

INTERMEDIATE EXAMINATION

DECEMBER 2008

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) *Promoters of a company stand in a fiduciary position towards it.*
- (ii) *Every member of an illegal association shall be personally liable for all liabilities incurred in carrying on the business.*
- (iii) *Hindu undivided family (HUF) form of business is significantly different from a corporate form of business organisation.*
- (iv) *The role of Chairman-cum-Managing Director of an average sized company in India is vital in the management of the company.*
- (v) *A director of a company wants to hold an office or place of profit.*

(5 marks each)

Answer 1(i)

Promoters of a company stand in a fiduciary position towards it. There are two fiduciary duties of a promoter, namely:

1. A promoter cannot make either directly or indirectly, any profit at the expense of the company he promotes, without the knowledge and consent of the company and that if he does so, in disregard of this rule, the company can compel him to account for it. In relation to disclosure it may be noted that part disclosure is worse than none. A promoter is not forbidden to make profit but to make secret profit. He may make a profit out of promotion with the consent of the company in the same way as an agent may retain a profit obtained through his agency with his principal's consent.

In *Gluckstein v. Barnes*, (1900) A.C. 240 it was held that where a promoter makes some profits in connection with a transaction to which company is a party and does not make full disclosure of his profits; the company has the right to affirm the contracts and promoter should handover his profits to the company.

2. A promoter is not allowed to derive a profit from the sale of his own property to the company unless all material facts are disclosed. If a promoter contracts to sell his own property to the company without making a full disclosure, the company may either repudiate the sale or affirm the contract and recover the profit made out of it by the promoter. Either way the dishonest promoter is deprived of his advantage.

Answer 1(ii)

The members of an illegal association are individually liable in respect of all acts or contracts made on behalf of the association; they cannot either individually or collectively, bring an action to enforce any contract so made, or to recover any debt due to the association [*Wilkinson v. Levison* (1925) 42 T.L.R. 97].

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

- (i) personally liable for all liabilities incurred in carrying on the business of, or by, the illegal association, and
- (ii) punishable with fine up to Rs. 10,000.

Answer 1(iii)

Hindu undivided family (HUF) form of business is significantly different from a corporate form of business organization. Following are the differences between a company and a Hindu Undivided Family:-

1. A company consists of heterogeneous members, whereas a Hindu Undivided Family Business consists of homogenous members since it consists of members of the joint family itself.
2. In a Hindu Joint Family business, the *Karta* (manager) has the sole authority to contract debts for the purpose of the business, other coparceners cannot do so. There is no such system in a company.
3. A person becomes a member of Joint Hindu Family business by virtue of birth. There is no provision to that effect in the company.
4. No registration is compulsory for carrying on business for gain by a Hindu Joint Family even if the number of members exceeds twenty [*Shyamlal Roy v. Madhusudan Roy*, AIR 1959 Cal. 380 (385)]. Registration of a company is compulsory.

Answer 1(iv)**Role of Chairman-cum-Managing Director**

The role of Chairman-cum-Managing Director of an average sized company in India is vital in the management of the company. Moreover, the role of a Chairman-cum-Managing Director are set out in detail in the document by which he is appointed, i.e. either in the articles of association of the company or in the Board resolution or company resolution through which he is appointed or by the agreement which he enters into with the company.

The Companies Act lays down that the managing director of a company is entrusted with substantial powers of management. However, he exercises his powers subject to the superintendence, control and directions of the Board of directors of the company. He is fully answerable to, and functions under the overall supervision, guidance and control of the Board of directors. The Board cannot divest itself of the powers it has to exercise under the Act and under the memorandum and articles of association of the company by delegating all its powers to the managing director.

Answer 1(v)

According to Section 314 of the Companies Act, 1956, no director of a company, shall hold any office or place of profit receiving any amount of remuneration under the company, or its subsidiary except with the consent of the company by a special resolution. However, proviso to sub-section (1) provides that it shall be sufficient if the special resolution is passed at the first general meeting held after such appointment.

Sub-section (3) of section 314 provides that a director shall be deemed to hold an office or place of profit under the company if the director holding an office obtains from the company anything by way of remuneration over and above the remuneration to which he is entitled as such director. Such remuneration may be by way of salary, fees, commission, perquisites, the right to occupy free of rent any premises as a place of residence or otherwise. Sub-section (3) makes it quite clear that remuneration drawn as a director is not remuneration drawn for holding any office or place of profit in the company. Accordingly, a director of a public company who also acts as a honorary editor of its newspaper cannot be said to hold any office or place of profit in the company.

