LESSON 1

MEANING, FEATURES AND TYPES OF COMPANIES

Structure

1.0 OBJECTIVES

After reading this lesson, you should be able to:

- Understand the meaning of a company and its features.
- Get the insight of lifting the corporate veil.
- Know how companies are classified on various basis.

1.1 INTRODUCTION

Limitations of traditional forms of business organisations i.e. sole proprietor and partnership, led to the advent of company form of organisation. The traditional forms of organisations failed to meet the increasing requirements of capital and skills needed for large-scale business enterprises. The industrial revolution brought about revolutionary changes in the methods of production. The production was not confined to the local limits of a city, town or village but became international in character. This, in turn, resulted in an ever growing need for capital and managerial skills which was never experienced before. Another key factor which led to the rapid development of the company form of organisation was the reluctance on the part of the sole traders or partners in the partnership firms, to bear the brunt of unlimited liability.

The company form of organisation furnished the organisers with twin advantages of limited liability and huge capital resources, besides, free transferability of shares and a separate legal entity. The last two, combined with other characteristics of the company form of organisation, enabled greater mobilisation of capital resources and a longer life-perpetual existence of the company, irrespective of the life of the members of the company constituting it.

1.2 MEANING OF A COMPANY

According to Section 2 (20) of the Companies Act, 2013 "company" means a company incorporated under this Act or under any previous company law. A company incorporated under any previous company law means an existing company.

The definition given above fails to reveal what a company is or what its salient characteristics are. Chief Justice Marshall of U.S.A. has defined a company in the following words: "A corporation is an artificial being, invisible, intangible and existing only in the contemplation of law. Being a mere creation of law, it possesses only the properties which the charter of its creation confers upon it, either expressly or as incidental, to its very existence."

According to Prof. Haney, "A company is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal." This definition given by Prof. Haney very clearly reveals what a company is and what its essential characteristics are.

1.3 FEATURES OF A COMPANY

Following are the essential characteristics of a company:

1. Incorporated association. A company is an incorporated or registered association. It is created either by an Act of Legislature or by registration under the Companies Act. An unincorporated association cannot be called a company in the strict legal sense of the word. Only after a company is incorporated or registered, it becomes a separate entity.

2. Artificial legal person. A company is an artificial person as against a natural person. It is created by a process of law. It has no physical existence. It has no body and as such you cannot shake it down in a fit of anger. It has no soul, no conscience and hence, it is called an artificial person. At the same time, it enjoys certain rights and has some obligations like a natural person. It can transfer property, enter into contracts, sue or be sued and fined for violating the provisions of the Companies Act.

3. Separate entity. A company, after it is incorporated, acquires a separate entity or what is called a juristic personality, entirely distinct from the individual members constituting it. It has the right to own and transfer property. It can sue and be sued in its own name by its members as well as outsiders. Even if a shareholder owns virtually the whole of its capital, the company is a separate legal entity in the eyes of law, as distinguished from a shareholder.

This principle was enunciated in the famous case of Salomon v. Salomon & Co. Ltd. (1897) A. C. 22. One Salomon, a leather merchant, sold his business for £ 30,000 to Salomon & Co. Ltd. The Salomon & Co. consisted of Salomon himself, his wife, four sons and one daughter. The purchase consideration was paid by the company to Salomon by allotment of 20,000 fully paid shares of £ 1 each and £ 10,000 worth of debentures carrying a floating charge over all the assets belonging to the company. One share each was allotted to the other six members comprising his wife, four sons and one daughter. Salomon, thus, had an absolute control over the company. After a period of only one year, the company ran into financial difficulties and was ordered to be wound-up. The creditors of the company sought priority over the debenture holders on the ground that the company and Mr. Salomon were one and the same person. They further contended that the company was a mere 'alias' or an agent for Salomon. The business was, solely his, conducted solely for him and by him and the company was mere 'sham' and 'fraud'. Hence, Salomon was liable to indemnify the company against its trading debts. The House of Lords, however, held that the existence of a company is quite independent and distinct from its members and that the company's assets must be applied in payment of the debentures first in priority to unsecured creditors.

The following observations made by Lord Macnaghten in this connection are worth noting: "The company is at law a different person altogether from the subscribers 'to the Memorandum' and, though it may be that after incorporation the business is precisely the same as it was before, and 'the same persons are managers, and the same hands receive the profits, the company 'is not in law the agent of the subscribers or trustee for them'. Nor are the subscribers, as members, liable in any shape or form, except to the extent and in the manner provided by the Act."

4. Perpetual existence. A company has a continued existence. As a company has a separate entity, it is comparatively more stable than a sole proprietorship or partnership. The life of the company is not dependent upon the life of the individual members constituting it. The death, insolvency, insanity or retirement of any member or director does not affect the life of the company. Even the death of all the members will not mean the death of the company.

During the war all the members of one private company, while in general meeting, were killed by a bomb. But the company survived, not even a hydrogen bomb could have destroyed it.

5. Common seal. Since a company is an artificial person it cannot act by itself. It has to act through natural persons the directors. The directors, while entering into contracts on behalf of the company are required by law to affix the company's seal, if there is any, as a token of its signature.

6. Limited liability. Perhaps, the most important advantage for which a company is formed, is the limited liability. The liability of every member of the company is limited to pay the face or nominal value of a share. If he has paid the full amount due on his share, he will not be required to pay anything more to meet company's liability. For example, if the face value of a share in a company is ₹ 10 and the shareholder has paid ₹ 8, his liability to the company is for the remaining balance of ₹ 2 only and no more. In case of a company limited by guarantee, the liability of the member is limited to the amount he has guaranteed to contribute to the assets of the company, in the event of its being wound-up.

7. Transferability of shares. One of the important characteristics of a company is transferability of its shares. The shares of a public company are freely transferable. The Articles of a public company cannot and of a private company must impose restrictions on the transfer of shares. However, a company cannot impose absolute restrictions on transfer of its shares. Such a restriction would be void. As per the Companies Act, 2013, a public company, whose shares are listed on a recognised stock exchange cannot refuse to register transfer of its shares.

8. Separate property. It is a corollary of the concept of separate entity. A company is regarded as a separate entity distinct from its members. Such a company is capable of owning, enjoying and also of transferring property in its own name. Although, its members or shareholders contribute its capital, yet they are not the joint owners of the property of the company. No member can claim himself to be the owner of the company's property during its existence or on its winding-up. The shareholders do not even have an insurable interest in the property of the company.

9. Capacity to sue. A company is a separate legal entity. As such, it can sue and be sued in its own name.

1.4 LIFTING THE CORPORATE VEIL

A company is regarded as a separate entity distinct from its members [Salomon v. Salomon Co. Ltd. (1897) A.C. 22]. As such, the members cannot be held liable for the acts of the company. Thus, there is a veil (curtain or cloak) between the company and its members. Ordinarily, the Court or Tribunal will not look behind the corporate entity i.e., the Court or Tribunal will not see who are the real persons controlling the company.

However, this concept of separate entity cannot be misused by the members of the company to evade taxes or play fraud on people. In such cases, the Court or Tribunal cannot be a silent spectator. As such, the Court or Tribunal can and ought to lift or pierce the corporate veil to look or find out the real persons doing the mischief under the garb of corporate personality. This is known as "lifting or piercing the corporate veil".

The circumstances under which the Court or Tribunal can lift the corporate veil may be broadly divided into two categories:

(A) Cases falling under judicial decisions.

(B) Cases falling under express statutory provisions.

(A) Under Judicial Decisions

L Protection of revenue. The Courts have lifted the corporate veil where it was used to evade taxes or circumvent tax obligations.

Santanu Roy v. Union of India (1988) 38 E.L.T. (Del.). In this case show cause notices were issued to individual directors of M/s Duncan Agro Industries Ltd. by the Central Excise authorities for alleged evasion of excise duty by reason of fraud. This was challenged by the directors on the ground of the liability being that of the company. The High Court lifted the corporate veil to determine the liability of the directors. The Court observed that any director, who is a party to the fraud or commissioning of any tort, is personally liable.

2. Prevention of fraud or improper conduct. If the separate entity of the company is misused for defrauding people or avoiding legal obligations, the Court or Tribunal can lift the corporate veil.

Gilford Motor Co. v. Horne (1913) 1 Ch. 935, Horne was appointed as a managing director of Gilford Motor Co. The service agreement imposed a condition that Horne shall not solicit the customers of the company. Horne formed a company which solicited the plaintiff s customers. Held, the company was a mere cloak or sham for the purpose of enabling Horne to commit breach of his service agreement to solicit customers. The Court restrained Horne, as well as the defendant company, from soliciting customers.

3. Determination of enemy character of a company. When the management of a company is in the hands of persons residing in an enemy country, the Court or Tribunal may lift the corporate veil as the company acquires an enemy character. In such cases to allow alien enemies to trade under the garb of corporate entity, will be against public policy.

4. Avoidance of welfare legislation. The Court or Tribunal can lift the corporate veil if it finds that the company is misusing its corporate entity to avoid welfare legislation.

5. To determine contempt of Court. Where corporate veil is used to avoid contempt of Court or Tribunal, the Court or Tribunal can pierce the corporate veil and punish the guilty persons for contempt of Court.

6. Determination of technical competence of the company. Just as to determine enemy character of a company corporate veil can be pierced, similarly, to determine technical competence of the company, its corporate veil can be pierced.

(B) Under Express Statutory Provisions

The Companies Act, has also made certain express provisions under which the corporate veil can be lifted. Some of the important cases are as follows:

1. Reduction of members below the statutory minimum. If at any time the number of members of a public company falls below 7 (below 2 in case of a private company) and the business of the company is carried on for more than 6 months, while the number is so reduced, every member who is aware of the fact shall be severally liable for all debts of the company contracted after the said period of 6 months However, the members who left the company during the said 6 months period will not be liable. It should be noted that members who continue after 6 months period shall be liable only when they are aware that the number of members has fallen below the statutory minimum. Thus, it would be seen that the Company Law lifts the corporate veil in such cases and makes the members personally liable despite the fact that company is a separate entity and the liability of the members is limited.

2. Misrepresentation in prospectus [Sec. 35 (I) and 447]. If misrepresentation is made in a prospectus, every person, who authorised the issue of the prospectus, shall be personally liable to those who subscribed on the faith of untrue statements made in the prospectus.

Criminal liability for misstatements in prospectus (Sec.34). Where a prospectus, issued, circulated or distributed under this Chapter, includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus shall be liable under section 447:

Civil liability for misstatement in a prospectus. (Sec. 35) (1). Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who:

(a) is a director of the company at the time of the issue of the prospectus;

(b) has authorised himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

(c) is a promoter of the company;

(d) has authorised the issue of the prospectus; and

(e) is an expert referred to in sub-section (5) of Section 26, shall, without prejudice to any punishment to which any person may be liable under Section 36, be liable to pay compensation to every person who has sustained such loss or damage.

(2) No person shall be liable under sub-section (1), if he proves:

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

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

(c) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

3. Fraudulently inducing persons to invest money (Sec. 36). Any person who, either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into:

(a) any agreement for, or with a view to acquiring, disposing of, subscribing for, or underwriting securities; or

(b) any agreement, the purpose or the pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities; or

(c) any agreement for, or with a view to obtaining credit facilities from any bank or financial institution shall be liable for action under section 447.

4. Failure to return application money [Sees. 39 (3)]. If the stated minimum amount has not been subscribed and the sum payable on application is not received within a period of thirty days from the date of issue of the prospectus, or such other period as may be specified by the Securities and Exchange Board, the amount received under sub-section (1) shall be returned within such time and manner as may be prescribed.

In case of any default to return application, the company and its officer who is in default shall be liable to a penalty, for each default, of one thousand rupees for each day during which such default continues or one lakh rupees, whichever is less. [Sec. 39(4)].

5. Improper use of "Limited" or "Private Limited" words after the name of a company (Sec. 453). If any person or persons trade or carry on business under any name or title, of which the word "Limited" or the words "Private Limited" or any contraction or imitation thereof is or are the last word or words, that person or each of those persons shall, unless duly incorporated with limited liability, or unless duly incorporated as a private company with limited liability, as the case may be, punishable with fine which shall not be less than five hundred rupees but may extend to two thousand rupees for every day for which that name or title has been used.

6. Holding and subsidiary companies [Sec. 2(46)]. A "holding company" is one which controls the management of the other company while the other company is called its subsidiary. In the eyes of law, holding and subsidiary companies are separate entities. It has been held that even a 100% subsidiary is a separate entity and its holding company will not be liable for its acts.

However, the Court or Tribunal may lift the corporate veil in order to establish the relationship of holding and subsidiary company to find out the real persons who control the affairs of the company. As such, in some cases the law may not treat a subsidiary company as an independent company. For example, every holding company shall attach to its Balance Sheet, copies of the Balance Sheet, Profit and Loss Account, Directors Report and Auditor's Report in respect of each of its subsidiary company. Again, when a private company becomes a subsidiary of a public company, virtually it is treated as a public company.

7. For investigation of affairs of a company (Sections 90 and 216). In case, an inspector is appointed to investigate the affairs of a company he is empowered to investigate the affairs of anybody corporate under the same management or group. For the purpose of fixing responsibility for mismanagement, fraud etc. the corporate veil or personality can be disregarded, i.e., the persons behind the legal facade can be identified and punished.

8. For investigation of ownership of a company (Sections 90 and 216). 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 (a) who are, or have been, financially interested in the company; and (b) who are, or have been, able to control or materially influence the policies of the company. For this purpose, the corporate veil can be lifted so as to identify the real persons controlling the company.

9. To check fraudulent trading (Sec. 447). If during the winding-up of a company, it appears that the business of the company has been carried on with intent to defraud the creditors of the company or any other person, or for fraudulent purposes, the Court or Tribunal can lift the corporate veil to find out the real persons responsible for it. The Court or Tribunal may hold those persons personally liable for all or any debts of the company without any limitation of liability.

1.5 TYPES OF COMPANIES

These are various kinds of companies and these can be classified on a number of basis. The important basis on which these companies can be classified is as follows:

1.5.1 On the Basis of Creation

There are three principal modes in which a company may be created. These are:

(i) Chartered companies. In olden times, kings by virtue of the powers vested in them, used to create companies by granting Royal Charter. Such companies were known as 'Chartered Companies', and were governed by their Charters. Example of such companies are The Bank of

England, The East India Company, etc. The Companies Act did not apply to them. Such companies are not created now-a-days.

(ii) Statutory companies. Such a company is created by statutes or special Acts of Parliament or State Legislatures. Such companies are incorporated to carry on business of national importance. For example, The Reserve. Bank of India, The Life Insurance Corporation of India, The Food Corporation of India, etc. These companies are conferred special powers and are governed by the provisions of the Acts by which such companies are created. However, provisions of the Companies Act may also apply to these companies in so far as they are not inconsistent with the provisions of the Special Acts under which these companies are created. Such companies need not use the word 'Limited' at the end of their names.

(iii) Incorporated or registered companies. A company registered under the Companies Act is known as a registered or incorporated company. By far the largest number of companies is created in this manner. Such companies may be public or private; with limited or unlimited liability; having share capital or no capital.

1.5.2 On the basis of Liability

On the basis of liability, companies are classified under the following three heads: (i) Limited by shares, (ii) Limited by guarantee and (iii) Unlimited company.

(i) Limited by Shares Sec. 2 (22). 'Company limited by shares' means a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them." The shareholders are liable to pay unpaid amount, if any, due on the shares held by them. There is no danger of private property of the members being used for the payment of creditors of the company. The unpaid amount on the shares may be called up by the company at any time. By far, the largest number of companies is of this type.

(ii) Limited by Guarantee Sec. 2(21). "Company limited by guarantee' means a company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake to contribute to the assets of the company in the event of its being wound up." Companies formed for non-trading purposes, e.g., for the promotion of art, science, culture, sports, etc. are limited by guarantee. The liability of its members is limited, by its Memorandum, to such an amount as the members have respectively undertaken to contribute to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member as the case may be. The amount guaranteed by each member cannot be demanded until the company is wound up. Such members are liable in case the present members are unable to contribute the guaranteed amount. Such companies may be granted exemption by the Government from using the word 'Limited' or 'Private Limited' as part of their name.

(iii) Unlimited Company. Just as the liability of sole traders or partners is unlimited, the liability of the members of an unlimited company may be unlimited. A member can be called upon to pay an unlimited amount to pay off the creditors in proportion to his interest in the company. However, there is an important difference in the nature of liability of the members of an unlimited company. Creditors of an unlimited company cannot file suit against the individual members directly. In case of a partnership firm, creditors can directly sue the partners. A company limited or unlimited is regarded as a separate entity from its members. Such companies are rarely found these days.

1.5.3 On the Basis of Number of Members

On the basis of number of members, companies are classified under the following heads:

(i) Private Company Sec. 2(68). A 'Private company' is defined by Sec. 2(68) (iii) as .a company which by its articles

(i) restricts the right to transfer its shares;

(ii) except in case of One Person Company, and Producer Company, limits, the number of members to 200, and

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this clause, be treated as a single member.

Provided further that:

(A) persons who are in the employment of the company; and

(B) persons who, having been formerly in that employment and have continued to be members after the employment ceased, shall not be included in the number of members; and

(iii) prohibits any invitation to the public to subscribe for securities of the company

Ownership and control of a private limited company is confined to a close friends and relatives. Thus, a private company is an organisation which enables a family or association of close friends to get the benefits of limited liability vis-a-vis all the advantages of a partnership organisation i.e. close control and secrecy of business, etc. The name of a private company must end with the words 'Private Limited' or its abbreviation "(P) Ltd.". A private company does not employ public funds and is usually run as a family concern. Therefore, in comparison to a public company, a private company enjoys certain privileges.

(ii) One person Company Sec. 2(62). 'One person company' means a company which has only one person as a member. It shall be a private company.

The Companies Act, 2013 vide Sec. 3(1) has introduced the new concept of One Person Company. Provided that the memorandum of One Person Company shall indicate the name of the other person, with his prior written consent in the prescribed form, who shall, in the event of the subscriber's death or his in capacity to contract become the member of the company and the written consent of such person shall also be filed with the Registrar at the time of incorporation of the One Person Company alongwith its memorandum and articles:

Provided further that such other person may withdraw his consent in such manner as may be prescribed.

Provided also that the member of One Person Company may at any time manage the name of such other person by giving notice in such manner as may prescribed.

Provided also that it shall be the duty of the member of One Person Company to intimate the company the change, if any, in the name of the other person nominated by him by indicating in the memorandum or otherwise within such time and in such manner as may be prescribed, and the company shall intimate the Registrar any such change within such time and in such manner may be prescribed:

Provided also that any such change in the name of the person shall not be deemed to be an alteration of the memorandum.

Such a company i.e. One Person Company may be either:

(a) a company limited by shares; or

(b) a company limited by guarantee; or

(c) an unlimited company.

(iii) Public Company Sec. 2(71). 'Public company' means a company: which is not a private company. Provided that a company which is a subsidiary of a company not being a private company shall be deemed to be public company for the purposes of this Act even where such subsidiary companies continues to be a private company in its articles. In simple words, a private company which is a subsidiary of a public company will become a public company.

Thus, the restrictions which apply to a private company are not applicable to a public company. There is no restriction on transfer of shares—its shares are freely transferable. There is no restriction on the maximum number of members and it can offer its shares and debentures to the public for subscription through a prospectus. Thus the ownership and control of a public company is in the hands of public at large.

PRIVILEGES OF A PRIVATE COMPANY

One of the important objects of company law is to protect the interests of the public. As such, to safeguard the interest of the shareholders of a public company which raises its capital from the public, a large number of provisions have been made. However, in case of private companies, no such public interest is involved as these companies do not raise their capital from the public. Hence, private companies have been granted a number of privileges and exemptions. The exemptions available to private companies are as follows:

(1) It can be started only with two members as against seven required for a public company.

(2) It can work with only two directors in place of three as are required in case of a public company.

(3) It is not required to file a prospectus.

(4) It can allot shares without waiting for the minimum subscription.

(5) It need not issue right shares to the existing members.

(6) It need not keep an index of members.

(7) Only two persons personally present will form the quorum unless the Articles provide for a larger number.

(8) Poll can be demanded by one member if not more than 7 members are present, and by 2 members if more than seven members are present.

(9) Unless the Articles of the company provide otherwise, a member of a private company cannot appoint more than one proxy to attend the meeting on the same occasion.

(10) Directors need not file their consent to act as director or to take up qualification shares and pay for them.

(11) Directors of a private company holding office for life before 1st April, 1952 cannot be removed.

(12) A private company can give financial assistance directly or indirectly for purchase or subscription of its own shares.

(13) No restrictions on loans to directors apply to private companies.

(14) No restrictions on the appointment, payment of remuneration to Directors or Managing Directors.

(15) No restrictions on the number of companies to be managed by a director. In case of a public company one person cannot become director in more than 20 companies and managing director in more than 2 companies.

(16) All the Directors can be permanent and need not retire by rotation.

(17) Provisions regarding general meetings, voting, etc. need not be followed by a private company.

(18) No restrictions on loans to other companies under the same management

(19) No right of appeal to the Company Law Tribunal in case a private company does not register a transfer or transmissed of shares.

(20) Restriction regarding inter-company investment of funds in the same group do not apply to private companies.

(21) Company Law Tribunal cannot prevent change in the Board of Directors of an independent private company if in its opinion such change is prejudicial to the interest of the company.

(22) Only members of a private company can inspect and copy its Profit and Loss Account filed with the Registrar of Companies.

(23) A private company may provide for additional grounds for disqualifications of directors.

(24) A private company may provide for additional grounds for vacation of office by a director.

(25) No restrictions on interested director to participate or vote in Board's proceedings.

Conversion of Companies

(A) Conversion of a Private Company into a Public Company

A private company may become a public company either by defaulter or choice.

1. Conversion by default. If a private company makes a default in complying with the conditions of Sec. 2 (68) (e.g. exceeding the limit of 200 members or inviting public to purchase its shares or debentures), it ceases to be a private company and shall be treated as a public company. It shall not be entitled to the privileges and exemptions conferred on private companies under the Act.

However, if the Company Law Tribunal is satisfied that the non-compliance was accidental or due to inadvertence or other sufficient cause, it may grant relief from such consequences. It may also grant relief on just and equitable grounds. While granting relief, it may impose such terms and conditions as seem to it just and equitable.

2. Conversion by choice or volition. When it is desired to convert a private company into a public company, it can be done by altering the articles to this effect so as to remove the restrictions imposed upon a private company.

It will be necessary for the company to increase its paid-up share capital by passing an ordinary resolution. Again, necessary changes in the Articles to suit the needs of a public company e.g. provisions regarding general meetings, election of directors, annual accounts and audit etc. are made. It is usual to prepare new Articles or to adopt Table A in such cases.

The company is required to file with the Registrar of Companies, within 15 days of alteration of Articles, the following documents:

1. a copy of the special resolution;

2. a printed copy of the altered or new Articles, as the case may be;

3. a copy of the prospectus;

4. a copy of the ordinary resolution to increase the share capital, if increased.

After conversion, the company shall cease to be a private company and will lose all of its privileges and exemptions.

(B) Conversion of Public Company into a Private Company

Likewise a public company can be converted into a private company. A special resolution is to be passed to alter the Articles so as to:

(1) restrict the right to transfer shares of the company;

(2) limit the number of members to two hundred excluding:

 (a) present employees who are member.

 (b) ex-employees who are still members of the company.

(3) prohibit invitation to public to subscribe for any shares in or debentures of the company or to make deposit.

After obtaining the approval of the Tribunal, the following documents with necessary fees should be filed with the Registrar of Companies within 15 days of the order granting permission:

(1) a copy of Special Resolution;

(2) a printed copy of altered Articles;

(3) a copy of Tribunal's order granting approval to convert the company into a private company.

1.5.4 On the Basis of Ownership

On the basis of ownership, companies may be classified into (i) Government company and (ii) Non-Government company.

(i) Government Company [Sec. 2(45)]. Government company means any company in which not less than 51% of the paid-up share capital is held by the Central Government or by any State Government or Governments or partly by the Central Government or partly by any State

Government or Government and includes a company which is a subsidiary company of such a Government Company. The Companies Act is applicable to such companies subject to the modification as approved by both Houses of Parliament.

(ii) Non-Government Company. Companies which are not Government companies i.e. which are not owned and controlled by the Central or any State Government(s) are called Non-Government companies. A public limited company is usually a non-Government company.

1.5.5 On the Basis of Control of a Unit

On the basis of control of a unit, companies can be classified into (i) Holding company and (ii) Subsidiary company.

(i) Holding company [Sec. 2(46)]. A holding company in relation to one or more other companies means a company of which such companies are subsidiary companies.

(ii) Subsidiary company [Sec. 2(87)]. "Subsidiary company" or "subsidiary" in relation to any other company (that is to say a holding company), means a company in which the holding company:

A company is a subsidiary of another if-

(i) controls the composition of the Board of Directors, or

(ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies.

Provided such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such number as may be prescribed.

Explanation: For the purposes of this clause:

(a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or (ii) is of another subsidiary of the holding company;

(b) the composition of the Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some powers exercisable by it at its discretion can appoint or remove all or a majority of the directors.

The Act defines a holding company and a subsidiary company by explaining the circumstances in which a company shall be deemed to be subsidiary of another.

1.5.6 On the Basis of National Interest

On the basis of national interest companies can be classified as (i) Indian Company, (ii) Foreign Company.

(i) Indian Company. A company incorporated in India and having a place of business in India is an Indian company. However, all other companies, unless those are foreign companies, are Indian companies.

(ii) Foreign Company [Sec. 2(42)]. Foreign company means any company or body corporate incorporated outside India which:

(a) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(b) conducts any business activity in India in any other manner.

However, a foreign company in which fifty percent or more of the paid-up share capital (equity or preference or both) is held by Indian citizens and/or companies incorporated in India, shall comply with such other provisions as may be prescribed with regard to the business carried on by it in India as if it were a company incorporated in India. (Sec. 379)

1.5.7 Companies not for Profit

Sec. 4 requires a company formed for profit to use the word ‘Limited’ or ‘Ltd.’ at the end of its name if it is a public company and ‘Private Limited’ or ‘Pvt. Ltd.’ if it is a private company. However, a company formed for promoting commerce, art, science, religion, charity or any other useful object, not for profit, with limited liability, can be exempted (under a license under Sec. 8 from the Central Government) from using the word limited or private limited at the end of its name. Such companies are popularly called ‘Licensed Companies’. Such a company has to apply its profits, if any, or other income in promoting its objects. It cannot pay any dividend to its members [Akil Deshastha, etc. Mandal v. Joint Charity Commr., (1973) 43 Comp. Cas. 361]. The Central Government can grant a license on such terms and conditions as it thinks fit. The Central Government may also direct that these conditions shall be inserted (given) in the Memorandum or in the Articles of Association of the company or, partly in one and partly in the other. The company is under an obligation to abide by these conditions and regulations.

Such a company cannot alter the object clause of its Memorandum without the previous approval of the Central Government. If the company contravenes this provision, its license can be revoked.

1.5.8 Illegal Association

A body of persons for the achievement of some common object is called an "association". Broadly, such an association may be (i) for profit, or (ii) not for profit, i.e., for the promotion of art, culture, religion, etc. To protect the public from the mischief of large trading associations, whose membership may be constantly changing, the Companies Act, 2013 provides for their compulsory registration.

According to Sec. 464 every association of persons consisting of more than prescribed number of persons for the purpose of carrying on any business for gain, must be registered under the Companies Act, 2013 or be formed under some other Indian Law (e.g. an association may be registered under the Co-operative Societies Act, 1912). In case such an association is not registered, it will be called an illegal association and it has no legal existence. However, a Hindu Undivided Family carrying on any business with more than the prescribed number of persons will not be an illegal association even if it is not registered under the Companies Act, 2013 or any other law. But in case two or more joint Hindu families form a partnership, then a joint family shall not count as one person but all the adult members of both the joint families shall be counted. The number of minors in both the joint families will be ignored. It is because a partnership firm has no separate legal entity, its partners will be counted as separate members of the company. However, the number of person that may be prescribed under this section shall not exceed 100.

1.6 SUMMARY

A company is a voluntary association of persons formed for the purpose of doing business having a distinct name and limited liability. The life of a company does not depend on the death, insolvency or retirement of any or all shareholders or directors. Lifting the corporate veil means disregarding the corporate personality and looking behind the real person who control the companies affairs. It is the duty of the Court to lift the veil to protect public policy and prevent transactions contrary to public policy. Companies Act recognises different types of companies that can be registered under the Act. There are various factors on the basis of which companies can be classified.

1.7 KEYWORDS

Company: It is a voluntary association of persons formed for the purpose of doing business having a distinct name and limited liability.

One Person Company: It is a one shareholder corporate identity, where legal and financial liability is limited to the company only.

Company limited by Guarantee: These are such companies where shareholders promise to pay a fixed amount to meet the liabilities of a company in the case of liquidation.

Statutory Companies: These are the companies incorporated by a special Act of Parliament and activities of these companies are governed by respective Act.

Public Company: It means a company which is not a private company.

1.8 SELF ASSESSMENT QUESTIONS

1. Define a company. Explain its characteristics.
2. "A company is an artificial person created by law with a perpetual succession and a common seal." Comment on the above statement and clearly explain the characteristics of a company.
3. "A company is a separate entity." Do you agree? Under what circumstances corporate veil can be pierced?
4. Define a private company. What privileges and exemptions are granted to a private company?
5. What is a private company? How can a private company be converted into a public company and vice-versa?
6. Distinguish between:

   (a) A company limited by shares, and A company limited by guarantee.

How the above two differ from an unlimited company?

7. Write short notes on:

(a) Chartered company, (b) Illegal association,

(c) Holding company (d) Subsidiary company,

(e) Government company, (f) Foreign company.

1.9 SUGGESTED READINGS

- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

LESSON 2

INCORPORATION OF A COMPANY

Structure

2.0 OBJECTIVES

Upon competing this lesson, you should be able to:

- Get insights of the legal position of promoters, their status, duties and liabilities.
- Understand the procedure of incorporation of a company.
- Explain the effect of getting the Certificate of Incorporation.

2.1 INTRODUCTION

A company is an artificial person but does not take birth like natural people. A company is a creature of law. The formation of a company is a legal process, which involves a series of steps and legal formalities. These steps are to be taken by a person or a group of persons interested in the formation of a company. There are three stages in the formation of a company namely promotion, incorporation and commencement of business. The present lesson discusses in detail the process of incorporation of a company in India.

2.2 PROMOTION OF A COMPANY

Promotion is the very first stage in the formation of a company. Promotion begins when someone discovers an idea or when the idea comes to the mind of someone regarding some business. Promotion includes the analysis and feasibility of converting the idea into reality. Any person who assumes the responsibility of promotion is called ‘Promoter’.

Promotion has been defined as:

(1) According to Prof. E.S. Mead, “Promotion includes four elements - discovery, investigation, assembling and financing”.

(2) According to C.W. Gerstenberg, “Promotion may be defined as the discovery of business opportunities and the subsequent organisation of funds, property and managerial ability into a business concern for the purpose of making profits therefrom.”

Stages in Promotion

There are four stages involved in promotion:

(1) Discovery of an Idea: An individual or a group of persons may discover an idea of starting a new business or expanding an existing business. For example, one may discover an idea to start a Cinema Hall in a particular area. There may not be a Cinema Hall in that area or the idea may be to break the monopoly of an existing Cinema Hall in that area.

(2) Investigation: Discovered business opportunities have to be investigated thoroughly before any money can be invested to exploit them. The person discovering the idea may be very optimistic. His optimism may be because of his over enthusiasm or for other reasons. Continuing our previous illustration of a Cinema Hall, investigation will be done to ascertain:

(i) Whether necessary size of plot of land for the Cinema is available or not.

(ii) Whether necessary permission to run the Cinema Hall will be available from the local authorities, i.e., Delhi Development Authority, Delhi Municipal Corporation etc. if the hail is to be constructed in Delhi.

(iii) How much capital would be required?

(iv) How much income would be generated?

(v) Whether the capital invested would give a reasonable rate of return and so on.

(3) Assembly: Having discovered and investigated the profitability of a business proposition, steps will be taken to put the idea into practice. This will involve acquisition of land and buildings, plant and machinery, patent rights etc. At this stage promoters associate other persons who also act as first directors of the proposed company. Later on, the promoters enter into pre-incorporation contracts for the assembly of the necessary assets and properties to run the company.

(4) Registration or Incorporation of a Company: For the purpose of registration of the company, the promoters have to take the following steps:

(i) To prepare the Memorandum of Association and Articles of Association.

(ii) To get certificate of incorporation.

(iii) To get certificate of commencement of business.

Promoter

The promoter is a person who does the necessary preliminary work incidental to the formation of a company. It is compendious term used for a person who undertakes, does and goes through all the necessary and incidental preliminaries, keeping in the view the object to bring into existence an incorporated company.

Chronologically, the first persons who controls a company's affairs are its promoters. It is they who conceive the idea of forming the company with reference to a given object and then to set it going and it is they who take necessary steps to incorporate it.

In Whaley Bridge Calico Printing Co. Vs. Green Smith (1880) 5 QBD, 109, Lord Bowen stated that the term 'promoter' is a term not of law, but of business operations familiar to the commercial world, by which a company is generally brought into existence.

According to Lord Lindley, "With respect to the word, we are of opinion that it has no very definite meaning. As used in connection with companies the term 'promoter' involves the idea of exertion for the purpose of setting up and starting a company."

Who are Promoters

A registered company may act as a promoter whether a person is or is not a promoter of a company is a question of fact depending upon the role performed by him in the formation of the company.

A person who does not play a prominent role may also be a promoter if he has so acted. But if a person is employed merely in a professional or technical capacity such as solicitor, accountant, valuer or business consultant, he will not be a promoter. It also excludes such persons who act in a professional capacity or persons engaged in procuring the formation of a company. But if any such person acts beyond the scope of professional duty and helps in any way in the formation of a company or in preparations for the management of its affairs, he will become a promoter.

Types of Promoters

The promoters may be of the following types:

(1) Accidental Promoters: Some persons are not the professional promoters. Sometimes some idea strikes to their mind accidentally and they try to convert it into reality. They are known as accidental promoters.

(2) Professional Promoters: These promoters take the promotion as their profession. They usually perform the work of promotion for various business undertakings. Professional promoters may be an individual, partnership firm, an association of persons and even a company.

(3) Financial Promoters: Some are the promoters who undertake the promotion of a company, complete the professional activities and then purchase the entire share capital of the company promoted. They provide financial certainty and assurance to the company. Later on, they may sell the shares at some profit.

Functions of a Promoter

Promoters are the persons who give birth to a company. They are the founders of a business enterprise. They have many functions to perform, which are as follows:

(1) To get the idea of the formation of a company.

(2) To analyse the idea.

(3) To consult the experts of the field regarding the feasibility of idea.

(4) To search out the persons who may agree to be the first directors of the company and to sign the Memorandum of Association.

(5) To decide the name, the place of registered office, the places of the offices, the object of the company, the amount of capital and its composition.

(6) To prepare and enter into contracts with underwriters.

(7) To select and decide the bankers, auditors, brokers and legal experts.

(8) To prepare the Memorandum of Association, Articles of Association and Prospectus.

(9) To file the necessary documents with the Registrar of Companies.

