

INTERMEDIATE EXAMINATION

DECEMBER 2007

COMPANY LAW

Time allowed : 3 hours

Maximum marks : 100

- NOTE :** 1. Answer **SIX** questions including Question No. 1 which is **COMPULSORY**.
2. All references to sections relate to the Companies Act, 1956 unless stated otherwise.

Question 1

Comment on any four of the following :

- (i) *Certain companies are exempted from the provisions of section 58A of the Act.*
 - (ii) *Chairman of the general meeting of a company can follow any of the methods for ascertaining sense of the meeting.*
 - (iii) *The quorum for Board meeting should be present throughout the meeting.*
 - (iv) *A certificate of incorporation is the conclusive evidence that all the requirements of the Companies Act, 1956 have been complied with.*
 - (v) *All investments made by a company must be held by it in its own name.*
- (5 marks each)*

Answer 1(i)

Sub-section (7) of Section 58A of the Companies Act, 1956 provides that the following would be exempt from the provisions of Section 58A of the Act:

- (a) banking company;
- (b) such other companies as the Central Government may, after consulting the Reserve Bank of India, specify in this behalf;
- (c) such classes of financial companies as the Central Government may, after consultation with the Reserve Bank of India specify in this behalf except the provisions relating to advertisement.

Answer 1(ii)

Chairman of the general meeting is required to ascertain the sense of the meeting to arrive at the decision. Sense of the meeting means the will or intent of the assembly. Following are various alternative methods of ascertaining the sense of the meeting:

- 1. *By Acclamation* : Formal motions, like the motion of thanks to the chair, are generally adopted unanimously by applause or shouting or cheering by members.
- 2. *By voice* : The method is also adopted when there is perfect or near unanimity on the motion. This method is not used in company meetings.
- 3. *By show of hands*: According to this method, the Chairman calls upon the persons present who are entitled to vote to raise hands in favour of the motion and against the motion. On comparison of the hands shown for and against the

motion, the Chairman announces his verdict whether the resolution is carried or lost.

4. *By divisions* : In this method, the Chairman requests those present to divide themselves into two different blocks/rooms or lobbies. Those in favour of motion walk into one block and those against the motion into another block. Number of persons in each block are separately counted and the result is accordingly declared by the Chairman.
5. *By ballot* : Under this method ballot papers are distributed to everyone entitled to vote. The members record their vote on the ballot paper by a suitable mark. These papers are either deposited in a box or collected by tellers.
6. *By poll* : Poll means “counting of heads”. Section 179 provides that the poll be taken if the Chairman or a prescribed number of members are dissatisfied with the result of voting by show of hands.

Answer 1(iii)

The meeting of board of directors cannot commence its business unless quorum is present. Section 287(2) has fixed the quorum as one third of the total strength of the board, fraction thereof being rounded off as one, or two directors whichever is high. As decided in *Balakrishna V Balu Subudhi* (AIR 1949 Part 184), the quorum of the board is required at every stage of the meeting and unless a quorum is present at every such stage, the business transacted is void. Therefore, the quorum for board meeting should be present throughout the meeting.

Answer 1(iv)

Once the required documents have been delivered to the Registrar of Companies and the necessary fee paid, the Registrar, after satisfying himself, issues a certificate of incorporation. Certificate of incorporation constitutes the birth certificate of the company.

According to Section 35 of the Companies Act, 1956, a certificate of incorporate given by the Registrar in respect of any association shall be conclusive evidence that all the requirements of the Act have been complied with in respect of registration and matters precedent and incidental thereto, and that the association is a company authorized to be registered and duly registered under the Act. The certificate of incorporation is conclusive evidence that everything is in order as regards registration and that the company has come into existence from the earliest moment of the day of incorporation stated therein with rights and liabilities of a natural person, competent to enter into contracts [*Jubilee Cotton Mills Ltd. v. Lewis* (1924) A.C.]. The validity of the registration cannot be questioned after the issue of the certificate.

In *Moosa v. Ebrahim* ILR (1913) 40 Cal. 1(P.C.) it was held that the certificate prevents anyone alleging that the company does not exist.

Even if the two signatures to a Memorandum were written by one person, or were forged, the certificate would be conclusive that the company was duly incorporated. [*Hammond v. Prentice Bors.* (1920) 1 Ch 201]. But it is to be clearly understood that it is for the purpose of incorporation only that the certificate was made conclusive by the

legislature and the certificate cannot legalize object contained in the memorandum. [*Performing Right Society Ltd. v. London theatre of Varieties* (1992) 2 KB 433].

Answer 1(v)

According to Sub-section (1) of Section 49 of the Companies Act, 1956, investments made by a company (other than an investment company) on its own behalf shall be made and held by it in its own name. The requirement that the investment made by the company must be held in its own name is confined to only those investments which are made by it on its own behalf and not on behalf of someone else.