Question 2

- (a) *Choose the most appropriate answer from the given options in respect of the following :*
- (i) *every public limited company should have minimum number of directors —*
 - (a) 5
 - (b) 7
 - (c) 3
 - (d) 2.
 - (ii) *Maximum value of shares which an investor must hold in a company to become a 'small shareholder' is —*
 - (a) Rs. 5,000
 - (b) Rs. 10,000
 - (c) Rs. 20,000
 - (d) Rs. 25,000.
 - (iii) *A private limited company may commence its business after obtaining —*
 - (a) Certificate of commencement of business
 - (b) Certificate of incorporation
 - (c) Approval from an appropriate government
 - (d) Approval from the Registrar of Companies.
 - (iv) *Form No.32 is required to be filed by a company in connection with the cessation of the office of —*
 - (a) Company Secretary
 - (b) Chief Financial Officer
 - (c) Chief Executive Officer who is not a Director
 - (d) None of the above.

- (v) *The facility of postal ballot under section 192A is available to —*
- All companies*
 - All private companies*
 - All public limited companies*
 - Only listed companies.*
- (vi) *No company shall directly or indirectly make any loan or give guarantee to any other body corporate —*
- Exceeding 60% of its paid-up capital or 100% of its free reserves whichever is more*
 - Exceeding 60% of its paid-up capital or 100% of its free reserves whichever is less*
 - Exceeding 100% of its paid-up capital or 60% of its free reserves whichever is more*
 - Exceeding 60% of its paid-up capital and free reserves or 100% of its free reserves whichever is more. (1 mark each)*
- (b) *Re-write the following sentences after filling-up the blank spaces with appropriate word(s)/figure(s) :*
- Partnership is a form of _____ company.*
 - The shares in a company are _____ property.*
 - The _____ acts as the official signature of the company.*
 - A company cannot go beyond and exercise powers more than what is stated in _____ .*
 - Directors are _____ of the monies of the company but not of the debts due to the company. (1 mark each)*
- (c) *The paid-up share-capital of Xel (P) Ltd. is Rs.20 lakh consisting of 2,00,000 equity shares of Rs.10 each fully paid-up. Atul (P) Ltd. and its subsidiary Dainy (P) Ltd. are holding 60,000 shares and 50,000 shares respectively in Xel (P) Ltd.*
- Examine with reference to the provisions of the Companies Act, 1956 whether Xel (P) Ltd. is a subsidiary of Atul (P) Ltd. Will your answer be different, if Dainy (P) Ltd. holds 1,10,000 shares in Xel (P) Ltd. and no shares are held by Atul (P) Ltd. in Xel (P) Ltd. ? (5 marks)*

Answer 2(a)

- (i) (c) 3
- (ii) (c) Rs.20,000
- (iii) (b) Certificate of incorporation
- (iv) (a) Company Secretary
- (v) (d) Only listed companies
- (vi) (a) Exceeding 60% of its paid-up capital or 100% of its free reserves whichever is more.

Answer 2(b)

- (i) Partnership is a form of **unincorporated** company.
- (ii) The shares in a company are **movable** property.
- (iii) The **common seal** acts as the official signature of the company.
- (iv) A company cannot go beyond and exercise powers more than what is stated in **memorandum of association**.
- (v) Directors are **trustees** of the monies of the company but not of the debts due to the company.

Answer 2(c)

According to Section 4 of the Companies Act, a company shall be deemed to be subsidiary of another, if the first-mentioned company is any other company, holds more than half in the nominal value of its equity share capital. For example, Company B (holding company) holds more than half in the nominal value of equity shares of company A (subsidiary).

In view of the above provisions, XEL (P) Ltd. cannot be a subsidiary of Atul (P) Ltd.

If Dainy (P) Ltd. holds 1,10,000 shares in XEL (P) Ltd. and no shares are held by Atul (P) Ltd. in XEL (P) Ltd, then in that case XEL (P) Ltd will be considered a subsidiary of Dainy (P) Ltd. The reason is that Dainy (P) Ltd holds more than half in the nominal value of its equity share capital of XEL (P) Ltd.

