

PAPER – 4 : CORPORATE LAWS AND SECRETARIAL PRACTICE

Question Nos. 1,2 and 3 are compulsory.
Answer any four from the rest of the questions.

Question 1

Answer any two of the following:

- (a) M/s ABC Ltd. had power under its memorandum to sell its undertaking to another company having similar objects. The Articles of the company contained a provision by which directors were empowered to sell or otherwise deal with the property of the company. The Shareholders passed an ordinary resolution for the sale of its assets on certain terms and required the directors to carry out the sale. The Directors refused to comply with the wishes of the shareholders where upon it was contended on behalf of the shareholders that they were the principal and directors being their agents were bound to give effect to their decision. Based on the above facts, decide the following issues, having regard to the provisions of the Companies Act, 1956 and case laws.
- (i) Whether the contention of shareholders against the non-compliance of their wishes by the directors is tenable.
 - (ii) Can shareholders usurp the powers which by the articles are vested in the directors by passing a resolution in the general meeting? (5 Marks)
- (b) KYC a recognised Stock Exchange has not maintained proper books of account of the stock exchange, on the ground that such books of account are not essential. A compliant in this regard was made to SEBI who appointed Mr. E. An expert to make an enquiry. Explain whether SEBI is authorised to make inquiry and take action against the stock exchange. (5 Marks)
- (c) PQR Ltd. is holding 33% of the paid up equity capital of Koya Stock Exchange. The company appoints MNL Ltd. as its proxy who is not a member of the Koya Stock Exchange, to attend the vote at the meeting of the stock exchange. Examine whether the Koya Stock Exchange can restrict the appointment of MNL Ltd. as proxy for PQR Ltd. and further restrict, the voting rights of PQR Ltd. in the Koya Stock Exchange. (5 Marks)

Answer

- (a) General Powers vested in the Board of Directors:

The provisions relating to the general powers which are vested are given under Section 291 of the Companies Act, 1956. As per this section, the Board of Directors of a company is entitled to exercise all such powers and to do all such acts and things as the company is authorised to exercise and do. This means the powers of the Board of Directors are co-extensive with those of the company. The proposition is, however subject to two conditions:

Firstly, the Board shall not do any act which is to be done by the company in general meeting. Secondly, the Board shall exercise all such powers subject to the provisions

contained in the Companies Act, 1956 or in the Memorandum or the Articles of the Company or in any regulations made by the Company in general meeting. But no regulation made by the company in general meeting shall invalidate any prior act of the Board which would have been valid if that regulation had not been made.

It is the first and elementary principle of company law that when powers are vested in the Board of directors by the Articles of a company, they cannot be interfered with by the shareholders as such (*Murarka etc. Works Ltd. vs. Mohal Lal* AIR (1961) Cal 251).

In exercising their powers the directors do not act as agent for the majority members or even all the members. The members therefore cannot by resolution passed by a majority or even unanimously supercede the powers of directors or instruct them how they shall exercise their powers. The above problem is based on decision given by the Chancery Court in the case *Automatic Self Cleansing Filter Syndicate Co. Ltd. Vs. Cunninghame* (1906) 2 Ch 34 and this case was also followed in India in *MP & V Works Vs Murarka* AIR 1961 Cal 251.

In view of above discussion, the contention of shareholders against the non-compliance of their wish by the directors is not tenable and shareholders cannot usurp the power which by articles vested in the directors by passing even a resolution of a numerical majority at the general meeting. The shareholders have, however, the power to alter the Articles of Association of the company in the manner they like subject to the provisions of the Companies Act, 1956.

- (b) Section 6 of the Securities Contracts (Regulation) Act, 1956 empowers SEBI to carry out regular inspection of all exchanges at periodical intervals and also special investigation, if need be. According to section 6 every recognised stock exchange shall furnish periodical returns to SEBI in the prescribed format. These returns contain information on current affairs of the exchange including volume and value of transactions, short deliveries, important decisions taken by board etc. Every stock exchange has to maintain books of accounts for a period of 5 years and these books may be inspected by SEBI at any point of time. SEBI may by order in writing call for information or explanation relating to affairs of an exchange or its member. SEBI also has the power to appoint one or more inquiry officers who may submit their report to SEBI. Every director, manager, secretary or officer of the exchange is bound to provide information to enquiry officer or SEBI representative who is looking into the affairs of the exchange.

So, SEBI is authorised to make inquiry and take action against the stock exchanges. However, SEBI shall have the power to modify or withdraw its directions, either of its own motion or on the representation of the member concerned. (Rule 11 of Securities Contracts (Regulation) Act, 1956).

- (c) Section 7(a) of the Securities (Contracts) Regulation Act, 1956 provides that a recognised stock exchange is empowered to amend rules to provide for all or any of the following matters:
 - (a) Restriction of voting right to members only.

- (b) Regulation of voting rights by specifying that each member is entitled to one vote only irrespective of number of shares held.
- (c) Restriction on right of members to appoint proxy.

As such Koya Stock Exchange can restrict the appointment of MNL Ltd., if rules of the exchange so provide. If it is not so provided, rules may be amended and after getting approval of the Central Government regarding amendment, it can restrict appointment of proxies.