Section 49(2) provides that where a company has right to nominate a director or directors on the Board of another company, it would be open to the appointing or nominating company to hold the shares upto the amount of qualification shares (i) in its own name, (ii) jointly in its own name and the name of appointee or nominee director, or (iii) exclusively in the name of the appointee or nominee. As per Section 49(3), a company may hold any share or shares in its subsidiary through nominee or nominees of the company if it is so required to ensure that the number of members of the subsidiary does not fall below the minimum number prescribed under the Act for public and private companies.

Exemptions

1. Sub-section (4) of Section 49 exempts a company from the requirement of holding shares or securities on its own behalf and in its own name if its principal business consists of buying and selling of shares or securities.
2. In terms of the provisions of Section 49(5), Section 49(1) does not prevent a company:
 - (a) from depositing with the bank, being the bankers of the company, any shares or securities for collection of any dividend or interest payable thereon; or
 - (b) from depositing with or transferring to, or holding in the name of, the State Bank of India or a scheduled bank, being the bankers of the company, shares or securities, in order to facilitate the transfer thereof. However, if within a period of 6 months from the date from which the shares or securities are transferred by the company to, or are first held by the company in the name of, the State Bank of India or a scheduled bank as aforesaid, no transfer of such shares or securities takes place, the company shall, as soon as practicable, after the expiry of that period, have the shares or securities retransferred to it from the State Bank of India or the scheduled bank or, as the case may be, again hold the shares or securities in its own name; or
 - (c) from depositing with, or transferring to, any person any shares or securities, by way of security for the re-payment of any loan advanced to the company or the performance of any obligation undertaken by it;
 - (d) from holding investments in the name of a depository when such investments are in the form of securities held by the company as a beneficial owner.

Question 2

State, with reasons and relevant legal provisions/case law, wherever applicable, whether the following statements are correct or incorrect. Attempt any four :

- (i) *Company form of business organisation is not a popular form of business organisation.*
- (ii) *Foreign company has opened an office for operating bank accounts in India. Hence it is supposed to 'carry on business' in India.*
- (iii) *Where the outsider has knowledge of irregularity, the doctrine of indoor management protects the outsider.*
- (iv) *Stock exchange registered under the Companies Act, 1956 can carry a provision in their articles of association empowering directors to expel any member of the company under any of the given conditions.*
- (v) *Registrar of Companies has power to condone the delay beyond 30 days of the date of satisfaction of charge and allow filing of satisfaction of charge.*

(4 marks each)

Answer 2(i)

Incorrect. Due to following advantages company form of organization is popular:

1. *Corporate personality* : A company is a distinct legal or juristic person independent of its members.
2. *Limited liability* : The Companies Act provides that in the event of the company being wound-up, the members shall have liability to contribute to the assets of the company in accordance with the Act [Section 34(2)].
3. *Perpetual succession* : Notwithstanding any change in its members, the company will be the same entity with the same privileges and immunities, estate and possessions.
4. *Transferability of shares* : Section 82 of the Companies Act provides that the shares or other interest of any member in a company shall be movable property, transferable in the manner provided by the articles of the company.
5. *Separate property* : A company as a legal entity is capable of owning its funds and other assets. [*Gramophone & Typewriter Co. v. Stanley*, (1906) 2 K.B. 856 at p. 869.]
6. *Capacity to sue* : As a juristic legal person, a company can sue in its name and be sued by others.
7. *Flexibility & autonomy* : The company has an autonomy and independence to form its own policies and implement them, subject to the general principles of law, equity and good conscience and in accordance with the provisions contained in the Companies Act, Memorandum and Articles of Association.

Answer 2(ii)

Incorrect. Following activities are held as not constituting "carrying on business":

1. Carrying on small transactions.
2. Conducting meetings of shareholders & directors.

3. Operating bank account.
4. Transfer of shares or other securities.
5. Operating through independent contractors.
6. Procuring orders.
7. Creating or Financing debt.
8. Securing or collecting debts or enforcing claims to property of any kind.

Answer 2(iii)

Incorrect. The doctrine of indoor management does not protect any person who has actual or even an implied notice of the lack of authority of the person acting on behalf of the company. Thus, a person knowing fully well that the directors do not have the authority to make the transaction but still enters into it, cannot seek protection under the rule of indoor management. In *Howard v. Patent Ivory Co.* (38 Ch.D 156), the articles of a company empowered the directors to borrow upto one thousand pounds only. They could, however, exceed the limit of one thousand pounds with the consent of the company in general meeting. Without such consent having been obtained, they borrowed 3,500 pounds from one of the directors who took debentures. The company refused to pay the amount. Held, the debentures were good to the extent of one thousand pounds only because the director had notice or was deemed to have the notice of the internal irregularity.

Answer 2(iv)

The Department of Company Affairs (now Ministry of Corporate Affairs) has clarified that an article for expulsion of a member is opposed to the fundamental principles of the Company Jurisprudence and is ultra vires the company.

Also, in the light of proviso to Section 29, if there is a provision in the Articles empowering the Directors of the company to expel any member of the company under any of the given conditions, then such a provision shall be totally inconsistent with the provisions of Section 29 of the Act.