Question 3

- (a) *Wasim and Hamid, each held half the issued share capital of a company, whose articles of association provide thus : "The Board of directors may, at any time, in their absolute and uncontrolled discretion, refuse to register any transfer of shares." Wasim died and his executor applied to have Wasim's shares registered in his name. The Board of directors refused to register the transfer of shares under the above mentioned provision of the articles of association. State with reasons whether the court can come to the rescue of Wasim's executor.*
(5 marks)
- (b) *What are the restrictions imposed on the borrowing powers of the Board of directors ?*
(5 marks)
- (c) *Define a 'member'. Distinguish between a 'member' and a 'shareholder'. In what ways may a person become and cease to be a member of the company ?*
(6 marks)

Answer 3(a)

In the given case, the company appears to be a private company as there are only two members. Hence, it falls u/s 111 of the Act. Under the aforesaid section, the company must have sent the refusal to transfer shares within two months to the executor of Wasim who in turn may appeal to the Company Law Board within two months of the receipt of refusal to transmission of the shares in favour of Wasim's executor. The Company Law Board shall come to the rescue of Wasim's executor.

Answer 3(b)

Section 292(1) of the Act, provides that the Board of directors of a company shall exercise the power to borrow moneys on behalf of the company, by means of resolution passed at a meeting of the Board. Every resolution of the Board delegating the powers must specify the total amount outstanding at any one time up to which the money may be borrowed by the delegate.

The Board of Directors is competent by resolution to enhance the rates of interest in exercise of the powers under Sub-sections (1)(b) and (1)(c) of Section 292. The exercise of that power is not controlled by Section 293.

A trading company has an implied power to borrow, even though the memorandum of association does not contain an authority to borrow. In the case of non-trading company, however, there must be express power to borrow. *General Auction Estate & Monetary Co. v. Smith*, (1891) 3 Ch 432; *Badger Mansell v. Viscount Cobham, Re*, (1905) 1 Ch 568, 574.

The company's power of borrowing may also be exercised by delegating to agents other than directors unless prohibited by the Articles of Association of the company. The expression 'borrowing money' is not confined to the taking of money on the promise to return it, with or without interest; it will also include the entering into any arrangement for deferred payment of the price of machinery, raw materials, etc.

Answer 3(c)**Definition of 'Member'**

According to Section 41 of the Companies Act, 1956 :

- (1) The subscribers of the memorandum of a company shall be deemed to have agreed to become members of the company, and on registration, shall be entered as members in its register of members;
- (2) Every other person who agrees in writing to become a member of a company and whose name is entered in its register of members shall, be a member of the company;
- (3) Every person holding equity share capital of a company and whose name is entered as beneficial owner in the records of a depository shall be deemed to be a member of the concerned company.

Difference between a member and a shareholder

Normally all the shareholders are members and all the members are shareholders. However, members are those whose names have been entered in the Register of Members of the company. Hence, situation may arise when a shareholder may not be a member viz.:

- (a) A person is holding a share warrant.
- (b) A person has bought shares but his name is not been entered in the register of members.
- (c) An heir/legal representative holds shares of the deceased till transmission in his name.

Similarly, in certain situations a member may not be a shareholder, for instance-

- (a) Person has transferred/sold shares but his name has been appearing in the Register.
- (b) Name of a person has been included in the Register by mistake.

Subject to the Memorandum and Articles, any *sui juris* (a person who is competent to contract) except the company itself, can become a member of a company. A person ceases to be a member of a company when his name is removed from its register of members.

Question 4

- (a) *Discuss the role of the Company Secretary as a statutory officer, as a co-ordinator and as an administrative officer.* (5 marks)
- (b) *Briefly mention the provisions of the Companies Act, 1956 relating to appointment and re-appointment of the sole selling agent.* (5 marks)
- (c) *In a general meeting of Zora Textiles Ltd., only 15 members were present. The quorum, as per the articles of association of the company, was 10 members personally present. For a special resolution, only 9 members voted for the resolution, 2 members voted against the resolution and 4 members abstained from voting. No poll was demanded. The Chairman of the meeting declared the special resolution to be carried. Examine the validity of the resolution.* (6 marks)

Answer 4(a)

The role of a company secretary may conveniently be studied from three different angles:

- (a) as a statutory officer,
- (b) as a co-ordinator,
- (c) as an administrative officer.

(a) Statutory Officer

The company secretary is an officer responsible for compliance with numerous legal requirements under different Acts including the Companies Act, 1956 as applicable to companies. Under the Companies Act, 1956 he is responsible for performance of the duties of a secretary and such other ministerial and administrative duties as may be assigned to him.