Koya Stock Exchange can also restrict the voting rights of PQR Ltd.

Question 2

Answer any two of the following:

- (a) Examine with reference to the provisions of the Foreign Exchange Management Act, 1999, the residential status of the branches mentioned below:
 - (i) NNM Ltd. an Indian Company having its registered office at Mumbai, India established a branch at New York USA on 1st April, 2005.
 - (ii) DDI Ltd. a company incorporated and registered in London established a branch at Kanpur in India on 1st April, 2005.
 - (iii) DDI Ltd. has a branch office at Singapore which is controlled by its Kanpur branch
(7 Marks)
- (b) Explain the meaning of "Capital Account Transactions" under the Foreign Exchange Management Act, 1999. State its categories and also examine whether the following transactions are permissible or not under the above act as Capital Account transactions:
 - (i) Investment by person resident in India in Foreign Securities.
 - (ii) Foreign currency loans raised in India and abroad by a person resident in India.
 - (iii) Export, import and holding of currency / currency notes.
 - (iv) Trading in transferable development rights.
 - (v) Investment in a Nidhi Company.
(7 Marks)
- (c) (i) An arrangement has been made among the Cotton producers that the cotton produced by them will not be sold to mills below a certain price. The arrangement was in writing but it was not intended to be enforced by legal proceeding. Examine whether the above arrangement can be considered as an agreement within the meaning of section 2(b) of the Competition Act, 2002.
(3 Marks)
- (ii) The Central Government has formed the opinion that Mr. CBM (A member of the Competition Commission of India) has abused his position which may be prejudicial to public interest as a member of the commission. Examine the powers of the Central Government in this regard.
(4 Marks)

Answer

- (a) As per Section 2(u) of the Foreign Exchange Management Act, 1999, 'person' includes the following:

A Company

Any agency, office or branch owned by a 'person'

Further, Section 2(v) defines a 'person resident in India' as to include: any person or body corporate registered or incorporated in India, an office, branch or agency in India owned or controlled by a person resident outside India. And an office, branch or agency outside India owned or controlled by a person resident in India.

Considering the provisions of the two sections, the residential status is as follows:

- (i) NNM Ltd. as well as the New York branch of NNM Ltd. is a 'person'. Therefore, the residential status under FEMA shall be determined for each of them separately. NNM Ltd. is incorporated in India. Therefore, it is a 'person resident in India'. NNM Ltd. (a person resident in India) has established a branch outside India. Therefore, the New York branch of NNM Ltd. falls under the clause 'an office', branch or agency outside India owned or controlled by a person resident in India and so the New York branch is a 'person resident in India'.
- (ii) DDI Ltd. as well as Kanpur branch of DDI Ltd is a 'person'. Their residential status is determined as follows:
 - (a) DDI Ltd (a foreign company) does not fall under any of the clauses of the definition of a 'person resident in India'. Therefore, DDI Ltd. is a 'person resident outside India'.
 - (b) The Kanpur branch of DDI Ltd. is a person resident in India' since it falls under the clause 'an office, branch or agency in India owned or controlled by a person resident outside India'.
- (iii) The Singapore branch of DDI Ltd., though not owned, is controlled by the Kanpur branch. The Singapore branch is a 'person resident in India' since it falls under the clause 'an office, branch or agency outside India owned or controlled by a person resident in India'.

- (b) Meaning of Capital Account Transactions

It means a transaction which alters the assets or liabilities including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of a person resident outside India, and includes transactions referred to in sub-section (3) of Section 6 of FEMA Act, 1999. The Reserve Bank of India has framed Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000. The provisions of these regulations are as under:

Categories of Capital Account Transactions:

As per these regulations, capital account transactions may be classified under the

following heads.

- (1) Permissible capital account transactions of persons resident in India (schedule 1)
- (2) Permissible Capital transactions of persons resident outside India (schedule II).
- (3) Prohibited capital account transactions.

A person resident in India may enter into any of the following capital account transactions provided the regulations specified by the Reserve Bank of India in respect of such capital account transactions are complied with. In view of the above provisions: among five capital account transaction of question first three i.e. (i), (ii) and (iii) are permissible capital account transactions and rest two i.e., (iv) and v are prohibited capital transactions.

- (c) (i) As per Section 2(b) of Competition Act, 2002 an 'agreement' includes any arrangement or understanding or action in concert, -
- (i) Whether or not, such a arrangement or understanding or action is formal or in writing; or
 - (ii) Whether or not, such an arrangement or understanding or action is intended to be enforceable by legal proceedings.

In the given case the understanding reached among the cotton producers not to sell below a certain price shall amount to an agreement as defined under section 2(b) notwithstanding the fact that arrangement is in writing but no intended to enforced by legal proceeding.

- (ii) Section 11(2) (e) of the Competition Act, 2002 empowers the Central Government to remove by an order, a member of the Competition Commission of India from his office if such member has abused his position as to render his continuance in office prejudicial as a member of Competition Commission. However Section 11(3) of the said Act puts some restrictions on such powers of the Central Government. According to this section, in case as stated in the question, Central Government wants to remove a member of the Competition Commission from his office on the above ground, it has to make a reference to the Supreme Court. The Supreme Court shall hold an enquiry in accordance with the procedure formulated by it and then report that the member in question ought to be removed from his office on such ground. Thus the Central Government can remove a member of Competition Commission from his office by following the above procedure.

