares.

(ii) *Offer to be made by notice.* The offer shall be made by notice specifying the number of shares offered and the time within which it should be accepted. Such time shall not be less than fifteen days from the date of the offer. The notice must also state that if the offer is not accepted within the specified time, it will be deemed to have been declined.

(iii) *Shareholder's right of renunciation.* Unless the articles otherwise provide, the offer shall be deemed to include a right to renounce all or any of the shares in favour of any other person and the notice must contain a statement of the right.

(iv) *Director's powers in case of shareholder's refusal.* After the expirty of the time specified in the notice or on receipt of earlier notice from the person declining to accept the shares, the board of directors may dispose of them in such manner as they think most beneficial to the company.

(v) *Offier of further shares to outsiders.* Further shares may be offered to outsiders to the total exclusion of the existing shareholders (a) if a special resolution to that effect is passed by the company in general meeting or (b) if an ordinary resolution is passed to that effect and the Central Government is satisfied on an application made by the board of directors in this behalf that the proposal is most beneficial to the company.

(vi) *Exceptions.* These provisions do not apply (a) to a private company or (b) to the increase of the subscribed capital of a public company caused by the exercise of an option attached to debentures or loans raised by the company to convert such debentures or loans into share of the company or to subscribe for shares in the company. The terms of issue of such debentures or loans must provide for the option to convert such debentures or loans into share of the company. Again, such terms must either have been approved by the Central Government or be in conformity with rules made by the Central Government. It is also necessary that the terms should have been approved by a special resolution of the company except when the loan is from the Government or any other institution specified by it.

Purchase by a Company of its Own Shares

Buy-back of shares. Prior to the Companies (Amendment) Act, 1999, companies were not permitted to purchase their own shares unless the consequent reduction of capital was effected and sanctioned in pursuance of Sections 100 to 104 or Section 402 (Sec. 77). Section 77-A, introduced by the

Companies (Amendment) Act, 1999 permits a company to purchase its own shares under a buy-back scheme out of: (i) its free reserves; or (ii) securities premium account; or (iii) the proceeds of an earlier issue. This is subject to the following conditions:

1. The buy back is authorised by the articles of the company.

2. A special resolution is passed in general meeting of the company authorising the buy-back.

3. The amount involved in the buy-back shall not exceed twenty-five per cent of the total paid-up capital and free reserves of the company. Provided further that the buy-back of equity shares in any financial year shall not exceed twenty-five of its total paid-up equity capital in that financial year.

4. The ratio of the debt owed by the company is not more than twice the capital and its free reserves after such buy-back.

5. All the shares to be bought-back are fully paid-up.

6. The buy-back of the shares listed on any recognised stock exchange should be in accordance with the regulations made by SEBI. In case of non-listed shares, the buy-back should be in accordance with guidelines as may be prescribed.

7. Every buy-back shall be completed within twelve months from the date of the special resolution.

8. A declaration of solvency shall be filed by the company with the Registrar and SEBI.

9. The shares bought-back shall be extinguished and destroyed physically within seven days of the last date of completion of buy-back.

10. Where a company buys-back it shares, it shall not make further issue of the same kind (including rights issue) within a period of twenty-four months except by way of bonus issue or in the discharge of subsisting obligations.

11. The company shall maintain a register containing the particulars of securities bought-back.

12. The company shall file a return with the Registrar and SEBI within thirty days of the completion of the process of buy-back. The return has to contain the prescribed particulars. (Sec. 77-A)

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 its details shall be disclosed in the balance-sheet. (Sec. 77-AA)

The buy-back process shall not be done through any subsidiary company including its own subsidiary companies or through any investment company or group of investment companies. A company shall not be allowed to buy-back if it is in default in repayment of deposits, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest thereon to any financial institution or bank. (Sec. 77-B)

Financial assistance for purchase of its own shares. No public company or its subsidiary private company can give financial assistance in any form to any person for the purchase of its own shares or the shares of its holding company subject to the following exceptions:

(i) The lending of money by a banking company in the ordinary course of its business.

But this exception does not empower a banking company to grant loans deliberately for the purpose of financing purchase of its own shares.[16]

(ii) The provision of money by a company for the purchase of fully paid shares in the company by trustees for and on behalf of the employees of the company.