(10) To get the certificate of incorporation

(11) To get the permission and to arrange for the use of capital.

(12) If the company has to purchase a going concern business, to finalise the purchase contract of such business.

(13) To enter into contracts with the vendors, underwriters, brokers and managing agents.

(14) To collect the amount on the issue of share capital.

(15) To get the certificate of commencement of business.

(16) To pay the preliminary expenses.

(17) To appoint the required number of personnel for the whole process.

To sum up, it can be concluded that a promoter performs all activities right from conceiving the idea in his mind to the commencement of business by the company. Thus, the promoter after establishment of company, comes out of the picture and lets the company go on with its business.

Rights of Promoters

Promoters have the following rights in the company:

(1) Right to Receive the Preliminary Expenses: Promoters are empowered to receive the preliminary expenses that they have incurred in the process of formation of company. It should be remembered that the promotes cannot file a suit to recover the preliminary expenses from the company. They can recover it only if there is a contract between them and the company and such a contract can take place after the company comes into existence i.e. certificate of incorporation and after certificate of commencement of business have been obtained and the contract is adopted (not ratified) by the company. Therefore, the promoters must have a valid contract entered into by the company after incorporation with them. Only in that case they can recover their preliminary expenses.

(2) Right to Receive Proportional Amounts from Fellow Promoters: Sometimes, the company is promoted by more than one promoter. In such a case, the company, if under contract, can make the full payment of their remuneration to any of the promoters. In that case, other promoters are empowered to collect their proportionate remuneration from their co-promoters.

(3) Right to Receive Remuneration: Promoters have to take a lot of pains for the promotion of a company. For this, they are entitled to get some remuneration from the company, they promote. The remuneration may be in cash, in the form of shares or debentures in the form of commission etc. Whatever mode of payment has been decided, they must get their remuneration according to that after disclosing it to an independent board of direction.

Liabilities of Promoters

The promoters have the following liabilities:

1. Promoters are the Founders of a Company: Therefore, they are under certain obligations which are as under:

(a) To Disclose and Repay the Secret Profits: If the promoter has made any profit out of a transaction, a promoter is bound to disclose it.

(b) Profit: As a corollary of the duty of full disclosure of material facts, a promoter is duty bound not to make any secret profit directly or indirectly. In case, he makes any secret profit he is liable to return the same to the company.

In Gluckstein Vs. Barnes (1900) A.C. 240, a syndicate purchased the Olympia Company for £ 1,40,000 with a view to forming a company and reselling it to the new company. The syndicate promoted a new company and sold the Olympia to it for £ 1,80,000 making a profit of £ 40,000. Before the syndicate purchased the Olympia, it had purchased its debenture at a discount knowing that the debentures would be paid in full if the sale to the new company materialised. The new company paid the debentures in full with the result the syndicate made a profit of £ 40,000 and not the profit of £ 20,000 made on account of debentures. The House of Lords held that the promoters must pay £20,000 to the company as they have not made full disclosure.

2. Liability of Full Disclosure Material Facts: If the promoter fails to make a full disclosure of all relevant facts including any profit and his personal interest in a transaction with company, the company may sue him for damages for breach of his fiduciary duty and recover from him any secret profit mode directly or indirectly.

It should be noted that the disclosure to be made effective must be real and express, constructive disclosure is not enough. In case the promoters fail to do so, the company may rescind the contract and sue the promoters to return the money paid. Erlanger Vs. New Sambrero Phosphate Co. (1878) 3 A.C. 1218 well illustrates the point.

A syndicate, of which E was the head, purchased an island containing phosphate mines. E promoted a company and named fictitious persons as its directors. E sold the property to the new company by a contract between a nominee of the syndicate and the company at double the price originally paid by him (E). The purchase agreement was approved at the shareholders meeting. However, no material facts were disclosed at the meeting. The company went into liquidation and the liquidator sued E to recover the profit made. E argued that the directors had full knowledge of the transaction. The Court rejected his plea on the ground that the disclosure was not made to an independent Broad of Directors.

3. Liability for Preliminary Contracts: A promoter remains personally liable for preliminary contracts made by him because such contracts are not legally binding on the company even after incorporation. Since the company was not in existence when such contracts were made, the company cannot ratify them. The promoters may not be liable if such contracts are either adopted by the company or specifically enforced by the Court under the Specific Relief Act, 1963.

4. Liability for Misstatement in Prospectus: A promoter will be liable for any omission of any material facts or misstatement made in the prospectus if he was a party to the issue of the prospectus. In case, the promoter is guilty of omission or misstatement of facts in the prospectus, he will be liable to pay compensation to every person who suffered any loss or damage because of such a prospectus. The promoter may also become liable to criminal proceedings.

5. Liability in Course of Winding-up: If during the winding-up proceedings an application is made by the official liquidator, the Tribunal may make a promoter liable for misfeasance or breach of trust committed by him in the promotion or formation of the company [Sec. 300].

If the official liquidator has made a report to the Tribunal alleging fraud, the Tribunal may order public examination of the promoter. The Court or Tribunal having jurisdiction to wind up a company is empowered to suspend him for a period extending upto 5 years from becoming a director or taking part in the promotion, formation or management of a company, if he is found guilty of fraudulent conduct in the course of winding-up of the company.

Remuneration of the Promoter

A promoter has no right to get compensation from the company for his services in promoting the company, unless there is a contract to that effect. In practice, a promoter takes remuneration for his services in one of the following ways:

(1) Cash Payment: The very first and the traditional method of making the payment for the services of promoters is to pay in cash.

(2) Shares and Debentures: The second method for making the payment to promoter is to allot them the shares and debentures of the company promoted by them.

(3) Commission: Promoters may also be paid for their services by way of commission in the net profits of the company for a certain period.

(4) Promoter may sell his own property at a profit to the company for cash or fully paid shares provided he makes disclosure to this effect.

Any remuneration paid to the promoters must be disclosed in the prospectus.

Pre-incorporation or Preliminary Contracts: The promoters of a company usually enter into contracts to acquire some property or right in the company which is yet to be incorporated, such contracts are called pre-incorporation or preliminary contract. The promoters generally enter into such contracts as agents for the company about to be formed. The legal position is that "Two consenting parties are necessary to a contract whereas the company, before incorporation, is not an entity."

According to law of agency, a person cannot act as an agent for another who is not in existence. Thus, a company is not bound by a pre-incorporation contract.

A solicitor was engaged to prepare the necessary documents and to obtain the registration certificate of a company. He paid the registration fee and incurred the necessary expense. After registration the company refused to pay for the services and expenses. The Court held that, "the company could not be sued in law for those expenses, in as much as it was not in existence at the time when the expenses were incurred.” [English and Colonial Produce Co. (1906)2 Ch. 435].

Position of Promoters as Regards Pre-incorporation Contracts

Following is the position of a promoters regarding pre-incorporation contracts:

(1) Company not Bound by Pre-Incorporation Contracts: A company when it comes into existence is not bound by a pre-incorporation contracts even where it takes the benefit of the contract entered into on its behalf.

(2) Company cannot Enforce Pre-incorporation Contracts: A company cannot after incorporation enforce the contract made before its incorporation.

The leading case on the point is in Natal Land and Colonization Co. Ltd. Vs. Pauline Colliery Syndicate Ltd. (1904) A.C. 120. N. Co. entered into a contract with A, who was acting as the nominee of the syndicate (which was not yet incorporated) to grant a lease of coal mining rights. After the syndicate was registered, it sued N. Co. for specific performance of the agreement. It was held that the syndicate was not entitled to the lease as the company was not in existence when the contract was signed.

(3) Promoter Personally Liable: The promoters remain personally liable on a contract made on behalf of a company not yet in existence. Such a contract is deemed to have been entered into personally by the promoters and they are liable to pay damages for failure to perform the promises made in company’s name.

(4) Ratification of a Pre-incorporation Contract: A company cannot ratify a contract entered into by promoters on its behalf before its incorporation. Therefore, it cannot by adoption or ratification obtain the benefit of the contract purported to have been made on its behalf before it comes into existence. The adoption of the pre-incorporation contracts by the company will not create a legal contract between the company and the other parties even though the adoption of the contract is made as one of the objects of the company in its Memorandum and Articles. In such a case, it is safer for the promoters acting on the behalf of the company about to be formed to provide in the contract that:

(i) If the company makes a fresh contract in terms of the pre-corporation, the liability of the promoters shall come to an end; and

(ii) If the company does not make a fresh contract within a limited period, either of the parties may rescind the contract.

However, Specific Relief Act, 1963 provides some relief in this direction. Sec. 15(h) and 19(c) of the Specific Relief Act provide that when the promoters of a company have, before its incorporation, entered into a contract for the purposes of the company, such contract may be specifically enforced by or against the company. The important condition in this connection is that these contracts should be for the purposes of the company. Thus, in Imperial Ice Manufacturing Co. Vs. Manchershaw 13 Mum, L.R. 165 it was observed that such contracts should be for the working purposes of the company such as a contract for the supply of machinery for making ice, etc.

2.3 INCORPORATION OF COMPANY

Incorporation or registration of the company is the second stage in the formation of a company. Any seven or more persons (two or more in case of a private company) can form the company. Even one person can also form a company. Association for any lawful purpose may form an incorporated company with or without limited liability. Companies limited by shares are the most popular form of companies.

Lawful Purpose: The purpose for which a company is proposed to be established must be lawful. It must not be in contravention of the general law of the country.

Documents to be Filed with Registrar: Before a company is registered, it is desirable to ascertain from the Registrar of the companies if the proposed name of the company is approved. Then, the following documents duly stamped together with the necessary fees are to be filed with the Registrar of the Companies of the State in which the registered office of the company is to be situated:

(1) Filing Documents with the Registrar [Sec. 71]: These shall be filed with the Registrar within whose jurisdiction the registered office of a company is proposed to be situated, the following documents and information for registration, namely:

(a) Memorandum and Article: The Memorandum and Articles of the company duly signed by all the subscribers to the Memorandum in such manner as may be prescribed.

(b) Declaration in Prescribed Form: A declaration in the prescribed form by an advocate, a chartered accountant, cost accountant or company secretary in practice, who is engaged in the formation of the company, and by a person named in the Articles as a director, manager or secretary of the company, that all the requirements of this Act and the rules made thereunder in respect of registration and matters precedent or incidental thereto have been complied with.

(c) Affidavit from the Subscriber: An affidavit from each of the subscribers to the Memorandum and from persons named as the first directors, if any, in the Articles that he is not convicted of any offence in connection with the promotion, formation or management of any company, or that he has not been found guilty of any fraud or misfeasance or of any breach of duty to any company under this Act or any previous company law during the preceding five years and that all the documents filed with the Registrar for registration of the company contain information that is correct and complete and true to the best of his knowledge and belief.

(d) Address for Correspondence: The address for correspondence till its registered office is established.

(e) Detail Particulars: The particulars of name, including surname or family name, residential address, nationality and such other particulars of every subscriber to the Memorandum alongwith proof of identity, as may be prescribed, and in the case of a subscriber being a body corporate, such particulars as may be prescribed.

(f) Particulars of First Director: The particulars of the persons mentioned in the Articles as the first directors of the company, their names, including surnames or family names, the Director Identification Number, residential address, nationality and such other particulars including proof of identity as may be prescribed; and

(g) Particulars of the Interests of the First Directors: The particulars of the interest of the persons mentioned in the Articles as the first directors of the company in other firms or bodies corporate alongwith their consent to act as directors of the company in such form and manner as may be prescribed.

(2) Registrar to Issue Certificate of Incorporation: The Registrar on the basis of documents and information filed under sub-section (1) shall register all ie documents and information referred to in that sub-section in the register and issue a certificate of incorporation in the prescribed form to the effect that the proposed company is incorporated under this Act.

(3) Allotment of Corporate Identity Number: On and from the date mentioned in the certificate of incorporation issued under sub-section (2), the Registrar shall allot to the company a corporate identity number, which shall be a distinct identity for the company and which shall also be included in the certificate.

(4) Preservation of Documents: The company shall maintain and preserve at its registered office copies of all documents and information as originally filed with Registrar till its dissolution under this Act.

(5) Action against False Particulars: If any person furnishes any false or incorrect particulars of any information or suppresses any material information, of which he is aware in any of the documents filed with the Registrar in relation to the registration of a company, he shall be liable for action under Section 447.

(6) Liable for Action under Section 447: Without prejudice to the provisions of sub-section (5) where, at any time after the incorporation of a company, it is proved that the company has been got incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company, or by any fraudulent action, the promoters, the persons named as the first directors of the company and the persons making declaration under clause (b) of sub-section (1) shall each be liable for action under Section 447.

(7) Power of Tribunal: Without prejudice to the provisions of sub-section (6), where a company has been got incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company or by any fraudulent action, the Tribunal may, on an application made to it, on being satisfied that the situation so warrants:

(a) pass such orders, as it may think fit, for regulation of the management of the company including changes, if any, in its Memorandum and Articles, in public interest or in the interest of the company and its members and creditors; or

(b) direct that liability of the members shall be unlimited; or

(c) direct removal of the name of the company from the register of companies; or

(d) pass an order for the winding-up of the company; or

(e) pass such other orders as it may deem fit:

Provided that before making any order under this sub-section:

(i) the company shall be given a reasonable opportunity of being heard in the matter; and

(ii) the Tribunal shall take into consideration the transactions entered into by the company, including the obligations, if any, contracted or payment of any liability.

Effect of Registration [Section 9]

From the date of incorporation mentioned in the certificate of incorporation, such subscribers to the Memorandum and all other persons, as may, from time to time, become members of the company, shall be a body corporate by the name contained in the Memorandum, capable of exercising all the functions of an incorporated company under this Act and having perpetual succession with power to acquire, hold and dispose of property, both movable and immovable, tangible and intangible, to contract and to sue and be sued, by the said name.

2.4 COMMENCEMENT OF BUSINESS

A company both public as well as private after its incorporation, cannot start its business immediately. These have to obtain one more certificate known as certificate to commence business.

Certificate to commence business is issued by the Registrar of Companies after the following conditions are complied with (Sec. 11):

(1) A company having a share capital shall not commence any business or exercise any borrowing powers unless:

(a) Filing of declaration: A declaration is filed by a director in such form and verified in such manner as may be prescribed, with the Registrar that every subscriber to the Memorandum has paid the value of the shares agreed to be taken by him on the date of making of this declaration; and

(b) Filing of verification its Registered office: The company has filed with the Registrar a verification of its registered office as provided in sub-section (2) of section 12.

(2) Penalty: If any default is made in complying with the requirements of this section, the company shall be liable to a penalty which may extend to five thousand rupees and every officer who is in default shall be punishable with fine which may extend to one thousand rupees for every day during which the default continues.

(3) Action for removal of Name: Where no declaration has been filed with the Registrar under clause (a) of sub-section (1) within a period of one hundred and eighty days of the date of incorporation of the company and the Registrar has reasonable cause to believe that the company is not carrying on any business or operations he may, without prejudice to the provisions of sub-section (2), initiate action for the removal of the name of the company from the register of companies under Chapter XVIII.

2.5 SUMMARY

Formation of a company is a lengthy process broadly divided into promotion, incorporation and commencement of business. The persons who bring the company into existence are known as promoters. A promoter is not entitled to any remuneration unless the company agrees to make such payment after incorporation. Incorporation or registration is the second stage in the formation of a company. It involves preparation of Memorandum and Articles of Association, making of statutory declaration and filing of these documents and consent of directors alongwith the necessary registration and stamp fees. When the Registrar of Companies is satisfied that all the requirements of the Act have been complied with, he will register the company and issue a certificate of incorporation. Thereupon, the company comes into existence. The certificate of incorporation is a conclusive evidence that the company has been duly registered. A company can commence business only after it has obtained certificate to commence business.

2.6 KEYWORDS

Promoter: He is a person who bring the company into existence.

Preliminary Contracts: Contracts which are entered into, by agents on behalf of a prospective company before it has come into existence.

Incorporation of a Company: It means the fulfilment of those legal requirements which bring a company into existence.

2.7 SELF ASSESSMENT QUESTIONS

1. Explain the procedure for the incorporation of a company and state the name of documents that are to be filed with the Registrar of the company.

2. Discuss the legal formalities that are to be complied with under Indian Companies Act regarding the formation of the company.

3. Set out the different steps in the formation of a limited liability company from promotion to the commencement of business.

4. What is meant by incorporation of a company? Describe the process of incorporation of a company.

5. Who is a company promoter? Discuss the work of a company promoter and his relationship with the company promoted by him.

6. What do you mean by Promoters? Explain the functions, rights and liabilities of company promoters.

2.8 SUGGESTED READINGS

- Avtar Singh, Company Law, Eastern Book Company, Lucknow.
- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.

LESSON 3

MEMORANDUM OF ASSOCIATION

Structure

3.0 OBJECTIVES

After reading this lesson, you should be able to:

- Explain the meaning and purpose of Memorandum of Association;
- Understand the provisions of Companies Act as to clauses of the memorandum;
- Describe the procedure of alteration of the clauses of the memorandum; and
- Discuss the doctrine of ultra vires and effects of ultra vires acts.

3.1 INTRODUCTION

The memorandum of association is one of the basic documents required to be originally framed by every company and filed with the Registrar for its registration. It sets out the constitution of the company and provides the foundation on which the structure of the company is built. It defines the scope of the company's activities and its relations with the outside world. Memorandum of association decides the type of activities a company can do and also its relationship with the outside world.

3.2 MEANING AND PURPOSE OF MEMORANDUM OF ASSOCIATION

The first step in the formation of a company is to prepare Memorandum of Association. According to Sec. 2(56) of Indian Company Act, 2013, "Memorandum means the Memorandum of Association of a company as originally framed or as altered from time to time in pursuance of any previous company law or of this Act".

It is the most important document of a company. It is called 'Charter of the Company' because it contains the object of the company and limits the powers of the company. It is compulsory to file this document at the time of registration of the company.

A Fundamental Document: The Memorandum of Association is a document of great importance in relation to the company. It contains the fundamental conditions on which alone the company is allowed to be incorporated. It lays down the area of operation of the company. It also regulates the external affairs of the company in relation to the outsiders. The purpose is to enable shareholders and those who deal with the company to know the permitted range of the enterprise. It not only shows the object of the formation of a company but also the utmost possible scope of it.

Purpose of Memorandum of Association

The purpose of the Memorandum is two fold:

(1) The prospective shareholders shall know the field to or the purpose for which their money is going to be used by the company and what risk they are undertaking in making investment.

(2) The outsiders dealing with the company shall know with certainty as to what the objects of the company are and as to whether the contractual relations into which they contemplate to enter with the company is within the objects of the company.

The Memorandum of a company shall be in respective forms specified in Table A, B, C, D and E in Schedule I as may be applicable to such company.

Each subscriber shall sign and add his address, description and occupation, if any, in the presence of at least one witness.

3.3 CONTENTS OF MEMORANDUM OF ASSOCIATION

The Memorandum of any company shall contain the following clauses:

(I) Name clause (II) Situation clause (III) Object clause

(IV) Liability clause (V) Capital clause (VI) Subscription clause

I. Name Clause

The first clause of the Memorandum shall state the name of the proposed company. The name of a company establishes its identity and the symbol of its existence.

Rules regarding Name: A company may, subject to the following rules, select any suitable name:

(1) Undesirable Name to be Avoided: A company cannot be registered by a name which, in the opinion of the Central Government, is undesirable. Broadly speaking, a name is undesirable and therefore rejected, if it is either:

(a) Too similar to the name of another company, or

(b) Misleading, i.e., suggesting that the company is connected with a particular business or that it is an association of a particular type when this is not the case.

(2) Injunction if Identical Name Adopted: If a company gets registered with a name which resembles the name of an existing company, the other company with whom the name resembles can apply to the Court for an injunction to restrain the new company from adopting the identical name [Ewing Butter Cup Margarine Co. Ltd. (1917) 2 Ch. 1]. This is of because of the reputation and company gains a monopoly of the use of that name and no other company can be registered under a name identical with it or so nearly resembling it as is calculated to deceive.

An injunction will not be granted to prevent the use of a purely descriptive word with a definite meaning and in common use. However, the Court or Tribunal will not grant an injunction to prevent the use of a purely descriptive word with a definite meaning and in common use.

In the case of Aerators Ltd. Vs. Tollitt (1902) 2 Ch. 3191, a company registered as Aerators Limited sought to restrain the registration of another company under the name of 'Automatic Aerators Patents Limited'. The main object of both the companies was the manufacture of apparatus for the instantaneous automatic aeration of liquids although the patents and apparatus of the two companies were distinct. The Court refused to grant injunction.

(3) Limited or 'Private Limited' as the Last Word or the Words of the Name: The Memorandum shall state the name of the company with 'Limited' as the last word in case of a public limited company and with the 'Private Limited' as the last word of the name in case of a private limited company.

The omission to use word 'Limited' as part of the name of a company shall make the name incorrect. If a company makes the contract without the use of the word 'Limited', the officers of the company who make the contract would be deemed to be personally liable. The omission to use the word 'Limited' as part of the name of a company must have been deliberate and not merely accidental. Note the following case:

In the case of Dermatine Co. Ltd. Vs. Ashworth (1905) T.L.R 510, a bill of exchange drawn upon a limited company in its proper name was duly accepted by two directors of the company. The rubber stamp by which the words of acceptance were impressed on the bill was longer than the paper of the bill and hence the word 'Limited' was missed. Held the company was liable to pay and directors were not personally liable. "It was an error of the most trifling kind and mischief aimed at by the Act did not exist."

(4) Prohibition of Use of Certain Names: The Emblems and Names (Prevention of Improper Use) Act, 1950 prohibits the use of or registration of a company with any name or emblem specified in the Schedule to that Act. The Schedule specifies the following items, i.e., the name emblem or official seal of the UNO, World Health Organisation, the United Nations Educational, Scientific and Cultural Organisation, the World Meteorological Organisation and the International Civil Aviation Organisation, the Indian National Flag, the name, emblem or official seal of the Central Government and State Government. The name emblem or official seal of the President of India or Governor of any State or connection with any local authority or any corporation or body constituted by the Government under any law for the time being in force.

Once a company is registered with a certain name, it must appear in a conspicuous manner on the outside of every office or place of work and on letters, notices and cheques etc. of the company. In case of one-person company, the name of the person who, in the event of death of the subscriber, shall become the member of the company.

Penalty. If default is made in complying with this provision, the company and every officer in default shall be liable to fine, which may extend to ₹ 1,000 per day till the default continues.

II. Situation Clause

The second clause of the Memorandum must mention the name of the State in which the registered office of the company is to be situated. This fixes the domicile of the company. It is sufficient to mention the name of the State in which the registered office of the company is to be situated. Actual address is not mentioned in the Memorandum. However, notice of its registered office and every change therein has to be given to the Registrar within 15 days of incorporation or change, as the case may be. It is usual to file the notice of registered office of the company along with the Memorandum at the time of registration. For default, the above penalty shall also apply in this case.

According to Sec. 12(3), every company shall:

(a) paint or affix its name, and the address of its registered office, and keep the same painted or affixed, on the outside of every office or place in which its business is carried on, in a conspicuous position, in legible letters, and if the characters employed therefore are not those of the language or of one of the languages in general use in that locality, also in the characters of that language or of one of those languages;

(b) have its name engraved in legible characters on its seal, if any;

(c) get its name, address of its registered office and the Corporate Identity Number alongwith telephone number, fax number, if any, e-mail and website addresses, if any, printed on all its business letters, billheads, letter papers and in all its notices and other official publications; and

(d) have its name printed on *hundies*, promissory notes, bills of exchange and such other documents as may be prescribed:

Provided that where a company has changed its name or names during the last two years, it shall paint or affix or print, as the case may be, alongwith its name, the former name or names so changed during the last two years as required under clauses (a) and (c):

Provided further that the words ‘One Person Company’ shall be mentioned in brackets below the name of such company, wherever its name is printed, affixed or engraved.

III. The Object Clause

The objects of a company shall be clearly set forth in the Memorandum, for a company can do what is within or incidental to, the objects stated in the Memorandum. The object clause both defines and confines scope of the company's power and once registered, it can only be altered as provided by the Act.

Purpose of the Object Clause: The purpose of object clause in the Memorandum is two-fold:

Firstly, it protects the investors who learn from it the purpose to which their money can be applied. It ensures that their money will not be risked in any business which is not authorised by the Memorandum. Secondly, it protects tile creditors and other persons who deal with the company as they can infer (know) from it the extent of the company's powers.

Any act done beyond the powers conferred by the Memorandum will be ultra vires. A Company is free to choose its objects but the objects should not be illegal, unlawful, against public policy or against the Companies Act, e.g. to trade with enemy etc.

The object for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof.

In Evans Vs. Brunner Mond & Co. (1921)1 Ch. 359, a company engaged in manufacture of chemicals, proposed to devote a substantial sum of money to the encouragement of scientific education. It was proved that this Act would ultimately benefit the company, but a shareholder objected on the ground that it was beyond the powers of the company. Held, the proposal was fairly incidental to the company's object.

IV. Liability Clause

The liability of members of the company whether limited or unlimited is stated in liability clause, and also state:

(i) in the case of a company limited by shares, that liability of its members is limited to the amount unpaid, if any, on the shares held by them; and

(ii) in the case of a company limited by guarantee, the amount upto which each member undertakes to contribute:

(A) to the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be a member, for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and

(B) to the costs, charges and expenses of winding-up and for adjustment of the rights of the contributories among themselves.

V. Capital Clause

The Memorandum of a company, having a share capital, shall state the amount of the share capital with which the company is to be registered and the division thereof into shares of a fixed amount.

Sec. 4(i)(e) states that the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the Memorandum agree to subscribe which shall not be less than one share; and

(ii) the number of shares each subscriber to the Memorandum intends to take, indicated opposite his name;

(iii) in the case of One Person Company, the name of the person who, in the event of death of the subscriber, shall become the member of the company.

VI. Subscription Clause

Though this clause is not numbered in the Act, is generally given at the and of the Memorandum. This clause reads like this "we the several persons, whose names, addresses and occupations are subscribed, are desirious of being formed into a company in pursuance of this Memorandum of Association, and we respectively agree to take the number of shares in the capital of the company set opposite our respective names."

In case of 'One Person Company', subscription clause reads like this "I, whose name and address is given below, am desirous of forming a company in pursuance of this Memorandum of Association and agree to take all the shares in the capital of the company."

This clause states that the persons subscribing their signatures to the Memorandum are willing to form themselves into an association. One subscriber cannot attest the signature of the other. A subscriber is also required to take at least one share. He should mention against his name the number of shares taken by him. In case of a public company, the Memorandum shall be signed by at least seven persons (two in case of a private company).

3.4 ALTERATION IN MEMORANDUM OF ASSOCIATION

Memorandum of Association is the fundamental document of a company. It cannot be and should not be freely altered. Sec. 13 of this Act states the manner in which Memorandum of Association can be altered.

I. Alteration in Name Clause

Sec. 13, (1) save as provided in Section 61, a company may, by a special resolution and after complying with the procedure specified in this section, alter the provisions of its memorandum,

(2) Any change in the name of a company shall be subject to the provisions of sub-section (2) and (3) of Section 4 and shall not have effect except with the approval of the Central Government in writing:

Provided that no such approval shall be necessary where the only change in the name of the company is the deletion therefrom, or addition thereto, of the word 'Private', consequent on the conversion of any one class of companies to another class in accordance with the provisions of this Act.

(3) When any change in the name of a company is made under sub-section (2), the Registrar shall enter the new name in the register of companies in place of the old name and issue a fresh certificate of incorporation with the new name and the change in the name shall be complete and effective only on the issue of such a certificate.

II. Alteration in Situation Clause

A company can change its registered office from one place to another according to the provisions of this Act under section 13.

(1) The alteration of the Memorandum relating to the place of the registered office from one State to another shall not have any effect unless it is approved by the Central Government on an application in such form and manner as may be prescribed [Sec. 13(4)].

(2) The Central Government shall dispose of the application under sub-section (4) within a period of sixty days and before passing its order may satisfy itself that the alteration has the consent of the creditors, debenture-holders and other persons concerned with the company or that the sufficient provisions has been made by the company either for the due discharge of all its debts and obligations or that adequate security has been provided for such discharge [Sec. 13(5).

(3) Save as provided in Section 64, a company shall, in relation to any alteration of its Memorandum, file with the Registrar:

(a) the special resolution passed by the company under sub-section (1);

(b) the approval of the Central Government under sub-section (2), if the alteration involves any change in the name of the company [Sec. 13(6)].

(4) Where an alteration of the Memorandum results in the transfer of the registered office of a company from one State to another, a certified copy of the order of the Central Government approving the alteration shall be filed by the company with the Registrar of each of the States within such time and in such manner as may be prescribed, who shall register the same, and the Registrar of the State where the registered office is being shifted to, shall issue a fresh certificate of incorporation indicating the alteration [Sec. 13(7)].

III. Alteration in Object Clause

Sec. 13 of the Companies Act, 2013 states a company can change its objects in furtherance of the objectives stated in the Memorandum.

An alteration should be made in accordance with the provisions and the manner prescribed. For changing the object clause, the company has to pass a special resolution and obtain the approval of the Central Government. Every change shall be noted in every copy of the Memorandum. A company, which has raised money from public through prospectus and still has any unutilised amount out of the money so raised, shall not change its objects for which it raised the money through prospectus unless a special resolution is passed by the company and:

(i) the details, as may be prescribed, in respect of such resolution shall also be published in the newspapers (one in English and one in vernacular language) which is in circulation at the place where the registered office of the company is situated and shall also be placed on the website of the company, if any, indicating therein the justification for such change;

(ii) the dissenting shareholders shall be given an opportunity to exit by the promoters and shareholders having control in accordance with regulations to be specified by the Securities and Exchange Board of India.

The Registrar shall register any alteration of the Memorandum with respect to the objects of the company and certify the registration within a period of 30 days from the date of filing of the special resolution in accordance with clause (a) of sub-section (6) of this section.

No alteration made under this section shall have any effect until it has been registered in accordance with the provisions of this section.

Any alteration of the Memorandum, in the case of a company limited by guarantee and not having a share capital, purporting to give any person a right to participate in the divisible profits of the company otherwise than as a member, shall be void.

Penalty: In case of default the company and every officer who is in default shall be liable to a penalty of ` 1,000 for every copy of the Memorandum or Article issued without such alteration [Sec. 15(2)].

IV. Change in Liability Clause

The liability of the members cannot be made unlimited without their consent in writing. By changing Memorandum or Articles, a member cannot be compelled to buy additional shares of the company. However an association, by altering its Memorandum or Articles can raise the periodical subscription without the consent of its members in writing. Further, liability of the directors, managing directors or manager can be made unlimited with their consent provided the Article so provide.

Further unlimited liability of the shareholders can be made limited by passing a special resolution and obtaining the approval by the Company Law Tribunal. In the alternative an, unlimited company may register itself as a limited company. However, it will not affect any debt, liabilities, obligations already incurred or contracts made before such registration.

V. Alteration in Capital Clause

Power of Limited Company to Alter its Share Capital [Sec. 61]

(1) A limited company having a share capital may, if so authorised by its Articles, alter its Memorandum in its general meeting to:

(a) increase its authorised share capital by such amount as it thinks expedient;

(b) consolidate and divide all or any of its share capital into share of a larger amount than its existing shares:

Provided that no consolidation and division which results in changes in the voting percentage of shareholders shall take effect unless it is approved by the Tribunal on an application made in the prescribed manner;

(c) convert all or any of its fully paid-up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;

(d) sub-divide its shares, or any of them, into shares of smaller amount than is fixed by the Memorandum, so, however, that in the sub-division the proportion between the amount paid and the amount, if any, unpaid on each reduced share shall be the same as it was in the case of the share from which the reduced share is derived;

(e) cancel shares which, at the date of the passing of the resolution in that behalf, have not been taken or agreed to be taken by any person, and diminish the amount of its share capital by the amount of the shares so cancelled.

(2) The cancellation of shares under sub-section (1) shall not be deemed to be a reduction of share capital.

Notice to be given to Registrar for Alteration of Share Capital [Sec. 64]

(1) Where:

(a) a company alters its share capital in any manner specified in sub-section (1) of Section 61;

b) an order made by the Government under sub-section (4) read with sub-section (6) of section 62 has the effect of increasing authorised capital of a company; and or

(c) a company redeems any redeemable preference shares.

The company shall file a notice in the prescribed form with the Registrar within a period of 30 days of such alteration or increase or redemption, as the case may be, along with an altered Memorandum.

(2) If a company and any officer of the company who is in default contravenes the provisions of sub-section (1), it or he shall be punishable with fine which may extend to one thousand rupees for each day during which such default continues, or five lakh rupees, whichever is less.

3.5 DOCTRINE OF ULTRA VIRES

A company has the power to do all such thing as are:

(1) Authorised to be done by the Companies Act, 2013;

(2) Essential to the attainment of its object specified in the Memorandum; and

(3) Reasonable and fairly incidental to its objects.

Everything else is ultra vires the company. Ultra means 'beyond' and 'vires' means 'powers'. The term 'ultra vires' a company means that the doing of the act is beyond the legal power and authority of the company. All ultra vires acts of a company shall be fully null and void and can never be ratified and become valid even though, all the shareholders of the company agree to ratify such transactions. It is not necessary that an act to be considered ultra vires must be illegal; it may be and may not be. It cannot become ultra vires by reasons of estoppel, lapse of time, ratification, acquiescence or delay. The rule is meant to protect future shareholders and the public at large who deal with the company. The leading case on the point is Ashbury Rly. Carriage & Iron Company Ltd. Vs. Riche (1975) L.R. 7 H.L. 653, A company was incorporated with the objects:

(a) Make, sell or lend on hire, railway carriages and wagons;

(b) To carry on the business of mechanical engineers and general contractors;

(c) To purchase lease, work and sell mines, minerals, land and buildings.

The company entered into a contract with Riche for the financing of the construction of a railway line in Belgium. The question raised was whether that contract was valid. The House of Lords held that the contract was ultra vires the company and void so that not even the subsequent assent of the whole body of shareholders could ratify it.

The doctrine of ultra vires as laid down in the Ashbury's case was affirmed by the House of Lords in Attorney General Vs. Great Eastern Railway Co. (1880) 5 Ap. Cas 473. It was stated that the doctrine of ultra vires "ought to be reasonably and not unreasonably, understood and applied, and whatever may fairly be regarded as incidental to or consequential upon those things which the legislature has authorised ought not be held by Judicial construction to be ultra vires." Note the following case:

Deuchar Vs. Gas Light & Coke Co. (1925) A. (69)], a gas company was empowered to make and supply gas, manufacture and sell residuals and to provide such apparatus and materials as it deemed requisite for those purposes. After purchasing Caustic Soda for a number of years it decided to manufacture its own Caustic Soda. Held, it was not ultra vires the company.

The main feature of doctrine of ultra vires is that a company being a corporate person should not be punished for its own acts or acts of its agents, if they are beyond its powers and privileges. A contract of a company which is ultra vires is wholly void and of no legal effect. But there is nothing to prevent a company from protecting its property. The leading case on this point is:

National Telephone Co. Vs. St. Peter Port Constables (1900) A.C. 317. A telephone company put up telephone wires in a certain area. The company had no power in the Memorandum to put up wires there. The defendants cut them down. Held, the company could sue for damage to the wires.

