

BASIC UNDERSTANDING ABOUT COMPANIES

Compulsory registration under the Companies Act

Pursuant to section 11(2) of the Companies Act, 1956, where more than twenty persons jointly desire to carry on any business (Ten person in case of banking company) with the object of acquisition of gain, they can go about to pursue that objective only if they form a company and get it registered under the provisions of the Act.

What is a company?

Company is a voluntary association of persons formed for the purpose of doing business having a distinct name and limited liability. It is a juristic person having a separate legal entity distinct from the members who constitute it, capable of rights and duties of its own and endowed with the potential of perpetual succession.

As per definition given by Companies Act, 1956, a 'company' includes company formed and registered under the Act or an existing company *i.e.* a company formed or registered under any of the previous company laws.

Advantages or features of a company

- (i) A company is a legal entity, distinct and independent of those persons who from time to time are its members.
- (ii) The liability of the company's members can be limited to the extent they have agreed to contribute towards the capital of the company with reference to the number of shares and/or the amount of guarantee respectively undertaken by them.
- (iii) Its members are not personally liable for any act or omission on the part of the company, unless the law expressly provides otherwise.
- (iv) The company being a juristic person, distinct from the members constituting it, can acquire, own, enjoy and alienate property in its own name.
- (v) The company being a legal entity can sue and also be sued in its own name.
- (vi) The continuity of the company is not effected by the death or disability of any of its members. This feature is referred to as "perpetual succession".
- (vii) Transfer of member's interest in the company can be readily attained without in any way adversely affecting its property, business, or existence.
- (viii) The members of the company equitably share the profit by way of dividend and the company's assets in the event of its winding up in proportion of its capital respectively contributed by them.

- (ix) Incorporation of company provides better borrowing facilities as the company can raise large amount, on comparatively easier terms. Even banking and financial institutions prefer to render financial assistance to incorporated companies.
- (x) Once the company is brought into existence on its incorporation, it can only be dissolved with the provisions of the law.

Disadvantages of a company form of organisation

- (i) Unlimited liability: It is pertinent to note that while the members' liability is limited, the company itself is fully liable for its debts and thus has unlimited liability.
- (ii) Personal liability of directors and members arises in following cases:
 - (a) when the number of members of a private company is reduced below two and in case of a public company reduced below seven and the company continues to carry on business for more than 6 months, every person who is a member of the company and has knowledge of the fact, shall be severally liable for the debts contracted during that time;
 - (b) when in any act or contract, the name of the company has been mis-described, those who have actually done the act or made the contract, shall be personally liable for it;
 - (c) holding and subsidiary companies are generally viewed as independent entities. However, this independence is reduced to a certain extent when such companies are required to present accounts and financial position of the group as a whole to its creditors, shareholders and public.
- (iii) Formalities and expenses: Many formalities like obtaining Directors Identification Number, Digital Signature and expenses are involved in the incorporation of the company and
Day-to-day management and compliance of the company, such as holding meetings of the Board of directors and general meetings, preparation of accounts and auditing, passing of resolutions, preparation of statutory register and records, filing of on-line documents with the Registrar, etc.
- (iv) Company is not a citizen.

Characteristics of a company

A company registered under the Companies Act has the following features: —

- (i) separate legal entity;
- (ii) incorporated body;
- (iii) artificial legal person;
- (iv) perpetual succession;
- (v) limited liability;

- (vi) common seal;
- (vii) right to own property;
- (viii) right to sue;
- (ix) right to enter into contracts;
- (x) flexibility of investment;
- (xi) separation of control from the ownership.

Classification of companies

Companies under the Companies Act, 1956 may be classified on various grounds as under:

I. On the basis of business activities undertaken:

(1.) Manufacturing Companies: Companies mainly engaged in any type of manufacturing activities are primarily classified as manufacturing companies. These companies are required to comply with the provisions of Companies Act, 1956 alongwith *the Companies (Auditor's Report) Order, 2003 (CARO)*.

(2.) Service Companies: Companies mainly engaged in any type of service activities like consultancy, management, information technology, etc., although they may have other businesses, are termed as service companies. These companies have to comply with the provisions of Companies Act, 1956 alongwith the rules prescribed in the Companies (Auditor's Report) Order, 2003 (CARO).