Question 3

Answer any two of the following:

- (a) M/s Earth Chemicals and Engineering Ltd. is a closely held unlisted company with a paid up share capital of Rs. 3.00 crores, since 1st April, 2001 and its net worth as on 31st March, 2007 was Rs. 5.00 crores. The net tangible assets of the company as per last three audited balance sheets as at 31st March, 2005, 2006 and 2007 were Rs. 4.00 crores, 4.50 crores and 5.00 crores respectively out of which monetary assets were less

than Rs. 50 lakhs in each of the three years. The company was incorporated in 1998 and commenced its business on 1st April, 1998 and since then it has earned good profits and it has not incurred any loss in any year in the past. The company has not declared any dividend so far. But according to the profits earned so far, the management could have declared dividends in each of the last five years. The name of the company was changed from Earth Engineering Ltd. to its present name effective from 1st October, 2006. The company wants to make a public issue of shares to raise Rs. 20.00 crores by issuing equity shares at premium. For the purpose of including the information in the prospectus. The company has prepared its accounts for 12 months ended 30th September, 2007 showing segment wise revenue, which reveals that revenue from chemical segment was more than the revenue from engineering segment. Keeping the relevant guidelines issued by SEBI into account, examine whether the company can make the desired issue of equity shares based on the facts stated above. (8 Marks)

- (b) An investor has complained to SEBI that he has not received the payment due to him from the stock broker registered with Calcutta Stock Exchange Association Ltd. The complainant has requested SEBI to take appropriate action against the stock broker. State with reference to the provisions of Securities and Exchange Board of India Act, 1992. The action that can be taken against the stock broker, the procedure to be adopted and the factors that will be taken into account of SEBI. (8 Marks)
- (c) "When two or more provisions of the same statute are repugnant to each other, the court will try to construe the provisions in such a manner, if possible, as to give effect to all". Examine the statement with reference to the provisions of sections 166 and 210 of the Companies Act, 1956 which appear to be seemingly contradictory to each other for compliance. (8 Marks)

Answer

- (a) According to para 2.2.1 of Guidelines laid down in Chapter II of the SEBI (Disclosure and Investor Protection) Guidelines, 2000, an unlisted company can make an initial public offer of equity shares if the following conditions are fulfilled:
- A. The company has net tangible assets of at least Rs. 3 crores in each of the preceding three full years (of 12 months each), of which not more than 50% is held in monetary assets. Provided that if more than 50% of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such excess monetary assets in its business / project.
 - B. The company has a track record of distributable profits in terms of section 205 of the Companies Act, 1956, for at least three out of immediately preceding five years. Provided further that extraordinarily items shall not be considered for calculating distributable profits in terms of section 205 of the Companies Act, 1956.
 - C. The company has a net worth of at least Rs. 1 crore in each of the preceding 3 full years (of 12 months each).
 - D. In case the company has changed its name within the last one year, at least 50% of

the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name; and

- E. The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e. offer through offer document + firm allotment + promoter's contribution through the offer document) does not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year.

In the given question, the company has net tangible assets exceeding Rs. 3 crores in each of the preceding three years and it has monetary assets which are less than 50% thereof, the company has a track record of having distributable profits in last three out of last five years, the declaration of dividend is not essential. The company has a net worth of more than Rs. 1 crore in each of the preceding three full years. The company has changed its name by including the word "chemicals" therein and as per the information provided, the revenue earned by the company from this activity is more than 50% of the total revenue earned by it during the preceding one full year of 12 months. Finally, the issue size is Rs. 20.00 crores, which is less than five times its pre-issue net worth of Rs. 5 crores. The company is free to price their equity shares. Hence, the company can raise Rs. 20 crores through public issue of equity shares at a premium.

- (b) A stock broker registered with any recognised stock exchange is governed by the provisions of Securities and Exchange Board of India Act, 1992. Accordingly, he exposes himself to certain penalties under Section 15F of the Act, in certain circumstances. According to Section 15F (b) of the Act, if a registered stock broker fails to make payment of the amount due to the investor in the manner or within the time specified in the relevant regulations, he shall be liable for a penalty of one lac rupees for each day during which the default continues or one crore rupees whichever is less.

For the purpose of adjudging any default under Section 15F of Securities and Exchange Board of India Act, 1992 as per Section 15I of the said Act, SEBI shall appoint any of its officers not below the rank of Division Chief to be an adjudicating officer for holding the enquiry in the prescribed manner after giving the person concerned a reasonable opportunity of being heard for the purpose of imposing any penalty.

Section 15J of the said act enumerates following factors that shall have to be taken into account by the adjudicating officer while adjudging the quantum of penalty.