(iii) The making of loans by a company to its employees (other than directors or managers) to enable them to buy fully paid shares in the company and to hold them by way of beneficial ownership. The amount of loan to any employee cannot exceed six months' salary as it stands at that time. (Sec. 77)

However, a loan or financial assistance extended in contravention of this section is valid and enforceable[17] and so is the purchase of shares with such financial assistance.[18]

Conversion of Loans into Shares

The Companies (Amendment) Act, 1963, has empowered the Central Government to direct the conversion of its loans or debentures to the companies into equity share capital. For this purpose the order will be made by the Central Government on such terms and conditions as appear to the Government to be reasonable. In issuing any such order, the public interest will be the guiding factor. [Sec. 81 (4) to (7)]

QUESTIONS

1. (a) Explain the difference between the nominal, subscribed and paid-up capital of company.

(b) State the circumstances in which and the conditions under which, further issue of capital may be made a company.

[Company Secretary (Final), April 1976]

2. (a) Define the term 'share'. How does a preference share differ from an ordinary share?

(b) Describe the various kinds of preference shares.

[Poona, B.Com. (Part I), 1969]

3. State the provisions of the Companies Act as regards voting rights attached to different kinds of shares.

4. Explain the different ways in which a company can alter its capital. Also state

[16] *Lonis Steen v. Charles Allen Law* (1964) 1 Comp. L. J. 157.

[17] *Victor Battery Co. v. Curry* (1946) 1 All. E.R. 518.

[18] *Unity Co. (Pvt.) Ltd. v. Diamong Sugar Mills Ltd.*, A.I.R. (1971) Cal. 18.

the procedure to be followed in respect of each of them.

5. What is meant by class rights? State the conditions to be fulfilled for variation of class-rights under the Companies Act, 1956. *[I.C.W.A., June 1976]*

6. (a) Can a public company buy its own shares or provide financial help for the purchase of its shares?

(b) How can the share capital of a company be reduced?

[Delhi, B.Com. (Hons.), 1973]

7. "A company can offer new shares to outsiders before offering them to the existing shareholders." Comment. *[Delh, B.Com. (Hons.), 1975]*

8. Can new shares be offered by a company to outsiders without offering the same first to the existing shareholders? If so, please state the circumstance under which it can be done. *[C.A. (Inter), May 1977]*

9. What do you understand by right of pre-emption or issue of right shares? State the provisions of the Act in relation to further issue of shares.

10. Write short notes on the following:

(a) Right shares

(b) Reserve capital

[Delhi B.Com. (Hons.), 1986]

11. What are the provisions of law regarding the issue and redemption of redeemable preference shares?

PRACTICAL PROBLEMS

1. (a) A public limited company has two classes of shares, namely, ordinary share and 9 per cent non-cumulative preference shares. It wishes to change it rights regarding the preference shares. There is no provision in the articles or memorandum regarding such variation. Advise the company.

(b) If the holders of 15 per cent of preference shares are opposed to this, what should they do? *[C.A., Nov. 1972]*

2. There was a labour dispute in a factory owned by a public limited company. In order to settle it, the directors of the company decided to offer 5,000 shares of Rs. 10 each to the employees of the company for subscription and alloted as fully paid-up shares. The amount due on shares was to be collected from them in 10 equal instalments. Examine the validity of the scheme.

[I.C.W.A., June 1976]

3. The articles of a company provided for "cumulative preferential dividend" for preference shares. The company altered its articles and the word "cumulative" before "preference" was dropped, so as to convert the cumulative preference shares into non-cumulative preference shares. Does the above change affect the rights of the preference shareholders?

4. The articles of a company contained a clause like this: "The holders of preference shares shall be entiteled out of the net profits of each year to a preference dividend at the rate of ten per cent per annum." Due to losses, the company could not pay dividend to its preference shareholders in 1977 and 1978. Can the preference shareholders compel the directors to pay the dividend of 1977 and 1978 out of the huge profits made by the company in 1979?

5. A company, having lost nearly the whole of capital, proposed a scheme of reduction of capital. Under the scheme, the preference shareholders had to forego their arrears of accumulated dividend and seventy per cent of their capital and the equity shareholders had to forego eighty per cent of their capital. The scheme was approved by the required majority at separate meetings of both the equity and preference shareholders. Some preference shareholders subsequently challenged the scheme contending that *prima facie* the whole of the capital paid up on the equity shares should be cancelled before any part of the capital paid-up on preference shares is cancelled. How would the court decide?

6. A company declared Rs 5 out of each Rs 10 share as reserve capital by passing a special resolution. Thereafter, debentures were issued charging the said reserve capital. Is the charge on reserve capital valid?