But the Stock exchanges, registered under the provisions of the Companies Act, can carry such a provision in its Articles, because the Companies Act is a general law whereas the Securities Contracts Regulation (SCR) Act is a special law. The regulation of stock exchanges is done by SCR Act and SEBI Act and not by Companies Act. Hence, the Articles of Stock Exchange may provide for additional matters as per SCR Act, which may not be possible for inclusion in the Articles of a company as per the provisions of the Companies Act. [*Madras Stock Exchange Ltd. v. S.S.R. Rajkumar* (2003) 116 Comp. Cas. 214 (Mad.)].

Another relevant case law is *Naresh Chandra Sangal v. Calcutta Stock Exchange Association Ltd.* (1970) RD-SC 202.

Answer 2(v)

Incorrect. Section 138 of the Companies Act, 1956 requires that a company has to file Satisfaction of Charge within 30 days of the full payment or satisfaction of the charge with the Registrar of Companies. But Registrar does not have power to extend this time limit. The power to extend the time limit lies with Company Law Board under Section 141 of the Act.

Accordingly, where the Company Law Board is satisfied that omission to give intimation to the Registrar of the payment or satisfaction of a charge, within the time required was accidental or due to inadvertence or some other sufficient cause or is not of a nature to prejudice the position of creditors or shareholders of the company, it may on the application of the company or any other person interested and on such terms and conditions as seem just and expedient to it, direct that the time for giving of intimation of payment or satisfaction shall be extended.

Question 3

- (a) *Re-write the following sentences after filling-up the blank space with appropriate word(s)/figure(s) so as to convey the correct meaning :*
- (i) *Statutory auditor is appointed by shareholders at every _____.*
 - (ii) *Every company must have a registered office within _____ days of its incorporation or from the day it begins to carry on business.*
 - (iii) *Balance of unclaimed dividend has to be transferred to _____ after seven years.*
 - (iv) *Additional director is appointed by _____.*
 - (v) *For calling a general meeting of shareholders, a notice of _____ is required.*
 - (vi) *Due diligence certificate is required to be issued by _____ at the time of public issue of shares. (1 mark each)*
- (b) *The doctrine of ultra vires is a protection to the shareholders of the company. Discuss. (6 marks)*
- (c) *Dinesh, one of the joint-holders of shares of a company, sent a requisition to the company to split the shares equally amongst him and the other joint-holders, by issuing fresh share certificates. State whether the company is bound to comply with this requisition. (4 marks)*

Answer 3(a)

- (i) Statutory auditor is appointed by shareholders at every **Annual General Meeting**.
- (ii) Every company must have a registered office within **30** days of its incorporation or from the day it begins to carry on business.
- (iii) Balance of unclaimed dividend has to be transferred to **Investor Education and Protection Fund** after seven years.
- (iv) Additional director is appointed by **Board of Directors**.
- (v) For calling a general meeting of shareholders, a notice of **not less than 21 days** is required.
- (vi) Due diligence certificate is required to be issued by **merchant bankers** at the time of public issue of shares.

Answer 3(b)

In the case of a company, whatever is not stated in the memorandum as the objects or powers is prohibited by the doctrine of ultra vires. The word 'ultra' means beyond and

the word 'vires' means the powers. As a result, an act which is ultra vires is void, and does not bind the company. Neither the company nor the other contracting party can sue on it. Also, as stated earlier, the company cannot make it valid, even if every member assents to it.

The general rule is that an act which is ultra vires the company is incapable of ratification. An act which is intra vires the company but outside the authority of the directors may be ratified by the company in proper form [*Rajendra Nath Dutta v. Shilendra Nath Mukherjee*, (1982) 52 Comp. Cas. 293 (Cal.)].

The rule is meant to protect shareholders and the creditors of the company. But if the act is ultra vires (beyond the powers of) the directors only, the shareholders can ratify it. Or if it is ultra vires the articles of association, the company can alter its articles in the proper way. The doctrine of ultra vires was first enunciated by the House of Lords in the classic case, *Ashbury Railway Carriage and Iron Co. Ltd. v. Riche*, (1878) L.R. 7 H.L. 653

An ultra vires contract is as null and void as that of contract with a minor [*Steel Equipment & Construction Co. (P) Ltd. Re* (1968) 38 Com. Cases 82, (1967) 1 Comp LJ 172 (Cal)]. A shareholder can get back the money paid by him to the company under an ultra vires allotment of shares. A transferee of shares from him would not have been so allowed. [*Margarate Linz v. Electric Wire Co. of Salestine Ltd.* (1948) 18 Com. Cases 201, 205 : AIR 1949 PC 51].

The members can get an injunction to restrain the company wherein ultra vires act has been or is about to be undertaken. In *Jehangir R. Modi v. Shamji Ladha*, [(1866-67) 4 Bom. HCR (1855)], the Bombay High Court held: "A shareholder can maintain an action against the directors to compel them to restore to the company the funds of the company that have been employed in transactions that they have no authority to enter into, without making the company a party to the suit."