- (i) The amount of disproportionate gain or unfair advantage, wherever quantifiable, made as a result of the default.
 - (ii) The amount of loss to the investor or group of investors as a result of the default.
 - (iii) The repetitive nature of the default.
- (c) The statement in question is relates to an important rule of interpretation that is 'Rule of Harmonious Construction' of a Statute. According to this rule when there is doubt about the meaning of the words of a statute, these should be understood in the sense in which they harmonise with the subject of the enactment and the object which the legislature had in view. Their meaning is found not so much in strictly grammatical or etymological

propriety of language, nor even its popular use, as in the subject or in the occasion on which they are used and the object to be attained. Where there are in an enactment two or more provisions which cannot be reconciled with each other, they should be so interpreted whichever possible as to give effect to all of them. This is what is known as the Rule of Harmonious Construction. Let us take an example: According to Section 166(i) of the Companies Act, 1956 there must be not more than fifteen months gap between two consecutive annual general meetings of a Company. Section 210 requires the Board of Directors to lay at every annual general meeting of a company a profit and loss account, which must cover the period since the preceding account and must be made up to date not earlier than the date of the meeting by more than six months. The profit and loss account is required to be accompanied by a balance sheet as at the date to which the profit and loss account is made up. For some special reasons, however, the Registrar may give an extension for not more than 3 months to hold the meeting. In such a case, the accounts must relate to a period not earlier than the date of the meeting by more than six months plus the extension period. From this, it can easily be made out that except the first annual general meeting which is subject to different rules an annual general meeting is to be held subject to the following rules:

- (i) The meeting must be held in each calendar year
- (ii) It must be held not later than 15 months (18 months if extension is granted) from the date of the previous general meeting.
- (iii) Further, it must be held within six months (or six months + extension) of the date of balance sheet.

These three requirements are cumulative and separate; failure to comply with any of them constitutes an offence. Thus even where a company may hold its annual general meeting within the time limit of 15 months (or 18 months, if extension is granted) it may still be guilty of contravention of Section 210. Therefore, to give effect to both the provisions of sections, they are to be interpreted harmoniously and in fixing the date of the annual general meeting Section 166 as well as section 210 are to be taken into account. The following illustration will make things clear:- The financial year of a company ends on 31st March each year, presumption that the annual general meeting to adopt the accounts etc. relating to the year ended on 31st March, 2006 was held on 30th September, 2006 under Section 166 (i) the next general meeting need not be held till 31st December, 2007. But the relevant accounts would be those of the year ended on 31st March, 2007 which would be more than six months before the date of meeting. Therefore, the last date for holding that meeting would be 30th September, 2007.

Question 4

- (a) Mr. X was appointed as the Managing Director of ABC Ltd. for a period of 5 years w.e.f, 1st January, 2006. Since his work was found unsatisfactory. His services were terminated from 15th August, 2007 by paying compensation for the loss of office as provided in the agreement entered into by the company. Later, the company discovered that during his tenure of office Mr. X was guilty of many corrupt practices and that he

should have been removed without payment of compensation. Advise the company whether the services of the Managing Director can be terminated without payment of compensation as provided in the agreement and whether the company can recover the amount already paid to Mr. X filing a suit. (8 Marks)

- (b) M/s FAB Electronics Ltd. (FEL) has appointed four private companies as its selling agents for sale of its white goods in the four regions of the country. A complaint has been made to the Registrar of Companies, new Delhi that the four selling agents are in fact functioning as sole selling agents and that the terms and conditions of their appointment are not in the interest of FEL. Advise FEL about the provisions of the Companies Act and the action that may be taken by the authorities under the Act.

(7 Marks)

Answer

- (a) According to Section 318 of the Companies Act, 1956 a Managing Director is entitled to be paid compensation for loss of office. However, Section 318(3) (e) provides that no compensation is payable if the director concerned has been guilty of fraud or breach of trust or of gross negligence in or gross mismanagement in the conduct of the affairs of the Company. However, in the present case, compensation amount was paid and subsequently the misconduct on the part of Mr. X was noticed by the company. In the case of Bell Vs. Lever Bros (1932) Lever Bros removed their managing director of a subsidiary by paying them compensation. It was afterwards discovered that during his tenure of office he had been guilty of so many breaches of duty and corrupt practices that he could have been removed without compensation. An action was then commenced to recover back the compensation money. It was held that Bell was not bound to refund the compensation money and to disclose any breach of his fiduciary obligation so as to give the company an opportunity to dismiss him. Thus, in normal circumstances, ABC Ltd., is entitled to terminate the services of Mr. X as Managing Director without payment of compensation as he was guilty of many corrupt practices. In the present case, however, ABC Ltd. will not be able to recover the compensation money already paid to Mr. X the Managing Director.
- (b) According to Section 294(6) of the Companies Act, 1956 where a company has more selling agents than one, by whatever name called and it appears to the Central Government that it is necessary to obtain information about the terms and conditions of appointment of such agents for the purpose of determining whether any of those selling agents are in fact working as sole selling agents. The Central Government has the power to call for such information as may be necessary to find out the correct position. On the basis of the information obtained, the Central Government may by an order declare that selling agents be the sole selling agent for the area so stated with effect from such date as may be specified in the order. From the date so specified in the order, the appointment of the sole selling agent shall be regulated by the terms and conditions as may be varied by the Central Government. It shall be the duty of the company to furnish all information and documents and refusal to do so will involve penalty which may extend upto Rs. 50,000/-. Thus it is imperative for the company to furnish all the

information and documents in its possession to the Registrar of Companies or any authority making any enquiry in this regard that the selling agents are not functioning as sole selling agents.