(3.) Non-Banking Finance Companies: Companies, which are not banking companies but are engaged in the business activities, related to loan, finance, investment, leasing, hire purchase and other fund-based activities, are termed as Non-Banking Financial Companies. There are certain criteria for NBFC Companies viz. Compulsory registration with the RBI for commencement/continuance of NBFC activities, minimum Net Owned Fund, requirement of compulsory rating and RBI compliance before acceptance of deposits, etc.

(4.) Non-profit making Companies: Any association desirous of being incorporated as a company with limited liability, without the addition of word "Limited" or the words "Private Limited" as the case may be shall make an application electronically to the **Central Government (powers delegated to the Regional Director)** on behalf of such company/proposed company as the case may be, for grant of licence under section 25.

It is usual to form such companies whose objects may be to protect and promote the interests of traders and business groups or to promote art, science, religion, charity or

such other general purpose, which is in the overall interest of the community. Section 25 of the Companies Act, 1956 deals with the powers of the Central Government to dispense with 'Limited' in the name of charitable or other companies on fulfillments of certain conditions and is entrusted with the power to grant licence to association that for the companies proposed to be formed without the word "Limited" or "Private Limited" in their names or to companies already formed to delete the said words from their names where the Central Government is satisfied that:—

- (a) the object for which the company is proposed to be formed or already formed is to promote commerce, art, science, religion, charity or any other useful objects;
- (b) profits, if any, earned in carrying out the object and other income are proposed to be applied only for promoting its objects; and
- (c) the company intends to prohibit the payment of dividend to its members.

II. On the basis of liabilities of the members and directors:

(1) Companies with Limited liability: In such types of companies, the liabilities of members are always limited subject to some exceptions.

Companies limited by shares

These types of companies are quite common in commercial, trading and industrial world. Such companies are characterised with an authorised share capital of a certain amount, which is divided into shares. The authorised share capital may comprise of more than one kind of shares, viz. ordinary or equity shares (voting and non-voting) and preference shares. The liability of each member of such company is limited to the unpaid amount of shares and premium, if any, held by him.

Companies limited by guarantee and having share capital

Such a company by way of undertaking in its Memorandum of Association restricts the liabilities of its members to a certain fixed amount, for payment of the debts and liabilities of the company in the event of winding up. The members are liable only for the amount contracted before he ceased to be a member or payment of the debts and liabilities within one year after he ceased to be a member. Such companies may also have share capital whenever necessary. In that event, the members will be liable for the amount, if any, remaining unpaid on the shares subscribed by them, in addition to the above guaranteed amount.

Companies limited by guarantee without having share capital

Companies limited by guarantee without having share capital are exactly similar in nature to the guarantee companies as referred above except that there will be no share capital. The members will be liable, in the circumstance referred to above, to contribute an amount not exceeding the sum specified in the Memorandum of Association.

(2) Companies with unlimited liability: Every member in such a company is jointly and severally liable for all the debts and liabilities of the company.

III. On the basis of membership pattern/size:

(1) Public Limited Companies: The Company defined under section 3(1)(iv) of the Companies Act, 1956 is a public company which—

- (i) is not a private company;
- (ii) has a minimum paid-up capital of Rs. 5 lakhs or such higher capital as may be prescribed;
- (iii) is a private company but subsidiary of a public company.

(2) Private Companies: Section 3(1)(iii) defines a private company as one which—

- (a) has a minimum paid-up share capital of Rs. 1 Lakh or such higher capital as may be prescribed; and
- (b) by its Articles of Association:
 - (i) restricts the right to transfer its shares;
 - (ii) limits the number of its members to 50 which will not include:—
 - A. members who are employees of the company; and
 - B. members who are ex-employees of the company and were members while in such employment and who have continued to be members after ceasing to be employees;
 - (iii) prohibits any invitation to the public to subscribe for any shares or debentures of the company; and
 - (iv) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.

A private company, in addition to the earlier conditions, shall have a minimum paid-up share capital of Rupees One Lakh or such higher capital as may be prescribed and its Articles shall prohibit invitation or acceptance of deposits from persons other than its members, directors or their relatives. In case of such companies, public interest is not involved.

The basic characteristics of a private company in terms of section 3(1)(iii) of the Act do not get altered just because it is a subsidiary of a public company in view of the fiction in terms of section 3(1)(iv)(c) of the Act that it is a public company. May be it is a public company in relation to other provisions of the Act but not with reference to its basic characteristics. Therefore, all the provisions in the articles to maintain the basic characteristics of a private company in terms of section 3(1)(iii) will continue to govern the affairs of the company even though it is a subsidiary of a public company.