Ultra-vires acts may be classified into the following parts:

(1) When an act is performed or a transaction is carried out which, though legal in itself, is not authorised by the object clause in the Memorandum or by statute. It is said to be ultra vires the company.

(2) If an act is ultra vires the company, it cannot be ratified even by the whole body of shareholders.

(3) If an act is ultra vires the directors i.e., beyond the scope and powers of the directors but intra vires that company, it can be ratified by the shareholders by a special resolution in a general meeting.

(4) If an act is ultra vires the Articles, it can be ratified by altering the Articles by a special resolution in a general meeting.

Effects of Ultra Vires Transactions

Ultra vires transactions are the acts for which a company or its directors are not authorised to do such acts have the following effects:

(1) Company is not Bound by Ultra Vires Acts: A company is not bound by the ultra vires acts and a company can never ratify these acts even though all the shareholders of the company agree to ratify their acts.

(2) Personal Liability of Directors: Any member of a company can maintain an action against the directors of the company to compel them to restore to the company the funds of the company that have been employed by them in ultra vires transactions. If any funds of the company are misapplied, the directors are personally liable to the company for breach of trust even when the misapplication by the directors is done is good faith or when it is not fraudulent.

In Sharpe Re (1892) 1 Ch. 154, case the directors of a company paid dividends on shares out of capital which is an ultra vires act. The company was afterwards wound-up. Held, the directors were liable to refund the money to the company.

(3) Injunction Order: If any member of the company feels that the company is going to do anything ultra vires, he may go to the Court and obtain an injunction order to get the work stayed.

(4) Ultra Vires Contracts are Void and Illegal: If company has entered into any contract which is ultra vires its Memorandum, all such contracts are completely void and hence can never be ratified.

(5) Liability of the Directors for Breach of Warranty of Authority: Directors are known as the agents of the company. They must work within the limits and powers of the company. If it is proved that they have induced any one to enter into any contract ultra vires the Memorandum of company, they will be held personally liable for such contracts and liable for breach of their duties. They will have to compensate all the losses of that person.

In the case of Weeks Vs. Propert (1873) LR & C.P 427, the directors of a railway company which had fully exhausted its borrowing powers advertised for money to be lent on debentures, 'W' lent £500 upon the footing of advertisement and received a debenture. Held, the debenture was void but 'W' could sue the directors for breach of warranty of authority.

(6) No Suit can be Filed: A company can not sue any person for its ultra vires act and similarly, it can not be sued by others.

(7) Ultra Vires Acquired Property: If a company has acquired some property under an ultra vires transaction, it has the right to hold that property and protect it against damages by other persons.

(8) Ultra Vires Torts: A company is not liable for torts (civil wrongs) committed by its agents or servants during the course of ultra vires transactions.

Exceptions to the Doctrine of Ultra Vires

Following are the exceptions to the doctrine of ultra vires:

1. If an act is ultra vires the directors of a company but is intra vires the company, the company may ratify it.
2. If an act is ultra vires the Articles of Association of a company, the Articles may be altered to include the act within the powers of the company.
3. It an act is intra vires but is irregularly done, the shareholders may ratify it.
4. If a person borrows money from a company under a contract which is ultra vires the company, the company can sue him for the recovery of the money.
5. If an act is ultra vires the company, the right arising independently thereon are not affected.
6. If a company takes an ultra vires loan and uses it to pay off intra vires debts, the lender who has lent money is substituted in place of creditors and as such he can recover the money.
7. If a company has taken an ultra vires loan through some misinterpretation of fact by the directors, the lender has the right to make directors personally liable on the ground of breach of implied warranty of authority.
8. If a director of a company makes payment ultra vires the company, the company can compel him to refund the amount.

3.6 SUMMARY

Memorandum of Association of a company is the most important document of a company. It is the charter of a company. It defines and confines the powers of a company. Any act which is beyond the powers conferred by the Memorandum is called ultra vires. It contains name clause, situation clause, object clause, liability clause, capital clause and subscription clause. The name of the company can be altered by a special resolution and with the approval of Central Government in writing. By change of name, the constitution of the company is not changed, only the name changes. A company can change its registered office from one place to another within the local limits of the city, town or village, where it is situated, by merely passing a Board resolution. A company can change its objects clause by passing a special resolution. Companies Act permits a company, by a special resolution and after compiling with the procedure specified, alter the provisions of its memorandum.

3.7 KEYWORDS

Memorandum of Association: It is a charter of a company and defines the limitations of the powers of a company.

Doctrine of Ultra Vires: A doctrine declaring that any act contrary or in excess of the scope of the activity of the company will be null and void and not binding on the company.

3.8 SELF ASSESSMENT QUESTIONS

1. What is a Memorandum of Association? What are its contents?
2. "The Memorandum of Association is the fundamental law or a charter of the company defining the object and limiting the powers of a company." Explain.
3. What are the compulsory clauses in the Memorandum of Association? In what cases, in what mode and to what extent can a company alter these clauses?
4. Set out the restrictions imposed on the choice of a name for a company. How can a company change its name?
5. Explain the necessity of setting out clearly the objects in the Memorandum of Association as per the Companies Act, 2013.
6. Why is it necessary for a company to have a registered office? Can the registered office of a company be changed?
7. Discuss the doctrine of ultra vires vis-a-vis a company, the directors and the Articles. What is the legal effect of ultra vires acts?
8. "Memorandum of Association is the most important charter of a company." Discuss. How can it be altered?

3.9 SUGGESTED READINGS

- Avtar Singh, Company Law, Eastern Book Company, Lucknow.
- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

LESSON 4

ARTICLES OF ASSOCIATION

Structure

4.0 OBJECTIVES

After reading this lesson, you should be able to:

- Explain the meaning and contents of articles of association of a company.
- Describe the provisions and procedure of alteration of articles.
- Explain the relationship and difference between memorandum and articles of association.
- Discuss the legal effect of memorandum and articles of association.
- Throw light on the doctrine of constructive notice and indoor management.

4.1 INTRODUCTION

A company is an incorporated body so there have to be some rules and regulations for the management of its internal affairs and conduct of its business. It is equally important for a company to have some guidelines for managing its relationship with its members and also between the members. Moreover, the rights and duties of its members and the company are also to be recorded. A document which serve all these mentioned purpose is called the articles of association. Articles of association of a company are the internal rule book that every incorporated organisation must have and work by. It forms a part of the constitution of the organisation which establishes a contract between the members and organization and also among the members themselves. Articles also set out the rights and duties of directors and stockholders individually and in meetings.

4.2 MEANING AND CONTENTS OF ARTICLES OF ASSOCIATION

The Articles of Association are the rules, regulations and bye-laws for the internal management of the affairs of the company. They are framed with the object of carrying out the aims and objects as set out in the Memorandum of Association.

The Articles of Association have been defined by Sec. 2(5) of Indian Companies Act, 2013 as "Article means the Articles of Association of company as originally framed or as altered from time to time or applied in pursuance of any previous company law or of this Act."

The Article shall also contain such matters, as may be prescribed. Provided that nothing prescribed in this sub-section shall be deemed to prevent a company from including such additional matters in its Articles as may be considered necessary for its management.

The Article may contain provisions for entrenchment to the effect that specified provisions of the Articles may be altered only if conditions or procedures as that are more restrictive than those applicable in case of special resolution, are met or complied with.

The Article of a company shall be in respective forms specified in Table F, G, H, I and J in Schedule I as may be applicable to such company.

The Articles are next in importance to the Memorandum which contains the fundamental conditions upon which alone a company is allowed to be incorporated. They are as such subordinate to and controlled by the Memorandum. In Ashbury Railway Carriage & Iron Company Ltd. Vs. Riche (1875) L. R.7 H.L. 653, it was observed that the 'Articles' play a part subsidiary to the Memorandum of Association. They accept the Memorandum of Association as charter of the company and so accepting it. The Articles proceed to define the duties, the rights and the powers of the governing body as between themselves and the company at large, mode and term in which changes in internal regulation of the company may from time to time be made.

In framing the Articles of a company care must be taken that regulations framed do not go beyond the power of company itself as contemplated by the Memorandum of Association. They should also not violate any of the provision of the Companies Act. In Peveril Gold Mines Ltd. Re (1898) Ch 122 case, it was stated that the contents of the Articles should not violate the provisions of the Companies Act.

Contents of Articles of Association

Articles usually contain provisions relating to the following matters:

(1) The amount of share capital and its division.

(2) Amount of minimum subscription.

(3) Call money and procedure to call.

(4) Procedure for the allotment of shares.

(5) Procedure for the forfeiture and re-issue of shares.

(6) Provision for the reorganisation of shares capital.

(7) Procedure for the reduction of share capital.

(8) Procedure to confirm preliminary contracts.

(9) Right to borrow and the procedure of arranging loans.

(10) Commission payable on underwriting and brokerage.

(11) Types of meetings and the time to call them.

(12) Share certificates.

(13) Lien on shares and transfer of shares.

(14) Conversion of shares into stock.

(15) Voting rights of members, voting and poll procedures.

(16) Directors, their appointment, remuneration, qualifications, power and proceeding of Board of Directors.

(17) Rules regarding auditor, manager, secretary and treasurer.

(18) Rules regarding use of common seal.

(19) Rules regarding the keeping of books of accounts

(20) Rules regarding the capitalisation of profits.

(21) Rules regarding the creation of reserve funds

(22) Rules regarding the winding-up to company.

(23) Rules regarding the commission on shares and debentures.

(24) Rules regarding the issue of preference shares.

(25) Right to pay interest out of capital.

(26) Right to issue the share warrants.

(27) Right to appoint internal auditor.

(28) Right to declare interim dividend.

(29) Right to limit the rights of directors.

(30) Right to distribute the profits of the company.

In addition to the above matters, an un-limited company must disclose in Articles of Association the number of share with which the company is to be registered and the amount of share capital, if any, with which the company is to be registered. In case of a company limited by guarantee, Articles of Association must disclose the number of members with which the company is to be registered. It must also disclose the amount of guarantee that they have agreed to contribute in case of winding-up of company.

4.3 MODELS OF ARTICLES OF ASSOCIATION

Schedule I of the Companies Act gives various model forms of Articles of Association of various types of companies which are as follows:

Table F: Articles of Association of a company limited by shares.

Table G: Articles of Association of a company limited by guarantee and having a share capital.

Table H: Articles of Association of a company limited by guarantee and not having share capital.

Table I: Article of Association of an unlimited company and having share capital.

Table J: Article of Association of an unlimited company and not having share capital.

Companies which must have their own Articles

The following companies shall have their own Articles:

(a) Unlimited companies.

(b) Companies limited by guarantee.

(c) Private companies limited by shares.

The Articles must be signed by the subscribers of Memorandum and registered along with the Memorandum.

4.4 ALTERATION OF ARTICLES FO ASSOCIATION

For the alteration of Articles, Sec. 14 of Indian Companies Act, 2013 states that:

(1) Subject to the provisions of this Act and the conditions contained in its Memorandum, if any, a company may, by a special resolution, alter its Articles including alterations having the effect of conversion of:

(a) a private company into a public company; or

(b) a public company into a private company:

Provided that where a company being a private company alters its Articles in such a manner that they no longer include the restrictions and limitations which are required to be included in the Articles of a private company under this Act, the company shall, as from the date of such alteration, cease to be a private company:

Provided further that any alteration having the effect of conversion of a public company into a private company shall not take effect except with the approval of the Tribunal which shall make such order as it may deem fit.

(2) Every alteration of the Articles under this section and a copy of the order of the Tribunal approving the alteration as per sub-section (1) shall be filed with the Registrar, together with a printed copy of the altered Articles, within a period of fifteen days in such manner as may be prescribed, who shall register the same.

(3) Any alteration of the Articles registered under sub-section (2) shall, subject to the provisions of this Act, be valid as if it were originally in the Articles. As per Sec. 15 of this Act, alteration of Memorandum or Articles to be noted in every copy:

(1) Every alteration made in the Memorandum or Articles of a company shall be noted in every copy of the Memorandum or Articles, as the case may be.

(2) If a company makes any default in complying with the provisions of sub-section (1), the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every copy of the Memorandum or Articles issued without such alteration.

Limitations of the Alteration

Following are the limitations of the alteration of Articles:

(1) Must not be in Consistent with the Act: The alteration of the Articles must not be inconsistent with or go beyond the provisions of the Companies Act.

(2) Must not Conflict with Memorandum: The alteration of the Articles must not exceed the power given by the Memorandum or conflict with the provisions of the Memorandum. If it does, it will be ultra vires and wholly void or inoperative.

(3) Must not Sanction Anything Illegal: The alteration must not purport to sanction anything which is illegal. But if it is illegal and it is not clearly prohibited by the Memorandum it may be held to be valid even where it alters the whole structure of the company.

(4) Must be for the Benefit of the Company: The alteration must be bonafide for the benefit of the company as a whole. In Allen Vs. Gold Reefs of West Africa Ltd. (1900) Ch. 656, it was observed that the power of alteration must be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities.

(5) Must not Increase Liability of Members: The alteration must not in any way increase the liability of existing members, but where the company is a club or association, the Articles may be altered to provide for subscription or charge at higher rate.

(6) Alteration by Special Resolution: The alteration can be made only by a special resolution as defined in the Act. Even a clerical error in the Articles should be set right by a special resolution.

(7) Approval of Central Government: When a public company is converted into a private company. The alteration in the Articles which has the effect of converting a public company into a private company can be made only if it is approved by the Central Government.

(8) Breach of Contract: A company is not prevented from altering its Articles even if such an alteration would result in breach of a contract, however, the affected party may file a suit for damages for the breach of contract.

(9) Must not Result in Expulsion of a Member: An assumption by the directors of a company of any power to expel a member by altering its Articles is illegal and void.

(10) No Power of the Court to Amend Articles: The Court has no power to amend or rectify the Articles even where there is a mistake or drafting error which the Court would rectify in case of any other contract. The Court can only declare some clause to be ultra vires.

4.5 ARTICLES AND MEMORANDUM: THEIR RELATION

The Articles are subordinate to Memorandum. The Articles cannot give powers to a company which are not conferred by the Memorandum. This is so because the object of the Memorandum is to state the purpose for which the company has been formed while the Articles provide the manner in which the internal management of the company is to be carried. The Articles may explain or supplement the Memorandum, but cannot extend or enlarge its scope.

The terms of the Memorandum cannot be modified or controlled by the Articles, so far as the fundamental conditions in the Memorandum are concerned, they cannot be explained with aid of the Articles. In this regard Brown L. observed, “The Memorandum contains the fundamental conditions upon which alone company is allowed to be incorporated. They are conditions introduced for the benefit of the creditors and the outside public as well as shareholders. The Articles are the internal regulations of the company”.

4.6 DIFFERENCE BETWEEN MEMORANDUM AND ARTICLES OF ASSOCIATION

Following are the differences between memorandum and articles of association:

	Memorandum of Association	**Articles of Association**
(1)	It is the charter of the company. It also defines the company’s relationship with outsiders.	They are the regulations for the internal management of the company and are subsidiary to Memorandum.
(2)	It defines the scope of the activities of the company or beyond which the actions of the companies cannot go.	They are the rules for carrying out the objects of the company as set out in the Memorandum.
(3)	It is the main document of the company.	They are subordinate to the Memorandum. If there is a conflict

		between the Articles and Memorandum, the Memorandum prevails.
(4)	Alteration in Memorandum of Association is very difficult and is not a common feature.	Articles of Association may be altered by passing a special resolution at the meeting.
(5)	Acts done by a company ultra vires the Memorandum are void and cannot be ratified by the shareholders.	Acts done by a company ultra vires the Articles but intra vires the Memorandum can be ratified by a company by passing a special resolution.
(6)	Outsiders are expected to be acquainted with the Memorandum of Association and if the company enters into any contract ultra vires the Memorandum, outsiders have no remedy against the company.	Outsiders are not expected to be acquainted with the Articles of a company and then can enforce the contract against the company if it is ultra vires the Articles of Association.

4.7 LEGAL EFFECTS OF MEMORANDUM AND ARTICLES OF ASSOCIATION

Sec. 10 of Indian Companies Act, 2013 states:

(1) Subject to the provisions of this Act, the Memorandum and Articles shall, when registered, bind the company and the members thereof to the same extent as if they respectively had been signed by the company and by each member, and contained covenants on its and his part to observe all the provisions of the Memorandum and of the Articles.

(2) All monies payable by any member to the company under the Memorandum or Articles shall be a debt due from him to the company.

The above provisions of the Companies Act clearly defines that the Memorandum of Association and the Articles of Association, after the registration bind the company and its members with their provisions. The effect of these provisions is to constitute a contract between each member and the company. The legal implication of these documents may be discussed as to how far documents bind:

(1) Members to the company, (2) Company to the members,

(3) Member Inter Se, (4) Company to the outsiders.

(1) Members to the Company: As between the members and the company, the Memorandum and the Articles constitute a binding contract. The effect of this is that each member is bound to the company to conform to the Memorandum and the Articles as if each member has actually signed the same. Boreland's Trustee Vs. Steel Bros & Co. Ltd. (1901) 1 Ch 279, the Articles of a company as altered provided that the shares of any member who becomes bankrupt should be sold to certain persons at a fair price. B, a shareholder became bankrupt and his trustee in bankruptcy claimed that he was not bound by the altered Articles. Held, the Articles were a personal contract between B and the rest of the members and his trustee were bound by the contract.

(2) Company to the Members: A company is bound to the members in the same manner as the members are bound to the company. The company can exercise its rights as against any member, only in pursuance of, and in accordance with, the Memorandum and the Articles. A member can obtain an injunction restraining the company from doing an ultra vires act. In Wood Vs. Odessa Water Works' Co. (1889)42, Ch, D 636 case, the Articles of W. Company provided that the directors may with the sanction of the company at general meeting declare a dividend to be paid to the members. A resolution was passed to give the shareholders debenture bonds instead of paying dividend in cash. A member filed the suit to restrain the directors from acting on resolution as it was not in accordance with the Articles of the company. Held, the word 'to be paid' meant paid in cash and a shareholder could restrain the company from acting on resolution on the ground that it had contravened the Articles.

(3) Member Inter Se: Members are bound to each other but these documents do not create an express agreement between the members of the company. A member cannot bring a suit in his own name against another member to enforce the Articles. Otherwise, there may be a large number of cases against one defaulter, which will be absurd. However, where the member at fault holds the majority of shares he will not, therefore, be allowed to take an action in the name of the company. In such a case, an action may be brought against him by another shareholder in his own name.

This was established by Lord Herschell in Wettron Vs. Saffery (1897) A. C. 299. "It is quite true that the Articles constitute a contract between each member and the company, but the Articles do not regulate their rights inter se. Such rights can only be conferred by or against a member through the company or through the liquidator."

In some cases, where the Articles seek to regulate the rights of shareholders in their capacity as members, they constitute a contract between two members and in which case contract can be directly enforced by a member against another without joining the company as a party.

(4) Company to the Outsiders: Neither the company nor its members are bound to the outsiders. This is so even if the names of the outsiders are mentioned in these documents. Again, Articles do not confer any right even upon a member in a capacity other than that of a member. There must be an independent contract entered into between the company and the outsiders.

Eley Vs. Positive Govt. Security Life Ass. Co. (1876) EXD 88, the Articles of the company provided that E should be the solicitor of the company for life and could be removed from office only for misconduct. E took office and became a shareholder. After sometime, the company dismissed him without alleging misconduct. E sued the company for damages for breach of regulations in the Articles. Held, the Articles did not constitute any contract between the company and outsiders as such no action could be taken.

4.8 CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES

Every outsider dealing with a company is deemed to have notice of the contents of Memorandum and Articles. These documents, on registration with the Registrar, assume the character of public documents, this is known as Constructive Notice of Memorandum and Articles.

The Memorandum and Articles are open and accessible to all. It is the duty of every person dealing with a company to inspect these documents and see that it is within the power of the company to enter into the proposed contract. The legal effect of these constructive notices is that if a person deals with a company in a manner which is not inconsistence with the provisions of the Memorandum or Articles of the company, he must be deemed to have dealt with the company at his own risk and cost if he suffers any loss and because of such a deal, he will have to bear the loss himself.

Kolta Venkataswamy Vs. Ram Murthi (1934) 4 Comp. Case 289, the Articles of Association of a company contained a clause that all deeds and documents of the company shall be signed by the managing director, the secretary and a working director on behalf of the company. A deed of mortgage was signed by the secretary and a working director only. Held, the mortgage could not be enforced as the illegality appeared on the face of deed, and therefore, the deed was invalid notwithstanding that plaintiff acted in good faith and money was applied for the purpose of the company.

The doctrine of constructive notice of the Memorandum and Articles, however, is not a positive doctrine but a negative one. It is like the doctrine of estopple. It does not operate against the company. It operates only against an outsider dealing with the company. It prevents him from alleging that he did not know that the Memorandum and Articles rendered a particular act ultra vires the company.

4.9 DOCTRINE OF INDOOR MANAGEMENT

Though the doctrine of constructive notice assumes that the persons dealing with the company has gone through its Memorandum and Articles of Association, however, there is one exception to the above doctrine. The exception is that the persons dealing with the company are not bound to enquire into the regularity of the internal proceedings of the company. They are entitled to assume that the provisions of the Articles of Association of a company have been fully observed by its officers and outsiders cannot be expected to see that the company follows its internal regulations. Thus, whereas the doctrine of constructive notice protects the company against outsiders, the doctrine of indoor management seeks to protect outsiders against the company.

The Articles empowered the directors to borrow on bond such sums of money, as they were authorised by a proper resolution of the company. They issued a bond to Turquard without the authority of such a resolution. It was held that the company was bound by the loan. The plaintiff was entitled to assume that the necessary resolution had been duly passed. The reason for the rule is that the outsiders cannot know as to what has happened within the doors of the company that were closed to them. Memorandum and Articles are public documents but the minutes book of the director’s meeting or shareholder’s meeting. (from where a person could ascertain the internal irregularity). Thus, details of internal proceedings are not open to the public.

The gist of the rule is that persons dealing with limited liability companies are not bound to inquire into the regularity of the internal proceedings and will not be affected by irregularities of which they had no notice.

In Laxmi Ratan Cotton Mills Ltd. Vs. J. K. Jute Mills Co. Ltd (1957) 27 Comp. Case 660 (All) where the plaintiff sued the defendant company for a loan of 1,50,000 it was held that where the act done by a person, acting on behalf of the company is within the scope of his apparent authority. It binds company no matter whether the plaintiff has read the documents or not. In this case, the defendant company raised the place that the transaction was not bindings as no resolution sanctioning the loan was passed by the Board of Directors. The Court held, "A transaction entered into by the borrowing company cannot be defeated merely on the ground that no such resolution was in fact passed. The passing of such a resolution is a mere matter of indoor management and it cannot be used to defeat the just claim of a bonafide creditor".

Exceptions to The Doctrine Indoor Management

The doctrine of indoor management is subject to the following exceptions:

(1) Knowledge of Irregularity: Where a person dealing with the company has actual or constructive notice of the irregularity as regard internal management, he cannot claim the benefit under the rule of indoor management. The rule is based on common sense and any other rule would "encourage ignorance and condone dereliction of duty". In the case of Devi Dutta Mal Vs. Standard Bank of India, A.I.R. (1927) Lah, 797, a transfer of shares in a company was approved by two directors. One of these directors was not validity appointed. The other was disqualified by reason of transferor himself. These facts were known to the transferor. Held, the transfer was ineffective.

In another case of Maward Vs. Patent Ivory Co. (1888) 38 Ch. D. 156, the directors of a company could borrow any amount upto $ 1,000 without the approval of the shareholders in general meeting. But for any amount beyond $ 1,000 they had to obtain the consent of the shareholders in general meeting. The directors themselves lent to the company an amount in excess of borrowing powers of the company without the consent of the shareholders in general meeting. Held, the directors had the notice of the internal irregularity and hence the company was liable to pay only for $ 1,000.

(2) Negligence: Where a person dealing with a company could discover the irregularity if he had made proper inquiries. He cannot claim the benefit of the rule of indoor management. The protection of the rule is also not available where the circumstances surrounding the contract are so suspicious as to invite inquiry.

In the case of Anand Bihari Lal Vs. Dinshaw & Co. A.I.R. (1942) Oudh 417, the plaintiff, in this case, accepted a transfer of company's property from its accountant. Held, the transfer was void as such a transaction was apparently beyond the scope of the accountant's authority.

(3) Forgery: Where the acts done in the name of company on the ground of forgery are void ab initio, the doctrine of indoor management does not apply. A company can never be held bound for forgeries committed by its officers. The leading case on the point is Ruben Vs. Great Fingall Consolidated Co. (1906) A.C. 439. The secretary of a company issued a share certificate under the company's seal with his own signature and the signature of a director forged by him. Held, the share certificate was no binding on the company. The person who advanced money on the strength of the certificate was not entitled to be registered as holder of the share.

(4) No Knowledge of Articles: A person should have knowledge of the Articles if he wants protection under the rule of 'indoor management'. The rule is based on the principle of estoppel and a person can be protected if he has relied on the Articles. As such if a person while entering into contract with a company has no knowledge of the company's Articles of Association, he cannot rely on those Articles as conferring ostensible or apparent authority on the agent of the company with whom he dealt. [Rama Corporation Vs. Proven Tin and General Investment Co. (1952) 2 Q.B. 1471].

4.10 SUMMARY

Articles of association regulates the internal management of the affairs of the company by way of defining the powers of its officers and establishing a contact between the company and the members and between the members inter se. The articles of a company are subordinate to and subject to the memorandum of association. Therefore, any clause in the articles going beyond the memorandum will be ultra vires. The articles are only internal regulations, over which the members of the company have full control and may alter then according to what they think fit. Although a company has a statutory right to alter into articles of association yet the power to alter in subject to the provisions of Companies Act and to the conditions contained in Memorandum. The doctrine of constructive notice provides protection to the company against the outsiders. The principle of indoor management, on the other hand, operates to protect the outsiders against the company.

4.11 KEYWORDS

Articles of Association: A document containing rules and regulations and bye-laws for governing the internal affairs of a company.

Doctrine of Constructive Notice: A doctrine declaring that both Memorandum and Articles are public documents after being registered with the Registrar of Companies and everyone dealing with the company is deemed to have constructive notice of them.

Doctrine of Indoor Management: A doctrine declaring that the outsiders dealing with the company are entitled to presume that the internal formalities as required by the company's articles must have been observed by the management of the company.

4.12 SELF ASSESSMENT QUESTIONS

1. What are Articles of Association? How can they be altered?
2. What is the legal effect of the Articles of Association between:

   (a) Members and the company, (b) Members inter se (c) Company and outsiders.
3. What are the main point of distinction between the Memorandum of Association and Articles of Association?
4. "The power of altering Articles is wide yet it is subject to a large number of limitations." Explain.
5. Discuss the scope of the 'doctrine of indoor management'. To what extent has the doctrine been incorporated in the Companies Act, 2013?
6. "The doctrine of indoor management is silver lining to strangers dealing with a company." Comment.
7. "The doctrine of constructive notice relating to Memorandum and Articles of Association is not a positive doctrine but a negative one". Discuss.

4.13 SUGGESTED READINGS

- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.

- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

LESSON 5

PROSPECTUS AND COMMENCEMENT OF BUSINESS

Structure

5.0 OBJECTIVES

After reading this chapter, you should be able to:

- Define public offer, prospectus, abridged prospectus.

- Explain the contents of prospectus.
- Highlight the provisions of registration and issue of prospectus.
- Outline the provisions of shelf prospectus and red hearing prospectus.
- Outline the effects of misstatement in prospectus.

5.1 INTRODUCTION

Every company requires capital for its business activities. Therefore, every company issues its securities. But the public and private companies cannot use almost the same ways or methods for issuing their securities. The ways/modes of issuing securities by both the classes of companies are briefly described in the ensuing paragraphs.

A public company may issue securities in any one or more of the following ways:

1. To public through prospectus, i.e., 'public offer.'
2. Through private placement.
3. Through a rights issue.
4. Through bonus issue, that is, issue of bonus securities.

It should be clearly noted that a listed company or a company that intends to get its securities listed on any recognized stock exchange can make an offer of its securities to the public. While making such an offer, the company shall comply with the provisions of the Securities and Exchange Board of India Act (SEBI Act), 1992 and the Rules and Regulations made thereunder for issue of securities [Sec. 23(1)].

A private company may issue securities by any one of or all the following ways:

1. Through private placement.
2. Through a rights issue.
3. Through a bonus issue, i.e., issue of bonus securities [Sec. 23(2)].

It is clear from the above description that there is only one difference in the ways of issuing securities by the two classes of companies. All the public companies can issue securities through a prospectus but no private company can do so. But all public companies as well as private companies can adopt any of the remaining methods for issue of their securities.

It also becomes clear that a private company is not entitled to issue its securities through prospectus or to the public. Hence, the provisions of the SEBI Act and the Rules and Regulations made thereunder do not apply to private companies.

5.2 PUBLIC OFFER

Public offer of securities means an offer of securities made to the public through a prospectus. The expression 'public offer' is quite comprehensive and it includes the following kinds of offers:

1. Initial public offer (IPO).
2. Further or follow up public offer (FPO). Both these public offers are made through the prospectus.
3. Offer for sale of securities to the public by an existing shareholder. Such offer is also made through issue of a prospectus. It may be both the initial public offer (IPO) and further or follow up public offer or FPO.

1. **Initial Public Offer (IPO):** When an unlisted company makes either a fresh issue of shares or company's promoters offer their holding of shares for sale or both for the first time to the public, it is called an IPO. This paves way for listing and trading of the company's securities in the stock exchanges. Thus, IPO means any of the following:
   (a) Issue of shares for the first time to the public by an unlisted company.
   (b) Offer of sale of shares for the first time by the promoters of a company out of their holding of shares.

2. **Further or Follow on Public Offer (FPO):** When an already listed company makes either a fresh issue of shares to the public or when promoters of a listed company make an offer for sale of their shareholding to the public, after an IPO, it is called a FPO. Thus, further public offer means any of the following:
   (a) Fresh issue of securities by a listed company at any time after an IPO to the public.
   (b) Offer of sale of securities by the promoters of a listed company out of their holding at any time after an IPO.

In case of any public issue of shares, an offer document is issued to the public, which is known as the prospectus. It is the document containing all the relevant information about the company, promoters, projects, financial details, objects of raising the money, terms of the issue, etc. It is used for inviting public for subscription for securities of a company being offered by the issuer.

Whenever a promoter or a member makes an offer for sale of his holding of securities, he is also required to issue a document for inviting public for subscription of securities of the company. Such a document is called the 'offer for sale,' which is 'deemed to be a prospectus' in legal terms. Legal experts sometimes call it a 'prospectus by implication'.

5.3 PROSPECTUS

Prospectus means any document described or issued as a prospectus and includes a red herring prospectus (referred to in Section 32) or shelf prospectus (referred to in Section 31) or any notice, circular, advertisement, or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate [Sec. 2(70)].

In simple words, a prospectus is any document that is described or issued as a prospectus by a body corporate for inviting offers from public for subscription or purchase of its securities. It may be noted that the term prospectus include a red herring prospectus, shelf-prospectus, and any notice, circular, advertisement, or other document if it is described or issued as a prospectus. It is issued by a body corporate for inviting offers from public for the subscription or purchase of its securities.

Characteristics/Features

The main characteristics or features of a prospectus are as follows:

1. A prospectus is a document which is described or issued as prospectus by a company.
2. A prospectus. includes any red herring prospectus, shelf prospectus, notice, circular, advertisement, or any other document that is issued as prospectus.
3. It may be issued only by public companies. Private companies cannot issue prospectus.
4. It is issued as an invitation to the public by a public company for inviting offers from the public for the subscription or purchase of its securities.

5. A prospectus is a document in writing. It cannot be oral. An oral invitation to the public is not deemed to be a prospectus. Television and film advertisements cannot be treated as prospectus.
6. The date indicated in the prospectus shall be the deemed date of its publication.
7. Every prospectus issued must contain the matters and set out all the reports specified by the provisions of the Companies Act [Sec. 26].
8. A prospectus is signed by the directors or proposed directors and other persons of the company who authorize it to be issued [Sec. 26].
9. A prospectus can be issued to the public only after its registration with the Registrar.
10. The provisions relating to prospectus by a listed company and public company, which intends to get its shares listed on any stock exchange, are administered by SEBI [Sec. 24(1)].

Who can issue prospectus?

Prospectus may be issued by any of the following:

1. By a public company.
2. By any person on behalf of the public company.
3. By any person who is or who has been engaged or interested in the formation of a company.
4. By any person on behalf of a person who is or who has been engaged or interested in the formation of a public company [Sec. 26(1)].
5. A deemed prospectus may be issued by the person or the company to whom a company allots or agrees to allot securities with a view to the same securities being offered for sale to the public [Sec. 25].

When issue of prospectus not needed?

Issue of prospectus or abridged prospectus is not necessary in the following cases:

1. Where the securities of a public company are not offered to the public [Sec. 23]. This will be the case when the public company issues its securities through private placement offer letter [Sec. 42].

2. Where the securities are offered to the existing members of the company with or without the right of renunciation in favour of any other person.

3. Where the securities offered are uniform in all respects with securities previously issued and dealt in or quoted on a recognized stock exchange [Sec. 26(2)].

4. Where a bona fide invitation is made to a person to enter into an underwriting agreement with respect to the securities [Sec. 33].

It should be noted that a private company cannot issue a prospectus.

5.4 CONTENTS OF PROSPECTUS

The Companies Act, 2013 does not contain any model prospectus. It only prescribes the contents of a prospectus. It also states that a prospectus shall also contain the matters as may be prescribed. According to the provisions of Companies Act and the Rules made thereunder, a prospectus to be issued shall contain the particulars with respect to the following matters:

I. Date: Every prospectus shall be dated. The date indicated in the prospectus shall be deemed to be the date of its publication.

2. Signature: Every prospectus shall be signed by all persons named therein as directors or proposed directors of the company or by his duly authorized agent.

3. Information: Every prospectus issued by a company or on behalf of a company shall contain the following information:

(a) Names and addresses of the registered office of the company, company secretary, chief financial officer, auditors, legal advisors, bankers, trustees, if any, underwriters and such other persons as may be prescribed.

(b) Dates of opening and closing of the issue.

(c) Declaration about the issue of allotment letters and refunds within the prescribed time. The Rules notified by Ministry of Corporate Affairs (MCA) prescribe that the declaration shall be made by the Board or the Committee authorized by the Board in the prospectus that the allotment letters shall be issued or application money shall be refunded within 15 days from the closure of the issue or such lesser time as may be specified by SEBI. In case of failure to do so, the application money shall be refunded to the applicants forthwith. If the money still remains unpaid, the company shall be liable to pay interest to the applicants at the rate of 15 per cent per annum for the delayed period.

(d) A statement by the Board of directors about the separate bank account with a scheduled bank. This statement shall include that all monies received out of the issue are to be transferred to this account. Moreover, disclosure of details of all monies including utilized and unutilized monies out of the previous issue shall be made in the prescribed manner.

(e) Details about underwriting of the issue. The Rules notified by MCA prescribe that the names, addresses, telephone numbers, fax numbers, and e-mail addresses of the underwriters and the amount underwritten by them shall be stated in the prospectus.