(b) Co-ordinator

The Company Secretary as a co-ordinator has an important role to play in administration of the company's business and affairs. It is for the secretary to ensure effective execution and implementation of the management policies laid down by the Board.

(c) Administrative Officer

The principal duty of a secretary as an administrator is to ensure that the activities of a company are in conformity with the company's policy. In his role as an

administrator, the secretary provides the very foundation on which the entire structure of company administration is constructed.

Answer 4(b)

Section 294 of Companies Act regulates the appointment of sole selling agent. It provides –

- (i) *Section 294(1)* – No company shall appoint a sole selling agent for any area for a term exceeding 5 years at a time. However, re-appointment or extension of appointment as sole selling agent for further periods not exceeding 5 years at a time is not prohibited.
- (ii) *Section 294(2)* – The Board of Directors shall appoint a sole selling agent for any area subject to the condition that the appointment shall cease to be valid if it is not approved by the company in the first general meeting held after the date on which the appointment is made.
- (iii) *Section 294(2A)* – If a company in the general meeting as aforesaid dis-approves the appointment, it shall cease to be valid with effect from the date of that general meeting. Bombay High Court has in *Arantee Mfg. Corp. v. Bright Bolls (P) Ltd.*, further clarified that the provision of section 294(2) are mandatory in nature. As such, the appointment of Sole Selling Agent will be invalid, if the Board resolution does not clearly state the condition laid down in section 294(2).

To sum up, if the Board resolution does not contain the provision of section 294(2), the appointment will be void ab initio.

In the alternative, even though the Board passed a resolution in compliance with the provisions of section 294(2), still if the appointment is not considered or approved by the first general meeting after such Board resolution, in that case also the appointment will be invalid and such appointment shall not be capable of being ratified by approval at subsequent general meeting.

Re-appointment of Sole Selling Agent

In terms of explanation (a) to section 294AA, the term appointment in relation to sole selling agent includes re-appointment of such sole selling agent. Therefore, initially the appointment can be made for a period of 5 years only but the term may be extended from time to time for 5 years on each occasion [Proviso to section 294 (1)].

Answer 4(c)

According to section 189 (2) of the Companies Act, 1956, a resolution shall be a special resolution when the votes cast in favour of the resolution (whether on a show of hands, or on a poll, as the case may be), by members who, being entitled so to do, vote in person, or where proxies are allowed, by proxy, are not less than three times the number of the votes, if any, cast against the resolution by members so entitled and voting.

In the present case, out of 15 members present, 9 members voted for the resolution. Only 2 members voted against the resolution. In view of the above provisions, the resolution seems to be a valid one.

Question 5

- (a) *Discuss the rule in Foss vs. Harbottle. Enumerate the main advantages that flow from the said rule.* (5 marks)
- (b) *Insertion of section 58AAA is intended to take a strict view against companies that accept deposits and do not repay the same on maturity. Comment.* (5 marks)
- (c) *The Board of directors of Fairdeal Properties Ltd. has decided to take-up the business of food processing activity because of the downward trend in real estate business. There is no provision in the objects clause of the Memorandum of Association to enable the company to undertake the business of food processing activity. State with reasons whether the objects clause may be amended and if so, mention the procedure therefor.* (6 marks)

Answer 5(a)***Rule in Foss v. Harbottle***

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 the member sue as he has been injured. This is so, because the plaintiff must not only show that injury has been caused but also that the injury has been caused by a breach of duty made to him. 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.

Advantages of the Rule in Foss v. Harbottle

The main advantages that flow from the *Rule in Foss v. Harbottle* are of a purely practical nature and are as follows :

1. *Recognition of the separate legal personality of company* : If a company has suffered some injury, and not the individual members, it is the company itself that should seek to redress.
2. *Need to preserve right of majority to decide* : The principle in Foss v. Harbottle preserves the right of majority to decide how the affairs of the company shall be conducted. It is fair that the wishes of the majority should prevail.
3. *Multiplicity of futile suits avoided* : Clearly, if every individual member were permitted to sue anyone who had injured the company through a breach of duty, there could be as many suits as there are shareholders. Legal proceedings would never cease, and there would be enormous wastage of time and money.
4. *Litigation at suit of a minority futile if majority does not wish it* : If the irregularity complained of is one which can be subsequently ratified by the majority it is futile to have litigation about it except with the consent of the majority in a general meeting. In *Mac Dougall v. Gardiner*, (1875) 1 Ch. 13 (C.A.), the articles empowered the chairman, with the consent of the meeting, to adjourn a meeting and also provided for taking a poll if demanded by the shareholders. The adjournment was moved, and declared by the chairman to be carried; a poll was

then demanded and refused by the chairman. A shareholder brought an action for a declaration that the chairman's conduct was illegal. Held, the action could not be brought by the shareholder; if the chairman was wrong, the company alone could sue.