Answer 3(c)

Where the shares of a company are held in joint names and one of these joint holders makes a request to the company to split the shares held by them jointly, equally between/among the three joint holders by issuing fresh share certificates in their individual names, the company shall not be legally bound to do so unless the transfer deeds executed jointly by all the three joint holders duly stamped and executed are lodged with the company together with the relevant share certificates in terms of section 108 of the Companies Act, 1956.

It has also been held in *Dr. Rajiv Das v. United Press Ltd.* (2001) 44 CLA 268:2002 that where the consent of other joint holders was not taken, original certificates or transfer deeds duly signed and stamped were not furnished, the refusal by the company was held to be justified.

Question 4

(a) *Distinguish between any two of the following :*

- (i) 'Forfeiture of shares' and 'surrender of shares'.
- (ii) 'Whole-time director' and 'managing director'.

- (iii) 'Preliminary contracts' and 'provisional contracts'. (4 marks each)
- (b) The chairman at a Board meeting counts 6 votes in favour and 7 votes against the resolution. Can the chairman cast his own vote, which he had not exercised earlier, in favour of the resolution and also the casting vote which the articles of association authorise, and declare the resolution as passed? (4 marks)
- (c) Amol, a non-member of Shristhi Ltd., has been appointed as a director of the company. Later on, he has become the chairman of the company. In an annual general meeting of Shristhi Ltd., Amol presided over the meeting. Zahir, a member of the company, objected to his chairmanship on the ground that Amol is not a member of the company. Discuss the validity of the objection. (4 marks)

Answer 4(a)(i)**'Forfeiture of shares' and 'surrender of shares'**

Both forfeiture and surrender of shares result in termination of membership of a person. But both differ from each other in the following respects:

- (a) *Initiative* – In case of forfeiture, the company takes the initiative but initiative is taken by the member in case of surrender of shares.
- (b) *Reason* – Shares can be forfeited for non-payment of calls only but surrender of shares may be accepted for other reasons also e.g. for exchange into new shares.
- (c) *Object* – The object of forfeiture of shares is to penalize a member for non-payment of call whereas the object of surrender of shares is when he cannot make payment of calls or he wants to exchange with new shares of the same nominal value.
- (d) *Legal technicalities* – In case of forfeiture of shares, the rules and regulations are to be followed exactly and carefully as a slight irregularity will invalidate the forfeiture. However, it is not so in case of surrender of shares.

Answer 4(a)(ii)**'Whole-time director' and 'managing director'**

A whole-time director has not been defined in the Act. He may be defined as a director who devotes his whole or substantially the whole of his working time to the work connected with the company. He is an employee director of the company. A managing director is a director who is entrusted with the substantial powers of the management which would not otherwise be exercisable by him. [Section 2(26)]. The substantial powers means the powers to take decisions regarding policy matters e.g. pricing policies of products, adoption of new technique of production etc. Both differ as under:

- (i) *Powers* – A managing director has substantial powers of management whereas it is not so in case of whole-time director who has the powers as per terms of appointment.
- (ii) *Period of Office* - A managing director can be appointed for a maximum period of 5 years at a time whereas there is no limit in case of whole-time director.

- (iii) *Number of Companies* – A managing director may be appointed in that capacity in more than one company at the same time but whole-time director is a full time employee and he cannot hold office at a time in more than one company.
- (iv) *Appointment with Manager* - A whole-time director can be appointed in a company having a manager but managing director cannot be appointed in a company having a manager.

Answer 4(a)(iii)**‘Preliminary contracts’ and ‘provisional contracts’**

Before the company is being formed, promoters acting on behalf of the company to be formed enter into contracts for the purchase of property or for securing services etc. Preliminary contracts are contracts purported to be made on behalf of a company before its incorporation. Before incorporation, a company is non-existent and has no capacity to contract. Hence, nobody can contract on behalf of the company as its agent. Therefore, a contract by promoter of a company prior to its incorporation never binds the company because it has no legal existence.

Even if the company takes some benefit from a contract made before its formation, the contract is not binding on the company. For such contracts promoter alone remain personally liable, unless company enters into a fresh contract after its incorporation.

Provisional contracts are those contracts, which are made after incorporation of a company but before certificate of commencement of business is obtained by the company. These are not binding on the company until the company is entitled to commence business on the grant of the certificate of commencement of business. But once this certificate is issued, such contracts automatically become binding on the company. [Sub-section (4) of section 149].

Answer 4(b)

As per Guidance Note on Meetings of the Board of Directors issued by ICSI, a chairman does not have an inherent right to the casting vote nor it is a right given by the statute. It has to be conferred on the chairman by the articles. In the given case, the articles of the company authorize the chairman to cast his casting vote.

However, the guidance note provides that where the chairman chooses to exercise his vote as a director, he should do so before the voting is concluded. It also provides that a casting vote is a second or deciding vote. If the votes are divided unequally, the question of using a casting vote does not arise. It is only in the event of equality of votes, for and against, that the question of a casting vote assumes relevance.