In a decided case of **Hillcrest Realty SDN.BHD v Hotel Queen Road (P) Ltd. (2006) 72 CLA 245 (CLB)** it was held that one of the basic characteristics of a private company in

terms of that section is restriction on the right to transfer and the same will apply even if a private company is a subsidiary of a public company.

(3) Government Companies: Section 617 of the Companies Act, 1956 defines Government Company on the basis of amount invested in the capital of the company. Such types of companies may be private limited, public limited whether listed or not.

If not less than fifty-one per cent of the paid-up share capital of the company is held by the Central Government or by a State Government or State Governments or partly by the Central or partly by one or more State Governments, then the company shall be treated as Government Company and includes any subsidiary of a Government Company. Government Companies is exempted from certain provisions of the Companies Act, 1956.

IV. On the basis of place of registration:

(1) Indian Company (Incorporated in India) (2) Foreign Company (Company incorporated outside India but having place of business in India)

V. On the basis of control over the management:

(1) Holding Company (2) Subsidiary Company

Holding and Subsidiary Companies

A Company shall be deemed to be subsidiary of another if the other company controls the composition of the Board of directors of the former; or the other company exercises or controls more than half of the total voting power of the former where that former company was incorporated prior to the commencement of the Companies Act, 1956 in which the holders of the preference shares issued prior to such commencement have the same voting rights as equity shares; or the other holds more than half in nominal value of the equity shares of the former; or the former company is a subsidiary of any other company which is the subsidiary of the other. [Section 4(1)]

Composition of directors in the subsidiary company

The composition of a Board of directors of the company shall be controlled by the another company if the latter by the exercise of some power exercisable by it at its discretion without the consent or concurrence of any other person can appoint or remove the all or majority of the directors of the former company, if any of the following conditions is satisfied:

- (i) that a person cannot be appointed as a director of a former company without the exercise in his favour of the power by the latter company;
- (ii) that a person's appointment as a director in the former company follows necessarily from his appointment as director or manager of, or to any other office or employment, in the latter company;

(iii) that the directorship is held by an individual nominated by the latter company or its subsidiary.

An agreement to provide authority to the lenders to appoint directors in the company may be deemed to be control over the composition of the Board of directors

It is possible to obtain control in regard to composition of the Board by agreement by which one company may agree to advance funds to another company and in return be given control to appoint all or majority of the Board of directors in the borrowing company. This right would be sufficient to constitute the lending company as holding company and the borrowing company as subsidiary.

Ascertainment whether the company is a subsidiary of another company

To ascertain whether one company is a subsidiary of another, following points may also be noted:

- (i) Any shares held in a company in a fiduciary capacity on behalf of some other person will not come under the shareholding held by the other.
- (ii) Any shares held by a nominee for the other company will be included in the other company's shareholding. Further, shares held by a subsidiary or by a nominee for the subsidiary shall be treated as held or exercisable by that other company.
- (iii) Where the ordinary business of the other or its subsidiaries includes lending of money and shares are held or power exercisable by way of security only, such shares shall not be taken to be the shareholding of the other.

Where a body corporate is incorporated in a country outside the country, a subsidiary or holding company of the body corporate under the law of that country shall be deemed to be a subsidiary or holding company of the body corporate within the meaning of this Act, whether the requirements of section 4 are fulfilled or not. [Section 4(6)]

Producer Companies

By the Companies (Amendment) Act, 2002, a new Part IXA has been inserted under the Act with the main objective to provide provisions for formation of co-operative society as a company and to convert existing co-operative societies into companies as the provisions available under Part IX were available for conversion of a partnership firm into a company.

The conversion of co-operatives into producer companies is purely voluntary. The conversion option by co-operative society can be exercised only if two-thirds of the members of the concerned society vote in favour of the resolution to that effect. The producer company indicate that only certain categories of persons can participate in the ownership of such companies, the members of the producer company have necessarily to be "primary producers", that is persons engaged in an activity connected with, or relatable to, primary produce.

The Companies (Amendment) Act, 2002 provides a statutory and regulatory framework that creates the potential for producer-owned enterprises to compete with other enterprises on a competitive footing by way of various forms of companies. This will provide an opportunity to cooperative institutions to voluntarily transform themselves into new form of producer companies.

Scope of the Act

The Companies Act applies to all trading and other corporations, which are incorporated under the Act or any of the earlier Companies Act. But it does not apply to universities, co-operative societies, unincorporated trading, scientific and other societies.