Answer 5(b)

Section 58 AAA of the Companies Act, 1956 provides that -

- (1) notwithstanding anything contained in sections 621 and 624, every offence connected with or arising out of acceptance of deposits under section 58A or section 58AA shall be cognizable offence under the Code of Criminal Procedure, 1973 (2 of 1974).
- (2) No court shall take cognizance of any offence under sub-section (1) except on a complaint made by the Central Government or any officer authorized by it in this behalf.

In view of the above provisions, it is clear that insertion of section 58 AAA is intended to take a strict view against companies that accept deposits and do not repay the same on maturity.

Answer 5(c)

In the present case, Fairdeal Properties Ltd. has decided to take up the business of food processing activity because of downward trend in real estate business. As there is no provision in the objects clause in this regard, the company needs to change its object clause. For this purpose, following procedure needs to be adopted.

1. Issue notice for a Board meeting in writing to every director of the company for the time being in India and at his usual address in India to every other director [Refer Section 286 of the Act]. The notice must contain time, date and venue for the meeting and detailed agenda of the business to be transacted thereat.
2. Hold the Board meeting at the appointed time, date and venue to—
 - (i) consider and to pass a resolution approving the proposed amendments to the objects clause of the memorandum of association of the company.
 - (ii) consider and to pass another resolution fixing time, date and venue for holding general meeting of the company for passing a special resolution under Section 17 of the Act for change of objects clause of the memorandum of association of the company.
 - (iii) approve notice for the general meeting and the explanatory statement to be annexed to the notice under Section 173 (2) of the Act for the general meeting and to authorise the company secretary or some other competent officer to issue the notice on behalf of the Board.
3. Issue notice of the general meeting to all the members of the company, its directors and the auditors.
4. Send three copies of the notice to each stock exchange where the securities of

the company are listed [Refer clause 31(c) of the Listing Agreement]. A general notice of the general meeting may also be published in newspapers.

5. Hold the general meeting and pass the proposed special resolution.
6. Send to each stock exchange, six copies of the alterations of the memorandum of association (one of them must be certified) as soon as they are adopted by the company in general meeting in case of a listed company (Refer clause 33 of the Listing Agreement).
7. Send to each stock exchanges, a copy of the proceedings of the general meeting in case of a listed company (Refer clause 33 of the Listing Agreement).
8. File with the Registrar of Companies, e-form 23 along with a copy of the special resolution passed by the company with a copy of the explanatory statement annexed to the notice of the meeting and the amended copy of memorandum of association attached to the e-form, within one month of passing of the resolution.
9. Obtain from the Registrar of Companies, certificate of registration of the alteration of the memorandum. Under MCA-21, the user may select "Get Certified Copy" and follow the procedure. Once the request reaches the concerned MCA official, the official will takeout the printouts of the documents and sign it with seal and deliver the same in physical form.
10. Amend each copy of the memorandum of association of the company available in the office or in the alternative fresh copies of memorandum of association be printed.

Question 6

- (a) *In the State of Uttar Pradesh & Others vs. Renusagar Power Co. & Others., the Hon'ble Supreme Court has observed thus : "The concept of lifting the corporate veil is a changing concept. The veil of corporate personality, even though not lifted sometimes, is becoming more and more transparent in modern jurisprudence. It is high time to reiterate that, in the expanding horizon of modern jurisprudence, lifting of the corporate veil is permissible : its frontiers are unlimited..... ." In the light of this observation, state the circumstances in which corporate veil may be lifted.* (8 marks)
- (b) *You are the Company Secretary of a public limited company which was incorporated on 25th March, 2005. The company has earned huge profits for the financial year 2006-07. The management of the company wants to make some political contribution. Discuss the relevant factors and advise the management on making political contributions by your company. Will your suggestion be a different one, if the company was incorporated and was in existence for more than three financial years ?* (8 marks)

Answer 6(a)

The circumstances under which the courts may lift the corporate veil may broadly be grouped under the following two heads :—

- (a) Under statutory provisions.

(b) Under judicial interpretations.