Therefore, in the given case, the chairman cannot cast his own vote which he had not exercised earlier as the voting has concluded. He cannot cast his casting vote as the votes are not divided equally, and where the votes are divided unequally, the question of using a casting vote does not arise.

Answer 4(c)

Regulation 50 of Table A of Schedule I appended to the Companies Act, 1956 stipulates that the chairman, if any, of the Board shall preside as chairman at every

general meeting of the company. Though the shareholders do not have the power to elect a person who is not a member as chairman, but the Articles can provide 'otherwise' and may permit a non-member to be the chairman.

In the given case, Amol is the chairman of the Board who can preside as chairman at every general meeting. Therefore, the objection of Zahir will not hold good.

Question 5

- (a) *Discuss the provisions relating to change of name of a company.* (4 marks)
- (b) *Briefly discuss the doctrine of cypres.* (4 marks)
- (c) *A private limited company in its articles of association provides a format of 'proxy form' different from the one prescribed by the Companies Act, 1956 in Schedule IX.*

A shareholder submits an instrument appointing proxy to the company in the form as prescribed in Schedule IX. But the company rejects the proxy on the ground that it is not in the form prescribed in its articles of association. Is the rejection valid? Discuss citing legal provisions. (4 marks)

- (d) *A public limited company forfeited 80 equity shares and re-issued the same which resulted in earning a surplus of Rs. 2,000. The company did not file return of allotment with the Registrar of Companies in respect of re-issued shares. Explain whether the company has contravened any provision of the Companies Act, 1956 by non-filing of the return.* (4 marks)

Answer 5(a)

Changing name of a company involves amendment to name clause in the Memorandum of Association. The company will approach Registrar of companies for availability of new name. As per Section 21 of the Companies Act, 1956, special resolution has to be passed and approval from the central government has to be obtained. Approval of the Central Government is not necessary if the change relates to the addition/deletion of the word 'private' to the name. The powers of the central government have been delegated to the Registrar of Companies. The change in the name will not affect any rights and obligations of the company or legal proceedings.

For this purpose an application is required to be made to the Registrar in e-Form 1A with a fee of Rs. 500/- to ascertain availability of name. The period of validity is sixty days. The change must be communicated to the Registrar by filing e-Form No. 23 prescribed under the Companies (Central Government's) General Rules and Forms, 1956 (as amended) along with a printed or typewritten copy of the special resolution and explanatory statement within 30 days of the passing thereof. Also as per the instructions for filling e-form 23, the memorandum and articles of association of a company are also required to be attached.

Answer 5(b)

While forming a charitable trust, the objects are specified by the settler. When the objects of the trust subsequently become impossible or impracticable or unlawful, the trust will not fail. In such cases the Court has power to apply the trust to some other charitable object as nearly as possible resembling the intention of author. This power of the Court is known as "doctrine of cypres". When a particular mode of charity indicated by the author is not capable of being carried out, yet a general intention of charity is

indicated by the author of the trust, the Court would execute it 'cypres' i.e. in a way as nearly as possible to that which testator specified.

Answer 5(c)

The provisions of Section 176(6) provides that the instrument appointing a proxy, if in any of the forms set out in Schedule IX of the Companies Act, shall not be questioned on the ground that it fails to comply with any special requirements specified for such instrument by the Articles. However in terms of Section 170(1)(ii), provisions of Section 176(6) shall not be applicable to the private company in question as it is not a subsidiary of a public company and that it has specifically provided a format of 'proxy form' in its articles of association. Therefore, the rejection of the company is valid.

Answer 5(d)

No, the public company has not contravened any provisions of the Companies Act, 1956. no return of allotment of the shares re-issued need to be filed with the Registrar. Such re-issue, in fact cannot be called allotment. According to the provisions of Section 75(5) of the Act, forfeited shares can be further re-issued at a premium without any legal formalities. The issue of forfeited shares is treated as a sale and not as allotment of shares.

When a share is forfeited and then re-issued, it is not allotment in the above sense. The word allotment used for such re-issue in Section 75(5) seems to have its origin in a confusion of thought. [*Sri Gopal Jalan & Co. v. Calcutta Stock Exchange Assn. Ltd.* AIR 1964 SC 250]

Question 6

- (a) *Can a company reduce its share capital without sanction of the court ?*
(4 marks)
- (b) *Explain the circumstances when a person ceases to be a member of a company.*
(4 marks)
- (c) *Anant buys 20 shares of a public company from Basant through a stock broker. Anant receives the share certificate and the blank transfer deed countersigned by Basant but does not lodge the transfer deed for registration. Examine the legal effect of unregistered transfer between the transferor and the transferee.*
(4 marks)
- (d) *A meeting of the Board of directors of a company was convened on 31st December, 2007 to discuss some important matters. 5 Directors out of 7 directors write to the chairman that they would like to attend the meeting but could not do so due to other pre-occupations. The last meeting was held on 29th September, 2007. Advise the chairman.*
(4 marks)

Answer 6(a)

In the following cases, the reduction of share capital can take place without confirmation by the Court/Tribunal:

- (i) *Surrender of shares* - where shares are surrendered to the company, whether by way of settlement of a dispute or for any other reason, it will have the same

effect as a transfer in favour of the company and amounts to a reduction of capital.