(f) Consent of the directors, auditors, bankers to the issue, expert's opinion, if any and of such other persons, as may be prescribed. The Rules notified by MCA also prescribe that the prospectus shall contain the consent of trustees, solicitors or advocates, merchant bankers to the issue, registrar to the issue, lenders, and experts.

(g) The authority for the issue and the details of the resolution passed therefore.

(h) Procedure and time schedule for allotment and issue of securities.

(i) Capital structure of the company in the prescribed manner.

(j) Main objects of public offer, terms of the present issue and such other particulars as may be prescribed [Sec. 26(1) (a)].

(k) Main objects and present business of the company and its location, schedule of implementation of the project [Sec. 26(1) (a)].

(1) Minimum subscription, amount payable by way of premium, issue of shares otherwise than on cash [Sec. 26(1) (a)].

(m) Details of directors including their appointments and remuneration, and such particulars as to the nature and extent of their interests in the company as may be prescribed [Sec. 26(1) (a) and Rule PAS-3 (5)].

(n) Disclosures in such manner as may be prescribed about sources of promoter's contribution [Sec. 26(1) (a) and Rule PAS-3 (6)].

4. **Particulars of Project:** The prospectus shall also contain the following particulars relating to the project:

   (a) Management perception of risk factors specific to the project.

   (b) Gestation period of the project.

   (c) Extent of progress made in the project.

   (d) Deadlines for completion of the project.

5. **Particulars of Litigation:** The prospectus shall also contain the particulars relating to any litigation or legal action [Sec. 26(1) (a) and Rule PAS-3(4)].

6. **Reports:** Every prospectus shall also set out the following reports for the purposes of the financial information:

(a) Reports by the auditors of the company with respect to its profits and losses and assets and liabilities and such other matters as may be prescribed.

(b) Reports relating to profits and losses for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding the financial year of the issue of prospectus. Such reports shall also include such reports of its subsidiaries. The reports shall be in such a manner as may be prescribed.

(c) Reports made in the prescribed manner by the auditors (i) upon the profits and losses of the business of the company for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding the issue and (ii) assets and liabilities of its business on the last date to which the accounts of the business not exceeding 180 days before the issue of the prospectus.

(iv) Reports about the business or transaction to which the proceeds of the securities are to be applied directly or indirectly [Sec. 26(1)(b)].

7. **Declaration:** Prospectus shall also include a declaration made about the compliance of the provisions of this Act. This apart, a statement shall also be included in it to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts

(Regulation) Act, and the SEBI Act and the rules and regulations made thereunder [Sec. 26(1) (c)].

8. **Any Other Matters:** A prospectus shall also state such other matters and set out such other reports, as may be prescribed [Sec. 26(1) (d)].

Other Contents

Certain other matters including the following shall also be included in the prospectus:

1. **Additional Matters to be Stated in the Document Issued by Issue House:** The offer for sale by an issue house shall state the following additional particulars:

   (i) The net amount of the consideration received or to be received by the company in respect of the securities to which the offer relates.

   (ii) The time and place at which the contract under which the said securities have been or are to be allotted may be inspected [Sec. 25(3)].

2. **Matters to be Stated on the Face of the Prospectus:** Every prospectus issued shall contain on its face the following matters:

   (a) That a copy has been delivered for registration to the Registrar.

   (b) Specify any documents required by this Section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents [Sec. 26(6)].

3. **Reproduction of Provisions Relating to Personation for Acquisition of Securities:** The provisions relating to personation for acquisition etc. of securities shall be prominently reproduced in every prospectus issued by company and in every form of application for securities [Sec. 38].

Conditions for Inclusion of Expert's Certificate

A prospectus issued shall include a statement purporting to be made by an expert subject to the following conditions:

(i) The expert shall not be the person who is and has been engaged, or interested in the formation or promotion or management of the company.

(ii) He has given his written consent to the issue of the prospectus and has not withdrawn such consent before the delivery of a copy of the prospectus to the Registrar for registration.

(iii) A statement of the above fact (consent) has been included in the prospectus [Sec. 26(5)].

Punishment for Non-Inclusion of Contents in Prospectus

If a prospectus is issued in contravention of the provisions relating to contents of prospectus [Section 26], the following shall be punished:

(i) The Company: The company shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh.

(ii) Every Person who is Party to the Issue: Every person who is knowingly a party to the issue of such prospectus shall be punishable with imprisonment for a term which may extend to 3 years or with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh, or with both [Sec. 26(9)].

Advertisement of Prospectus

Sometimes, an advertisement of any prospectus of a company is published in any manner. But it shall be necessary to specify therein the contents of its memorandum as regards to the following:

(i) The objects.

(ii) The liability of members.

(iii) The amount of share capital of the company.

(iv) The names of the signatories to the memorandum.

(v) The number of shares subscribed by signatories.

(vi) The capital structure of the company [Sec. 30].

Application of Provisions to Every Prospectus and Application Form

The above stated provisions as to contents of prospectus shall apply to a prospectus or a form of application, whether issued on or with reference to the formation of a company or subsequently [Sec. 26(3)].

Exceptions/Exemptions

None of the above provisions as to content of a prospectus shall apply in the following cases:

(a) To issue to existing members or debenture-holders of a company. It shall be immaterial whether an applicant has a right to renounce the shares or not in favour of any other person.

(b) To issue a prospectus or form of application relating to shares or debentures which are, or are to be, in all respects uniform with shares or debentures previously issued and for the time being dealt in or quoted on a recognized stock exchange [Sec. 26(2)].

5.5 REGISTRATION OF PROSPECTUS

A prospectus can be issued only after its registration. The main provisions with respect to registration of prospectus are as follows:

1. **Preparing Prospectus:** A prospectus needs to be prepared for its registration. It should contain all the matters specified by Section 26 and the Rules made thereunder. In addition, it should set out the following documents, reports, and declaration:

   (i) Consent of directors, auditors, and bankers to the issue and other specified persons.

   (ii) Reports by the auditors of the company with respect to its profits and losses and assets and liabilities and such other prescribed matters.

   (iii) Reports relating to profits and losses for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding the financial year of the issue of prospectus including such reports of its subsidiaries.

   (iv) Reports by the auditors upon the profits and losses of the business of the company for each of the five financial years (or each of the years of actual existence of the company, whichever is less) immediately preceding issue and assets and liabilities of its business on the last date to which the accounts of the business were made up.

   (v) A declaration to the effect that the provisions of this Act have been complied with.

(vi) A statement to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation) Act, and the SEBI Act and the rules and regulations made thereunder.

2. **Dating of Prospectus:** A prospectus should be dated. The date indicated in the prospectus shall be taken as the date of publication of prospectus.

3. **Signing of Prospectus:** The copy of the prospectus which is to be delivered for registration must be signed by every person who is named therein as a director or proposed director of the company. Alternatively, it may be signed by his duly authorized agent in writing [Sec.26].

4. **Approval by Various Agencies:** As per the rules and regulations of SEBI, the draft prospectus has to be approved by the following agencies/authorities:

   (i) The lead manager to the issue.

   (ii) Each of the stock exchanges where the securities of the company are listed or proposed to be listed.

   (iii) The lead financial institution underwriting the issue.

5. **Vetting by SEBI:** A prospectus is vetted by SEBI to ensure adequacy of disclosures. As per the directions of the MCA, the Registrar shall not register a prospectus before it is vetted by SEBI. After vetting, if SEBI is satisfied, it shall certify that the contents of the prospectus are not in contravention of any law or rules and regulations. However, SEBI does not take any responsibility to the correctness of statements made or opinions expressed in the prospectus.

6. **Delivery to the Registrar:** The next step is the delivery of the prospectus along with all documents, approvals, and vetting certificate to the Registrar for its registration. It should be delivered to the Registrar on or before the date of its publication [Sec. 26].

7. **Registration of Prospectus:** The Registrar shall register the prospectus if all the formalities required for registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus. The registration shall be done on or before the date of its publication [Sec. 26].

5.6 ISSUES OF PROSPECTUS

The main provisions with respect to the issue of prospectus to public are as follows:

1. **Issue Only after Registration:** No prospectus shall be issued to the public unless it is duly registered by the Registrar. Therefore, only duly registered prospectus must be issued [Sec. 26(4)].

2. **Matters to be Stated on the Face of Prospectus:** Every prospectus issued shall contain on its face the following matters:

   (a) That a copy of it has been delivered for registration to the Registrar.

   (b) Specify any documents required by this Section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents [Sec. 26(6)].

3. **Issue of Prospectus within 90 Days:** The prospectus must be issued within 90 days of the date on which a copy thereof is delivered to the Registrar. If a prospectus is issued after 90 days of the date of registration, it shall not be a valid prospectus [Sec. 26(8)].

4. **Penalty for Issue of Prospectus in Contravention of These Provisions:** If a prospectus is issued in contravention of the above provisions, the company shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh. Moreover, every person who is knowingly a party to the issue of such prospectus shl1 be punishable with imprisonment for a term which may extend to 3 years or with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh or with both [Sec. 26(9)].

5. **Furnishing a Copy of the Prospectus on Request:** Where a request for a copy of the prospectus is made by any person, it shall be furnished to him before the closing of the subscription list and offer. If a company makes any default in complying with this provision, it shall be liable to a penalty of ` 50,000 for each default [Sec. 33].

5.7 VARIATION IN TERMS OF CONTRACT OR OBJECTS

Sometimes, a company, which has raised money from public through prospectus, still has any unutilized amount out of the money so raised. If such a company intends to alter or vary the terms of contracts referred to in the prospectus or objects for which the prospectus was issued, it can do so if it satisfies the following conditions:

1. Special Resolution: The company shall pass a special resolution through postal ballot for effecting such variation change. The notice of the proposed special resolution through postal ballot shall contain the following particulars:

(a) The original purpose or object of the issue.

(b) The total money raised.

(c) The money utilized for the objects of the company stated in the prospectus.

(d) The extent of achievement of proposed objects (that is 50 per cent, 60 per cent, etc).

(e) The unutilized amount out of the money so raised through the prospectus.

(f) The particulars of the proposed variation in terms of contracts referred to in the prospectus or objects for which prospectus was issued.

(g) The reason and justification for seeking variation.

(h) The proposed time limit within which the proposed varied objects would be achieved.

(i) The clause-wise details as were required with respect to the originally proposed objects of the issue.

(j) The risk factors pertaining to the new objects.

(k) The other relevant information which is necessary for the members to take an informed decision on the proposed resolution.

2. Publication of Notice of Resolution: The company shall publish an advertisement of the notice in respect of such resolution to shareholders. It shall also be published in Form No. PAS- 1 in the newspapers (one in English and one in vernacular language) circulating in the city where the registered office of the company is situated. It shall be indicating clearly the justification for such variation. Such advertisement shall be published simultaneously with dispatch of postal ballot notices to shareholders [Sec. 27 and Rule PAS-7(2)].

The notice shall also be placed on the website of the company, if any.

3. Opportunity to Exit to the Dissenting Shareholders: The promoters and shareholders having control on the company shall give an opportunity to the dissenting shareholders to the resolution to exit from the securities in which they have invested their money. The exit offer shall be given at such price, and in such manner and conditions as may be specified by the SEBI [Sec. 27].

5.8 ABRIDGED PROSPECTUS

An abridged prospectus means a memorandum containing such salient features of a prospectus as may be specified by the SEBI by making regulations in this behalf [Sec. 2(1)].

Application Form to be Accompanied by Abridged Prospectus: No form of application for the purchase of any of securities of a company shall be issued unless such form is accompanied by an abridged prospectus [Sec. 33(1)].

Exceptions: But no one shall be required to issue a copy of the abridged prospectus with the form of application in the following cases:

(i) Where the form is issued in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to such securities.

(ii) Where it is issued in relation to securities which were not offered to the public [Sec. 33].

Copy of Prospectus on Request: A copy of the prospectus shall, on a request being made by any person before the closing of the subscription list and the offer, be furnished to him [Sec. 33(2)]

Penalty: If a company makes any default in complying with this provision it shall be liable to a penalty of ` 50000 for each default [Sec. 33].

The SEBI Regulations make it clear that the Lead Merchant Banker is responsible for compliance with the provisions in respect of the abridged prospectus.

5.9 DEEMED PROSPECTUS

Now-a-days, it is a common practice that the securities of a company are allotted or agreed to be allotted to some intermediary known as the 'issuing house.' The issuing house, in turn, is required to offer all or any of these securities to the public by means of some document. Such a document issued by an issuing house is known as offer for sale of securities. For all purposes it shall be and deemed to be a prospectus issued by the company. The provisions relating to offer for sale of securities by an issuing house are summarized here.

1. Deemed Prospectus: Sometimes, a company allots or agrees to allot any securities of the company to another company or firm with a view to all or any of those securities being offered for sale to the public. In such a case, any document by which such offer for sale is made by that another company or firm shall be and deemed to be a prospectus issued by the company.

Since, the offer document issued by another company or firm is a deemed prospectus, it shall have the following consequences:

(i) All the provisions with respect to contents of the prospectus shall apply to the document.

(ii) The provisions as to registration and issue of prospectus shall also apply to this document.

(iii) Any misstatement in the document or omission of any material fact from the document shall have the same effect as in case of a prospectus.

(iv) The liability of the persons authorizing the issue of a false or misleading document to the subscribers of securities shall be the same as that of the persons authorizing the issue of such prospectus [Sec. 25(1)].

2. Presumption of Intention to Offer Securities to the Public: Generally, the agreement with the issuing house contains the clauses that securities shall be offered to the public. But in the absence of any express provision in the agreement, the intention to offer securities to the public shall be presumed in the following cases unless the contrary is proved:

(i) If the offer of the securities or any of them for sale to the public (by issuing house) is made within six months of allotment or agreement to allot (to the issuing house) the securities.

(ii) If at the date of offer (by issuing house) to the public, the whole consideration to be received by the company in respect of the securities has not been received by it [Sec. 25(2)].

3. Additional Matters to be Stated: The offer for sale must state all the matters and set out all the reports as specified by Section 26. Besides these, the following additional particulars should be stated in the offer for sale:

(i) The net amount of the consideration received or to be received by the company in respect of the securities to which the offer relates.

(ii) The time and place at which the contract under which the said securities have been or are to be allotted may be inspected [Sec. 25(3)).

4. Persons Offering to be Named in the Prospectus as Directors: The persons making the offer shall be named in the prospectus as directors of the company [Sec. 25(3)].

5. Signing of Offer for Sale: Where a person making an offer (i.e., issuing house) is a company, it shall be sufficient if the offer document is signed on behalf of the company by two directors of the company or if it is a firm, it is signed on behalf of the firm by not less than one-half of the partners in the firm [Sec. 25(4)].

5.10 SHELF PROSPECTUS

The provisions of shelf prospectus have been incorporated in the Act for the convenience of certain class or classes of companies such as the public financial institutions, public sector banks, or scheduled banks. With the introduction of the provisions of shelf prospectus, they will not be required to prepare prospectus for every issue of securities and file it with the Registrar. This will save a lot of money and time required for complying with many formalities.

'Shelf prospectus' means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus [Explanation to Sec. 31].

Provisions Regarding Shelf Prospectus

The provisions with respect to shelf prospectus are as follows:

1. **Any Class of Companies to File:** Any class or classes of companies may file a shelf prospectus with the Registrar at the stage of the first offer of securities. The SEBI has been authorized to make regulations for preparing and filing a shelf prospectus.

2. **Validity Period:** The shelf prospectus shall indicate a period not exceeding one year as the period of validity of such prospectus. The period of validity shall commence from the date of opening of the first offer of securities under that prospectus.

3. **No Need to File Again during the Validity Period:** A company filing a shelf prospectus shall not be required to file a further prospectus in respect of a second or subsequent offer of such securities issued during the period of validity of that prospectus [Sec. 31(1)].

4. **Filing of an Information Memorandum:** A company filing a shelf prospectus shall be required to file an information memorandum containing the following information:

   (i) All material facts relating to new charges created.

(ii) Changes in the financial position as have occurred between the first offer of securities or the previous offer of securities and the succeeding offer of securities.

(iii) Such other changes as may be prescribed.

5. **Time of Filing Information Memorandum:** The information memorandum shall be filed within the prescribed time, prior to the issue of a second or subsequent offer of securities under the shelf prospectus. [Sec. 31(2)].

6. **Applications for Securities Received before Making Such Changes:** Sometimes, a company may receive applications for the allotment of securities along with advance payments of subscription before the making of any such change through information memorandum. In such a case, the company shall intimate the changes to such applicants. If they express a desire to withdraw their application, the company shall refund all the monies received as subscription within 15 days thereof [Sec. 31(2)].

7. **Information Memorandum and Shelf Prospectus to be Deemed Prospectus:** An information memorandum is filed at the time of making every offer of securities. Such memorandum together with the shelf prospectus shall be deemed to be a prospectus [Sec.31(3)].

5.11 RED HERRING PROSPECTUS

In the recent years, the issue of securities to the public is being made through the process of book building. In this process, the issuer company may file a red herring prospectus with the Registrar.

Red herring prospectus means a prospectus which does not have complete particulars on the quantum or price of the securities offered and the quantum of securities included therein [Sec. 32].

Provisions Regarding Red Herring Prospectus

The main provisions with respect to the red herring prospectus are as follows:

1. **Issue Prior to the Issue of Prospectus:** A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus [Sec. 32(1)].

2. **Filing with the Registrar:** A company proposing to issue a red herring prospectus shall file it with the Registrar at least three days prior to the opening of the subscription list and the offer [Sec. 32(2)].

3. **Same Obligations as are Applicable to Prospectus:** A red herring prospectus shall carry the same obligations as are applicable to a prospectus.

4. **Highlighting the Variations in Prospectus:** Every company shall highlight the variations if any variation between the red herring prospectus and a prospectus as variations in the prospectus [Sec. 32(3)].

5. **Filing of Prospectus with the Registrar and SEBI:** Upon the closing of the offer of securities, a prospectus shall be filed with the Registrar and the SEBI. The prospectus shall state therein the following information:

   (i) The total capital raised whether by way of debt or share capital.

   (ii) The closing price of the securities.

   (iii) Any other details as are not included in the red herring prospectus [Sec. 32].

The Golden Rule for Framing Prospectus

A prospectus is a document issued by a company inviting offers from the public for subscription of shares or debentures. Thus, it is a very important document. It may have far-reaching effects on the goodwill of the company as well as the relation between the company and its members. Such a document, therefore, must be complete and accurate in every respect and must not conceal or omit any material fact. In short, the 'golden rule' as to the framing of prospectus must be observed.

The 'golden rule' was enunciated by Kindersely, VC in New Brunswick etc. Co v. Muggeridge (1860) 3 LT 651. This was described as the golden legacy. The rule may be summed up in the following words:

Those who issue a prospectus hold out to the public are of great significance to the persons who will subscribe securities of the company. Public is invited to subscribe securities on the faith of representation made in the prospectus. The company and the persons who authorize the issue of a prospectus are therefore bound to state everything with strict accuracy. They must not omit any material fact within their knowledge which may adversely affect the nature, extent, or quality of the privileges and advantages which the prospectus assures to the subscribers.

5.12 MISSTATEMENT OR UNTRUE STATEMENT IN PROSPECTUS

A misstatement or an untrue or false statement is one which is misleading in the form and context in which it has been included in a prospectus. A prospectus shall also be deemed to have untrue statement or deemed to be misleading if any matter is omitted from it which should have been included in it. In simple words, a prospectus is said to be a 'misleading prospectus' in the following cases:

(i) Where a prospectus includes a statement which is untrue in the form and context in which it is included.

(ii) Where a prospectus omits any matter which is calculated to mislead those who act on the faith of the prospectus [Sec. 34].

Remedies or Consequences of Misleading Prospectus

If a prospectus issued by a company contains false or misstatement or omits to include any material fact in it, it is said to be a misleading prospectus. In case a company issues such a misleading prospectus and the subscribers acting on the faith of such prospectus subscribe for the securities of the company, it will give rise to many consequences. The aggrieved subscribers acting on the faith of such prospectus shall have remedies against the following entities:

A. Remedies against the company.

B. Remedies against the directors, promoters, experts etc.

A. Remedies against the Company

A company has civil liabilities towards the subscribers, who subscribed for securities of a company acting on the faith of its misleading prospectus. Therefore, aggrieved subscribers are entitled to the following remedies against the company:

1. Rescission of contract.

2. Compensation for damages.

1. Rescission of the Contract: A person who subscribes for securities on the faith of a misleading prospectus may apply for the rescission of the contract. On rescission, the subscriber returns the securities allotted to him and gets his money back with interest.

The aggrieved subscriber can exercise the right or remedy to rescind the contract, if the following conditions are satisfied:

(i) The prospectus must have been issued by the company or by someone on behalf of the company.

(ii) There must be an untrue or misleading statement in the prospectus or omission of a material fact from the prospectus. For instance, the prospectus of a company stated that it had paid dividends during the five years of economic depression. But it was not disclosed that the dividends were paid out of the realized capital profits whereas there were considerable trading losses during those years. The Court held that the prospectus was false in material particulars

(iii) The misstatement must relate to the material fact. The fact should not be of law. Even it should not be an expression of opinion. For instance, a prospectus of a company stated that two leading businessmen of repute have agreed to become directors of the company. In fact, they had only expressed their willingness to help the company. The Court held that the prospectus contained misstatement of fact and subscribers could rescind the contract.

(iv) The subscriber must have relied and acted on the misstatement in the prospectus. It must have induced him to subscribe for shares. If a person subscribes for securities of a company without reading its prospectus, he is not entitled to rescind the contract.

(v) The right of rescission is available to the original allottees of securities. If a person buys shares in the open market, he has no remedy against the company even though he might have bought relying on the prospectus.

(vi) The right of rescission must be exercised within a reasonable time, before any proceedings to wind up the company have been commenced.

Loss of right of rescission: The right of rescission of contract is lost in the following circumstances:

(i) If the subscriber affirms or adopts the contract for purchase of shares. For instance, if the subscriber attempts to sell the shares allotted, receives dividends, pays calls or attends general meeting; he is said to have affirmed the contract.

(ii) If the subscriber fails to exercise his right of rescission within a reasonable time after becoming aware of the misstatement in the prospectus. In a case, an applicant became aware of misstatement in prospectus in July. But he applied for rescission of the contract in December. The Court held that the unexplained delay of five months debars him from obtaining relief.

(iii) If the right of rescission is not exercised before the commencement of proceedings of winding up of the company. But where a subscriber has started proceedings for rescission of the contract of shares, the passing of the winding up order would not prevent him getting the relief.

(iv) When the restitution or restoring the original position of the parties becomes impossible.

(v) Where the misrepresentation is of law and not of facts. For example, a prospectus states that the shares shall be issued at a discount of 25 per cent. It is a misrepresentation of law because no company can issue shares at a discount [Sec. 53].

(vi) When the subscriber misreads the prospectus.

2. Compensation for Damages: Another remedy available to every aggrieved subscriber is to claim compensation for damages or loss sustained by him. For availing this remedy, the aggrieved subscribers will have to prove the following facts:

(i) That he acted on the misleading prospectus and subscribed for securities of the company.

(ii) That the prospectus was issued by the company or someone on behalf of the company.

(iii) That he has actually sustained/suffered a loss or damage due to such misleading prospectus.

(iv) That he has rescinded the contract for the purchase of securities, that is, he has returned the securities allotted by the company [Sec. 35(1)].

Thus, the right to claim compensation is available only when an aggrieved subscriber rescinds the contract for purchase of securities. He cannot retain the securities as well as claim the compensation of damages. He will have to rescind the contract before he can claim the compensation.

B. Remedies against the Directors, Promoters, Experts etc.

The Act lists the persons who are liable for misleading prospectus. They are as follows:

(a) Every person who is a director of the company at the time of the issue of the prospectus.

(b) Every person who has authorized himself to be named and is named in the prospectus as a director of the company or has agreed to become such director.

(c) Every person who is a promoter of the company.

(d) Every person who has authorized the issue of the prospectus.

(e) Every person who is an expert and who is or has been engaged and interested in the formation, promotion, Or management of the company [Sec. 35(1)].

The liability of directors, promoters, experts etc. may be classified under the following two heads:

1. Civil liability.

2. Criminal liability.

Civil Liability: The directors, promoters, experts etc., (listed above) of the company shall have civil liability towards every person who subscribed for securities acting on the misleading prospectus. In other words, every aggrieved subscriber has the following remedies against the directors etc.:

1. Damages for misstatement and omission [Sec. 35(1)].

2. Unlimited personal liability for fraudulent prospectus [Sec. 3 5(2)].

1. Damages for Misstatement or Omission: Every aggrieved subscriber for securities of the company acting on any misleading prospectus (i.e. any misstatement included in the prospectus or omission of any matter from the prospectus) shall be entitled to hold liable every director, promoter, experts etc., (all listed above) to pay the compensation for any loss or damage sustained by him. To claim damages, the subscriber shall be required to prove the following facts:

(i) That he subscribed for the securities of the company acting on the misleading prospectus.

(ii) That he has suffered loss or damage due to such subscription [Sec. 35(1)].

Defences Available: No person shall be liable to pay compensation if he proves the following facts:

(i) Withdrew Consent before Issue: A director will not be liable, if he proves that he withdrew the consent to become director before the issue of the prospectus and the prospectus was issued without his authority or consent.

(ii) Issued without Knowledge or Consent: No person shall be liable, if he proves that the prospectus was issued without his knowledge or consent and on becoming aware its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent [Sec. 35(2)]

2. Unlimited Personal Liability for Fraudulent Prospectus: Sometimes, it is proved that a prospectus was issued with intent to defraud the applicants for the securities or any other person or for any fraudulent purpose. In such a case, every person who is director, promoter, expert, etc. shall be personally responsible without any limitation of liability. They shall be liable without any limit for all or any of the losses or damages that may have been sustained by any person who subscribed to the securities on the basis of such prospectus [Sec. 35(3)].

Criminal Liability: The criminal liability for a misleading prospectus is as follows:

Liability/Punishment for Misstatement or Untrue Statement in Prospectus: Where a misleading prospectus is issued, circulated, or distributed, every person who authorizes the issue of such prospectus shall be liable under Section 447 [Sec. 34].

According to Section 447, any person who is found to be guilty of fraud shall be punishable with imprisonment for a term which shall not be less than 6 months but which may extend to 10 years. This apart, he shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

Where the fraud in question involves public interest, the term of imprisonment shall not be less than 3 years [Sec. 447].

Defences Available: A person shall not be held liable under Section 447, if he proves any of the following facts:

(i) That such statement or omission was immaterial.

(ii) That he had reasonable grounds to believe and did up to the time of issue of the prospectus believe that the statement was true.

(iii) That he had reasonable grounds to believe that the inclusion or omission of any matter was necessary [Proviso to Sec. 34].

OTHER IMPORTANT PROVISIONS

1. Entities Entitled to Take Action/Remedies: The Act lists entities that are entitled to take action or claim remedies [under Sections 34, 35, and 36] against the company or every person liable for issue, circulation, and distribution of misleading or fraudulent prospectus. Any of the following entities affected by any misleading statement or the inclusion or omission of any matter in the prospectus are entitled to file a suit or take any other action:

(a) Any group of persons.

(b) Any association of persons [Sec. 37].

(c) Any person.

2. Punishment for Fraudulently Inducing Persons to Invest Money: Sometimes, a person either knowingly or recklessly makes any statement, promise, or forecast which is false, deceptive, or misleading, or deliberately conceals any material facts. If he does so with a view to induce another person to enter into, or to offer to enter into any of the following agreements, he shall be liable for action under Section 447:

(a) Any agreement for acquiring, disposing of, subscribing for, or underwriting of securities.

(b) Any agreement (the purpose or the pretended purpose of which is) to secure a profit for any of the parties from the yield of securities or by reference to fluctuations in the value of securities.

(c) Any agreement for or to obtaining credit facilities from any bank or financial institution [Sec. 36].

3. Punishment for Personation for Acquisition, etc. of Securities: Any person who

(a) makes or abets making of an application in a fictitious name to a company for acquiring, or subscribing for, its securities; or

(b) makes or abets making of multiple applications to a company in different names or in different combinations of his name or surname for acquiring or subscribing for its securities; or

(c) otherwise induces directly or indirectly a company to allot or register any transfer of, securities to him, or to any other person in a fictitious name shall be liable for action under Section 447.

Reproduction in Prospectus: The above provisions of shall be prominently reproduced in every prospectus issued by a company and in every form of application for securities.

Disgorgement of Gain: Where a person has been convicted under this Section, the Court may also order disgorgement of gain, if any, made by, and seizure and disposal of the securities in possession of such person. The amount received through disgorgement or disposal of securities shall be credited to the Investor Education and Protection Fund [Sec. 38].

5.13 COMMENCEMENT OF BUSINESS

According to the provisions of the Companies Act, every company is entitled to commence its business as soon as it obtains its certificate of incorporation. No other formality is required to be complied with for commencement of business by any company after its incorporation.

If a company fails to commence its business within one year of its incorporation, the Registrar may initiate action for removing its name from the register of companies [Sec. 248].

5.14 SUMMARY

A prospectus is a document inviting deposits or offers from public for the subscription of its shares and debentures. Companies Act, 2013 does not contain any model prospectus but it only prescribes the contents of a prospectus. A prospectus can be issued only after its registration. If a company intends to alter or vary the terms of contract referred to in the prospectus or objects for which the prospectus was issued, it can do so if it has passed a special resolution, publish an advertisement of the notice in respect of such resolution and opportunity to exit to the dissenting shareholders has been given. A person who has been induced to subscribe the shares on the faith of misstatement made in a prospectus can sue the company, the directors and the promoters and experts, if any. Every company is entitled to commence its business as soon as it obtains its certificate of incorporation.

5.15 KEYWORDS

Prospectus: It is a document inviting deposits or offers from the public for the subscription of its securities.

Red Hearing Prospectus: A prospectus which does not include complete particulars of the quantum or price of the securities included therein.

Public offer: An offer of securities made to the public through a prospectus.

Deemed Prospectus: A document by which offer for sale of securities is made by a member of a company to the public.

5.16 SELF ASSESSMENT QUESTIONS

1. What do you understand by prospectus of a company? What particulars are given in a company prospectus? Explain.
2. What is a prospectus? Is the issue of a prospectus obligatory for a public company? Discuss the consequences of misstatement in a prospectus.
3. 'It is not compulsory for a public company to issue a prospectus, while a private company is even not permitted to issue it.' Explain this statement. What are the consequences of misstatement in prospectus?
4. Discuss the consequences of omission, misrepresentation, and fraud in connection with prospectus of a company. Also narrate the circumstances under which a director may be absolved from the liability.
5. Clearly explain the provisions relating to the registration and issue of a prospectus.

5.17SUGGESTED READINGS

- Avtar Singh, Company Law, Eastern Book Company, Lucknow.
- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

LESSON 6

PROCEDURE FOR ALLOTMENT, TRANSFER AND TRANSMISSION OF SHARES AND DEBENTURES AND SHARE CERTIFICATE VS. SHARE WARRANT

Structure

6.0 OBJECTIVES

After reading this lesson, you should be able to:

- Define allotment and explain the provisions of allotment of shares.
- Describe the procedure of transfer and transmission of securities.
- Enumerate share certificate and share warrant.

6.1 INTRODUCTION

A prospectus is a document issued by a public company with a view to invite the public to make offers to the company for purchase of its securities. In response to this invitation, the applications are made by prospective purchasers of securities. These applications are in the nature of form made to the company, which the company might accept or reject. If the company accepts the applicant's offer, it results in the allotment of securities to the public. Any public company which does not want to invite public for subscription of its securities through prospectus and every private company (cannot invite public for subscription of its securities) may make allotment of securities after issue of offer letter for private placement of securities to persons exceeding the prescribed number of persons.

6.2 DEFINITION OF ALLOTMENT

The term 'allotment' has not been defined in the Companies Act. Simply stated, allotment means appropriation of a certain number of shares to a certain person/persons out of the unappropriated share capital of the company.

According to the Supreme Court of India, 'Allotment means the appropriation out of previously unappropriated share capital of a company, of a certain number of shares to a person. In the words of Justice Chitty, "Allotment is generally neither more nor less than the acceptance by the company of the offer to take shares." Thus, allotment is the acceptance of the applications (offers) made by persons to take shares in a company. It should be noted that re-issue of forfeited shares is not the allotment of shares because it is out of previously appropriated or allotted capital of the company.

Effect of Allotment

On allotment of shares, a contract is reached between the company and the allottee. Therefore, the company is bound to deliver shares to the allottee and the allotee is liable to make payment of unpaid amount on the shares as and when called by the company. But in case, if he fails to make the payment of the allotment money or the calls made on the shares, his shares may be forfeited by the company. Consequently, he loses all the rights of a member in the company.

6.3 MINIMUM SUBSCRIPTION

No public company inviting public for subscription of its securities (through prospectus) can allot securities unless the amount stated in the prospectus as minimum amount has been subscribed. The concept of minimum subscription has radically changed. According to the latest concept, minimum subscription is the amount which is stated as such in the prospectus. The amount of minimum subscription is mandatorily required to be received by a public company on or before the date of closure of the issue in order to become entitled to allot the securities.

Minimum Amount of Subscription

If the amount called on application is not full issue price, the amount of minimum subscription to be received shall be in proportion to the amount so called. It should be noted that while calculating the net issue amount, the amount of securities reserved for certain categories of persons and the amount of securities reserved for preferential allotment are excluded.

The SEBI Regulations have clearly given a formula for deciding the quantum of minimum amount of subscription. According to these regulations, an issuer company is required to receive minimum subscription of 90 per cent of the net issue amount (including devolvement of underwriters, if applicable). But in case of an initial public offer, the minimum subscription to be received shall be subject to allotment of minimum number of specified securities.

Exceptions: The provisions of minimum subscription do not apply in the following cases:

(i) In case of offer for sale by existing members of the company.

(ii) In case of further issue of shares without a right to renounce the same in favour of others.

Period of Receiving the Amount

The Companies Act states that the minimum amount of subscription may be received within a period of 30 days from the date of issue of the prospectus or such other period as may be specified by the SEBI. SEBI Regulations prescribe that an issuer company shall receive the amount of minimum subscription (i.e., 90 per cent of issue price) on or before the date of closure of the issue. Since SEBI Regulations override the provisions of the Companies Act, the amount of minimum subscription must be received in accordance with the SEBI Regulations. According to the SEBI Regulations, public issue shall be kept open at least for three working days but not for more than ten working days. Hence, minimum subscription should be received by the date of closure of the issue fixed by the company.

Consequences on Failure

The following shall be the consequences if issuer company fails to receive the minimum amount of subscription:

1. **No Allotment:** If the minimum amount of subscription is not received within the specified time, the issuer company cannot allot the securities offered.
2. **Refund of Subscription:** If the issuer company fails to receive the minimum amount of subscription, it shall return the amount of subscription within specified time period.

Penalty

Sometimes, a company makes any default in complying with the above provisions (i.e., allots securities or does not refund the amount of subscription). In such a case, the company and its officer who is in default shall be liable to a penalty for each default of `1000 for each day during which such default continues or ` 1 lakh whichever is less [Sec. 39(5)].

Personal Liability to Refund

Sometimes, a company fails to receive the amount of minimum subscription and thereafter fails to refund it within the specified time, i.e., 15 days of the closure of the issue. In such a case the directors of the company who are officers in default shall jointly and severally be liable to repay that money with interest at the rate of 15 per cent per annum.