(a) Under Statutory Provisions - The veil of corporate personality may be lifted in certain cases or pierced as per express provisions of the Companies Act, 1956. In other words, the advantage of 'distinct entity' and 'limited liability' may not be allowed to be enjoyed in certain circumstances. Such cases are :

Reduction of membership [Sec. 45] - If, at any time, the number of members of a company is reduced below the statutory minimum (seven in the case of a public company and two in the case of a private company), and the company carries on business for more than six months while the number is so reduced.

Misrepresentation in prospectus [Sees. 62&63] - In case of misrepresentation in a prospectus, every director, promoter and every other person, who authorises such issue of prospectus incurs liability, towards those who subscribed for shares on the faith of untrue statement (Sec. 62).

Holding-subsidary company [Sec. 212] - A holding company is required to disclose to its members the accounts of its subsidiaries. Sec. 212 provides that every holding company shall attach to its balance sheet, copies of the balance sheet, profit and loss account, director's report and auditor's report, etc., in respect of each subsidiary company. It amounts to lifting the corporate veil because in the eyes of law a subsidiary is a separate legal person and through this mechanism their identity is known.

For investigation of ownership of company [Sec. 247] - Under section 247, the Central Government may appoint one or more inspectors to investigate and report on the membership of any company for the purpose of determining the true persons who are financially interested in the company and who control its policy or materially influence it.

Liability for ultra vires Acts - Directors and other officers of a company will be personally liable for all those acts which they have done on behalf of a company if the same are ultra vires the company.

(b) Under Judicial Interpretations

Protection of revenue - In *CIT v. Sri Meenakshi Mills Ltd.* AIR 1967 SC 819, where the veil had been used for evasion of taxes and duties, the court upheld the piercing of the veil to look at the real transaction.

Prevention of fraud or improper conduct - Where the medium of a company has been used for committing fraud or improper conduct, courts have lifted the veil and looked at the realities of the situation.

Determination of the enemy character of a company - Company being an artificial person cannot be an enemy or friend. However, during war, it may become necessary to lift the corporate veil and see the persons behind as to whether they are enemies or friends. It is because, though a company enjoys a distinct entity, its affairs are essentially run by individuals.

Where company is used to avoid welfare legislation - 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.

Answer 6(b)

According to section 293A of the Companies Act, 1956, no other company which has been in existence for less than three financial years, shall contribute any amount or amounts, directly or indirectly,—

- (i) to any political party; or
- (ii) for any political purpose to any person.

In the present question, the company was incorporated on 25th March, 2005. Assuming that the company wants to make a political contribution in 2007 itself, in view of the above provisions, the company cannot do so. However, if the company was incorporated and was in existence for more than three financial years, the company can make a political contribution as per the provisions of section 293A of the Companies Act, 1956.

Question 7

- (a) *Mention the disqualifications of directors under section 274(1)(g) and the duties of statutory auditors in this regard.* (5 marks)
- (b) *What is 'debenture trust deed' ? What are the advantages of execution of such a deed ?* (5 marks)
- (c) *What are the effects of non-registration of charges ?* (6 marks)

Answer 7(a)

According to section 274(1)(g) of the Companies Act, 1956, a person shall not be capable of being appointed director of a company, if such person is already a director of a public company which,—

- (a) has not filed the annual accounts and annual returns for any continuous three financial years commencing on and after the first day of April, 1999; or
- (b) has failed to repay its deposit or interest thereon on due date or redeem its debentures on due date or pay dividend and such failure continues for one year or more:

Provided that such person shall not be eligible to be appointed as a director of any other public company for a period of five years from the date on which such public company in which he is a director failed to file annual accounts and annual returns under sub-clause (a) or has failed to repay its deposit or interest or redeem its debentures on due date or pay dividend referred to in sub-clause (b).

Statutory Auditor's Duty

- (a) It shall be the duty of the statutory auditor under section 227(3)(f) to report to the members of the disqualifying company as well as the appointing company whether any director is disqualified from being appointed as a director under section 274(1)(g) and furnish a certificate each year as to whether on the basis of his examination of the books and records of the company, any director of the company disqualified for appointment as a director or not.

- (b) It shall be the duty of the statutory auditor of the 'disqualifying company' under section 227(3)(f) to report to the members of the company whether any director in the company has been disqualified during the year from being re-appointed as a director or being appointed as director in another company under section 274(1)(g).