- (ii) *Forfeiture of Shares* – a company may, if authorized by its articles, forfeit shares for non-payment of calls and the same will not require confirmation of the Court.
- (iii) *Diminution of capital* – where a company cancels shares which have not been taken or agreed to be taken by any person. [Section 94(1)(3)].
- (iv) Redemption of redeemable Preference Shares.
- (v) Purchase of shares of a company by the company under section 402.
- (vi) Buy-back of its own shares under section 77A.
- (vii) Reduction of capital when company is defunct – under Section 560, ROC is empowered to strike off the name of the company from the register on the ground of non-working. [*Great Universal Stores Ltd.*, Re (1960) 1 All ER 252].
- (viii) Unlimited company – Section 100 does not apply to it. It can reduce its capital. [*Borough Commercial and Building Society* (1893) 2 Ch 242].

Answer 6(b)

A person ceases to be a member of a company when his name is removed from its registrar of members, which may occur in any of the following situation:

- (i) on transfer of shares;
- (ii) forfeiture of shares;
- (iii) his shares are sold by the company to enforce a lien;
- (iv) on death of a shareholder;
- (v) he is adjudged insolvent and the official assignee disclaims his shares;
- (vi) redemption of redeemable shares;
- (vii) he rescinds the contract of membership on the ground of fraud or misrepresentation or a genuine mistake;
- (viii) his shares are purchased under section 402;
- (ix) the member is a company which is being wound up in India, and the liquidator disclaims the shares;
- (x) the company is wound up;
- (xi) share warrants have been issued in exchange of fully paid shares.

Although one ceases to be a member, he remains liable as a contributory and also entitled to share in surplus, if any.

Answer 6(c)

There is a binding contract between A and B and the title of the transferee i.e. A is complete and he becomes the equitable beneficial owner of the shares even though the transfer has not been lodged with the company and he has not acquired the legal title to shares. The dividends or other benefits received by B, subject to any agreement to the contrary, must be handed over to A who must indemnify B against calls made after that date. In *Hardoon v. Belilios* it was held that the transferee becomes a member of a company only when the transfer of shares is registered by the company. Pending

registration, the transferor is trustee of the shares for the transferee and the transferor continues to be the holder of the shares until his name is struck off the Register of members and the name of the transferee entered in his place.

Answer 6(d)

As per section 288(1) of the Companies Act, 1956, if a meeting of the Board could not be held for want of quorum, then, unless the articles otherwise provide, the meeting shall automatically stand adjourned till the same day in the next week, at the same time and place, or if that day is a public holiday, till the next succeeding day which is not a public holiday, at the same time and place.

Section 288(2) specifies that the provisions of section 285 shall not be deemed to have been contravened merely by reason of the fact that a meeting of the Board which had been called in compliance with the terms of that section could not be held for want of a quorum.

Therefore, in the given case, as the meeting convened on 31st December 2007 could not be held for want of quorum, it would automatically stand adjourned till the same day in the next week, at the same time and place, provided that day is not a public holiday, in which case it shall be on the next working day.

Question 7

- (a) *What is 'corporate veil' ? State the circumstances when it can be lifted.* (8 marks)
- (b) *What are the provisions for payment of interest out of capital ?* (4 marks)
- (c) *Discuss the rule of Foss vs. Harbottle.* (4 marks)

Answer 7(a)

By the provision of law, a corporation is clothed with a distinct personality, yet in reality it is an association of persons who are in fact, in a way, the beneficial owners of the property of the body corporate. A company, being an artificial person, cannot act on its own, it can only act through natural persons. This is known as corporate veil.

Lifting of Corporate Veil under Judicial Interpretation

Ever since the decision in the *Salomon v. Salomon & Co. Ltd.*, (1897) A.C. 22 normally Courts are reluctant or at least very cautious to lift the veil of corporate personality to see the real persons behind it. Nevertheless, Courts have found it necessary to disregard the separate personality of a company in the following situations:

- (a) Where the corporate veil has been used for commission of fraud or improper conduct, Courts have lifted the veil and looked at the realities of the situation. In *Gilford Motor Co. v. Horne*, (1933) 1 Ch. 935, a former employee of a company made a covenant not to solicit its customers. He formed a company which undertook solicitation. The company was restrained by the Court. Another relevant case law is *Jones v. Lipman*, (1962) 1 W.L.R. 832.
- (b) Where a corporate facade is really only an agency instrumentality. In *Re. R.G. Films Ltd.* (1953) 1 All E.R. 615; an American company produced a film in India

technically in the name of a British Company, 90% of whose capital was held by the President of the American company which financed the production of the film. Board of Trade refused to register the film as a British film which stated that English company acted merely as the nominee of the American corporation.