6.4 PROVISIONS OR RESTRICTIONS ON ALLOTMENT OF SHARES

The provisions relating to allotment of shares may broadly be classified under the following two heads:

1. General provisions/restrictions.

2. Provisions/restrictions under the Companies Act.

General Provisions/Restrictions

The general provisions relating to allotment of shares are based on the law of contract. Since allotment is the acceptance by the company of the offer (i.e., application) for shares made by a person, the general principles as to offer and acceptance of the law of contract apply to the allotment of shares. Such provisions/restrictions are as follows:

1. Proper Authority: Allotment of shares must be made by proper authority. The Board of Directors is the proper authority to allot shares in a company. It can allot shares by a resolution at its valid meeting. However, if the articles provide, the committee of the Board of Directors may also allot the shares. But an allotment made by the Board without proper authority will be invalid. However, such allotment may be ratified by the company. It should be noted that allotment of shares will be valid even if there was some defect in the appointment of directors because of application of the doctrine of indoor management or Turquand rule. Even allotment by an irregularly constituted Board is held to be valid.

2. Within Reasonable Time: The allotment must be made within a reasonable period of time. An application to take shares lapses if allotment is delayed unreasonably. It has been held that the interval of about six months between application and allotment is not reasonable. Therefore, the applicant may refuse to accept such allotment.

But in the recent years, law and practice have undergone several changes. As per the latest SEBI guidelines, companies are, as far as possible, required to make allotment of shares within 15 days of the closure of the public issue. In case, a company fails to despatch the allotment letters/refund orders within 15 days from the date of the closure of the issue, the directors shall be liable to pay the money along with interest at the rate of 15 per cent per annum.

3. Communication: The allotment must be communicated to the applicant. Mere entry of the applicant’s name in the register of shareholders is not sufficient to bind the applicant.

It is said to be a proper allotment when the applicant has been informed about the allotment. However, a formal allotment letter is not necessary. It is enough if the applicant is made aware of the allotment.

The communication by post is complete and valid when a properly addressed and stamped letter of allotment is posted. Validity of communication is not affected even if the letter is delayed or lost in transit. An allotee cannot get rid of the allotment by showing that he did not receive the letter.

4. Absolute and Unconditional: The allotment must be absolute and unconditional. It must be in accordance with the terms and conditions of the application. Any allotment made without fulfilling conditions of the application (condition precedent) shall not be binding on the applicant.

Example: A person applied for 400 shares in a company on the condition that he would be appointed cashier of a new branch of the company. The Court held that he was not bound by the allotment unless he was so appointed [*Mutual Bank of India v. Sohan Singh*, AIR (1936) Lah 790].

If an applicant without rejecting the allotment pledges the shares allotted, he is bound by the allotment. Then he loses his right to reject the allotment. Sometimes, applicant applies with a condition that is to be fulfilled by the company subsequent to the allotment. In such a case, company is not bound by the condition and allotment would be valid.

Example: Anta made an application for shares subject to a condition that he would pay further sums for the shares only when the company paid dividends. The Court held that Anta was bound by the allotment even though the company had gone into liquidation below paying the dividends [*Motilal Chunilal v. Thakorea* (1912) 14 Bom LR 648}.

5. Revocation: Application for shares (i.e. offer to take shares) as well as the allotment (i.e. acceptance) can be revoked. According to the provisions of the Contract Act, an application can be revoked at any time before the communication of acceptance (i.e. allotment) is complete as against the applicant. Therefore, an applicant has the right to revoke his offer, that is, application for purchase of shares and ask the company to return the money paid any time before he is informed of the allotment.

It may be noted that a verbal withdrawal of application for allotment of shares is not enough. A company can also revoke allotment of shares at any time before the communication of allotment is complete as against the company, i.e. at any time before the applicant comes to know about the allotment.

6. Consideration: The allotment of shares may be made for valid consideration. A company limited by shares has no power to issue shares as a gift. If there is no payment in money's worth for the shares, the allotment would be ultra vires. Consequently allotment of shares as donation is not valid. It has also been held that directors should allot the shares in utmost good faith only in the best interests of the company. In one case, the shares of a company of high market value were allotted at a meagre price. It was held that the allotment was not in the best interests of the company.

Provisions/Restrictions under the Companies Act

The provisions regarding/restrictions on allotment of securities issued through prospectus are as follows:

1. Registration of Prospectus: When a public company wants to invite offers from the public for the purchase of its securities, it will have to register a prospectus with the Registrar and issue it to the public. It should contain all the matters and set out all the reports specified under this Act or by the SEBI. It must be signed by every director or proposed director of the company or by his agent authorized in writing. When a company submits a prospectus complying with all these provisions, the Registrar shall register the same. Thereafter, it should be issued within 90 days of its registration; otherwise it shall be treated as invalid prospectus [Sec. 26].

2. Application to Stock Exchange before Making Public Offer: Every company making a public offer shall before making such an offer (i.e. before opening of the issue) make an application to one or more recognized stock exchange or exchanges and obtain permission for the securities to be dealt with in such stock exchange or exchanges [Sec. 40(1)].

3. Stating Name of Stock Exchange in Prospectus: The prospectus shall state the name or names of one or more recognized stock exchange(s) in which the securities shall be dealt with [Sec. 40(2)].

4. Issue of Application Form with Abridged Prospectus: Any application for the purchase of any of the securities of a company shall be issued with an abridged prospectus. However, a copy of the prospectus shall also be issued on a request being made by any person [Sec. 33].

5. Application Money: The amount payable on application on every security shall not be less than 5 per cent of the nominal amount of the security or such other percentage or amount, as may be specified by the SEBI [Sec. 39(2)].

SEBI Regulations require that the minimum amount payable on application for each security shall not be less than 25 per cent of the issue price of the security. In case of offer for sale, full issue price of security shall be payable on application for each security [Regulation 49]. The application money shall be paid by cheque or other instrument.

6. Keeping Application Money: All monies received on application from the public for subscription to the securities shall be kept in a separate bank account in a scheduled bank [Sec. 40(3)].

7. Minimum Amount/Subscription: No allotment of securities offered to the public can be made unless the following conditions are satisfied:

(i) The amount stated in the prospectus as the amount of minimum subscription must have been subscribed; and

(ii) The sums payable on application (i.e. minimum amount payable on application) must have been paid to and actually received by the company by cheque or other instrument [Sec. 39(1)].

8. Utilizing Application Money: All monies received on application from the public shall not be utilized for any purpose other than the following:

(a) For adjustment against allotment of securities or the allotment money. Such utilization is allowed where the securities have been permitted to be dealt with in the stock exchange or stock exchanges specified in the prospectus.

(b) For repayment of monies received from applicants. Such utilization is allowed where the company, for any reason, is unable to allot securities [Sec. 40(3)].

9. Punishment: If a default is made in complying with the provisions contained in clauses 2, 3, 6 and 8 above (Section 40), the company shall be punishable with a fine, which shall not be less than ` 5 Iakh but which may extend to ` 50 Iakh. Moreover, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh or with both [Sec. 40(5)].

10. Refund of Money if Minimum Amount is Not Subscribed: Sometimes, the amount stated as the minimum amount in the prospectus is not subscribed and the sum payable on application is not received within a period of 30 days from the date of issue of the prospectus, or such other period as may be specified by the SEBI.

SEBI Regulations specify 15 days for refund of such money. Hence, the amount received as application money must be refunded within 15 days from the closure of the issue. The money to be refunded shall be credited only to the bank account from which the subscription was remitted [Sec. 39(3) and Rule PAS-II].

11. Directors' Liability to Refund Money with Interest: Sometimes, the money required to be refunded for non-receipt of minimum subscription is not refunded within 15 days from the closure of issue. In such a case, the directors of the company (who are officers in default) shall jointly and severally be liable to repay the money with interest at the rate of 15 per cent per annum.

12. Penalty for Failure to Refund Application Money: In case any default is made in returning the application money, the company and its officer who is in default shall be liable to a penalty for each default of ` 1,000 for each day during which such default continues or ` 1 lakh, whichever is less [Sec. 39(5)].

13. Condition to Waive Compliance of Provisions Void: Any condition purporting to require or bind any applicant for securities to waive compliance with any of the requirements stated in clauses 2, 3, 6 and 8 above (Section 40) shall be void [Sec. 40(4)].

RETURN OF ALLOTMENT

The Act requires that whenever a company having a share capital makes any allotment of securities, it shall file with the Registrar a return of allotment in such manner as may be prescribed [Sec. 39(4)]. The Rules notified by MCA prescribe that whenever a company makes any allotment of its securities, the company shall within 30 days thereafter file with the Registrar a return of allotment in Form No. PAS-3 along with the prescribed fee. In addition, the following documents shall be attached to Form No. PAS-3

1. In case of Allotment of Shares for Cash: A list of allottees shall be attached to Form No. PAS-3. The list shall be stating their names, address, occupation, if any and number of securities allotted to each of the allottees. The list shall be certified by the signatory of Form No. PAS-3 as being complete and correct as per the records of the company.

2. In Case of Allotment of Shares (Not Being Bonus Shares) other than for Cash: In the case of securities (not being bonus shares) allotted as fully or partly paid up for consideration other than cash, a copy of the contract shall be attached to the form. It shall be duly stamped, pursuant to which the securities have been allotted. In addition, any contract of sale if relating to a property or an asset, or a contract for services or other consideration shall be attached.

3. In Case the Contract of Allotment, Sale or Service is not in Writing: Where a contract referred to in clause 2 above is not reduced to writing, the company shall furnish complete particulars of the contract. It shall be stamped with the same stamp duty as would have been payable if the contract had been reduced to writing. Those particulars shall be deemed to be an instrument within the meaning of the Indian Stamp Act.

4. Report of Valuer in Case the Consideration is other than Cash: A report of a registered valuer (in respect of valuation of the consideration) shall also be attached along with the contract as mentioned in clauses 2 and 3 above.

5. In case of Bonus Shares: In case of issue of bonus shares, a copy of the resolution passed at the general meeting authorizing the issue of such shares shall be attached to the form.

6. Report of the Valuer in case of Further Issue of Shares: Sometimes, shares are issued under the provisions of further issue of shares by a company other than a listed company. In such a case, the company shall attach the valuation report of the registered valuer to Form No. PAS-3 [Rule PAS-12].

Penalty: A default is made in filing a return of allotment to the Registrar. In such a case, the company and its officer who is in default shall be liable to a penalty for each default of `1000 for each day during which such default continues or ` 1 lakh, whichever is less [Sec. 39(5)].

6.5 TRANSFER OF SECURITIES

Section 44 states that the shares or debentures or other interest of any member in a company shall be movable property transferable in the manner provided by the articles of the company. Section

56 of the Companies Act, 2013 deals with the transfer and transmission of securities or interest of a member in the company.

Requirement for registering the transfer of securities: According to the law, a company shall not register a transfer of securities of the company, or the interest of a member in the company in the case of a company having no share capital, unless a proper instrument of transfer, in such form as may be prescribed, duly stamped, dated and executed by or on behalf of the transferor and the transferee (except where the transfer is between persons both of whose names are entered as holders of beneficial interest in the records of a depository), specifying the name, address and occupation, if any, of the transferee, has been delivered to the company by the transferor or the transferee within a period of 60 days from the date of execution, along with the certificate relating to the securities, or if no such certificate is in existence, along with the letter of allotment of securities.

Instrument of transfer lost/ not delivered: Where the instrument of transfer has been lost or the instrument of transfer has not been delivered within the prescribed period, the company may register the transfer on such terms as to indemnity as the Board may think fit.

Power of company to Register: Power of company to register shall not be effected by above provision (given under sub- section 1) on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted.

Transmission of securities on an application of transferor alone: Where an application is made by the transferor alone and relates to partly paid shares, the transfer shall not be registered, unless the company gives the notice of the application, in such manner as may be prescribed, to the transferee and the transferee gives no objection to the transfer within two weeks from the receipt of notice.

Company delivering the certificate: Every company shall, unless prohibited by any provision of law or any order of Court, Tribunal or other authority, deliver the certificates of all securities allotted, transferred or transmitted.

Different condition	**Period of the delivering the certificates**

In the case of subscribers to the memorandum;	Within 2 months from the date of incorporation
In the case of any allotment of any of its shares	Within a period of two months from the date of allotment
In the case of a transfer or transmission of securities.	Within a period of one month from the date of receipt by the company of the instrument of transfer or the intimation of transmission
In the case of any allotment of debenture	Within a period of six months from the date of allotment

Provided that where the securities are dealt with in a depository, the company shall intimate the details of allotment of securities to depository immediately on allotment of such securities.

Transfer of security of the deceased: The transfer of any security or other interest of a deceased person in a company made by his legal representative shall, even if the legal representative is not a holder thereof, be valid as if he had been the holder at the time of the execution of the instrument of transfer.

Default in compliance of the provisions: Where any default is made in complying with the provisions of sub-sections (1) to (5), the company shall be punishable with fine varying from 25,000 rupees to 5 lakh rupees and every officer of the company who is in default shall be punishable with fine with the minimum of 10 thousand rupees extending to 1 one lakh rupees.

Liability of depository: Where any depository or depository participant, with an intention to defraud a person, has transferred shares, it shall be liable under section 447 of the Companies Act, 2013 with the liability mentioned under the Depositories Act, 1996.

Punishment for personation of shareholder [Section 57]: If any person deceitfully personates as

- an owner of any security or interest in a company, or
- of any share warrant or coupon issued in pursuance of this Act, and

- thereby obtains or attempts to obtain any such security or interest or any such share warrant or coupon, or λ
- receives or attempts to receive any money due to any such owner,

Such person shall be punishable with imprisonment for a term which shall not be less than one year but which may extend to three years and with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

Refusal of registration and appeal against refusal [Section 58]: Section 58 of the Companies Act, 2013, deals with process of the company to be followed by on refusal to register the transfer of securities.

(i) **If a private company limited by shares refuses, to register the transfer of, or the transmission of the right to any securities or interest of a member in the company,** then the company shall send notice of the refusal to the transferor and the transferee or to the person giving intimation of such transmission, within a period of thirty days from the date on which the instrument of transfer, or the intimation of such transmission, was delivered to the company. The securities or other interest of any member in a public company are freely transferable, subject to the contract/arrangement.

(ii) **The transferee may appeal to the Tribunal against the refusal** within a period of thirty days from the date of receipt of the notice or in case no notice has been sent by the company, within a period of sixty days from the date on which the instrument of transfer or the intimation of transmission, was delivered to the company.

(iii) **If a public company without sufficient cause refuses to register the transfer of securities** within a period of thirty days from the date on which the instrument of transfer or the intimation of transmission, is delivered to the company, the transferee may, within a period of sixty days of such refusal or where no intimation has been received from the company, within ninety days of the delivery of the instrument of transfer or intimation of transmission, appeal to the Tribunal.

(iv) The Tribunal, while dealing with an appeal may, after hearing the parties, either dismiss the appeal, or by order

(a) direct that the transfer or transmission shall be registered by the company and the company shall comply with such order within a period of ten days of the receipt of the order; or

(b) direct rectification of the register and also direct the company to pay damages, if any, sustained by any party aggrieved.

(v) If a person contravenes the order of the Tribunal he shall be punishable with imprisonment for a term not less than one year but may extend to three years and with fine not less than one lakh rupees which may extend to five lakh rupees.

Rectification of register of member [Section 59]: Section 59 of the Companies Act, 2013 provides the procedure for the rectification of register of members after the transfer of securities. The provision states that-

(i) **Remedy to the aggrieved for not carrying the changes in the register of members:** If the name of any person is, without sufficient cause, entered in the register of members of a company, or after having been entered in the register, is, omitted there from, or if a default is made, or unnecessary delay takes place in entering in the register, the fact of any person having become or ceased to be a member, the person aggrieved, or any member of the company, or the company may appeal in such form as may be prescribed, to the Tribunal, or to a competent court outside India, specified by the Central Government by notification, in respect of foreign members or debenture holders residing outside India, for rectification of the register.

(ii) **Order of the Tribunal:** The Tribunal may, after hearing the parties to the appeal by order, either dismiss the appeal or direct that the transfer or transmission shall be registered by the company within a period of ten days of the receipt of the order, or direct rectification of the records of the depository or the register and in the latter case, direct the company to pay damages, if any, sustained by the party aggrieved.

(iii) The provisions of this section shall not restrict the right of a holder of securities, to transfer such securities and any person acquiring such securities shall be entitled to voting rights unless the voting rights have been suspended by an order of the Tribunal.

(iv) **Where the transfer of securities is in contravention of any of the provisions of the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992** or this Act or any other law for the time being in force, there the Tribunal may, on an application made by the depository, company, depository participant, the holder of the securities or the Securities and Exchange Board, direct any company or a depository to set right the contravention and rectify its register or records concerned.

(v) Default in complying with the order: If any default is made in complying with the order of the Tribunal under this section, the company shall be punishable with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, or with both.

6.6 TRANSMISSION OF SHARES

Transmission of securities has not been defined by the Companies Act. 'Transmission by operation of law' is not a transfer. It refers to those cases where a person acquires an interest in property by operation of any provision of law, such as by right of inheritance or succession or by reason of the insolvency or lunacy of the holder of securities or by purchase in a Court-sale.

Thus, transmission of securities takes place when the registered holder of securities dies or is adjudicated as an insolvent, or if the holder of securities is a company, it goes into liquidation. Because a deceased person cannot own anything, the ownership of all his property passes, after his death, to those who legally represent him. Similarly, when a person is declared insolvent, his entire property vests in the Official Assignee or Official Receiver. Upon the death of a sole registered holder of securities, so far as the company is concerned, the legal representatives of the deceased holder of securities are the only persons having title to the securities unless securities-holder had appointed a nominee, in which case he would be entitled to the exclusion of all others.

Section 56(1) of the Companies Act, 2013 states that the transfer of securities must be effected by a proper instrument of transfer and that a provision in the articles of an automatic transfer of securities of a deceased securities-holder is illegal and void. Such transfer does not amount to transmission which takes place by operation of law. Section 56(2) of the Act provides that nothing in the sub-section (1) shall prejudice the powers of the company to register, on receipt of an intimation of transmission of any right to securities by operation of law from any person to whom such right has been transmitted. It follows that, for such transmission, instrument of transfer is not required, and, merely an application addressed to the company by the legal representative is sufficient.

Articles of companies generally provide for formalities to be observed for transmission of shares. In the absence of such provision in the articles of the company, Regulations 23 to 27 of Table F of

Schedule I to the Act will govern the procedure for transmission. According to these regulations, the legal representatives are entitled to the shares held by deceased member and the company must accept the evidence of succession e.g., a succession certificate or letter of administrations or probate or any other evidence properly required by the Board of directors. He is, however, not a member of the company by reason only of being the legal owner of the shares. But he may apply to be registered as a member. On the contrary, instead of being registered himself as a member, he may make such transfer of the shares as the deceased or insolvent member could have made. The Board of directors also have the same right to decline registration as they would have had in the case of transfer of shares before death. But if the company unduly refuses to accept a transmission, the same remedies are available to the legal representative as in the case of a transfer namely, an appeal to the Tribunal under Section 58.

DISTINCTION BETWEEN TRASFER AND TRANSMISSION OF SHARES

S. No.	Transfer of Securities	Transmission of securities
1.	Transfer take place by a voluntary act of the transferor.	Transmission is the result of the operation of law.
2.	An instrument of transfer is required in case of transfer.	No instrument of transfer is required in case of transmission.
3.	Transfer is a normal course of transferring properly.	Transmission takes place on death of insolvency of a holder of securities.
4.	Transfer of securities is generally made for some consideration.	Transmission of securities is generally made without any consideration.
5.	Stamp duty is payable on transfer of securities by a holder of securities.	No stamp duty is payable on transmission of securities.

6.7 SHARE CERTIFICATE

A share Certificate refers to a document which is issued by a company evidencing that a person named in such certificate is the owner of the shares of Company as stated in the share certificate.

The Indian Companies Act mandates companies for issuing share certificates post their incorporation.

Details to be provided in a share certificate: Every share certificate issued in India should contain the below mentioned:

1. Name of issuing Company
2. CIN no. (Corporate Identification Number) of such Company
3. Address of the company's registered office
4. Name of owners of such shares
5. Folio number of member
6. Number of shares which is represented by such share certificate
7. An amount which is paid on such shares
8. Distinct number of the shares

The timeframe for issuing share certificates: After the incorporation of the company, the company needs to issue the share certificates within two months from incorporation date. Where additional shares are allotted to the new or existing shareholders, the share certificates should be issued within two months from allotment date. In a case related to the share transfers, the share certificates should be issued to transferees within a period of one month of receipt of the instrument of transfer by such Company.

Procedures for issuing share certificates

1. Board Meeting & Allotment of shares: A board meeting is called for deciding about allotment of shares. The board of directors assigns a committee of directors known as allotment committee. The allotment committee would then decide about allotment of shares. Once allotment committee provides its report with respect to allotment of shares, the Board then approves such report and then passes the resolution for allotting shares to the respective applicants. Once shares are allotted by the allotment committee, the company secretary sends the letters of allotment to the respective members. The allotment letter refers to a letter that notifies the applicant that the company has allotted a certain number of shares to him. This letter of allotment is considered as the share certificate till issuance of the final certificate.

2. **Register of members:** The company secretary then prepares a Register of members from the lists of application received and allotment sheets. Register of member provides information about the shareholders and details of the shares which are allotted to them.

3. **Preparing and Printing Share Certificates:** The company secretary must arrange the form of the share certificate according to the form suggested by the Articles of Association. The secretary must get the form printed together with all the required details as per the provisions of the governing law. The secretary needs to fill all the details in share certificate with help of the application register and allotment sheets. The secretary also needs to ensure that the share certificate is signed by two directors of the company. The secretary needs to sign the share certificate. The secretary also needs to ensure that the company's seal and revenue stamp is affixed on each of the share certificates. Once certificates are in order, a board meeting is called for passing the resolution for issuing share certificates.

4. **Intimation and dispatch of share certificate:** The company secretary needs to inform all the shareholders that share certificates are ready and would be delivered in exchange of allotment letters and bankers receipt confirming payment of the allotment money. A public notice should be issued for the general information of the members. Members who surrender their allotment letters, share certificate are dispatched by the registered post to them. The local shareholders as per their preference can also collect the share certificates personally from company's registered office or from agency appointed for dispatching the share certificates.

5. **Penalty for breach:** Where a company makes any default in complying with provisions relating to issue of share certificates, such company would be punishable with a fine that wouldn't be less than Rs. 25,000 but could extend to Rs. 5,00,000 and every defaulting officer of such company would be punishable with a fine that wouldn't be less than Rs. 10,000 but could extend to Rs.1,00,000

PROCEDURES FOR SHARE TRANSFER – PHYSICAL MODE

One of the key features of a company is that its shares are transferable. Privileges of a shareholder include his/her rights to transfer shares. If a Company is limited by assurance and has no share capital, no transfer of share is involved as there are no shares to transfer.

The ownership of shares can be transferred by delivery of possession, but there is a contractual relationship between the members and the company. When shares are transferred the contractual relationship is assigned to the transferee which needs an instrument of transfer. Transferring a share involves a series of steps, first an agreement to sell (Share Transfer Deed), then execution of a deed of transfer and finally registration of the transfer. In this article, we look at the procedures for approval and registration involved in share transfer which is physical in mode.

Transfer Deed

Share transfer deed is an instrument of transfer that must be executed by both transferor and transferee. Share transfer deed must be duly stamped and delivered to the company along with certificate relating to shares transferred. Any instrument of transfer which is not in conformity with these provisions cannot be accepted by the company. Share transfer in physical mode is executed with the help of Form “SH-4″.

Acknowledgement

Some companies send a notice or acknowledgement of the instrument to the transferor who has lodged a transfer with the company before the documents are scrutinized. The notice of acknowledgement is usually in the form of a letter which holds a checklist for scrutiny of the transfer documents. Some companies follow a practice of issuing transfer receipt. If the transfer application is made by the transferor alone and he has partly paid for the shares; the company must not register the transfer unless the company acknowledges the transferee, and he does not have any objection in transferring the shares within 2 weeks from the receipt of the notice. There is no statutory obligation on the company to give notice to the transferor when the transfer documents are lodged by the transferee.

Scrutiny

On receipt of all the transfer documents, a scrutiny should be done to ensure that all the documents are in place. The scrutiny should be done within 3 to 5 days from the receipt of the transfer documents. In case the documents are not acceptable, the same should be returned to the transferee. In case the signature of the transferor in the transfer instrument differs from the specimen signature on the company’s record, then the documents will be returned.

Approval

Every transfer of shares must be placed before the Board of Directors or committee for its approval. The registration takes place after approval. If everything is accepted after scrutiny, it should be approved by the right authority. Transfer of shares must be approved by the board. If articles of the company empower the board to delegate its power of approval of share transfer, then it may delegate it to a committee who might not be the company's directors.

Registration

Registration of share transfer is a requirement for the transferee obtaining the status of a member of the company. A transfer is incomplete without registration of share transfer. A share transfer form is a document through which the transferee agrees to accept the shares. This becomes a legal contract with the company. Once the company approves and registers the transfer, this leads to the entry of the transferee's name in the registry of the member and it qualifies his status as a member. The maintenance of the register of transfer is not a statutory requirement.

Delivery of Share Certificate

Transfer becomes effective only on registration of such shares by the company. The company shall deliver the share certificate within 1 month from the receipt by the company's instrument related to transfer. The instrument of transfer must be endorsed with the respective name of the transferee.

6.8 SHARE WARRANT

A Share Warrant is a document issued by the company under its common seal, stating that its bearer is entitled to the shares or stock specified therein. Share warrants are negotiable instruments. They are transferable by mere delivery without registration of transfer.

Conditions for issuing share warrants

The following conditions should be satisfied for issuing share warrants.

1. Only a public company can issue share warrants.

2. It must be authorized by the Articles of Association.

3. The shares must be fully paid-up.

4. The approval of the Central Government is necessary.

On the issue of the share warrant, the company must strike off the name of the member in its Register of Members and must enter the following particulars:

1. The fact of the issue of the share warrant,

2. A statement of the shares included in the warrant, distinguishing each share by its number, and

3. The date of issue of the warrant.

It is a negotiable instrument and mere delivery transfers the ownership of the shares. Coupons are attached to each warrant, bearing the dates on which the dividend will be paid by the company as it cannot know who the shareholder or who is entitled to the dividends. The person who produces the appropriate coupon can receive payment of the dividend.

Merits of Share Warrant

1. The shares mentioned in it are transferable by mere delivery of the warrant. Registration is not necessary.

2. It is a negotiable instrument. So one who purchases the share warrant in good faith and without negligence gets a better title than that of the transferor.

3. Banks accept share warrants as a security for loans.

4. The company may provide for future dividend payments by attaching dividend coupons with the share warrants.

Demerits of Share Warrant

Share warrants are not very popular in India. It is due to the following disadvantages:

1. The bearer of the warrant is not a member of the company.

2. Since it is bearer instrument, the holder always faces the risk of losing the document.

3. The company should be very careful while printing and keeping them in safe custody.

4. The stamp duty on share warrant is very heavy.

5. Prior approval of the Central Government is essential.

6. The number of shares mentioned in it does not constitute a share qualification for directorship.

Difference between share certificate and share warrant

Basis for Comparison	**Share Certificate**	**Share Warrant**
Meaning	A legal document that indicates the possession of the shareholder on the specified number of shares is known as share certificate.	A document which indicates that the bearer of the share warrant is entitled to the specified number of shares is share warrant.
Compulsory	Yes	No
Issued by	All the companies limited by shares irrespective of public or private.	Only public limited companies have the right to issue share warrant.
Negotiable Instrument	No	Yes
Transfer	The transfer of share certificate can be done by executing a valid transfer deed.	The transfer of share warrant can be done by mere hand delivery.
Original Issue	Yes	No
Amount paid	Issued against fully or partly paid up share.	Issued only against fully paid up shares
Approval of Central Government for issue	Not Required at all	Prior approval of Central Government is required for issued Share Warrant.
Time Horizon for Issue	Within 3 months of the allotment of shares.	No time limit prescribed.
Provision in Articles of Association	Not Required	Required

6.9 SUMMARY

No public company inviting public for subscription of its securities can allot securities unless the amount stated in the prospectus as minimum amount has been subscribed. Whenever a company having share capital makes any allotment of securities, it shall file with the Registrar a return of allotment of securities. The transfer of securities means a transfer by sale by the registered holders of the securities. Every security holder of a company is entitled to transfer his securities subject to certain restrictions, when the securities are transferred from one person to another person by operation of law, it is transmission of shares. A share certificate is a document of title of share issued by a company.

6.10 KEYWORDS

Allotment: Appropriation of a certain number of shares to a certain person out of unappropriated share capital of the company.

Minimum Subscription: It is the amount which is stated as such in the prospectus.

Transfer of Shares: It is a transfer by sale by the registered holders of the Securities.

Transmission of Securities: When the securities are transferred to another person by operation of law, it is transmission of shares.

Share Certificate: It is a document of titles of shares issued by a company.

6.11 SELF ASSESSMENT QUESTIONS

1. Explain the procedure for transfer of securities.
2. What is the difference between transfer of shares and transmission of shares? Explain.
3. What is a share certificate? How does it differ from share warrant?
4. What is meant by minimum subscription? State the provisions of Company Act regarding the refund and deposits of minimum subscription.
5. What are the restricted on allotment of shares as per Company Act?

6.12 SUGGESTED READINGS

- Avtar Singh, Company Law, Eastern Book Company, Lucknow.

- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

LESSON 7

MEMBERSHIP

Structure

7.0 OBJECTIVES

After reading this lesson, you will be able to understand

- The status of members and membership rights.
- Modes of acquisition of membership.
- Register and records to be maintained by a company.

7.1 INTRODUCTION

A company is composed of members, though it has its own entity distinct from members. The term 'member' refers to person whose name appears on the register of members. The Depository Act, 1996 defines members in Sec. 41(3) as every persons holding equity share capital of a company and whose name is entered as beneficial owner in the records of the depository, shall be deemed to be a member of the concerned company.

7.2 MEANING OF MEMBER

Section 2(55) of the Companies Act, 2013 defines a member as:

(1) The subscribers of the Memorandum of a company shall be deemed to have agreed to become members of the company and on its registration, shall be entered as members in its register of members.

(2) Every other person who agrees in writing to become a member of company and whose name is entered in register of 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 the depository shall be deemed to be a member of the concerned company.

Distinction between Members and Shareholders

The terms 'member' and 'shareholder' have been used interchangeably in the Companies Act. The word 'shareholder' is used in relation to a company having a share capital and there can be no membership except through the medium of shareholding. A holder of shares becomes a member only when his name is entered in the register of members. But the term 'member' is wider in scope and may be used in relation to all types of companies.

A shareholder may be distinguished from a member as follows:

(1) A holder of a share warrant is a shareholder but not a member as his name is struck off the register of members immediately after the issue of such share warrant.

(2) In the case of a company limited by guarantee having no share capital or an unlimited company having no share capital, there will only be members but not shareholders.

(3) A person who subscribes to the Memorandum of Association immediately becomes a member, even though no share is allotted to him. Till shares are allotted to the subscriber, he is a member but not the shareholder of the company.

(4) The transferor or the deceased person is a member so long as his name is on the register of members whereas he cannot be termed as a shareholder.

(5) Similarly, a shareholder by transfer is not a member until his name is entered in company's register of members.

7.3 WHO CAN BECOME A MEMBER?

Any person who is competent to contract (Sec. 11 of the Indian Contract Act, 1872) may become a member of a company. This is subject to the provisions of the Memorandum and the Articles of the company. The Articles may provide that certain persons cannot become members of the company.

Minor: A minor is not competent to become the member of a company because an agreement with a minor is absolutely void. Neither a minor nor his legal guardian can be made responsible for the payments of calls. Under Sec. 2(55) of the Companies Act, a member is defined as a person who 'agrees in writing' to become a member. The company, therefore, cannot register a member unless the person desirous to be a member applies in writing. But a minor cannot agree to be member of the company. Where a minor's name is entered in the register of member as an allottee, the company cannot afterwards of its own delete it and he is entitled to apply for rectification if the company does so. A minor can be appointed as 'nominee'. In such a case, the name of guardian should also be specified in the nominee form.

Company: A company is a legal person and hence is competent to contract. Therefore, it can become a member of another company. Any allotment or transfer of shares in a company to its subsidiary is void. This provision will not apply where the subsidiary is the legal representative of a deceased member of the holding company or is a trustee and the holding company is not beneficially interested under the trust.

(1) A Company may, if so authorised by its Articles, become a member of another company.

(2) A Company cannot become a member of itself, i.e., it cannot purchase its own shares.

(3) A Company cannot lend money to anyone for the purpose of purchase of its own shares.

Partnership Firm: A partnership firm, being not a person in the eyes of law, cannot be a member of a company. However, a firm can purchase share of a company in the individual names of its partners as joint shareholders, for that every partner is liable jointly and severally for all acts of the firm done while he is a partner. A firm may be a member of a non-profit making company but on its dissolution the membership ceases.

Foreigners: Foreigners can become members of companies registered in India by permission of the Reserve Bank of India under the Foreign Exchange Management Act, 1999 (FEMA) has to be obtained for the purpose. The right of the foreigners as a member will be suspended if he becomes an alien enemy.

Fictitious Persons: A person who takes the shares in the name of fictitious person becomes liable as a member. Besides, such a person can be punished for impersonation.

Insolvent: An insolvent cannot become a member of the company, but if a member has become an insolvent, he remains a member as long as his name appears in the register. However, the trustee in bankruptcy may get his name registered as the proprietor of the shares.

Trustee: A trustee cannot become a member in his capacity as a trustee. As such, a trustee who buys shares will be treated as a member in his individual capacity.

Hindu Undivided Family (HUF): A Hindu undivided family can purchase shares through its 'Karta'. As such only 'Karta' shall become its member.

Registered Society: A society registered under the Societies Registration Act, 1860, is a legal person. As such, it can become a member of company, if it is authorised by its bye laws or Articles or Memorandum.

Joint Members: If more than one person jointly applies for and are allotted shares in a company, each one becomes a member. In the case of joint holders, they can insist on having their names registered in such an order as they may require. They may also require their holding to be split into several joint holding with their names in different orders so that all of them may have a right to vote as first named holder in one or the other joint holdings. In the case of a public company, every joint holder is counted as a separate member [Narain Das Manmohan Das Ramji & Sons Vs. Indian Mfg. Co. Ltd., A.I.R. (1953) Born. 433]. However, in case of private company, joint holders are counted as a single member [Sec. 3(1)(c)]. The right and obligations of joint holders are regulated by the company's Articles. In case the Articles are silent on this point, the following regulations of 'Table A' shall apply automatically.

Subscribers to the Memorandum become members of the company after they have signed the Memorandum as their names are automatically entered on the register of members. However, they are not shareholders until the company has allotted shares to them.

7.4 HOW TO BECOME MEMBER?

A person may become a member of the company in any of the following ways:

1. By Subscribing to the Memorandum [Sec. 2(55)]

Every subscriber to the Memorandum of Association is deemed to have agreed to become its member and on its registration must be put on the register of members. Membership of the Memorandum is condition subsequent until the company is registered he is not deemed to be a member though the Memorandum bears his signature as a subscriber. Neither application for allotment of shares is necessary. Even an absence of entry in the register of member cannot deprive them of their status. They acquire, as soon as company in registered, the full status of members with all the rights and liabilities. The object underlying this provision is that the public might rely with confidence on the subscribes to become the members of the company.