Answer 7(b)

When a series of debentures are issued to numerous debentureholders, a trust deed is drawn up which is called a debenture trust deed. Under the terms of the deed the company undertakes to pay the debentureholders their principal and interest, and normally charge its property as security and declares a trust in favour of the debentureholders. The properties of the companies are mortgaged or charged to trustees. When a trust deed is executed, many of the conditions endorsed on the debenture are embodied in the trust deed and the security is enforced by the trustee instead of by the debenture holders. The trustees are bound to exercise due care and diligence to protect the interests of the debentureholders.

Advantages of Trust Deed

The trust deed has some advantages as follows:

- (a) If the company makes default, the trustees are then ready to take necessary steps, instead of leaving it to the initiative of some debentureholders.
- (b) The trustee is normally given the power to sell and thus realise the security without the aid of the Court.
- (c) The legal estate is vested in the trustee, and where necessary, the mortgage or charge is registered. This prevents a subsequent legal mortgage from priority.
- (d) The title deeds of the mortgaged property are deposited with trustees and the company is prevented from misusing these title deeds for any purpose.
- (e) The trustees ensure that the mortgaged property is kept insured and maintained in proper condition.

Answer 7(c)**Effects of non-registration of charges**

If a charge which requires registration under Section 125 is not registered as per Sub-section (1) of Section 125, the consequences are as follows:

- (a) The charge will be void as against the liquidator (if the company goes into liquidation) and against creditors, but against them only.
- (b) The charge is good against the company and the amount becomes payable immediately.
- (c) Until liquidation, the person seeking to enforce such a charge, has available to him all remedies of a mortgage against the company, though not against other creditors.
- (d) The company may give a subsequent valid mortgage to secure the same debt. But if a subsequent creditor, even with notice of the first charge, takes a registered charge before the first said charge is registered, he obtains priority.

- (e) During liquidation, the charge-holder (creditor) assumes the status of an unsecured creditor, as the charge is void against liquidator and creditors.
- (f) The holder of an equitable charge whose charge is void on the ground of non-registration, has no lien on the title deeds or documents deposited with him as the deposit is only ancillary to the void charge.
- (g) Although a security becomes void by non-registration, it does not affect the contract or obligation of the company to repay the money thereby secured. In fact, Section 125 provides that where a charge becomes void by non-registration, the money becomes immediately payable and the company cannot repudiate it on the ground of non-registration.
- (h) Omission to register particulars of charges as required is punishable with fine. The company and every officer of the company or other person who is in default shall be punishable with fine which may extend to five thousand rupees for everyday during which the default continues. A further fine of Rs. 10,000 may be imposed on the company and every officer of the company for other defaults relating to the registration of charges (Section 142).

Question 8

- (a) *Who is a Company Secretary in Practice ? What are the areas of practice for a Company Secretary in Practice ? What are his duties towards the profession ?*
(5 marks)
- (b) *What is 'secretarial audit' ? What aspects shall be covered by such audit ? Who are authorised to conduct such an audit ?*
(5 marks)
- (c) *Mohan, a person holding shares in demat form, wants to raise money by pledging his demat shares. Is it possible and, if so, advise him on the manner of creating a pledge or hypothecation of such shares ?*
(6 marks)

Answer 8(a)

Secretary in whole-time practice means a secretary who shall be deemed to be in practice within the meaning of sub-section (2) of section 2 of the Company Secretaries Act, 1980 and who is not in full time employment. Thus, a member of the Institute in practice and not in full time employment becomes a secretary in whole-time practice.

Area of practice specified for a PCS

Section 2(2) of Company Secretaries Act, 1980 has prescribed the following areas of practice for a company secretary in practice:

- (1) to engage himself in the practice of the profession of company secretaries to, or in relation to, any company, or
- (2) to offer to perform or perform service in relation to the promotion, formation incorporation, amalgamation, reconstruction, reorganization or winding up of companies, or
- (3) to offer to perform or perform such term as may be performed by –
 - (a) an authorized representative of a company with respect to filing, registering,

presenting, attesting or verifying any documents (including forms, applications and returns) by or on behalf of a company;

- (b) a share transfer agent;
 - (c) an issue house;
 - (d) a share and stock broker;
 - (e) a secretarial auditor or consultant
 - (f) an advisor to a company as management including any legal or procedural matter falling under SEBI Act, I(D&R) Act, Companies, SCCRA, any of the Rules or Byelaws of a recognized stock exchange, the MRTTP Act, FEMA or any other law for the time being in force;
 - (g) to issue certificates on behalf of, or for the purposes of the company or;
- (4) to hold himself out as a company secretary in practice; or
- (5) to render professional service or assistance with respect to matters of principle or detail relating to the practice of the profession of company secretary
- (6) to render such other service as in the opinion of the Council are or may be rendered by a PCS.