- (c) Where the doctrine conflicts with public policy: Courts lifted the corporate veil for protecting the public policy. In *Connors Bros. v. Connors* (1940) 4 All E.R. 179, the principle was applied against the managing director who made use of his position contrary to public policy. In this case the House of Lords determined the character of the company as “enemy” company, since the persons who were de facto in control of its affairs, were residents of Germany, which was at war with England at that time. The alien company was not allowed to proceed with the action, as that would have meant giving money to the enemy, which was considered as monstrous and against “public policy”.
- (d) For determining the character or status of the company, the Court may ignore the separate identity [*Daimler Co. Ltd. v. Continental Tyre & Rubber Co.*, (1916) 2 A.C. 307].
- (e) Where the veil has been used for evasion of taxes and duties, the Court upheld the piercing of the veil to look at the real transaction. [*Commissioner of Income Tax v. Meenakshi Mills Ltd.*, A.I.R. 1967 S.C. 819]. [*India Waste Energy Development Ltd. v. Government of NCT of Delhi*, (2003) 114 Com Cases 82 (Del)].
- (f) Where it was found that the sole purpose for which the company was formed was to evade taxes the Court will ignore the concept of separate entity, and make the individuals liable to pay the taxes which they would have paid but for the formation of the company. (Re.: *Sir Dinshaw Manakjee Petit*, A.I.R. 1927 Bombay 371).
- (g) Avoidance of welfare legislation is as common as avoidance of taxation and the approach in considering problems arising out of such avoidance has necessarily to be the same and, therefore, where it was found that the sole purpose for the formation of the new company was to use it as a device to reduce the amount to be paid by way of bonus to workmen, the Supreme Court upheld the piercing of the veil to look at the real transaction (*The Workmen Employed in Associated Rubber Industries Limited, Bhavnagar v. The Associated Rubber Industries Ltd., Bhavnagar and another*, A.I.R. 1986 SC 1).
- (h) In quasi criminal cases, the Courts have sometimes applied the doctrine.
- (i) Where it is found that a company has abused its corporate personality for an unjust and inequitable purpose, the court would not hesitate to lift the corporate veil. Further, the corporate veil could be lifted when acts of a corporation are allegedly opposed to justice, convenience and interests of revenue or workman or are against public interest.

Answer 7(b)

As a prudent financial policy, dividend is to be paid out of profits and must not be paid out of capital. However, a provision has been made in Section 208 of the Companies Act, 1956, which provides that where share are issued for financing a project having a

very long gestation period, the company may pay interest on the amount of capital paid up and such interest is to be capitalized towards cost of the project. This payment of interest out of capital is subject to following conditions:

1. The payment of interest should be sanctioned by the Central Government.
2. The payment can be made only upto the close of the half year after the half year in which the project was completed.
3. Rate of interest to be paid is 4% or such rate as may be approved by Government.
4. Payment of interest on capital should not amount to reduction of amount paid up on shares.

Answer 7(c)

The general principle of company law is that every member holds equal rights with other members of the company in the same class. In case of difference(s) amongst the members the issue is decided by a vote of the majority. But the protection of the minority is not generally available when the majority does anything in the exercise of the powers for internal administration of a company. The court will not usually intervene at the instance of shareholders in matters of internal administration, and will not interfere with the management of a company by its directors so long they are acting within the powers conferred on them under the articles of the company. In other words, the articles are the protective shield for the majority of shareholders who compose the Board of directors for carrying out their object at the cost of minority of shareholders. This basic principle of non-interference with the internal management of company by the court is laid down in the celebrated case of *Foss v. Harbottle* 67 E.R. 189; (1843) 2 Hare 461.

The rule, as applied to companies, is as follows. After all, the directors who have been fraudulent have injured the company and the members on the whole. Any loss to the company is loss to the members so why should not member sue as he has been injured. This is so, because the plaintiff must not only show that injury has been caused but the injury has been caused by a breach of duty made to him. The individual shareholders or even the minority shareholders who try to show that the directors owe a duty to them personally in their management of the company's assets will definitely fail. The directors owe no duty to the individual members, but only to the company as a whole. A company is a person and if it suffers injury through breach of duty owed to it, then the only possible plaintiff is the company itself acting, and it must always act, through its majority.