A subscriber to the Memorandum cannot rescind the contract to take the share on the ground of misrepresentation made by the promoter because:

(a) By his own act he brought the company into existence.

(b) The company could not appoint an agent before it came into existence and it is, therefore, not liable for the promoter’s act; and

(c) By signing the Memorandum, he became bound on the registration of the company, and not as between himself and the company, but also as between himself and the other persons who become members.

A person who subscribes to the Memorandum for a certain number of shares is bound to take that number of shares from the company and pay for them. The gift of fully paid shares to a subscriber by a third party does not satisfy his obligation in this respect.

2. Membership by Qualification Shares

Directors of the company on delivering to the register writer undertaking to take their qualification shares and to pay for them become members of the company and they are in the same position as if they were subscribers to the Memorandum. They are deemed to have become members automatically on the registration of the company.

3. Membership by Application and Allotment

A person may become a member of a company by an application for shares subject to the formal acceptance by the company. It creates a binding contract between the applicant and the company. The application may be absolute or conditional. If it is an absolute, an allotment and its notice is a sufficient acceptance. If it is conditional, the allotment must be according to the terms of the application, otherwise there will be no contract.

4. Membership by Transfer

A person may purchase shares in the open market. He becomes a member when the transfer of shares is effected and his name is entered in the register of members. The transfer of share is effected by lodging with the company an instrument of transfer signed by both the transferor and the transferee along with the share certificate. When the company enters the name of transferee in the register of members, he becomes its members.

5. By Transmission

A deceased member continues to be a member of the company so long as his name appears in the register of members. His legal representative who acquires a legal right to shares is entitled to have enter his name in the register of members. The company also has the power to register any person as shareholder to whom the right to any share (also debentures) in the company has been transmitted by operation of law and in such a case an instrument of transfer is not necessary. Provisions relating to transmission of shares are generally found in the Articles of a company.

6. By Acquiescence or Estoppel

After the amendment of Sec. 41 by the Companies (Amendment) Act, 1960, an agreement for becoming a member has to be in writing. As such a person cannot be deemed to have become a member by means of acquiescence or estoppel simply because his name in entered in the register of members. Prior to the amendment of Sec. 41 in 1960, the position was that if a person’s name was entered in the register of members and he, in fact, accepted the position and acted as a member, agreement in writing was presumed until the presumption was rebutted by proof to the contrary.

Now, the Companies Act, 2013 provides that a member means a person who agrees in writing to become a member and whose name is entered in the register of members of the company.

7.5 TERMINATION OF MEMBERSHIP

A person may cease to be the member of company by:

(1) An act of the parties; or (2) Operation of law.

1. Ceasation of Membership by Act of Parties: A person may cease to be the membership of a company:

(i) If he transfers his shares to another person.

(ii) If his shares are forfeited.

(iii) If the company sells his shares under some provision in its Articles (e.g. to enforce a lien).

(iv) If he rescinds his contract to take shares on the ground of misrepresentation in the prospectus or on the ground of irregular allotment.

(v) If redeemable preference shares are redeemed.

(vi) If he surrenders his shares, where surrender is permitted.

(vii) If shares warrants are issued to him in exchange of fully paid shares.

2. Ceasation of Membership by Operation of Law

(i) Insolvency: The shares of an insolvent vest in the Official Receiver of assignee. When the Official Receiver of assignee transfer his shares to another person, the insolvent ceases to be a member on the registration of the transferee as a member. But the insolvent remains a member as long as his name is not removed from the register of the company. [Wise Vs. Lansdell (1921) 1, Ch 420 (Ch. D. J.)]

(ii) Death: The deceased member’s estate, however, remains liable until the shares are registered in the name of his legal representative.

(iii) Sale of shares in execution of a decree of a Court.

(iv) Winding-up of the Company: During the winding-up of a company, a member continues to be liable as a contributory and is also entitled to shares in surplus assets, if any.

7.6 RIGHTS AND LIABILITIES OF MEMBERS

Rights of Members

When once a person becomes a member of a company, he is entitled to exercise all the rights of a member until he ceases to be a member in accordance with the provisions of the Act. The rights of the members of a company may be grouped under the following heads:

1. Statutory Rights: These are the rights which are conferred on the members by the Companies Act. These rights cannot be taken away or modified by any provision in the Memorandum or the Articles. Some of the statutory rights are as follows:

(a) Right to obtain copies of the Memorandum and Articles on request and on payment of the prescribed fees.

(b) Right to priority to have shares offered in case of increased capital.

(c) Right to transfer shares.

(d) Right to vote on resolutions at meetings of the company.

(e) Right to apply to the Court to have any variation of his rights set aside by the Court.

(f) Right to have a share certificate in respect of his shares delivered to him.

(g) Right to inspect the register of members, register of debenture holders and copies of annual returns.

(h) Right to apply to the Tribunal for calling annual general meeting when the company fails to call such a meeting.

(i) Rights to receive notice of meetings, attend and vote at meetings.

(j) Right to appoint proxy and inspect proxy register.

(k) Right to demand a poll or join in demand for a poll.

(l) Right to apply to the Tribunal for calling an extra ordinary meeting of the company where it is impracticable to call such a meeting.

(m) Right of a body corporate, as a member of a company, to appoint a representative to attend and vote at general meetings on its behalf.

(n) Right to require the company to circulate resolutions.

(o) Right to have on request minutes of proceedings of a general meeting.

(p) Right to receive dividend when declared.

(q) Right to receive copies of annual accounts of the company with the auditor's report.

(r) Right to participate in appointment of directors and auditors in the annual general meetings.

(s) Right to participate in appointment of directors in annual general meeting.

(t) Right to make an application to National Company Law Tribunal for ordering an investigation into the affairs of the company.

(u) Right to represent a petition to the National Company Law Tribunal for relief in cease of oppression and mismanagement.

(v) Right to participate in passing of a special resolution that the company may be wound-up by the Court or voluntarily.

(w) Right to receive a share in the capital of the company and the surplus assets, if any, on the company's liquidation.

(x) Right to participate in the appointment and in the fixation of remuneration of one or more liquidators in case of a member's voluntarily winding-up and fill any vacancy in the office of a liquidator so appointed by them.

2. Documentary Rights: These are the rights given to the members by the Memorandum and Articles of Association.

3. Legal Rights: These are the rights which are given to members by the general law, e.g. in case of any misstatement or concealment of a material fact in a prospectus, a person who has applied for shares on the faith of such prospectus and has been allotted shares can avoid the contract and claim damages under the general law.

The shareholder of a company has three classes of rights against the company under their share contract:

1. Right as to Control and Management: These include:

(a) Voting rights for the election and removal of directors and the incidental rights of holding the annual and extra-ordinary meetings and due notice thereof;

(b) Voting rights as to the making of amendments to the Memorandum of Association and other fundamental changes in the corporate existence and set-up;

(c) Voting rights as to making and amending of the Articles of Association which may regulate any matter; and

(d) The right to have the company managed honestly and carefully for the benefit and profit of the shareholders within the scope of the authorised business.

2. Proprietary Rights. These include:

(a) The right to participate ratebly in dividend distributions when ordered to the discretion of the directors;

(b) The right to participate in the distribution of assets in liquidation;

(c) The right to equality and honesty of treatment by the directors and by majority shareholders incorporate transactions affecting his interests, such as new issue of shares or amendment of Articles;

(d) The right to be registered as a shareholder in the company's book subject only to valid and authorised transfer of shares; and

(e) The privileges of immunity from personal liability for company's debts.

3. Remedial Rights: These include:

(a) The right to information and inspection of company's record; but a shareholder has no right of access to, or inspection of the books of account of a company.

(b) The right to bring representative suits on company's causes of action to prevent or remedy mismanagement or unauthorised acts and to compel company to enforce its rights; and

(c) Common law, equitable and statutory remedies for infringement of individual rights, when the interests of justice so require.

Right of Shareholders to Share in Assets of a Company

An incorporated company's assets are the property of the company and not that of its shareholders for the time being. No shareholder, therefore, has any right to any item therein. He is entitled to share in the profits while the company constitutes to carry on business and a share in the distribution of surplus assets when the company is wound-up. Note the observation made in this regard in the following decided case:

R.C. Cooper Vs. Union of India, A.I.R. (1970) S.C. 564, "A company registered under the Companies Act is a legal person separate and distinct from its individual members. Property of the company is not of the shareholders. A shareholder has merely an interest in the company arising under the Articles of Association, measured by a sum of money for the purpose of liability, and by a share in the profit. He has merely a right to share in the profit of the company subject to the contract contained in the Articles of Association."

Liability of Members

The liability of the members of a company depends on the nature of a company.

Company with Unlimited Liability: Every member of an unlimited company is liable in full for all the debts of the company contracted during the period of his membership.

Company Limited by Guarantee: The liability of the members of a company limited by guarantee is limited to the amount they under took to the assets of the company in the event of the winding-up.

Company Limited by Shares: In the case of a company limited by shares, the liability of a member of company is the amount, if any, unpaid on his shares. If his shares are fully paid, his liability is nil for all purposes. All money payable by any member to the company under the Memorandum or Articles shall be a debt due from him to the company. In the case of the death of a shareholder, his estate remains liable in respect of his shares. In the case of transfer of shares, the transferee on being registered as a shareholder become liable to pay all moneys thereafter becoming payable in respect of his shares.

Where a person is adjudicated insolvent, the official receiver or assignee may either sell the partly paid shares in which case the buyer would become liable in respect of shares or he may disclaim them as owner's property. If a person applies for shares in the name of a fictitious person or a person not in existence uses another person's name for himself or uses an alias and shares are allotted in that name or alias, he will be liable as a member. A shareholder is personally and severally liable if the numbers of the shareholders are reduced below the statutory minimum and company carries on business for more than 6 months. The effect of the provision would be to make such a company for practical purpose as unlimited company.

Members are liable to be put on the list of contributories in a winding-up if the whole amount due on the shares is not discharged. If a person has ceased to be a member within one year prior to the winding-up of the company, he is liable to be included in the 'B' list of past members and pay on the shares which he held to the extent of amount unpaid thereon provided:

(a) on the winding-up, debts exist which were incurred while he was a member, and

(b) the members of the list 'A' cannot satisfy the contribution required from them in respect of their shares.

7.7 REGISTER OF MEMBERS

(1) Every company shall keep and maintain the following registers in such form and in such manner as may be prescribed, namely:

(a) register of members indicating separately for each class of equity and preference shares held by each member residing in or outside India;

(b) register of debenture-holders; and

(c) register of any other security holders.

(2) Every register maintained under sub-section (1) shall include an index of the names included therein.

(3) The register and index of beneficial owners maintained by a depository under section 11 of the Depositories Act, 1996, shall be deemed to be the corresponding register and index for the purposes of this Act.

(4) A company may, if so authorised by its Articles, keep in any country outside India, in such manner as may be prescribed, a part of the register referred to in sub-section (1), called 'foreign register' containing the names and particulars of the members, debenture-holders, other security holders or beneficial owners residing outside India.

(5) If a company does not maintain a register of members or debenture-holder or other security holders or fails to maintain them in accordance with the provisions of sub-section (1) or sub-section (2), the company and every officer of the company who is in default shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh and where the failure is a continuing one, with a further fine which may extend to ` 1,000 for every day, after the first during which the failure continues.

Rectification of Register of Members

(1) If the name of any person is, without sufficient cause, entered in the register of members of a company, or after having been entered in the register, is, without sufficient cause, omitted therefrom, or if a default is made, or unnecessary delay takes place in entering in the register, the fact of any person having become or ceased to be a member, the person aggrieved, or any member of the company, or the company may appeal in such form as may be prescribed, to the Tribunal, or to a competent Court outside India, specified by the Central Government by notification, in respect of foreign members or debenture-holders residing outside India, for rectification of the register.

(2) The Tribunal may, after hearing the parties to the appeal under sub-section (1) by order, either dismiss the appeal or direct that the transfer or transmission shall be registered by the company within a period of 10 days of the receipt of the order or direct rectification of the records of the depository or the register and in the latter case, direct the company to pay damages, if any, sustained by the party aggrieved.

(3) The provisions of this section shall not restrict the right of a holder of securities, to transfer such securities and any person acquiring such securities shall be entitled to voting rights unless the voting rights have been suspended by an order of the Tribunal.

(4) Where the transfer of securities is in contravention of any of the provisions of the Securities Contracts (Regulation) Act, 1956, the Securities and Exchange Board of India Act, 1992 or this Act or any other law for the time being in force, the Tribunal may, on an application made by the depository, company, depository participant, the holder of the securities or the Securities and Exchange Board of India, direct any company or a depository to set right the contravention and rectify its register or records concerned.

Penalty

If any default is made in complying with the order of the Tribunal under this section, the company shall be punishable with fine which shall not be less than ` 1 lakh but which may extend to ` 5 lakh and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 1 year or with fine which shall not be less than ` 1 lakh but which may extend to ` 3 lakh, or with both.

Declaration in Respect of Beneficial Interest in Any Share

(1) Where the name of a person is entered in the register of members of a company as the holder of shares in that company but who does not hold the beneficial interest in such shares, such person shall make a declaration within such time and in such form as may be prescribed to the company specifying the name and other particulars of the person who holds the beneficial interest in such shares.

(2) Every person who holds or acquires a beneficial interest in share of a company shall make a declaration to the company specifying the nature of his interest, particulars of the person in whose name the shares stand registered in the books of the company and such other particulars as may be prescribed.

(3) Where any change occurs in the beneficial interest in such shares, the person referred to in sub-section (1) and the beneficial owner specified in sub-section (2) shall, within a period of 30 days from the date of such change, make a declaration to the company in such form and containing such particulars as may be prescribed.

(4) The Central Government may make rules to provide for the manner of holding and disclosing beneficial interest and beneficial ownership under this section.

(5) If any person fails, to make a declaration as required under sub-section (1) or sub-section (2) or sub-section (3), without any reasonable cause, he shall be punishable with fine which may extend to ` 50,000 and where the failure is a continuing one, with a further fine which may extend to ` 1,000 or every day after the first during which the failure continues.

(6) Where any declaration under this section is made to a company, the company shall make a note of such declaration in the register concerned and shall file, within 30 days from the date of receipt

of declaration by it, a return in the prescribed form with the Registrar in respect of such declaration with such fees or additional fees as may be prescribed, within the time specified under section 403.

(7) If a company, required to file a return under sub-section (6), fails to do so before the expiry of the time specified under the first proviso to sub-section (1) of Section 403, the company and every officer of the company who is in default shall be punishable with fine which shall not be less than ` 500 but which may extend to ` 1,000 and where the failure is a continuing one, with a further fine which may extend to ` 1,000 for every day after the first during which the failure continues.

(8) No right in relation to any share in respect of which a declaration is required to be made under this section but not made by the beneficial owner, shall be enforceable by him or by any person claiming through him.

(9) Nothing in this section shall be deemed to prejudice the obligation of a company to pay dividend to its members under this Act and the said obligation shall, on such payment, stand discharged.

Investigation of Beneficial ownership of Shares in Certain Cases

Where it appears to the central Government that there are reasons so to do, it may appoint one or more competent persons to investigate and report as to beneficial ownership with regard to any share or class of shares and the provisions of Section 216 shall, as far as may be, apply to such investigation as if it were an investigation ordered under that section.

Power to Close Register of Members or Debenture-Holders of other Security Holders

(1) A company may close the register of members or the register of debenture-holders or the register of other the security holders for any period or periods not exceeding in the aggregate 45 days in each year, but not exceeding 30 days at any one time, subject to giving of previous notice of at least 7 days or such lesser period as may be specified by Securities and Exchange Board of India for listed companies or the companies which intend to get their securities listed, in such manner as may be prescribed.

(2) If the register of members or of debenture-holders or of other security holders is closed without giving the notice as provided in sub-section (1), or after giving shorter notice than that so provided, or for a continuous or an aggregate period in excess of the limits specified in that sub-section, the

company and every officer of the company who is in default shall be liable to a penalty of ₹ 5,000 for every day subject to a maximum of ₹ 1,00,000 during which the register is kept closed.

7.8 ANNUAL RETURN

(1) Every company shall prepare a return (hereinafter referred to as the annual return) in the prescribed form containing the particulars as they stood on the close of the financial year regarding:

(a) its registered office, principal business activities, particulars of its holding, subsidiary and associate companies;

(b) its shares, debentures and other securities and shareholding pattern;

(c) its indebtedness;

(d) its members and debenture-holders along with changes therein since the close of the previous financial year;

(e) its promoters, directors, key managerial personnel alongwith changes therein since the close of the previous financial year;

(f) meetings of members or a class thereof, Board and its various committees along with attendance details;

(g) remuneration of directors and key managerial personnel;

(h) penalty or punishment imposed on the company, its directors or officers and details of compounding of offences and appeals made against such penalty or punishment;

(i) matters relating to certification of compliances, disclosures as may be prescribed;

(j) details, as may be prescribed, in respect of shares held by or on behalf of the Foreign Institutional Investors indicating their names, addresses, countries of incorporation, registration and percentage of shareholding held by them; and

(k) such other matters as may be prescribed, and signed by a director and the company secretary, or where there is no company secretary, by a company secretary in practice:

Provided that in relation to One Person Company and small company, the annual return shall be signed by the company secretary, or where there is no company secretary, by the director of the company.

(2) The annual return, filed by a listed company or, by a company having such paid-up capital and turnover as may be prescribed, shall be certified by a company secretary in practice in the prescribed form, stating that the annual return discloses the facts correctly and adequately and that the company has complied with all the provisions of this Act.

(3) An extract of the annual return in such form as may be prescribed shall form part of the Board's report.

(4) Every company shall file with the Registrar a copy of the annual return, within 60 days from the date on which the annual general meeting is held or where no annual general meeting is held in any year within 60 days from the date on which the annual general meeting should have been held together with the statement specifying the reasons for not holding the annual general meeting, with such fees or additional fees as may be prescribed, within the time as specified under section 403.

(5) If a company fails to file its annual return under sub-section (4), before the expiry of the period specified under Section 403 with additional fee, the company shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 5 lakhs and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to 6 months or with fine which shall not be less than ` 50,000 but which may extend to ` 5 lakh, or with both.

(6) If a company secretary in practice certifies the annual return otherwise than in conformity with the requirements of this section or the rules made thereunder, he shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 5 lakh.

Return to be Filed with Registrar in Case Promoters' Stake Changes

Every listed company shall file a return in the prescribed form with the Registrar with respect to change in the number of shares held by promoters and top ten shareholders of such company, within 15 days of such change.

7.9 PLACE OF KEEPING AND INSPECTION OF REGISTERS AND RETURNS

(1) The registers required to be kept and maintained by a company under Section 88 and copies of the annual return filed under Section 92 shall be kept at the registered office of the company;

Provided that such registers or copies of return may also be kept at any other place in India in which more than one-tenth of the total number of members entered in the register of members reside, if approved by a special resolution passed at a general meeting of the company and the Registrar has been given a copy of the proposed special resolution in advance:

Provided further that the period for which the registers, returns and records are required to be kept shall be such as may be prescribed.

(2) The registers and their indices, except when they are closed under the provisions of this Act, and the copies of all the returns shall be open for inspection by any member, debenture-holder, other security holder or beneficial owner, during business hours without payment of any fees and by any other person on payment of such fees as may be prescribed.

(3) Any such member, debenture-holder, other security holder or beneficial owner or any other person may:

(a) take extracts from any register or index or return without payment of any fee; or

(b) require a copy of any such register or entries therein or return on payment of such fees as may he prescribed.

Penalty

(4) If any inspection or the making of any extract or copy required under this section is refused, the company and every officer of the company who is in default shall be liable, for each such default, to a penalty of ` 1,000 for every day subject to a maximum of `1,00,000 during which the refusal or default continues.

(5) The Central Government may also, by order, direct an immediate inspection of the document, or direct that the extract required shall forthwith be allowed to be taken by the person requiring it.

Registrar Etc. to be Evidence

The registers, their indices and copies of annual returns maintained under sections 88 and 94 shall be prima facie evidence of any matter directed or authorised to be inserted therein by or under this Act.

7.10 SUMMARY

This article regulate the internal management of the affairs of the company by way of defining the powers of its officers and establishing a contract between the company and the members and between the members inter se. Any person owing any number of shares of a public company is known as a ‘shareholders’. A shareholder becomes a member of the company only after his name is recorded in the register of members of the company. A member ceases to be a member of a company when his name is removed from the register of members or register of beneficial owners. A shareholder is any person or a company having the ownership of a minimum of one share of the company. Being a member of the company, the shareholders enjoy a number of rights extended to them by the Act. Besides the requirement of maintaining different registers, the rules provide guidelines for having the index of names in registers so maintained.

7.11 KEYWORDS

Minor: Person below the age of majority.

Cessation of membership: A person ceases to be a member of a company when his name is removed from is register of members.

Joint Members: If more than one person apply for shares in a company and shares are allotted to them, each one of such applicant becomes a member.

7.12 SELF ASSESSMENT QUESTIONS

1. Define a member. Distinguish a member from a shareholder.
2. In what ways may a person become and ceases to be a member of a company?
3. When does the liability of a member of limited company become unlimited?
4. In what ways may a person become and cease to be a member of a company?
5. “Every shareholder of a company is also known as a member while every member may not be known as shareholder.” Comment.
6. What is an annual return? What are its contents? When must it be filed with the Registrar?
7. Briefly state the statutory rights of a member of a company,
8. What are the particulars to be recorded in a register of members of a company? Where is the register to maintained and who has to maintain it? Can a member have access to the register?

7.13 SUGGESTED READINGS

- Avtar Singh, Company Law, Eastern Book Company, Lucknow.
- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.

LESSON 8

BORROWING POWERS AND MANAGERIAL REMUNERATION

Structure

8.0 OBJECTIVES

After reading this lesson, you should be able to:

- Outline the provisions relating to borrowing powers of a company.
- Explain the consequences of ultra vires borrowings.
- Define charges and compare between fixed and flexible charge.
- Identify the charges whose registration is mandatory.
- Describe the provisions regarding managerial remuneration.

8.1 INTRODUCTION

It is a general commercial practice to borrow funds for the purpose of conducting business. Every company borrows money for its long-term, short-term, or medium-term requirements from various sources.

8.2 MEANING OF BORROWING

Borrowing or loan is a comprehensive term. It includes borrowings by issuing debentures or bonds or other securities or raising loans in any other way whether with or without security. But the term does not include the temporary borrowings or, loans repayable on demand, or within a period of 6 months from the date of borrowing or loan.

Provisions Regarding Power of Borrowing

Companies borrow funds or take loans. The provisions of law regarding borrowing powers of companies are summarized as follows:

1. Implied Power of Trading Company: A trading or commercial company has implied power to borrow even though there is no express power conferred on it by its memorandum. Therefore, a trading company can borrow for the purposes of its business unless it is prohibited by its memorandum. But the usual practice is that every trading company includes in its memorandum the express power to borrow monies for its business purposes. The articles of the company may prescribe the limit and manner in which the power to borrow may be exercised or delegated. A trading company means a company whose objective is to earn profit and distribute it among its members.

2. No Implied Power of Non-trading Company: A non-trading company has no implied power to borrow for any purpose. It can borrow only when its memorandum gives it an express power to borrow. It can borrow to the extent of the limit set by the memorandum. Here, non-trading company means a not-for-profit company (e.g, a building society, a literary, scientific institution, or an educational institution).

3. Statutory Limit on Borrowings: Board of directors of any company cannot borrow money (including the money already borrowed by the company) exceeding the aggregate of the paid-up capital of the company and its free reserves apart from the temporary loans obtained from bankers subject to the consent of the company by a special resolution [Sec. 180(1)].

4. Limits set by Memorandum: The memorandum or the articles may set a limit on borrowings by a company. But this limit cannot exceed the statutory limit or higher limit fixed by the general meeting.

5. Borrowing Beyond Limits: If a company borrows in excess of the statutory limit, the debt shall not be valid and effectual. However, if the lender proves that he advanced the loan in good faith and without knowledge that the limit imposed had been exceeded, he can reclaim the amount so advanced [Sec. 180(5)].

6. Temporary Loans not Included: While calculating the amount of borrowing under the statutory limit, the 'temporary loans' shall not be considered. The expression 'temporary loans' means loans repayable on demand or within 6 months from the date of the loan. It includes loans such as short-term cash credit arrangements, the discounting of bills, and the issue of other short-term loans of a seasonal character but does not include loans raised for the purpose of financing expenditure of capital nature [Sec. 180(1)].

7. Time to Exercise Power: A company can exercise its borrowing power only after it is entitled to commence its business. If any default is made in complying with this provision, the company shall be liable to a penalty, which may extend to ` 5,000. Moreover, every officer who is in default shall also be punishable with a fine, which may extend to ` 1,000 for every day during which the default continues [Sec. 11].

8. Person Authorized to Borrow: The Board of directors of a company has the power to borrow on behalf of the company. It can exercise the power to borrow by means of resolution passed at the meeting of the Board. However, the Board may delegate the power to borrow monies by a resolution passed at a meeting. It can delegate to any committee of directors, the managing director, the manager or any other principal officer of the company or in case of a branch office of the company the principal officer of the branch office [Sec. 179].

9. Powers to Mortgage or Charge Assets: The power to borrow naturally implies the power to mortgage or charge the property of the company. Usually, title deeds of property, book debts, goodwill, patent rights, or copyrights can be mortgaged or charged.

10. Certain Assets cannot be Mortgaged or Charged: The following assets of a company cannot be charged or mortgaged:

(i) Uncalled capital of the company

(ii) Reserve capital

(iii) Amount guaranteed by the members of a company limited by guarantee

(iv) Books of accounts.

8.3 CONSEQUENCES OF ULTRA VIRES BORROWINGS

Borrowing without or beyond express or implied powers are known as ultra vires borrowings.

These may be of two kinds:

I. Borrowings ultra vires the company.

II. Borrowings ultra vires the directors.

I. Borrowings *Ultra Vires* the Company

If a company borrows money without or beyond its express or implied powers, the borrowing is ultra vires. The following are the consequences of such borrowings:

(i) Borrowings ultra vires the company are void. Therefore, no relation of creditor and debtor arises between the parties.

(ii) The mortgage or charge created for the security of the loan shall be void and inoperative.

(iii) Borrowings ultra vires the company cannot be ratified even by a unanimous resolution passed in the company's general meeting.

(iv) Even no suit against the company can be filed under the general law of the land. It is because ultra vires lender has no legal or equitable debt against the company.

Remedies Available to Lender

Although the borrowings ultra vires the company are void but at equity, the lender has the following remedies:

1. Injunction: When a lender comes to know of the lending beyond the power of the company, he may obtain an injunction from the Court and restrain the company from parting with the money. But this remedy can be availed of only if the money lent has not been spent by the company.

2. Recovery or Restitution: The lender can recover the money from the company if he can trace and identify the money lent. If the money has been spent for the purchase of any property, he can claim possession of such property as its true owner. If the money lent cannot be traced but it can be proved that the company has been benefited thereby (e.g. by increase in assets), the lender can claim repayment of his money out of that benefit.

3. Subrogation: If the company has used the money borrowed in paying off its lawful creditors, the lender may be subrogated to the rights of the creditors. Consequently, the lender will be entitled to rank as a creditor of the company up to the amount so used. Thus, the lender steps into the shoes of the old creditors of the company who were so paid off.

4. Suit against Directors: If the directors exceed their power in borrowing the money, the lender may sue them personally for breach of warranty of authority.

II. Borrowings ultra vires the Directors

Sometimes, a borrowing is intra vires the company but ultra vires of those managing the company (i.e., directors of the company). Directors cannot borrow beyond the paid-up capital and free reserves of the company without the consent of the company by a special resolution. Any loan incurred by a company in excess of this limit shall not be valid unless the lender proves that he advanced the loan in good faith and without knowledge that the limit imposed on the power has been exceeded [Sec. 180(5)].

Where the directors of a company borrow money beyond their limit to borrow without the consent of the company in general meeting, ordinarily, the company is not bound to repay. However, if the money borrowed beyond the limit has been used for the benefit of the company either in paying its debts or for its legitimate business purpose, the company cannot escape its liability on the ground that the directors had no authority to borrow.

But sometimes, a managing director of a company who is not authorized to borrow money which is not necessary. It is neither bona fide nor for the benefit of the company. Hence, the company is not liable for the amount borrowed.

8.4 CHARGE AND MORTGAGE

The power to borrow naturally implies the power to charge or mortgage the property of the company. Therefore, when a company borrows money on the security of property of the company, it can charge or mortgage its property in favour of its creditors (i.e., lenders or debenture-holders).

Meaning of Charge and Mortgage

According to Section 2(16), "Charge means an interest or lien created on the property or assets of a company or any of its undertakings or both as security and includes a mortgage." In one case, charge has been defined in the following words:

"Where in a transaction for value, both the parties agree that the existing and future property shall be made available as security for the payment of a debt and that the creditors shall present right to have it made available, there is charge."

It may be noted that there is charge even though the present legal right of the creditor can only be enforced at some future date and though the creditor gets no legal right to property (either absolute or special or any legal right to possession), but only gets the right to have the security made available by an order of the Court.

Charge also includes a lien and an equitable charge whether created or evidenced by an instrument in writing or by deposit of title deeds or by an agreement to deposit.

Mortgage: A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future or the performance of an agreement which may give rise to a pecuniary liability [Section 58, The Transfer of Property Act, 1882].

Characteristics of Charge

Following are the characteristics of a charge:

1. Charge is an interest or lien created on an asset/property in favour of creditors.
2. Charge can be created:
   (a) On any asset or property.
   (b) On any undertaking.
   (c) On any movable or immovable property.

(d) On any present or future assets.

3. Charge can be created on any tangible or intangible property or on both.
4. It can be created on any property situated in or outside India.
5. Charge is evidenced by an instrument in writing.
6 Charge may also be created by deposit of title deeds of the property or by an agreement to deposit the same.
7. The purpose of creating a charge is to provide security for payment of a debt.
8. Every charge created by a company needs to be registered with the Registrar.

Kinds of Charges

Charges created on the property of a company may be of any of the two kinds:

1. Fixed or specific charge.

2. Floating charge.

1. Fixed or Specific Charge: A charge is said to be fixed or specific when it is created on some specific, ascertained, and definite property of a permanent nature such as land or building. Thus, such a charge covers the existing ascertained or capable of being ascertained and defined property. In case of such a charge, the company creating the charge can only deal with the property subject to the prior rights created by the charge. In other words, the company cannot dispose of the property without the consent of the charge-holder.

2. Floating Charge: A floating charge is an equitable charge on the floating assets of the company. It is a charge on the class of floating assets and not on any specific and definite assets. It is a charge on present as well future assets of the company, which goes on changing from time to time in the ordinary course of business.

The company is free to deal with the assets charged until the charge-holder takes steps to enforce the security or the company goes into liquidation. Thus, such a charge remains dormant until the company ceases to be a going concern or until the charge-holder enforces the security.

When the floating charge crystallizes, it becomes fixed charge and assets covered therein are subject to the same restrictions as in case of a fixed charge.

Characteristics: The main characteristics or the features of floating charge are as follows:

1. Floating charge can be created on all or any class of assets excluding the assets on which charge cannot be created.
2. It is a charge on present as well as future assets which in the ordinary course of business would be changing from time to time
3. The company is free to deal with assets charged until the charge-holder takes steps to enforce the security or the company goes into liquidation.
4. Such a charge remains dormant until the company ceases to be a going concern or until the charge-holders enforces the security.
5. When the floating charge crystallizes, it becomes a fixed charge.
6. When the company makes a breach of any condition of charge, the charge- holder can enforce the charge.
7. No particular words are necessary to create a floating charge. Any words which show the intention of the parties that the company shall continue to deal with the assets charged in ordinary course of business will create a floating charge.

Consequences and Advantages of Floating Charge

Following are the main advantages or consequences of floating charge till the charge crystallizes:

1. Use the Property: A company may continue to use the property on which a floating charge has been created.

2. Recharge or Mortgage: A company is entitled to create a further charge on the same assets to secure another debt provided it is not prohibited by the terms of the earlier charge. Every subsequent charge is deemed to have notice of all the earlier charges which have been registered (Sec. 80).

3. Fixed Charge after Floating Charge: A company may not only create a further floating charge on the assets already charged but can also create fixed charge on the same assets.

4. Sell, Transfer or Lease the Property: A company can sell or lease the property charged in the ordinary course of business if it is authorized by its memorandum. Even a company can transfer its whole of the undertaking to another under a scheme of amalgamation within the objects of the company.

8.5 DISTINCTION BETWEEN FIXED AND FLOATING CHARGE

Distinction between fixed and floating charges has been enumerated in Table 8.1

Table 8.1 Distinction between Fixed and Floating Charges

Basis of Distinction	**Fixed Charge**	**Floating Charge**
1. Nature of assets	Fixed charge may be created on specific and definite assets of permanent nature (e.g., land or building)	Floating charge may be created on any assets or class of floating assets.
2. Dealing in property	Property charged cannot be transferred. It an be used by the company.	Property charged can be used, sold, transferred, or mortgaged by the company.
3. Existing or future property	Fixed charge can be created only on existing ascertained property.	Floating charge can be created on existing as well as future assets of the company.
4. Change	Fixed charge cannot become floating charge	A floating charge may become fixed charge
5. Effect	Fixed charge has its effect from the day, it is created	Floating charge remains dormant till any event specified in the deed of the charge happens

6. Suspension	Right of fixed charge-holder cannot be suspended.	Rights of floating charge-holder can be suspended by an agreement.

Crystallization of Floating Charge

Crystallization is the process of conversion of floating charge into a fixed charge. Floating charge crystallizes in any of the following cases:

1. When the company ceases to carry on its business.
2. When the company goes into liquidation.
3. When the creditors or debenture-holders take steps to enforce the security.
4. When the creditor or debenture-holder gets a receiver appointed by the Court.
5. When the creditor/debenture-holder does any other act which affects the company's power of disposition over assets charged.
6. When any of the events specified in the charge deed happens.

Effect of Crystallization: When a floating charge crystallizes, it is said to become fixed. The charge-holder gets priority over the subsequent charge and other unsecured creditors. But the creditors who are entitled to preferential payment in the event of winding up of a company (under Section 327) shall get priority over the creditors holding a floating charge even if the company is not at that time in the course of winding up [Sec. 123].

Effect of Winding up on Validity of Floating Charge

A floating charge on the undertaking or property of the company created within 12 months immediately preceding the commencement of the winding up shall be invalid unless it is proved that the company immediately after the creation of the charge was solvent except in the following cases:

(i) Where the amount of any cash paid to the company at the time of or subsequent to the creation of the charge.

(ii) Where the amount of any cash paid to the company was the consideration for the charge together with interest on that amount. However, the amount of interest shall be at the rate of 5 per cent per annum or such other rate as may be notified by the Central Government in this behalf [Sec. 332].

The object of the above provision is to prohibit companies which are in insolvent condition from creating any floating charges on their assets, with a view to securing past liabilities. It also empowers the Central Government to prescribe by rules regarding the rate of floating charge.