Duties towards the profession

- (a) to conduct himself in a manner consistent with the high ideals of the profession of company secretaries and the dignity of the ICSI;
- (b) to uphold the cause of the profession and the ICSI in corporate, national and international affairs in which he may have the opportunity to participate;
- (c) to help the young members of the profession and inculcate in them a sense of discipline, to coordinate the various functions with a view to reaching a harmonious result etc.

Answer 8(b)

- (i) Secretarial Audit is an audit conducted for the purpose of reconciliation of the total admitted capital with both the depositories and the total issued and listed capital.
- (ii) Secretarial Audit shall require certification regarding the following aspects:
 - (a) that the total of the shares held in NSDL, CDSL and in the physical form tally with the issued/paid-up capital;
 - (b) that the Register of Members is updated;
 - (c) that the dematerialization requests have been confirmed within 21 days from the date of request, and state the shares pending confirmation for more than 21 days from the date of request and reasons for delay;
 - (d) the detail of changes in share capital (due to rights, bonus, preferential issue, IPO buy-back, capital reduction, amalgamation, demergers) during

the quarter and certify in case of listed companies whether in principle approval for listing from all stock exchanges was obtained in respect of all further issues.

- (iii) Secretarial Audit shall be undertaken by a qualified Chartered Accountant or a Company Secretary in whole time practice.

Answer 8(c)

It is possible for a person holding shares in demat form to raise money by pledging his demat shares. For this purpose, regulation 58 of the Securities and Exchange Board of India (Depositories and Participants) Regulations, 1996 has to be complied with -

58. (1) If a beneficial owner intends to create a pledge or hypothecation on a security owned by him, he shall make an application in this regard to the depository through the participant who has his account in respect of such security in the manner specified in sub-regulations (2) to (9).
- (2) If the security intended to be pledged or hypothecated is unencumbered, the participant shall, after making a note its records, of the notice of pledge or hypothecation, forward the application of the beneficial owner to the depository for its approval.
- (3) On receipt of application of the beneficial owner through the participant, the depository shall make such investigation as it may consider necessary and if it approves the creation of the pledge or hypothecation, it shall enter the particulars of the intended pledge or hypothecation in its records and where he does so, intimate the participant who shall also amend its records accordingly and immediately intimate the beneficial owner.
- (4) On receipt of the intimation under sub-regulation (3), the beneficial owner may create a pledge or hypothecation and where he does so, he shall intimate the depository through the participant of the creation of such pledge or hypothecation.
- (5) The participant, on receipt of the intimation under sub-regulation (4), shall substitute for the notice of pledge or hypothecation in its records an entry of pledge or hypothecation as the case may be and shall inform the pledgee, beneficial owner and the depository.
- (6) On receipt of the intimation under sub-regulation (5), the depository shall make in its records the changes referred to in sub-regulation (5).
- (7) Where the depository disapproves the creation of the pledge or hypothecation it shall record the reasons for such disapproval and intimate the participant, who in turn shall inform the beneficial owner and the beneficial owner shall not create a pledge or hypothecation with respect of the securities.
- (8) The entry of pledge made under sub-regulation (5) shall be cancelled by the participant when the beneficial owner redeems the pledge or hypothecation and makes a request, with the concurrence of the pledgee, to the participant to cancel the entry of pledge or hypothecation, and the participant shall inform the depository accordingly.
- (9) On receipt of the intimation under sub-regulation (8), the depository shall make in its records the changes referred to in sub-regulation (8).

- (10) No transfer of security in respect of which a notice of pledge or entry of pledge is in force, shall be affected by a participant without the concurrence of the pledgee.
 - (11) Where the pledgee satisfies the depository that owing to the default of the beneficial owner, the pledgee is entitled to be registered as beneficial owner of the pledged securities or a part thereof, the depository may, after giving the beneficial owner a reasonable opportunity to make such representation as he may wish to make, direct the participant to register the pledgee as beneficial owner of such securities and amend its own records accordingly.
 - (12) On receipt of the direction under sub regulation (9), the participant shall immediately carry necessary corrections in the record.
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