Question 8

(a) *Write short notes on any two of the following :*

- (i) *Minimum subscription*
- (ii) *Red-herring prospectus*
- (iii) *Sweat equity shares*
- (iv) *Illegal association.*

(4 marks each)

(b) *In a public limited company, some group of rich people joined and have acquired by paying very high prices of shares, a controlling interest. The company is well*

managed showing very good profits in the last three years. They want to appoint their own nominees as directors of this prosperous company. It is considered that this change in the Board of directors would prejudicially affect the affairs of the company. Discuss whether this change in the composition of Board of directors can be prevented. (4 marks)

- (c) *In a general meeting of Kutumbh Ltd. only 15 shareholders were present. For a special resolution, only 9 out of 15 shareholders voted for the resolution, 2 voted against the special resolution and 4 did not vote at all. No poll was demanded and chairman of the meeting declared the special resolution to be carried. Examine the validity of the resolution.* (4 marks)

Answer 8(a)(i)

Minimum subscription

As per SEBI Guidelines for disclosure and Investor Protection, if a company does not receive 90% of the issue amount from the public subscription including development from under writers in case of underwritten issue within 60 days from the date of closure of the issue, the amount of subscription received is required to be refunded to the applicability. If there is delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest prescribed under section 73 of the Companies Act. In case of non-under written public issue, if the company does not receive the minimum subscription of 90% of the issued amount on the closure of the issue, or if subscription level falls below 90% due to cheque having been returned unpaid or withdrawal of applications, the company shall forthwith refund the entire subscription amount received. In case of delay beyond 8 days, interest as per section 73 of the Companies Act is payable by the company.

Answer 8(a)(ii)

Red-herring prospects

“Red-herring prospectus” means a prospectus which does not have complete particulars on the price of the securities offered and the quantum of securities offered. The information memorandum and red-herring prospectus carry same obligations as are applicable in the case of prospectus. Every variation between the information memorandum and the red-herring prospectus shall be highlighted by the issuer company and shall be individually intimated to the persons invited to subscribe to the securities.

Further, as per section 60B(2) of the Companies Act, a company inviting subscription by an information memorandum shall file a red-herring prospectus at least three days before the opening of an offer.

Answer 8(a)(iii)

Sweat equity shares

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 right in the nature of intellectual property rights or value additions, by whatever name called. Section 79A [inserted by the Companies (Amendment) Act, 1999]

permits issue of such equity shares to employees or directors in recognition of their contribution for providing know-how etc. as aforesaid.

Notwithstanding anything contained in Section 79, a company can issue sweat equity shares, of a class of shares already issued, if the following conditions are satisfied:

- (i) the issue has been authorised by a special resolution passed by the company in the general meeting.
- (ii) the resolution clearly specifies number of shares, current market price, consideration, if any, and class or classes of directors or employees to whom such equity shares are to be issued.
- (iii) as on the date of issue, atleast one year should have elapsed from the date on which the company was entitled to commence business.
- (iv) a company whose shares are listed on a recognized stock exchange issuing sweat equity shares should comply with the regulations made in this behalf by SEBI.
- (v) a company whose shares are not so listed should issue sweat equity shares in compliance with the rules made in this behalf.

Answer 8(a)(iv)

Illegal association

An unincorporated company, association or partnership consisting of large number of persons has been declared illegal. Under the provisions of Section 11 of Companies Act, 1956, no company, association or partnership consisting of more than 20 persons (10 in case of banking business) can be formed for the purpose of carrying on any business for gain, unless it is registered as a company under the Companies Act, 1956, or is formed in pursuance of some other Indian law, or is a Joint Hindu Family carrying on business for gain.

Associations like charitable, religious or scientific, which are not formed for the purpose of acquisition of gain, are excluded from the scope of Section 11. The effect of this all is that if an association requires registration under Section 11 and is not registered then such an association is illegal and has no existence in the eyes of law. Since the law does not recognize it, an illegal association:

1. Cannot enter into any contract.
2. Cannot sue any member or outsider not even if the company is subsequently registered.
3. Cannot be sued by a member or an outsider.
4. Cannot be wound up by order of Court.

However, an illegal association is liable to be taxed [*Kumara Swamy Chettair v. ITO* (1957) ITR 457].

Under Section 11(4) and (5) every member of an illegal association is:

1. Personally liable for all liabilities incurred in carrying on the business of, or by, the illegal association, and
2. Punishable with fine up to Rs.10,000.

Answer 8(b)

Yes, the change in the Board of Directors of the company can be prevented because it would prejudicially affect the affairs of the company. According to section 409, if any director or manager of a company complains to the Company Law Board that as a result of a change in the ownership of shares, a change in the Board of Directors is likely to take place and such change would prejudicially affect the affairs of the company, the Company Law Board, may order that no such change in the Board of Directors or membership of the company can be made. Therefore, the Company Law Board, by its orders, can prevent the desired change in the Board of Directors of the company.

Answer 8(c)

Yes, the special resolution passed will be a valid resolution as the number of votes cast in favour of the special resolution is more than 3 times the number of votes cast against the resolution. According to section 189(2) of the Companies Act, 1956, the votes cast in favour of the resolution (which on a show of hands or a poll, as the case may be), by members entitled to vote are not less than three times the number of votes, if any, cast against the resolution by members entitled to vote. A special resolution requires a majority of three fourths of the votes, voting on a show of hands or on a poll. In the present case, total votes polled are 11 (9+2) out of 15 (9+2+4). The votes in favour of the resolution are 9, more than 3 times of 2 votes cast against the resolution. Therefore, the special resolution is a valid resolution.