Charges Whose Registration is Compulsory

It shall be the duty of every company to register the particulars of charge created on the following:

1. A charge created on the property or assets of the company.
2. A charge created on any of the undertakings of the company.
3. A charge created on any tangible or otherwise property or assets of the company.
4. A charge created on property or asset or undertaking situated in or outside India [Sec.77(1)].
5. A property acquired subject to charge.
6. Any modification in the terms or conditions of any charge already registered.
7. Any modification in the extent or operation of any charge already registered.
8. Any charge created in or outside India [Sec. 79].

Charges whose Registration is not Required

The charges which are not created by the parties to any agreement are not required to be registered. Following are some of such charges whose registration is not required:

1. Charges created by an order or decree of Court

2. Charges created by liquidator.

8.6 REGISTRATION OF CHARGE

The major provisions with respect to registration of charges are as follows:

1. Duty to Register Charges: It shall be the duty of every company to register every charge created on its property or assets or any of its undertakings. Charge created within or outside India needs to be registered. The registration of charge is essential even if the charged property is situated in or outside India and is either tangible or otherwise.

2. Filing Particulars and Instrument of Charge: For registration, every company shall file the particulars of charge with the Registrar. The particulars shall be signed by the company and the charge-holder.

The particulars of charge shall be filed along with a copy of the instrument creating the charge. The copy of every such instrument shall be verified as follows:

(a) Where the instrument or deed relates solely to the property situated outside India, the copy shall be verified by a certificate issued either under the seal if any, of the company or under the hand of any director or company secretary of the company. Alternatively, it may be verified by a certificate issued by an authorized officer of the charge-holder or under the hand of some person other than the company who is interested in the mortgage or charge.

(b) Where the instrument or deed relates (whether wholly or partly) to the property situated in India, the copy shall be verified by a certificate issued under the hand of any director or company secretary of the company or an authorized officer of the charge-holder [Sec. 77(1) and Rule CHG-3].

3. Time Limit for Registration: Every charge created shall be registered within 30 days of its creation [Sec. 77(1)].

4. Condonation of Delay by The Registrar: Sometimes, a company fails to register the charge within 30 days of its creation. In such a case, the company can apply to the Registrar for condonation of the delay. Such application shall be in Form No. CHG-1. This application shall be supported by a declaration from the company signed by its secretary or director. The declaration shall be to the effect that such belated filing shall not adversely affect rights of any other intervening creditors of the company.

If the Registrar is satisfied with the cause for not filing the particulars and instrument of charge within a period of 30 days of the date of its creation, he may allow the registration of the same after 30 days. But the company shall be required to register the charge within 300 days of the date of its creation or its modification on payment of additional fee [Sec. 77(1) and Rule CHG-4].

5. Extension of Time Limit by the Central Government: Sometimes, a company even fails to register a charge within 300 days of its creation. In such a case, the company may seek extension of time from the Central Government. The Registrar shall not register the charge unless the delay is condoned by the Central Government.

The Central Government is empowered to condone the delay and extend the time limit for registration of a charge even after 300 days of its creation. A company may make an application to the Central Government in Form No. CHG-8 along with the fee for seeking extension of time. The Central Government may issue an order for condonation of the delay and extension of time for registration of the charge in any of the following cases:

(i) Where such delay or omission was accidental or due to inadvertence.

(ii) When the delay or omission was due to some other sufficient cause.

(iii) Where the delay or omission is not of a nature to prejudice the position of creditors or shareholder of the company.

6. Registration by Registrar: On receipt of the order of the Central Government extending the time for registration of charge, the company shall file a copy of the order to the Registrar in Form No. INC-28 along with the fee. While filing the form, the company shall comply with the conditions stipulated in the order. The Registrar shall register the charge. While registering the charge, the Registrar shall ensure that such registration of charge shall not prejudice any right acquired in respect of the property before the charge is actually registered.

Certificate of Registration

Where a charge is registered with the Registrar, he shall issue a certificate of registration of such charge. The certificate shall be issued to the company and to the person in whose favour the charge is created (i.e., charge-holder). The certificate shall be in prescribed form and manner Sec. 77(2)).

Certificate Conclusive Evidence: The certificate of registration of charge issued by the Registrar shall be conclusive evidence of the fact that the requirements of registration of charge (under Chapter VI of the Act and the Rules made thereunder) have been complied with.

Deemed or Constructive Notice of Charge

Where any charge on any property or assets of a company or any of its undertakings is registered, any person acquiring such property, assets, or undertakings (or part thereof or any or interest therein) shall be deemed to have notice of the charge from the date of such registration [Sec. 80].

Provisions of Charge Applicable in Certain Matters

The provisions of charge [Sec. 77] shall apply to the following matters:

1. When a company acquires a property which is subject to a charge.

2. When the terms or conditions of any registered charge are modified.

3. When the extent or operation of any registered charge is modified [Sec. 79].

Unregistered Charge Not Taken into Account

No charge created by a company shall be taken into account by the liquidator or any other creditor unless it is duly registered and a certificate of registration of such charge is given by the Registrar [Sec. 77(3)]. But this provision shall prejudice any contract or obligation for the repayment of the money secured by a charge [Sec. 77(4)].

8.7 MANAGERIAL REMUNERATION

Managerial remuneration means the remuneration payable to managerial personnel of a company. For the purpose of calculation and payment of managerial remuneration, managerial personnel mean the following personnel:

(a) Managing director or manager.

(b) Whole-time director.

(c) Other directors.

The main provisions regarding managerial remuneration, that is, remuneration payable to Managing Director (MD), Whole-time Director (WD) or manager are as follows:

Maximum Limit of Remuneration

The maximum remuneration payable by a public company to its directors (MD, WD, and part-time directors) and manager in respect of a financial year cannot exceed 11 percent of the net profits of the company [Sec. 197(1)]. The net profits for the above purposes shall be computed in the manner referred to in Section 198. However, the remuneration of the directors shall not be deducted from the gross profits [Sec. 197(1) and 197(8)]. 1t should be noted that remuneration paid for services rendered other than of professional nature shall be inclusive of remuneration payable to directors [Sec 197(4)].

Exclusions from remuneration

The remuneration paid in any of the following ways shall be exclusive of maximum limit of remuneration:

1. Sifting Fee Payable to Directors: The limit of 11 per cent of net profits shall be exclusive of any fee payable to directors for attending meetings (i.e. sitting fee) of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board [Sec. 197(5)].

2. Remuneration for Services of Professional Nature: Any remuneration for services rendered by any director in other capacity shall not be included in the maximum amount of remuneration in the following cases:

(i) If the services rendered are of professional nature.

(ii) If in the opinion of the 'Nomination and Remuneration Committee' [if the company is a listed company or a company belonging to a prescribed class, i.e. covered under Section 178(1)], or the Board of directors in other cases, the director possesses the requisite qualification for the practice of the profession [Sec. 197(4)].

3. Insurance Premium Paid for Indemnifying Against Liability for Negligence etc.: Sometimes, insurance is taken by a company on behalf of its MD, WD, manager, CEO, CFO or company secretary for indemnifying any of them against any liability in respect of any negligence, default, misfeasance, breach of duty or breach of trust for which they may be guilty in relation to the company. In such a case, the premium paid on such insurance shall not be treated as part of the remuneration payable to any such personnel. However, if such person is proved to be guilty, the premium paid on such insurance shall be treated as part of the remuneration [Sec. 197(13)].

Higher Payment with Approval of Central Government

A company in a general meeting may authorize the payment of remuneration exceeding 11 per cent of the net profits of the company, subject to the provisions of Schedule V. However, such resolution of general meeting for higher remuneration shall require the approval of the Central Government [Sec. 197(1)].

Ceiling on Individual and Overall Remuneration

The remuneration payable to any one MD or WD or manager shall not exceed 5 per cent of the net profits of the company. If there is more than one such director, remuneration shall not exceed 10 per cent of the net profits to all such directors and manager taken together [Sec. 197(1)].

Remuneration in Case of No Profits or Inadequate Profits

Sometimes, a company has no profits or inadequate profits and cannot pay remuneration in accordance with the above provisions. In such a case, the company shall not pay to its directors (including any managing or whole-time director or manager), by way of remuneration any sum (exclusive of any fees payable to directors for attending meetings and for their professional services) except in accordance with the provisions of Schedule V. If the company is not able to comply with provisions of Schedule V, it shall pay the remuneration only with the previous approval of the Central Government [Sec. 197(3)].

Increase in Remuneration in Case of No Profits or Inadequate Profits

This is the case where Schedule V is applicable on the grounds of no profits or inadequate profits. In such cases, any provision for increase in remuneration (in the company's articles, or in an agreement entered into by it or in any resolution passed by the company in general meeting or its Board relating to the remuneration of any director which purports to increase or has the effect of increasing the amount thereof), shall not have any effect unless such increase is in accordance with the conditions specified in that Schedule. If such conditions are not being complied with, such increase shall be effective only when the approval of the Central Government is obtained [Sec. 197(11)].

Remuneration from Holding or Subsidiary Company

Any director who is in receipt of any commission from the company and who is a MD or WD of the company shall not be disqualified from receiving any remuneration or commission from any holding company or subsidiary company of such company. However, the company shall be required to disclose such fact in the Board's report [Sec. 197(14)].

DETERMINATION AND PAYMENT OF REMUNERATION

1. Determination of Remuneration: The remuneration payable to the directors of a company (including any MD or WD or manager), shall be determined by any of the following:

(i) By the articles of the company.

(ii) By a resolution passed by the company in general meeting.

(ii) By a special resolution passed by the company in general meeting, if the articles so require.

It may be noted that the remuneration shall be determined in accordance with and subject to the provisions of this Section (i.e. Section 197). It should be noted that the remuneration payable to a director determined aforesaid shall be inclusive of the remuneration payable to him for the services rendered by him in any other capacity except for the services of professional nature rendered in the professional capacity [Sec. 197(4)].

2. Mode of Payment: A director or manager may be paid remuneration in any of the following ways:

(i) By way of monthly payment.

(ii) By way of a specified percentage of the net profits of the company.

(iii) Partly by way of monthly payments and partly by way of a specified percentage of the net profits [Sec. 197(6)].

Sitting Fee

A director may receive remuneration by way of fee for attending meetings (sitting fee) of the Board or Committee thereof or for any other purpose whatsoever as may be decided by the Board. However, the amount of such fees shall not exceed the amount as may be prescribed. Moreover, different fees for different classes of companies and fees in respect of independent director may be such as may be prescribed [Sec. 197(5)].

The Rules notified by the MCA have prescribed that a company may pay a sitting fee to a director for attending meetings of the Board or committees thereof, such sum as may be decided by the Board of directors of the company. However, such fee shall not exceed ` one lakh per such meeting. It should be noted that the sitting fee for independent directors and women directors shall not be less than the sitting fee payable to other directors.

Remuneration to Non-executive (part-time) Directors

The remuneration payable to non-executive directors (who are neither managing directors nor whole-time directors) shall not exceed the following limits:

(i) One per cent of the net profits of the company, if there is a managing or whole- time director or manager.

(ii) 3 per cent of the net profits in any other case [Sec. 197(1)].

It may be pointed out that the percentages aforesaid shall be exclusive of any sitting fees payable to directors [Sec. 197(2)].

Remuneration to Independent Directors

An independent director shall not be entitled to any stock option. But he may receive remuneration by the following ways:

(i) Fees for attending meetings of the Board or the Committees thereof.

(ii) Reimbursement of expenses for participation in the Board and other meetings.

(iii) Profit related commission as may be approved by the members [Sec. 197(7)].

His right to remuneration and commission is subject to the provisions of Sections 197 and 198 [Sec. 149(9)].

OTHER PROVISIONS AS TO REMUNERATION

1. Refund of Excess Sums Drawn: Sometimes, a director draws or receives, directly or indirectly, by way of remuneration any such sums in excess of the limit prescribed or without prior sanction of the Central Government, if required. In such a case, he shall refund such sums to the company. Until such sums are refunded, the director shall hold them in trust for the company [Sec. 197(9)]. It should be noted that the company shall not waive the recovery of any sum refundable to it unless permitted by the Central Government [Sec. 197(10)].

2. Disclosure of Ratio of Remuneration in the Board's Report: Every listed company shall disclose in the Board's report, the ratio of the remuneration of each director to the median employee's remuneration. The Board's report shall contain such other details as may be prescribed [Sec. 197(12)].

3. Punishment: If any person contravenes the provisions of this Section, he shall be punishable with fine which shall not be less than ₹ one lakh but which may extend to ` 5 Iakh [Sec. 197(15)].

4. Recovery of Remuneration in Certain Cases: Sometimes, a company is required to re-state its financial statements due to fraud or non-compliance with any requirement under this Act and the Rules made thereunder. In such a case, the company shall recover from any past or present managing director or whole-time director or manager or Chief Executive Officer (by whatever name called) who, during the period for which the financial statements are required to be re-stated, received the remuneration (including stock option) in excess of what would have been payable to him as per restatement of financial statements [Sec. 199].

5. Central Government or Company to Fix Limit of Remuneration: The Central Government or a company may, (while giving its approval under Sec. 196, to any appointment or to any remuneration under Section 197 in respect of cases where the company has inadequate or no profits) fix the remuneration within the limits specified in this Act at such amount or percentage of profits of the company, as it may deem fit. While fixing the remuneration, the Central Government or the company shall have regard to the following:

(a) The financial position of the company.

(b) The remuneration or commission drawn by the individual concerned in any other capacity.

(c) The remuneration or commission drawn by him from any other company.

(d) Professional qualifications and experience of the individual concerned.

(e) Such other matters as may be prescribed [Sec. 200].

Moreover, the Rules notified by the MCA also require that the Central Government or the company shall have regard to the following matters while fixing remuneration:

(a) The financial and operating performance of the company during the 3 preceding financial years.

(b) The relationship between remuneration and performance.

(c) The principle of proportionality of remuneration within the company, ideally by a rating methodology which compares the remuneration of directors to that of other directors on the Board who receive remuneration and employees or executives of the company.

(d) Whether remuneration policy for directors differs from remuneration policy for other employees and if so, an explanation for the difference.

(e) The securities held by the director, including options and details of the shares pledged as at the end of the preceding financial year.

6. Forms of and Procedure as to Certain Applications: Every application made to the Central Government in relation to appointment and remuneration of managerial personnel shall be in Form No. MR-2 and shall be accompanied by prescribed fee.

Before any such application is made, there shall be issued by or on behalf of the company a general notice to the members of the company, indicating the nature of the application proposed to be made. Such notice shall be published at least once in a newspaper in the principal language of the district of the registered office of the company and circulating in that district and at least once in English in an English newspaper circulating in that district. The copies of the notices, together with a certificate by the company as to the due publication thereof, shall be attached to the application [Sec. 20 1(2) and (3) and Rule MR-6 and 7].

COMPUTATION OF PROFITS

The net profits for the purposes of managerial remuneration (Section 197) shall be computed in the manner referred to in Section 198. According to Section 198, the manner of computation consists of the following stages:

(a) Credit shall be given for the sums specified in Sub-Section (2).

(b) Credit shall not be given for those specified in Sub-Section (3)

(c) The sums specified in Sub-Section (4) shall be deducted.

(d) The sums specified in Sub-Section (5) shall not be deducted [Sec. 198(1)].

These stages (Sub-Sections) are explained in the ensuing paragraphs.

1. Credit for Bounties and Subsidies: In computing the net profits for the purpose of payment of managerial remuneration, credit shall be given for the bounties and subsidies received from any Government, or any public authority (constituted or authorized in this behalf, by any Government) unless and except in so far as the Central Government otherwise directs [Sec. 198(1) and (2)].

2. Credit not to be given: In making the computation of profits, credit shall not be given for the following sums:

(a) Profits, by way of premium on shares or debentures of the company which are issued or sold by the company.

(b) Profits on sales by the company of forfeited shares.

(c) Profits of capital nature including profits from the sale of undertaking or any of the undertakings of the company or of any part of it.

(d) Profits from the sale of any immovable property or fixed assets of capital nature comprised in the undertaking or any of the undertakings of the company. Such profits shall not be considered where the business of the company consists, whether wholly or partly, of buying and selling any such property or assets. However, where the amount for which any fixed asset is sold exceeds its written-down value, credit shall be given for so much of the excess as is not higher than the difference between the original cost of that fixed asset and its written-down value.

(e) Any change in carrying amount of an asset or of a liability recognized in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value [Sec. 198(3)].

3. Sums to be Deducted: In making the computation of profits, the following sums shall be deducted:

(a) All the usual working charges.

(b) Directors' remuneration.

(c) Bonus or commission paid or payable to any member of the company's staff or to any engineer, technician or person employed or engaged by the company, whether on a whole-time or on a part-time basis.

(d) Any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profits.

(e) Any tax on business profits imposed for special reasons or in special circumstances and notified by the Central Government in this behalf.

(f) Interest on debentures issued by the company.

(g) Interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets.

(h) Interest on unsecured loans and advances.

(i) Expenses on repairs to immovable or to movable property provided the repairs are not of a capital nature.

(j) Outgoings inclusive of contributions made (under Section 181) to bona fide and charitable funds.

(k) Depreciation to the extent specified in Section 123.

(l) The excess of expenditure over income, which had arisen in computing the net profits in accordance with this Section in any year in so far as such excess has not been deducted in any subsequent year preceding the year in respect of which the net profits have to be ascertained.

(m) Any compensation or damages to be paid by virtue of any legal liability including a liability arising from a breach of contract.

(n) Any sum paid by way of insurance against the risk of meeting any liability such as referred to in the above clause.

(o) Debts considered bad and written off or adjusted during the year of account [Sec.198(4)]

4. Sums not to be Deducted: In making the above computation, the following sums shall not be deducted:

(a) Income tax and super tax payable by the company under the Income Tax Act or any other tax on the income of the company not falling under Section 198(4) (d) and (e) above.

(b) Any compensation, damages or payments made voluntarily, that is to say, otherwise than in virtue of a liability such as is referred to in Section 198(4) (m) above.

(c) Loss of a capital nature including loss on sale of the undertaking or any of the undertakings of the company or of any part thereof not including any excess of the written-down value of any asset which is sold, discarded, demolished or destroyed over its sale proceeds or its scrap value.

(d) Any change in carrying amount of an asset or of a liability recognized in equity reserves including surplus in profit and loss account on measurement of the asset or the liability at fair value [Sec. 198(5)].

PROVISIONS OF PART II AND IN OF SCHEDULE V

Remuneration payable without approval of the Central Government: Parts II and III of Schedule V contain the limits of remuneration payable to managerial persons without approval of the Central Government. These may be described under the following heads:

I. Remuneration payable by companies having profits: Section I of the Schedule V.

II. Remuneration payable by companies having no profits or inadequate profits without Central Governments' approval: Section II of the Schedule V.

III. Remuneration payable by companies having no profits or inadequate profits without Central Government's approval in certain special circumstances: Section III of the Schedule V.

IV. Perquisites not included in managerial remuneration: Section IV of the Schedule V.

V: Remuneration payable to a managerial person in two companies: Section V of the Schedule V.

Remuneration Payable by Companies having Profits: Subject to the provisions of Sections 197, a company having profits in a financial year may pay any remuneration to a managerial person or persons not exceeding the limits specified in such Section.

Remuneration Payable by Companies Having No Profits or Inadequate Profits without Central Government's Approval: Where in any financial year during the currency of tenure of a managerial person, a company has no profits or its profits are inadequate, it may, without Central Government's approval, pay remuneration to the managerial person not exceeding the higher of the limits prescribed under Scheme (A) and B) given below: The Scheme (A) is as follows:

Where the Effective Capital is	Limit of Yearly Remuneration Payable shall not Exceed (`)
(i) Negative or less than 5 crore	30 lakh

(ii) 5 crore and above but less than 100 crore	42 lakh
(iii) 100 crore and above but less than 250 crore	60 lakh
(iv) 250 crore and above	60 lakh plus 0.01 per cent of the effective capital in excess of ` 250 crore.

However, the above limits shall be doubled if the resolution passed by the shareholders is a special resolution.

Explanation: It is hereby clarified that for a period less than one year, the limits shall be prorated.

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Scheme (B): In case of a managerial person who was not a security holder, holding securities of the company of nominal value of ` 5 lakh or more or an employee or a director of the company or not related to any director or promoter at any time during 2 years prior to his appointment as a managerial person (2.5 per cent of the current relevant profit).

However, if the resolution passed by the shareholders is a special resolution, this limit shall be doubled. The limits specified under this Section shall apply to the companies other than listed companies and their subsidiaries in the following cases:

(a) The payment of remuneration is approved by a resolution passed by the Board and, in the case of a company covered under Section 178(1) also by the Nomination and Remuneration Committee.

(b) The company has not made any default in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in the preceding financial year before the date of appointment of such managerial person.

(c) A special resolution has been passed at the general meeting of the company for payment of remuneration for a period not exceeding 3 years.

(d) A statement along with a notice calling the general meeting referred to in clause (iii) is given to the shareholders containing the information specified in Section II of Part II of the Schedule V including reasons and justification for payment of remuneration beyond the said limit.

Remuneration Payable by Companies having no Profit or Inadequate Profit without Central Government's Approval in Certain Special Circumstances: In the following circumstances a company may, without the Central Government's approval, pay remuneration to a managerial person in excess of the amounts provided in Section II above:

(a) Where the remuneration in excess of the limits specified in Section I or II is paid by any other company and that other company is either a foreign company or has got the approval of its shareholders in general meeting to make such payment, and treats this amount as managerial remuneration for the purpose of Section 197 and the total managerial remuneration payable by such other company to its managerial persons including such amount or amounts is within permissible limits under Section 197.

(b) A company may pay remuneration up to two times the amount permissible under Section II in the following cases:

(i) Where the company is a newly incorporated company, for a period of 7 years from the date of its incorporation.

(ii) Where the company is a sick company, for whom a scheme of revival or rehabilitation has been ordered by the Board for Industrial and Financial Reconstruction or National Company Law Tribunal, for a period of 5 years from the date of sanction of scheme of revival.

(c) Where remuneration of a managerial person exceeds the limits in Section II but the remuneration has been fixed by the Board for Industrial and Financial Reconstruction or the National Company Law Tribunal.

(d) A company in a Special Economic Zone as notified by the Department of Commerce from time to time which has not raised any money by public issue of shares or debentures in India and has not made any default in India in repayment of any of its debts (including public deposits) or debentures or interest payable thereon for a continuous period of 30 days in any financial year, may pay remuneration up to ` 2.40 crore per annum.

Perquisites Not Included in Managerial Remuneration

1. A managerial person shall be eligible for the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II and Section III

(a) Contribution to provident fund, superannuation fund or annuity fund to the extent these either singly or put together are not taxable under the Income Tax Act, 1961.

(b) Gratuity payable at a rate not exceeding half a month's salary for each completed year of service

(c) Encashment of leave at the end of the tenure

2. In addition to the perquisites specified, above an expatriate managerial person (including a non-resident Indian) shall be eligible to the following perquisites which shall not be included in the computation of the ceiling on remuneration specified in Section II or Section III:

(a) Children's Education Allowance: In case of children studying in or outside India, an allowance limited to a maximum of ₹ 12,000 per month per child or actual expenses incurred, whichever is less. Such allowance is admissible up to a maximum of two children.

(b) Holiday Package for Children Studying Outside India or Family Staying abroad: Return holiday package once in a year by economy class or once in two years by first class to children and to the members of the family from the place of their study or stay abroad India if they are not residing in India, with the managerial person.

(c) Leave Travel Concession: Return package for self and family in accordance with the rules specified by the company where it is proposed that the leave be spent in home country instead of anywhere in India.

For the purposes of this Schedule, 'family' means the spouse, dependent children and dependent parents of the managerial person.

8.8 SUMMARY

The power to borrow in the case of a company is generally specified in the Memorandum or in the Articles of a company. A public company having share capital cannot exercise borrowing power unless certificate of commencement of business is obtained. A company cannot borrow in excess of its paid up capital and free reserves. Again, a company cannot borrow without or beyond its express or implied powers, otherwise such a borrowing is ultra vires and is void. If the borrowing is ultra vires, the lender in equity has the rights of injunction, recovery, subrogation and suit against directors. Companies Act requires charges to be registered with the Registrar of Companies. The debt in respect of which the charge is created remains valid and can be recovered as an insecured debt. A charge created on specific property of permanent nature is called as fixed charge. Overall, managerial remuneration payable by a public company shall not exceed 11% of the net profit of the company for that financial year. However, company in general body meeting with the approval of Central Government may pay higher remuneration subject to regulations.

8.9 KEYWORDS

Mortgage: It is a transfer of interest in immovable property for securing payment of a debt.

Charge: It is a means of providing security for repayment of debt in the form of present or future title to movable or immovable property.

Floating Charge: It is an equitable charge on the floating assets of the company.

Managerial Remuneration: It is the remuneration payable to managerial personnel of a company.

8.10 SELF ASSESSMENT QUESTIONS

1. Explain the provisions of Companies Act regarding payment of managerial remuneration.
2. Explain the limits of remuneration of managing director mentioned in Schedule V of the Companies Act.
3. State the legal provisions as to borrowing powers of a company and discuss the consequences of ultra vires borrowings.
4. Define charge. Distinguish between fixed and floating charge and state the circumstances when the floating charge becomes fixed charge.
5. What are the charges whose registration is compulsory? What are the consequences of non-registration of charges?

8.11 SUGGESTED READINGS

- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.
- Avtar Singh, Company Law, Eastern Book Company, Lucknow.
- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.
- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.

LESSON 9

WINDING UP OF COMPANIES

Structure

9.0 OBJECTIVES

After going through the present lesson, you should be able to:

- Define winding up of a company and distinguish it with dissolution.
- List the grounds of compulsory winding up
- Identify the person entitled to file petition for winding up
- Describe the procedure of winding up by the Tribunal
- Explain the consequences of Compulsory winding up.
- Describe the provisions regarding voluntary winding up.
- List the provisions applicable to every mode of winding up.

9.1 INTRODUCTION

A company is an artificial person incorporated under the Companies Act. Its affairs can be put to an end by complying with a process prescribed under the same Act. This process is known as the process of winding up of companies.

9.2 MEANING OF WINDING UP

Winding up and liquidation are the two terms which are generally used to represent the last stage of the life of a company. Winding up means a process that leads to the dissolution of a company. It is a process whereby the existence of a company is brought to an end by gradually putting an end to the affairs of the company's business.

Prof. Gower defines, "Winding up of a company is a process whereby its life is ended and its property is administered for the benefit of its creditors and members. An administrator, called liquidator is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights."

According to A. Ramaiya, "Winding up is a means by which the dissolution of a company is brought about and its assets realized and applied in payment of its debts and after satisfaction of the debts, the balance, if any, is paid back to the members in proportion to the contribution made by them to the capital of the company."

Thus, winding up is a process by which the dissolution of a company is brought about. This process is carried out by a liquidator. He is appointed to realize the assets, pay the debts of the company out of the assets so realized and to distribute the surplus, if any, among the members of the company.

It should be noted that a company is not dissolved as soon as with commencement of winding up of the company. Winding up of a company is the first step towards dissolution of the company. In between winding up and dissolution, the legal existence of the company remains in force. Therefore, it is liable for taxes and other liabilities. Winding up of a company does not imply insolvency of the company. A perfectly solvent company can also be wound up if its members so desire. Moreover, a company cannot be adjudged insolvent under the insolvency laws.

9.3 MODES OF WINDING UP

A company may be wound up in any of the following ways:

I. Winding up by the Tribunal or compulsory winding up.

II. Voluntary winding up.

9.3.1 Winding up by Tribunal/Compulsory winding up

A company may be wound up by an order of the Tribunal. This mode of winding up is also known as compulsory winding up of a company.

Grounds for Winding Up

A company may be wound up by the Tribunal on any of the following grounds:

1. If the company is unable to pay its debts.
2. If the company has passed a special resolution for its winding up by the Tribunal. However, the Tribunal is not bound to order of winding up only because the company has so resolved. The Tribunal shall consider the interest of the company as well as of public before making such an order.
3. If the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality.
4. If the Tribunal has ordered the winding up of the company because it is a sick company.
5. If an application has been made by the Registrar or any other person authorized by the Central Government by notification under this Act, the Tribunal may order for winding up of a company. The Tribunal shall make such an order in any of the following cases:
   (a) If the affairs of the company have been conducted in a fraudulent manner.
   (b) If the company was formed for fraudulent and unlawful purpose.
   (c) If the persons concerned in the formation or management of affairs of the company have been found guilty of fraud, misfeasance or misconduct in connection therewith.
6. If the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding 5 consecutive financial years.
7. If the Tribunal is of the opinion that it is just and equitable that the company should be wound up [Sec. 27 1(1)].

It may be noted that the power of the Tribunal is discretionary. Hence, it may or may not exercise its powers.

Company's Inability to Pay its Debts

A company shall be deemed to be unable to pay its debts in the following cases:

1. Failure to Pay on Demand: Sometimes, a creditor, to whom the company is indebted for an amount exceeding ` 1 lakh, serves on the company a demand for payment of the amount. Thereafter, the company fails to pay the sum within 21 days after the receipt the creditor. In such a case, the company shall be deemed to be unable to pay. However, of such demand or to provide adequate security etc., to the reasonable satisfaction of the demand notice should have been served on the company at its registered office, by registered post or otherwise [Sec. 271(2)(a)].

2. Unsatisfied Decreed Debt: A company shall also be deemed to be unable to pay its debts if execution or other process issued on a decree or order of any Court or Tribunal in favour of a creditor of the company is returned unsatisfied in whole or in part [Sec.271(2) (b)].

3. Proving Inability to Pay Debts or Commercial Insolvency: A company shall also be deemed to be unable to pay its debts if it is proved to the satisfaction of the Tribunal that the company is unable to pay its debts. In determining whether a company is unable to pay its debts, the Tribunal shall take into account the contingent and prospective liabilities of the company [Sec. 271(2)(c)]. If a company cannot prove that its assets are sufficient to meet its liabilities within a reasonable time, the company may be considered as commercially insolvent company.

It may be pointed out that the Tribunal may also take in to account the public interest while deciding the ground of inability to pay the debts.

Just and Equitable Reason for Winding Up

The Tribunal may also order the winding up of a company, if the Tribunal is of opinion that it is just and equitable that the company should be wound up [Sec. 271(1)(f)]. The discretionary powers given to the Tribunal under this clause are very wide. The Tribunal may order winding up of a company whenever it appears to it just and equitable. What is just and equitable is a question of fact and decided upon the circumstances of each case. But generally while passing an order under this clause, the Tribunal takes into consideration the interest of the company, its employees, creditors, shareholders and the society in general. Where a petition for winding up is presented on the ground of just and equitable reason, the Tribunal may refuse to make an order of winding up in the following cases:

(i) If the Tribunal is of the opinion that some other remedy is available to the petitioners.

(ii) If the Tribunal is of the opinion that the petitioners are acting unreasonably in seeking the winding up of the company instead of pursuing the other remedy [Sec. 273(2)].

Thus, where a petition is made on this ground, the Tribunal also considers the other remedies available to the petitioners. Winding up order is in the nature of last resort when other remedies are not enough to protect the interests of the all the concerned. The following are some of the reasons on the basis of which the Tribunal have in the past ordered for winding up of companies on just and equitable grounds:

1. Deadlock in management: Where there is a total deadlock in the management of a company and there is no other practical remedy, the Tribunal may order a winding up.

Example: There were only two shareholders and directors in a private company with equal voting rights. The relationship of trust and confidence between them broke down to such an extent that one would not speak to the other. There was no means of over ruling the actions of them. On such situation of complete deadlock, the company was ordered to be wound up.

2. Loss of Substratum: Where the substratum of a company has lost, it is just and equitable to wind up the company. The substratum of a company shall be deemed to have lost in the following cases:

(a) Where the Subject Matter or Basis of Survival of Company is Lost: For instance, if a company has lost its only ship or if a company's entire assets are seized by a lender, the subject matter is said to be lost. It is just and equitable that the company be wound up.

(b) Where Main Object Fails: Where main object for which a company is incorporated has substantially failed, it is just and equitable that the company should be wound up. For instance, a company was formed for the purpose of manufacturing coffee under a German patent. However, the incidental object allowed the company to manufacture coffee under other patents. The company could not get the German patent but started manufacturing coffee under other patents. Held, it was just and equitable that the company be wound up [German Date Coffee Co, re, (1882) 20 Ch D 169].

3. Losses: Where it is impossible to carry on the business of the company except at a loss, it is just and equitable that the company be wound up.

4. Oppression of Minority: Sometimes, the directors of a company abuse their power to such an extent which seriously prejudices the interests of minority shareholders. In such a case, it will be a just and equitable ground for winding up the company.

5. Fraudulent or Illegal Purpose: If a company has been formed to carry out any fraudulent or illegal purpose, it is also a just and equitable ground to wind up the company. For example, if a company is formed for the sole purpose of conducting a lottery, it is illegal purpose. It may be ordered to be wound up.

6. Public Interest: Where public interest demands, the Tribunal may order winding up of a company. For example, if a company is wasting capital resources of the country, it may be ordered to be wound up.

7. Failure to Pay Dividend: Failure to meet the reasonable expectation of members to receive dividend can provide a ground for winding up.

8. Bubble Company: A company which does not have any business or assets or has no proper foundation is a bubble company or 'fly-by-night' company. Such a company is formed by the directors to rob the money of public and put it in their pocket. It is also a just and equitable ground for winding up of a company.

PERSONS ENTITLED TO FILE PETITION WTH TRIBUNAL

A petition for winding up of a company by the Tribunal may be presented to the Tribunal by any of the following [Sec. 272(1)]:

1. The Company Itself: A company may present a petition for its winding up, if the shareholders have passed a special resolution to this effect [Sec. 27 1(1)]. In the absence of any such resolution, winding up petition cannot be filed with the Tribunal even if almost all the members are in favour of winding up of the company. Moreover, the petition should be filed by a person authorised by the Board of directors.

Sometimes, a company becomes bound to apply to the Tribunal for winding up. Such a situation arises when at the meeting of creditors held for voluntary winding up two- thirds in value of creditors of the company are of the opinion that the company may not be able to pay its debts in full from the sale proceeds of assets. Therefore, two-third in value of the creditors passes a resolution that it shall be in the interest of all the parties if the company is wound up by the Tribunal. Then the company is bound to file a petition before the Tribunal within 14 days of such resolution [Sec. 306 (3)]. In such a case, any person authorized by the Board of directors may make a petition even without passing a special resolution for such winding up.

Condition for admission of petition by company: A petition presented by the company for winding up before the Tribunal shall be admitted only if it is accompanied by a statement of affairs in such form and in such manner as may be prescribed [Sec. 272(5)].

2. Creditor or Creditors: A petition for winding up of a company may be presented to the Tribunal by any creditor or creditors of the company. The term creditor includes contingent or prospective creditor(s). Moreover, the term creditors also includes (a) secured creditors, (b) debenture-holders, and (c) trustees for the debenture-holders [Sec. 272(2)]. Therefore, these persons may also file petition for winding up of the company. But where a creditor's debt is bonafide disputed by the company, the Tribunal shall not consider the petition of such creditor for an order for winding up. It should be noted that a petition for winding up of a company presented by a contingent or prospective creditor shall be admitted only if prior leave of the Tribunal is obtained for the admission of the petition. Such leave shall not be granted unless in the opinion of the Tribunal there is a *prima facie* case for the winding up of the company. Moreover, such leave shall not be granted until such security for costs has been given as the Tribunal thinks reasonable [Sec. 272(6)].