Question 5

- (a) The Board of Directors of XYZ Ltd. has agreed in principal to grant 'loan' worth Rs. 38 lakhs to MNC Ltd. on the basis of the following information. Advise XYZ Ltd. about the requirements to be complied with under the Companies Act, 1956 for the proposed inter-corporate loan to MNC Ltd.

(i)	Authorised share capital	Rs.	1,00,00,000	
(ii)	Issued, subscribed and paid up capital	Rs.	50,00,000	
(iii)	Free reserves	Rs.	10,00,000	(8 Marks)

- (b) M/s Flyover Constructions Ltd. has to recruit 2,000 Civil Engineers on contract basis for a period of 5 years. The company entered into an agreement with the employees that each employee will have to deposit Rs. 50,000 as security which sum will be returned on completion of 3 years of contract of service. The company wants to utilize the fund so collected in their business. Advise the company with reference to Companies Act in the matter of collection and utilisation of money received from employees as security deposit.

(7 Marks)

Answer

- (a) Inter corporate loans and investments are governed by the provisions of Section 372A of the Companies Act, 1956. As per this Section, a company can advance loans to other companies or invest in the securities, of other companies upto 60% of its paid-up capital and free reserves or upto 100% of its free reserves, whichever is more. Further no loan or investment exceeding the said limits can be made by a company unless authorised by a previous special resolution passed in this regard.

First determine whether a special resolution is required for providing loans to MNC Ltd.

This can be determined as follows:

Paid up capital XYZ Ltd. (A)	(A)	Rs. 50,00,000
Free reserves	(B)	Rs. 10,00,000
Aggregate of paid up capital and free reserves	(C)	Rs. 60,00,000
60% of aggregate of paid up capital and free reserves	(D)	Rs. 36,00,000
Higher of (B) or (D) i.e. the ceiling limit for inter-corporate loan/investment etc. without requiring company to pass Special Resolution		Rs. 36,00,000
Proposed loans to MNC Ltd.		Rs. 38,00,000

Since the proposed loan exceeds the ceiling limit a special resolution is required. XYZ Ltd. should adopt the following procedure for providing loan to MNC Ltd.

- (i) Unanimous approval of the Board by passing a resolution at a Board meeting.
- (ii) A special resolution shall be passed in the general meeting

The notice of special resolution shall state the specific limits, particulars of the company to which loan is proposed to be given, specific source of funding and other relevant details. The company shall file a copy of special with the registrar within 30 days of passing of the special resolution. If the company is listed company, it shall pass the resolution by postal ballot as prescribed under Section 192A.

- (iii) the company shall obtain the prior approval of the Public Financial Institution, if any, from whom it has taken a term loan.
- (iv) the company can provide such loan to other companies only if no default in respect of public deposits is subsisting.
- (v) the prescribed particulars shall be entered in the register maintained under Section 372A(5).

(b) Section 417 of the Companies Act, 1956 provides that

- (1) any money or security deposited with a company by any of its employee in pursuance of his contract of service with the company shall be kept or deposited by the company within fifteen days from the date of deposit.
 - (i) in a post office savings bank account, or
 - (ii) in a special account to be opened by the company for the purpose in the State Bank of India or in a scheduled bank, or
 - (iii) where the company itself is a scheduled bank, in a special account to be opened by the company for the purpose either in itself or in the State Bank of India or in any other scheduled bank.
- (2) No portion of such moneys or securities shall be utilised by the company except for the purposes agreed to in the contracts of service.
- (3) A receipt for moneys deposited with a company by its employee shall not be deemed to be security within the meaning of this section; and the moneys themselves shall accordingly be deposited as provided in sub-section (1).

So the Flyover Constructions Ltd. cannot utilize the money so collected. It will have to deposit the money in the special accounts as referred in the section.

Question 6

- (a) M/s Joel Ltd. was incorporated in London with a paid up capital of 10 million pounds. Mr. Y an Indian citizen holds 25% of the paid up capital. M/s. X Ltd. a company registered in India holds 30% of the paid up capital of Joel Ltd. M/s. Joel Ltd. has recently established a share transfer office at New Delhi. The company seeks your advice as to what formalities it should observe as a foreign company under Companies Act, 1956. State

briefly the requirements relating to filing of accounts with the Registrar of Companies by the foreign company in respect of its global business as well as Indian business.

(8 Marks)

- (b) The auditors of PQR Ltd. accepted the Certificate of the Manager, a person of acknowledge competence and high reputation, as to the value of the stock in trade. The stock was grossly overstated for several years in the balance sheets of the company. As a result of this over valuation dividends were paid out of capital. The Auditors did not examine the books of account very minutely. If they had done so and compared the amount of stock at the beginning of the year. With the purchases and sales during the year, they would have noticed the over valuation. The company subsequently went into liquidation and the auditors were sued to make good the loss caused by the wrongful payment of dividends relying on the balance sheets figures. Based on the above facts, you are required to decide. With reference to the provisions of the Companies Act, 1956 and the decided case laws, the following issues:
- (i) Whether auditors of the company will be liable for the loss caused to the company by the wrongful payment of dividends based on the Balance Sheets duly audited by the Auditors.
 - (ii) What are the statutory duties of the Auditors in this regard ?

(7 Marks)

Answer

- (a) As per section 591 (1) of the Companies Act, 1956, companies falling under the following two classes shall be known as foreign companies namely:
- (i) companies incorporated outside India which, after the commencement of this Act, establish a place of business within India, and
 - (ii) companies incorporated outside India which have, before the commencement of this Act, established a place of business within India and continue to have an established place of business within India at the commencement of this Act.

Notwithstanding anything contained in sub-section (1) of section 591, where not less than fifty percent of the paid up share capital (whether equity or preference or partly equity and partly preference) of a company incorporated outside India and having an established place of business in India, is held by one or more citizens of India or by one or more bodies corporate incorporated in India, or by one or more citizens of India and one or more bodies corporate incorporated in India, whether singly or in the aggregate, such company shall comply with such of the provisions of the Act as may be prescribed with regard to the business carried on by it in India, as if it were a company incorporated in India.

Here as more than 50% of the paid-up capital is held by an Indian citizen and an Indian company M/s Joel Ltd. shall be treated as Indian company. It shall have to comply with such provisions of the Act as may be prescribed as if it were a company incorporated in India.

Joel Ltd. has to submit the following documents with the Registrar of Companies, New Delhi within 30 days of establishment of business in India.

- (a) a certified copy of the charter, statutes, or memorandum and articles, of the company or other instrument constituting or defining the constitution of the company; and, if the instrument is not in the English language, a certified translation thereof.
- (b) the full address of the registered or principal office of the company;
- (c) a list of the directors and secretary of the company, containing the particulars mentioned in sub-section (2) of section 592.
- (d) the name and address or the names and addresses of some one or more persons resident in India, authorised to accept on behalf of the company service of process and any notices or other documents required to be served on the company; and
- (e) the full address of the office of the company in India which is to be deemed its principal place of business in India.

Section 594 provides for the requirements of accounts of a foreign company. As per this section

- (1) Every foreign company shall, in every calendar year –
 - (a) make out a balance sheet and profit and loss account in such form containing such particulars and including or having annexed or attached thereto such documents (including, in particular documents relating to every subsidiary of the foreign company) as under the provisions of this Act it would, if it had been a company within the meaning of this Act, have been required to make out and lay before the company in general meeting; and
 - (b) deliver three copies of those documents to the registrar; Provided that the Central Government may, by notification in the official gazette, direct that, in the case of any foreign company or class of foreign companies the above said requirements of clause (a) shall not apply, or shall apply subject to such exceptions and modifications as may be specified in the notification.

If any such document as is mentioned in sub-section (1) is not in the English language, there shall be annexed to it a certified translation thereof.

- (b) The answer to the problem given in question mainly relates to the duties of the auditors. Section 227 of the Companies Act, 1956 provides that the main duty of the auditor is to make a report to the members of the company on the accounts examined by him and the balance sheet and the profit and loss account of the company and on every document which is annexed to the balance sheet or profit and loss account laid before the company in general meeting. The auditor owes a duty to the members to state whether the accounts give a true and fair view of the affairs of the company at the end of the financial year and of the profit and loss account of the year.

The duty of an auditor is to give information in direct and express terms (Crichton's Oil Co. Re (1902) 2ch 86) and not merely to arouse inquiry. If he discovers that any illegal or improper payment papers to have been made, his duty will be to report to the members. The auditor occupies a fiduciary position in relation to the shareholders and in auditing the accounts maintained by the directors, he must act in the best interest of the shareholders who are in the position of beneficiaries.

But there is a limitation relating to perform the duties by the auditors. An auditor is not bound to be a detective, and to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of any thing of that kind he is only bound to be reasonable cautious and careful.

The above problem is related to case of Kingston Mill Co. Re (No 2) (1896) 2 ch 279. In this case it was held that, the auditors were not liable. It is not auditor's duty to take valuation of the stocks. There are many matters in which he may rely on the honesty and accuracy of others. Further they (auditors) do not guarantee the discovery of all frauds.

Question 7

- (a) M/s. City Hospital Private Ltd. has two groups of Directors. A dispute arose between the two groups out of which one group controlled the majority of shares. A very serious situation arose in the administration of the company's affairs when the minority group ousted the lawful Board of Directors from the possession and control of the management of the company's factory and workshop. Books of account and statutory records were held by the minority group and consequently the annual accounts could not be prepared for two years. The majority group applied to the company law board for relief under sections 397 and 398 of the Companies Act. You are required to decide with reference to the provisions of the said Act, the following issues:
- (i) Can majority of shareholders apply to the Company Law Board for relief against the oppression by the minority shareholders ?
 - (ii) Whether Company Law Board can grant relief in such circumstances. (8 Marks)
- (b) Worthless Ltd. has gone into liquidation because of the inability of the company to pay its debts. During the course of winding up, a proposal was put forward by the previous management to revive the working of the company through a scheme of arrangement between the company and its creditors. As per the scheme, all the creditors have to forego fifty percent of their dues. Some of the creditors have voiced their opposition to the said scheme. The company approaches you for advice. State the steps that have to be taken by the company in this regard. (7 Marks)

Answer

- (a) (i) The case stated in the question relates to the provisions of sections 397 and 398 of

the Companies Act, 1956 with regard to remedy available to majority shareholders.

Where the majority is prevented from protecting itself by controlling the directors at general body meetings, the majority becomes an artificial minority entitled to claim protection under Sections 397 and 398 (V. Sebastian, Dr V City Hospital (Pvt.) Ltd. (1985) 57 Comp. case 453 (Ker)] Thus the remedy under Sections 397 and 398 is confined not to an oppressed minority of the shareholders alone; an oppressed majority may also apply to the Company Law Board against their oppression from the side minority shareholders. In *Sindhri Iron Foundry (Pvt.) Ltd. Re* (1963) 78 C.W.N. 118, issue and allotment of a number of shares in a company whereby an admitted majority of shareholders was reduced to a minority was struck down. While granting relief to a majority group, Mitra J observed in their case;

“If the Court (now the Company Law Board) finds that the company's interest is being seriously prejudiced by the activities of one or the other group of shareholders, that two different registered offices at two different addresses have been set up, that two rival boards are holding meetings, that the company's business property and assets have passed into hands of unauthorised persons who have taken wrongful possession and who claim to be the shareholders and directors, there is no reason why the Court (now the company Law Board) should not make appropriate orders to put an end to such matters”.

- (ii) Relief by the Company Law Board: The Company Law Board may give relief if it is of the opinion:

1. that the company's affairs are being conducted (a) in a manner prejudicial to public interest, or (b) in a manner oppressive to any member or members; 2. that the facts justify the compulsory winding up order on the ground that it is just and equitable that the company should be wound up; 3. that to wind up the company would unfairly prejudice the applicants.

On being satisfied about the above requirements, the Company Law Board may pass such order as it thinks fit with a view to bring an end to the matters complained of. This provision would help salvage an otherwise sound concern which would have been, but for this principle, forced to into winding up.

- (b) As per Section 517 of the Companies Act, 1956 any arrangement entered into between a company about to be, or in the course of being wound up and its creditors shall, subject to the right to appeal under this section, be binding on the company and on the creditors if it is sanctioned by a special resolution of the company and acceded to by three-fourths in number and value of the creditors. Any creditor or contributory may, within three weeks from the completion of the arrangement, appeal to the Court (now Tribunal) against it and the Court (now tribunal) may thereupon, as it thinks just, amend, vary, confirm or set aside the arrangement. Thus, *M/s Worthless Ltd* may enter into a scheme of arrangement with the creditors by the procedure given below:

1. The draft scheme of arrangement shall be considered and approved by the board of directors.

2. The company shall apply to the court for directions to convene the meetings of the members and creditors.
3. A general meeting of the company shall be held and the special resolution approving the scheme of arrangement shall be passed.
4. A meeting of creditors shall be held whereat the scheme shall be agreed to by $\frac{3}{4}$ in number and value of the creditors. The company shall approach the Court (Tribunal) for approval of the scheme.

On receipt of the courts (Tribunal) order, the company shall file a certified copy of the Court (Tribunal) order with the Registrar of Companies.

Question 8

- (a) Mr. X appointed as the Managing Director of XYZ Ltd. w.e.f. 1st October, 2006. The company made an application to the Central Government for approval, as the remuneration proposed to be paid to Mr. X was beyond the limits laid down in schedule XIII to the Companies Act, 1956. The company started paying remuneration from the date of appointment and continued to do so till 31st March, 2007. The Central Government did not approve the remuneration as proposed by the company and restricted the same to a lower amount. On scrutiny of the accounts, it was noticed that the company till 31st March, 2007 has paid to Mr. X, a total sum of Rs. 1.20 lakhs in excess of the remuneration sanctioned by the Central Government. Explain with reference to the provisions of the Act whether Mr. X can keep the excess remuneration. Draft a resolution for waiver of recovery of the excess remuneration so paid by the company. (8 Marks)
- (b) The articles of association of DEF Ltd. mentioned in it that Mr. X and Mr. Y will act as directors of the company from the date of incorporation. The company was incorporated on 2nd January, 2007. The articles also provided that the directors will have to obtain qualification shares within one month from the date of appointment as director. Mr. X purchased the shares of the company on 28th February, 2007 and Mr. Y purchased on 28th March, 2007 thus violating the provisions contained in the articles. Having regard to the provisions of the companies Act. Examine the validity of the appointments of Mr. X and Mr. Y as directors. (7 Marks)

Answer

- (a) According to Section 309(5A) of the Companies Act, 1956, if any director draws any remuneration in excess of the remuneration sanctioned by the Central Government, he shall refund such excess remuneration to the company. Until such excess remuneration is returned he shall hold it in trust for the company. The company shall not waive the recovery of any sum refundable to it unless permitted by the Central Government.

In the present case Mr. X cannot therefore keep remuneration drawn by him which is in excess of the remuneration sanctioned by the Central Government, the Central Government permit the waiver of recovery of excess remuneration, the company may waive the recovery of excess remuneration, and then Mr. X will have a right to retain the

excess remuneration drawn by him.

Draft resolution for waiver of recovery of the excess remuneration:

"Resolved that subject to the approval of the central Government, consent of the company be and is hereby given waiving the recovery of an amount of Rs. 120,000 paid to Mr. X the director of the company, during the period 1st October, 2006 to 31st March, 2007 being in excess of the remuneration sanctioned by the Central Government vide letter no. dated

Resolved further that an application be made to the Central Government and the company secretary be and is hereby authorised to take the necessary steps in this regard."

- (b) Without prejudice to the restrictions imposed by section 266 of the Company Act, 1956, it shall be the duty of every director who is required by the articles of the company to hold a specified share qualification and whom is not already qualified in that respect, to obtain his qualification within two months after his appointment as director vide Section 270(1).

So it becomes incumbent on the part of every director to hold qualification shares within the time specified and if he does not hold the same at the time of his appointment as director he must acquire them within two months after his appointment as director. Any provision made in the articles of the company requiring a person proposed for directorship to hold qualification shares either before appointment or within a shorter than two month after his appointment will be void.

Here the provision in the articles of association to hold shares within one month shall be void. Keeping the above provision in consideration the appointment of Mr. X will be valid as he acquired the share before the expiry of two months. As far the appointment of Mr. Y is concerned he has failed to acquire the share within two-month period. As per section of 283(1)(a) the office of director shall become vacant if he fails to obtain the shares within the time specified in section 270(1). Therefore Mr. Y shall have to vacate his office. Here the date of incorporation is taken as the date of appointment.

Question 9

- (a) Mr. Z an expert in modern agriculture practices is willing to lend his services as a director of M/s. Lord Krishna Cotton Producer Company Ltd. registered under Section 581C of the Companies Act, 1956. Advise Mr. Z as to how he can be appointed as a director including (1) The total number of directors that can be appointed (2) The tenure of the directors (3) The time limit within which the appointment should be made (4) the co-option of directors and (5) the voting powers of such co-opted directors. (8 Marks)
- (b) M/s. Info-tech Overtrading Ltd. was ordered to be wound up compulsory by an order dated 15th October, 2007 of the Delhi High Court. The official liquidator who has taken control for the assets and other records of the company has noticed the following:
- (i) The Managing Director of the company has sold certain properties belonging to the company to a private company in which his son was interested causing loss to the company to the extent of Rs. 50 lakhs. The sale took place on 10th May, 2007.

- (ii) The company created a floating charge on 1st January, 2007 in favour of a private bank for the overdraft facility to the extent of Rs. 5 crores, by hypothecating the current assets viz., stocks and book debts.

Examine what action the official liquidator can take in this matter. Having regard to the provisions of the Companies Act, 1956. (7 Marks)

Answer

- (a) According to Section 581P of the Companies Act, 1956 the members who sign the memorandum and the articles are designated as first directors and shall govern the affairs of the company until the directors are appointed at the Annual General Meeting. According to Section 581 O every producer company shall have at least five and not more than fifteen directors. The election of directors shall be conducted within 90 days from the date of registration of the producer company. In the case of Inter-State Co-operative Society the election shall be held within a period of 360 days. The period of office of a director shall be not less than one year and not exceeding 5 years as may be specified in the articles. The directors are normally elected and appointed by the members in the Annual General Meeting. The Board may also co-opt one or more expert directors as an additional directors. Such directors cannot exceed 1/5th of the total number of directors. The expert directors shall not have the right to vote in the election of Chairman but shall be eligible to be elected as Chairman if it is provided by the articles. The maximum period for which such experts are appointed as directors will be as provided in the articles of association and it cannot exceed 5 years. Thus Mr. Z can be appointed as expert director but he will not have any voting right in the election of chairman of the Board of Directors. His tenure of office can be between one to five years.

- (b) The Official Liquidator can invoke the provisions contained in Section 531 of the Companies Act, 1956 to recover the sale of assets of the company. According to Section 531, any transfer of property, movable or immovable made within 6 months before the commencement of winding up will be deemed to be a fraudulent preference and hence invalid in the eyes of law. Since in the present case, the sale of immovable property took place on 10th May, 2007 and the company went into liquidation on 15th October, 2007 i.e., within 6 months before the winding up of the company and since the sale has resulted in a loss of Rs. 50 lakhs to the company. The official liquidator will be able to succeed in proving the case under Section 531 by way of fraudulent preference as the property was sold to a private company in which the son of the ex-managing director was interested.

According to Section 534 of the Companies Act, 1956 any floating charge created within 12 months of the commencement of the winding up will be treated as invalid unless it is proved that the company immediately after the creation of charge was solvent. In the present case it may be difficult for the Bank, the charge holder to prove that the company was solvent after the creation of the floating charge. The charge holder i.e., the Bank is however, entitled to recover from the company. The amount advanced along with 5% interest. Further preferential debts under Section 530 will have priority over debts secured by a floating charge. The official liquidator may thus prove that the floating charge created by the company is invalid.