3. Contributory or Contributories: In the event of winding up, the shareholders of the company are included in contributories. Any contributory or contributories may present petition for winding up [Sec. 27 2(1)]. A contributory shall be entitled to present a petition for the winding up of a company if the following conditions are satisfied:

(a) The shares or some of the shares in respect of which he is contributory, were originally allotted to him.

(b) He has been registered holder of the shares for at least 6 months out of the 18 months immediately before the commencement of the winding up.

(c) The shares have devolved on him through the death of a former holder [Sec. 272(3)].

A contributory is entitled to present a petition for winding up even in the following cases:

(i) He may not be a holder of fully paid-up shares.

(ii) The company may have no assets at all.

(iii) The company may have no surplus assets left for distribution among the shareholders after the satisfaction of its liabilities [Sec. 272(3)].

A contributory whose calls are in arrears may be allowed to present a petition for winding up provided he pays the calls or satisfies the Tribunal that he is willing to pay.

4. Joint Petition: A petition for the winding up of a company may be presented by all or jointly by any of the following parties:

(a) The company.

(b) Any creditor or creditors.

(c) Any contributory or contributories [Sec. 271(l)(d)].

5. The Registrar: The Registrar may file petition for the winding up of a company in the following cases:

(a) Where it appears to the Registrar that the company is unable to pay its debts. It may appear to the Registrar either from the financial condition of the company as disclosed in its balance sheet or from the report of an inspector appointed (under Section 210) for inspection and inquiry.

(b) Where the company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality.

(c) Where the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purpose etc.

(d) Where the company has made a default in filing with the Registrar its financial statements or annual returns for immediately preceding 5 consecutive financial years [Sec. 272(4)].

The Registrar shall obtain prior sanction of the Central Government for the presentation of the petition on any of the above stated grounds. However, the Central Government shall not accord its sanction unless the company has been given a reasonable opportunity of making representation [Sec. 272(4)].

6. Person Authorized by Central Government: If any person is authorized by the Central Government, he may present a petition for winding up on behalf of the Central Government [Sec. 272(1)(f)].

7. Central or State Government: Sometimes, it is found that a company has acted against the interests of the sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality. In such a case, a petition for winding up of the company may be presented to the Tribunal by the Central Government or by a State Government [Sec. 272(l)(g)].

Filing Copy of the Petition with Registrar

A copy of the petition made to the Tribunal for winding up shall also be filed with the Registrar. The Registrar shall in turn submit his views to the Tribunal within 60 days of receipt of such petition [Sec. 272(7)].

COMMENCEMENT OF WINDING UP BY TRIBUNAL

Sometimes, a resolution is passed by a company for its winding up by the Tribunal before the presentation of a petition to the Tribunal. In such a case, winding up of the company shall be deemed to have commenced at the time of passing of the resolution [Sec. 357]. But when a winding up petition is made by a person other than the company, the winding up shall be deemed to have commenced from the time of presentation of petition and not from the date of winding up order. If the Tribunal dismisses the petition, winding up does not commence.

Sometimes, more than one petition is filed with the Tribunal for an order of winding up of a company. In such a case, winding up shall be deemed to have commenced from the date of earliest petition even through the first petition was dismissed. All the proceedings before the order of the Tribunal shall be deemed to have been validly taken unless proof of fraud or mistake is produced [Sec. 357].

PROCEDURE OF WINDING UP BY TRIBUNAL

The procedure for winding up by the Tribunal is as follows:

1. Petition: The first step towards winding up by the Tribunal is the presentation of the petition for winding up. A petition may be presented by any of the following persons:

(a) By the company, if it has passed a resolution to this effect.

(b) By any creditor or creditors including any contingent or prospective creditor or creditors.

(c) By any contributory or contributories.

(d) By all or jointly with any of the persons specified above.

(e) By the Registrar.

(f) By any person authorized by the Central Government in that behalf.

(g) By the Central Government or a State Government [Sec. 272(1)].

2. Order by Tribunal: On receipt of a petition for winding up of a company, the Tribunal has the power to pass any of the following orders:

(a) To dismiss it with or without costs.

(b) To make any interim order as it thinks fit.

(c) To appoint a provisional liquidator of the company till the making of a winding up order.

(d) To make an order for the winding up of the company with or without costs.

(e) To make any other order as it thinks fit.

The Tribunal is bound to make any of such orders within 90 days from the date of presentation of the petition. It should be noted that while making an order for winding up, the Tribunal shall consider the following facts:

(i) That it cannot refuse to make a winding up order on the ground only that the assets of the company have been mortgaged for an amount equal to or in excess of those assets, or that the company has no assets [Sec. 273(1)].

(ii) It has a power to refuse to make a winding up order if it of the opinion that some other remedy is available to the petitioners. This power is available when a petition is presented on the just and equitable ground [Sec. 273(2)].

It should be noted that the Tribunal may direct the petitioner to deposit such security for costs as it may consider reasonable. In such a case, petitioner will have to deposit the security accordingly. The Tribunal before making an order for winding up of the company shall comply with the provisions stated in the points 3 to 5 given in the ensuing paragraphs.

3. Notice to Company and Appointment of Provisional Liquidator: Sometimes, the Tribunal considers the option to make an order for appointment of a provisional liquidator till the making of a winding up order. In such a case, the Tribunal before appointing a provisional liquidator shall give notice to the company and afford a reasonable opportunity to it to make its representations, if any. However, the Tribunal may not give such opportunity if it thinks fit to do so for special reasons. But such reasons have to be recorded in writing [Sec. 273(1)].

4. Issue of Directions to Company: Sometimes, a petition for winding up is filed before the Tribunal by any person other than the company. In such a case, if the Tribunal is satisfied that a *prima facie* case for winding up of the company is made out, it may direct the company to file the following within 30 days:

(i) Its objections against the petition.

(ii) A statement of its affairs.

The Tribunal may allow a further period of 30 days in a situation of contingency or special circumstances [Sec. 274(1)].

5. Filing Objections and a Statement of Affairs: Now it is the turn of the company to file its objections against the petition along with a statement of its affairs. These shall be filed within 30 days (or extended period of further 30 days) of the order in the prescribed form and manner. If a company fails to file its objections along with the statement of affairs, it shall not be any more entitled to oppose the petition [Secs. 274(1) and (2)]. Sometimes, a company itself files a petition for its winding up. In such a case, the petition must be accompanied by a statement of affairs without which the petition shall not be admitted by the Tribunal [Sec. 272(5)].

6. Appointment of Company Liquidator: In case the Tribunal makes an order for winding up, it shall appoint a Company Liquidator for the conduct of the proceedings for the winding up of the company. The Tribunal shall appoint an Official Liquidator or a liquidator from the panel maintained by the Central Government, as the Company Liquidator. If the Tribunal has appointed a provisional liquidator, it may appoint him as the Company Liquidator [Secs. 275(1) and (7)].

7. Intimation to Company Liquidator and Registrar: Where the Tribunal makes an order for the winding up of a company, it shall cause intimation thereof to be sent to the Company Liquidator and the Registrar within 7 days from the date of the order [Sec. 277(1)].

8. Endorsement in Records of Company and Notification in Gazette and to Stock Exchange: On receipt of the copy of the winding up order, the Registrar shall make an endorsement to that effect in his records relating to the company. He shall also notify in the Official Gazette that such an order has been made. In the case of a listed company, the Registrar shall also intimate about such order to the stock exchange(s) where the securities of the company are listed [Sec. 277(2)].

9. 'Winding Up Committee' and its Report: Within 3 weeks from the date of passing of winding up order, the Company Liquidator shall make an application to the Tribunal for constitution of a 'Winding Up Committee'. This Committee shall assist and monitor the progress of liquidation proceedings by the Company Liquidator in carrying out his functions [Sec. 277(4)].

10. Appointment of 'Advisory Committee': The Tribunal may, while passing an order of winding up, direct that there shall be an 'Advisory Committee'. In such a case, it shall appoint the Committee. The Committee shall advise the Company Liquidator and report to the Tribunal on such matters as it may direct [Sec. 287].

Consequences of Winding up Order by Tribunal

The following shall be the consequences of winding up order made by the Tribunal:

1. Intimation to Company Liquidator and Registrar: Where the Tribunal makes any order for winding up of a company, it shall cause intimation of the order to the following:

(i) The Company Liquidator or provisional liquidator.

(ii) The Registrar.

The intimation shall be sent within a period not exceeding 7 days from the date of passing of the order [Sec. 277(1)].

2. Registrar to Perform Certain Duties: On receipt of the copy of order of appointment of provisional liquidator or winding up order, the Registrar shall perform the following duties:

(i) Make an endorsement to that effect in his records relating to the company.

(ii) Notify in the Official Gazette that such an order has been made.

(iii) In the case of a 1ised company, the Registrar shall intimate about such an appointment or order to the stock exchange (s) where the securities of the company are listed [Sec. 277(2)].

3. Stay of Suits, etc., on Winding up Order: On passing of a winding up order or on appointment of a provisional liquidator, no suit or other legal proceedings shall be commenced. If any suit is pending on the date of the winding up order, it shall be proceeded with by or against the company only with the leave of the Tribunal [Sec. 279].

4. Directors to Submit Books of Accounts to the Liquidator: The directors and other officers of the company within a period of 30 days of such order, submit the books of account of the company to the Company Liquidator. These shall be completed and audited up to the date of the order and be in the manner specified by the Tribunal [Sec. 274 (3)].

5. Custody of Company's Properties to Company Liquidator: The Company Liquidator shall on the order of the Tribunal, forthwith take into his custody or control all the property, effects and actionable claims to which the company is or appears to be entitled to. He shall also take all necessary steps and measures to protect and preserve the properties of the company [Sec. 283(1)].

6. Deemed Notice of Discharge of Officers, Employees etc.: The winding up order shall be deemed to be a notice of discharge to the officers, employees and workmen of the company except when the business of the company is continued [Sec. 277(3)]. It may be noted that a company is not deemed to be continuing the business when the business is carried on by the liquidator for the beneficial winding up of the company.

7. Board's Powers Come to an End: On passing of a winding up order, the powers of the Board shall come to an end. The Company Liquidator shall be entitled to exercise the powers of the Board to carry on the business of the company for the beneficial winding up of the company [Sec. 290].

8. Monthly Report by Liquidator: The Company Liquidator shall place before the Tribunal a report along with minutes of the meetings of the Winding Up Committee. Such report shall be placed on monthly basis till the final report for dissolution of the company is submitted before the Tribunal [Sec. 277(6)].

9. Order to Operate in Favour of All Creditors and Contributories: The order for winding up of a company shall operate in favour of all the creditors and all contributories of the company. The order shall have effect as if it had been made out on the joint petition of creditors and contributories [Sec. 278].

10. Effect on Creditors where the Company is Solvent: Where a solvent company is being wound up, all debts payable on a contingency and all claims against the company (present or future, certain or contingent, ascertained or sounding only in damages) shall be admissible to proof against the company. A just estimate shall be made so far as possible, of the value of such debts or claims as may be subject to any contingency or may sound only in damages [Sec. 324].

11. Effect on Creditors where the Company is Insolvent: In case of an insolvent company (i.e. a company which is unable to pay its debts), the same rules shall prevail and be observed as are applicable under the law of insolvency with respect to the estate of insolvent person with regard to the following:

(a) Debts provable.

(b) The valuation of annuities and future and contingent liabilities.

(c) The respective rights of secured and unsecured creditors.

However, the security of every secured creditor shall be deemed to be subject to a *pari passu* charge in favour of the workmen to the extent of the workmen's portion therein. Where a secured creditor, instead of relinquishing his security and proving his debts, opts to realize his security, the consequences shall be as follows:

(i) The liquidator shall be entitled to represent the workmen and enforce such charge.

(ii) Any amount realized by the liquidator by way of enforcement of such charge shall be applied ratably for the discharge of workmen's dues.

(iii) So much of the debts due to such secured creditor as could not be realized by him or the amount of the workmen's portion in his security, whichever is less, shall rank *pari passu* with the workmen's dues.

All persons stated above shall be entitled to prove and receive dividends out of the assets of the company under winding up and make such claims against the company as they are entitled to make. Sometimes, secured creditor instead of relinquishing his security and proving his debts, proceeds to realize his security. In such cases, he shall be liable to pay his portion of the expenses incurred by the liquidator for the preservation of the security before its realization by the secured creditor [Sec. 325].

12. Effect of Floating Charge: Sometimes, a floating charge on the undertaking or property of the company is created within the 12 months immediately preceding the commencement of its winding up. Such charge shall be invalid unless it is proved that the company immediately after the creation of the charge was solvent or any cash in consideration of the charge was paid to the company at the time of or subsequent to its creation [Sec. 332].

13. Statement as to Winding up on Documents: During the course of winding up/liquidation, documents like invoices, orders for goods or business letters are issued by or on behalf of the company or by a Company Liquidator etc. Any such document on or in which the name of the company appears, shall contain a statement that the company is being wound up. If a company contravenes this provision, the company, and every officer of the company, the Company Liquidator and any receiver or manager, who wilfully authorises or permits the non-compliance, shall be punishable with fine which shall not be less than ` 50,000 but which may extend to ` 3 lakh [Sec. 344].

14. Disposal of Property, Transfer of Shares and Alteration of Status of Members shall be Void: In case of winding up by the Tribunal, any disposition of the property (including actionable claims) of the company, and any transfer of shares in the company or alteration in the status of its members made after the commencement of the winding up, shall be void unless the Tribunal otherwise orders [Sec. 334(2)].

15. Certain Attachments, Executions, etc., to be Void: After the commencement of winding up by the Tribunal, following attachments, executions etc., shall be void:

(i) Any attachment, distress or execution put in force, without leave of the Tribunal against the estate or effects of the company.

(ii) Any sale held, without leave of the Tribunal of any of the properties or effects of the company.

However, nothing in this section shall apply to any proceedings for the recovery of any tax or impost or any dues payable to the Government [Sec. 335].

16. Inspection of Books and Papers by Creditors and Contributories: After winding up order by the Tribunal, any creditor or contributory of the company may inspect the books and papers of the company only in accordance with and subject to the prescribed Rules. However, nothing shall exclude or restrict any such rights conferred on any of the following:

(i) On the Central Government or a State Government.

(ii) On any authority or officer thereof.

(iii) On any person acting under the authority of any such Government or of any such authority or officer [Sec. 346].

DISSOLUTION OF COMPANY

Dissolution is that stage of a company when the business affairs of the company have been completely wound up. On dissolution, the existence of the company legally comes to an end. On dissolution, the company's name is struck off by the Registrar from the register of companies. The provisions of the Act with respect to dissolution of a company by the Tribunal are as follows:

1. Time of Application for Dissolution: When the affairs of a company have been completely wound up, the Company Liquidator shall make an application to the Tribunal for dissolution of the company [Sec. 302(1)].

2. Order for Dissolution: The Tribunal makes an order for dissolution of the company in the following cases:

(i) When an application for dissolution is filed by the Company Liquidator.

(ii) When the Tribunal is of the opinion that it is just and reasonable in the circumstances of the case to order for the dissolution of the company.

When the Tribunal makes such an order, the company is dissolved from the

date of the order [Sec. 302(2)1.

3. Filing Copy of the Order with Registrar: A copy of the order shall be forwarded by the Company Liquidator to the Registrar within 30 days from the date of the order. The Registrar shall record in the register relating to the company a minute of the dissolution of the company [Sec. 302(3)].

4. Punishment: If the Company Liquidator makes a default in forwarding a copy of the order to the Registrar within 30 days from the date of the order, he shall be punishable with fine which may extend to ` 5,000 for every day during which the default continues [Sec 302(4)].

DISTINCTION BETWEEN WINDING UP AND DISSOLUTION

Distinction between winding up and dissolution has been enumerated in Table 9.1.

Table 9.1: Distinction between Winding up and Dissolution

Basis of Distinction	Winding up	Dissolution
1. Meaning	Winding up is a process whereby assets are realized, debts are paid off and surplus if any, is distributed among the members of the company.	Dissolution is that stage of a company when all steps of winding up are complete and business affairs of the company have been completely wound up.
2. Legal existence	During the process of winding up, legal existence of the company remains intact in the eyes of law.	Dissolution puts an end of the legal existence of the company.
3. Business affairs	During the course of winding up, a company may continue to carry on its business affairs as are necessary for beneficial winding up of the company.	No business affairs remain to be carried out on order of dissolution.
4. Decision	The final decision of winding up is taken either by the Tribunal or by both members and creditors of the company	The final decision of dissolution of a company is always taken by the Tribunal.

5. Company Liquidator	The process of winding up starts with the appointment of a Company Liquidator.	The appointment of Company Liquidator comes to an end on dissolution of the company.
6. Certification of debts	During the process of winding up any person can bring a claim of debt and the Company Liquidator shall pay the same.	After order of dissolution by the Tribunal, a debtor cannot get his claim certified.
7. Suit against company	During the process of winding up, a company may be sued in the court of law for taxes and other liabilities the same.	After dissolution, the company cannot be sued because it ceases to exist in the eyes of law.
8. Order	Winding up always precedes dissolution of the company.	Dissolution can never precede winding up the company.

COMPANY LIQUIDATOR

'Company Liquidator' is a person appointed as a Company Liquidator from a panel of professionals maintained by the Central Government by any of the following: -

(a) By the Tribunal in case of winding up by the Tribunal.

(b) By the company and creditors in case of voluntary winding up [Sec 2(23)].

Company Liquidator is an administrator appointed to take over control of the company. He realizes assets, pays its debts and distributes the surplus, if any, among the members of the company. A Company Liquidator while dealing with the winding up proceedings represents the company. He acts for and on behalf of the company. He can therefore, be said to be an officer of the company.

Provisional Liquidator

On receipt of a petition of winding up of a company, the Tribunal may appoint a provisional liquidator till the making of a winding up order. Before appointing a provisional liquidator, the Tribunal shall give a reasonable opportunity to the company to make its presentation [Sec. 273(1)]. The powers of provisiona1 liquidator shall be the same as those of the Company Liquidator unless restricted by the order appointing him [Sec. 275(3)].

Appointment of Company Liquidator

The provisions regarding appointment of Company Liquidator are as follows:

1. Appointment of Official Liquidator as Company Liquidator: For the purposes of winding up of a company by the Tribunal, the Tribunal at the time of passing of the order of winding up, shall appoint an Official Liquidator or a liquidator as the Company Liquidator [Sec.275(1)]. It should be noted that the Tribunal may appoint a provisional liquidator as the Company Liquidator for the conduct of the proceedings for the winding up of the company [Sec.275(7)].

2 Terms and Conditions of Appointment: The terms and conditions of appointment of a provisional liquidator or Company Liquidator and the fee payable to him shall be specified by the Tribunal. These shall be specified on the basis of task required to be performed, experience, qualification of such liquidator and size of the company [Sec. 275(5)].

3. Declaration by the Company Liquidator: On appointment as provisional liquidator or Company Liquidator, the liquidator shall file a declaration within 7 days from the date of appointment in the prescribed form. The declaration shall disclose the conflict of interest or lack of independence in respect of his appointment, if any, with the Tribunal. The obligation under the declaration shall continue throughout the term of his appointment [Sec. 275(6)].

Report by Company Liquidator

The provisions with respect to the report of Company Liquidator are as follows:

1. Report within Sixty Days: The Company Liquidator shall submit its report to the Tribunal within 60 days from the order of winding up.

2. Contents of the Report: The report shall contain the following particulars:

(a) The nature and details of the assets of the company. The details of assets shall include their location and value, cash balance in hand and in the bank, if any, and the negotiable securities, if any, held by the company. However, the valuation of the assets shall be obtained from registered valuers.

(b) Amount of capital issued, subscribed and paid-up.

(c) The existing and contingent liabilities of the company.

(d) The debts due to the company including the names, addresses and occupations of the persons from whom they are due and the amount likely to be realized on account thereof should also be given.

(e) Guarantees, if any extended by the company.

(f) List of contributories and dues, if any, payable by them and details of any unpaid call.

(g) Details of trademarks and intellectual properties, if any, owned by the company.

(h) Details of subsisting contracts, joint ventures and collaborations, if any.

(i) Details of holding and subsidiary companies, if any.

(j) Details of legal cases filed by or against the company.

(k) Any other information which the Tribunal may direct or the Company Liquidator may consider necessary to include [Sec. 281(1)].

3. Information about the Promotion of the Company, Fraudulent Acts of Promoters, etc.: The Company Liquidator shall include in his report the manner in which the company was promoted or formed. He shall also state in the report whether in his opinion any fraud has been committed by any person in its formation or by any officer of the company in relation to the company since its formation. Moreover, he shall also include in it any other matters which in his opinion are desirable to bring to the notice of the Tribunal [Sec. 281(2)].

4. Report on Viability of Business: The Company Liquidator shall also make a report on the viability of the business of the company or the steps which are necessary for maximizing the value of the assets of the company [Sec. 281(3)].

5. Any Other Report, if He Thinks Fit to Make: The Company Liquidator may also make any further report or reports [Sec. 281(4)].

6. Inspection and Copies/Extracts of the Report: Any creditor or a contributory of the company shall be entitled at all reasonable times to inspect the report submitted by the Company Liquidator. He shall also be entitled to take copies thereof or extracts there from on payment of the prescribed fees [Sec. 281(5)].

Tribunal's Directions on Report

The Tribunal is empowered to give directions or issue orders on the report of the Company Liquidator in the following matters:

1. Fixing Time Limit for Winding Up: The Tribunal shall on consideration of the report of the Company Liquidator fix a time limit within which the entire proceedings of winding up shall be completed and the company be dissolved. However, if the Tribunal is of the opinion that it will not be advantageous or economical to continue the proceedings, it may revise the time limit for completion of entire proceedings of winding up [Sec. 282(1)].

2. Order for Sale of the Company or its Assets: The Tribunal may order for sale of the company as a going concern or its assets or part thereof. Such an order may be made on examination of the reports submitted to it by the Company Liquidator and after hearing the Company Liquidator, creditors or contributories or any other interested person [Sec. 282(2)].

3. Order for Investigation and for Filing a Criminal Complaint: Sometimes, a report is received from the Company Liquidator or the Central Government or any person that a fraud has been committed in respect of the company. In such a case, the Tribunal shall, without prejudice to the process of winding up, order for investigation (Section 210). Moreover, on consideration of the report of such investigation it may pass order and give directions (under Sections 339 to 342) or direct the Company Liquidator to file a criminal complaint against persons who were involved in the commission of fraud [Sec. 282(3)].

4. Order to Take Steps to Protect or Enhance Value of Property: The Tribunal may order for taking all necessary steps and measures to protect, preserve or enhance the value of the assets of the company [Sec. 282(4)].

5. Any Other Order: The Tribunal may pass such other order or give such other directions as it considers fit [Sec. 282(5)].

POWERS OF COMPANY LIQUIDATOR

The Company Liquidator in a winding up of a company by the Tribunal has certain powers. These powers can be classified under the following two heads:

I. Powers exercisable with the direction of the Tribunal.

II. Powers exercisable with the direction of creditors or contributories.

I. Powers Exercisable with the Direction of the Tribunal

Following powers are exercisable subject to the overall control and direction of the Tribunal [Sec. 290(1)]:

1. To carry on the business of the company so far as may be necessary for the beneficial winding up of the company.
2. To do all acts and to execute, in the name and on behalf of the company, all deeds, receipts and other documents, and for that purpose, to use, when necessary, the company's seal.
3. To sell the immovable and movable property and actionable claims of the company by public auction or private contract with power to transfer such property to any person or body corporate or to sell the same in parcels.
4. To sell the whole of the undertaking of the company as a going concern.
5. To raise any money required on the security of the assets of the company.
6. To institute or defend any suit, prosecution or other legal proceeding, civil or criminal, in the name and on behalf of the company.
7. To invite and settle claims of creditors, employees or any other claimant and distribute sale proceeds in accordance with priorities established under this Act.
8. To inspect the records and returns of the company on the files of the Registrar or any other authority.
9. To prove rank and claim in the insolvency of any contributory for any balance against his estate, and to receive dividends in the insolvency, in respect of that balance, as a separate debt due from the insolvent, and rateably with the other separate creditors.
10. To draw, accept, make and endorse any negotiable instruments including cheque, bill of exchange, hundi or promissory note in the name and on behalf of the company.

11. To take out, in his official name, letters of administration to any deceased contributory, and to do in his official name any other act necessary for obtaining payment of any money due from a contributory or his estate which cannot be conveniently done in the name of the company.

12. To obtain any professional assistance from any person or appoint any professional, in discharge of his duties, obligations and responsibilities and for protection of the assets of the company. He shall also be empowered to appoint an agent to do any business which the Company Liquidator is unable to do himself.

13. To take all such actions, steps or to sign, execute and verify any paper, deed, document, application, petition, affidavit, bond or instrument as may be necessary for the following purposes:

    (i) For winding up of the company.

    (ii) For distribution of assets.

    (iii) In discharge of his duties, obligations and functions as Company Liquidator:

14. To apply to the Tribunal for such orders or directions as may be necessary for the winding up of the company [Sec. 290(1)].

15. To have professional assistance with the sanction of the Tribunal. The Company Liquidator may appoint one or more professionals to assist him in the performance of his duties and functions. Such professional may include chartered accountants, company secretaries, cost accountants, legal practitioners or such other professionals [Sec. 291(1)].

II. Powers Exercisable at the Direction of Creditors/Contributories

The following powers are exercisable in accordance with the directions/resolutions of creditors or contributories:

1. The Company Liquidator shall, in the administration of the assets of the company and the distribution thereof among its creditors, have regard to any directions which may be given by the resolution of the creditors or contributories at any general meeting or by the Advisory Committee.

2. The Company Liquidator may summon meetings of the creditors or contributories. The Company Liquidator shall summon such meetings at such times, as the creditors or contributories may by resolution, direct. Meetings on request may also be summoned whenever request in writing is made by not less than one-tenth in value of the creditors or contributories.

Any person aggrieved by any act or decision of the Company Liquidator may apply to the Tribunal, and the Tribunal may confirm, reverse or modify the act or decision complained of and make such further order as it thinks just and proper in the circumstances [Sec. 292].

DUTIES OF COMPANY LIQUIDATOR

The most prominent duties of the Company Liquidator in compulsory winding up are as follows:

1. To Start and Conduct Proceedings of Winding Up: The Company Liquidator on his appointment shall start and conduct the proceedings for winding up of the company. He shall conduct the proceedings in accordance with the provisions of the Companies Act and the directions given by the Tribunal [Sec. 275].

2. To File Declaration: On appointment as Company Liquidator, he shall file a declaration within 7 days from the date of appointment in the prescribed form. In such declaration he/it shall disclose the conflict of interest or lack of independence in respect of his/its appointment, if any, with the Tribunal [Sec 275(6)].

3. To Submit Report on Assets, Liabilities, Contributories, etc.: The Company Liquidator shall within 60 days from the order submit to the Tribunal a report. It shall be containing the particulars of the assets and liabilities of the company, amount of issued, subscribed and paid-up capital, the existing and contingent liabilities of the company, the debts due to the company, names of contributories, details of trademarks and intellectual properties, details of legal cases filed by or against the company etc. [Sec. 28 1(1)].

4. To Report Fraud: The Company Liquidator shall file a report to the Tribunal if any fraud has been committed by any person in the formation of the company or by any officer of the company in relation to the company since its formation. He shall also report any other matters which are desirable to be brought to the notice of the Tribunal [Sec. 28 1(2)].

5. To Report about Viability of the Business: The Company Liquidator shall also make a report and submit to the Tribunal on the viability of the business of the company or the steps which are necessary for maximizing the value of the assets of the company [Sec.281(3)].

6. To Make Application for Constitution of 'Winding Up Committee': Within 3 weeks from the date of passing of winding up order, the Company Liquidator shall make an application to the Tribunal for constitution of a Winding Up Committee. It shall assist and monitor the progress of liquidation proceedings by the Company Liquidator in carrying out the function [Sec. 277(4)].

7. To Convene Meetings and Submit Monthly Report to the Tribunal: The Company Liquidator shall convene the meetings of the Winding Up Committee. He shall place before the Tribunal a report on monthly basis till the final report for dissolution of the company is submitted before the Tribunal [Sec. 277 (6)].

8. Filing Final Report for Order of Dissolution: The Company Liquidator shall prepare and submit final report of the Winding Up Committee before the Tribunal for passing of a dissolution order in respect of the company [Sec. 277 (8)].

9. To Take Custody of Property: The Company Liquidator shall, on the order of the Tribunal forthwith take into his custody or control all the property, effects and actionable claims to which the company is or appears to be entitled to. He/it shall also take all necessary steps and measures to protect and preserve the properties of the company [Sec. 283].

10. To Convene Meeting of the Creditors and Contributories: The Company Liquidator shall convene a meeting of creditors and contributories. It shall be convened within 30 days from the date of order of winding up for enabling the Tribunal to determine the persons who may be members of the Advisory Committee. This meeting shall be chaired by the Company Liquidator [Sec. 283].

11. To Submit Periodical Report: The Company Liquidator shall submit periodical reports to the Tribunal. In any case he/it shall make a report at the end of each quarter with respect to the progress of the winding up of the company in prescribed form and manner [Sec. 288].

12. To Keep Books and Minutes: The Company Liquidator shall keep proper books in the prescribed manner in which he shall cause entries or record minutes of proceedings at meetings and of such other matters as may be prescribed [Sec. 293].

13. To Keep Books of Account and Account of Receipt and Payment: The Company Liquidator shall maintain proper and regular books of account including account of receipts and payments made by him in the prescribed form and manner. He shall also at prescribe times (but not less than twice in each year) present to the Tribunal an account of the receipts and payments in the prescribed form in duplicate. Such account shall be verified by a declaration in prescribed form and manner [Sec. 294].

14. To Forward Copy of Accounts of the Government Company to the Government: Where an account relates to a Government Company, the Company Liquidator shall forward a copy thereof to the following:

(a) To the Central Government, if that Government is a member of the Government Company.

(b) To any State Government, if that Government is a member of the Government Company.

(c) To the Central Government and any State Government, if both the Governments are members of the Government Company [Sec. 294(5)].

15. To Cause the Audited Accounts Printed: The Company Liquidator shall cause the audited accounts or a summary thereof to be printed. He shall also cause to be sent a printed copy of the accounts or summary thereof by post to every creditor and every contributory. However, the Tribunal may dispense with the compliance of the provisions of this duty in any case it deems fit [Sec. 294(6)].

16. To Take Action for Proper Exercise of Powers: The Company Liquidator shall also be under a duty to take all such actions that are necessary for proper exercise of powers granted to him under this Act [Sec. 290 (1)].

17. To Perform Duties Specified by Tribunal: The company Liquidator shall perform such other duties as the Tribunal may specify in this behalf [Sec. 290 (3)].

9.3.2 Voluntary Winding up

Earlier, voluntary winding up used to be of two kinds, namely the members' voluntary winding up and creditors' voluntary winding up. But the Companies Act, 2013 provides only for voluntary winding up. Such voluntary winding up may take place only with the consent of both members as well as the creditors. For such winding up, members are required to pass an appropriate resolution. Thereafter, two-third in value of the creditors are also required to give their consent to such resolution. If creditors in such value do not give their consent, the company cannot be wound up voluntarily. Thus, the Companies Act, 2013 has abolished distinction between members' and creditors' voluntary winding up.

Sometimes, two-third in value of creditors passes a resolution that it shall be in the interest of all parties if the company is wound up by the Tribunal. Then the company cannot be wound up voluntarily. In such a case, the company may be wound up only by the Tribunal. Hence, the company shall be bound to file a petition for its winding up by the Tribunal.

Conditions of Voluntary Winding Up

Following are the conditions with respect to voluntary winding up of a company:

1. Declaration of Solvency: Where it is proposed to wind up a company voluntarily, a declaration of solvency shall be made by the directors of the company. The declaration has to be made by its director or directors. In case the company has more than two directors, declaration should be made by majority of directors at a meeting of the Board. It should be verified by an affidavit to the effect that they have made a full inquiry into the affairs of the company and having done so, they have formed the opinion that the company has no debts or that it will be able to pay its debts in full from the sale proceeds of assets [Sec. 305(1)].

The declaration to be effective should fulfil the following conditions:

(a) It must be made within the 5 weeks immediately preceding the date of passing of the resolution. It must be delivered to the Registrar for registration before that date.

(b) It must contain a statement that the company is not being wound up to defraud any person or persons.

(c) It must be accompanied by a copy of the report of the auditors of the company on the profit and loss account of the company and the balance sheet of the company prepared up to the date of declaration.

(d) It must be accompanied by a report of the valuation of the assets of the company prepared by a registered valuer, if the company has any assets [Sec. 305(2)].

Sometimes, the company is wound up in pursuance of a resolution passed within a period of 5 weeks after making of the declaration, but its debts are not paid or provided for in full. In such a case, it shall be presumed, until the contrary is shown, that the director or directors did not have reasonable grounds for his or their opinion for such declaration.

Sometimes, a director of a company makes a declaration of solvency without having reasonable grounds for the opinion that the company shall be able to pay its debts in full. In such a case, he shall be punishable with imprisonment for a term which shall not be less than 3 years but which may extend to 5 years or with fine which shall not be less than 50, 000 but which may extend to 3 lakh or with both [Sec. 305(4)].

2. Resolution at General Meeting: After making a statutory declaration by the directors, the company shall pass a resolution for voluntary winding up. Such resolution must be passed within 5 weeks of such declaration. The company is required to pass an ordinary resolution in the following cases:

(i) If the winding up is to take place due to the expiry of the duration of the company fixed by its articles.

(ii) If the winding up is to take place due to the occurrence of any event in respect of which the articles provide that the company would be dissolved.

The company is required to pass a special resolution in any other case [Sec. 304].

3. Resolution at Creditors' Meeting: The company shall along with the calling of meeting of the company also call a meeting of its creditors on the same day or on the next day. It shall send a notice of such meeting by registered post to the creditors along with the notice of the meeting of the company called for passing a resolution for its voluntary winding up [Sec. 306(1)]. At such meeting, if two-third in value of creditors of the company are of the opinion that it is in the interest of all parties that the company be wound up voluntarily, then the company shall be wound up voluntarily, otherwise not. At such meeting of creditors, the Board of directors of the company shall present the following documents:

(a) A full statement of the affairs of the company.

(b) A list of creditors of the company.

(c) A copy of declaration of solvency.

(d) A statement of the estimated amount of the claims.

The Board of directors of the company shall appoint one of the directors to preside at the meeting [Sec. 306(3)].

4. Delivery of Declaration and Resolutions to Registrar: The company shall then deliver to the Registrar the declaration of solvency along with the resolution authorizing voluntary winding up. These shall be delivered within 5 weeks of the date of declaration [Sec. 305 (2)]. In addition, the company shall also deliver to the Registrar the resolution passed at the creditors' meeting within 10 days of its passing [Sec. 306 (4)].

5. Publication of Resolution: The company shall within 14 days of passing of the resolution give notice of the resolution by advertisement in the Official Gazette and also in a newspaper. The newspaper should be circulating in the district of the registered office or the principal office of the company. If a company, contravenes this provision, the company and every officer of the company who is in default shall be punishable with fine which may extend to ` 5,000 for every day during which such default continues [Sec. 307].

Commencement of Voluntary Winding Up

Voluntary winding up commences on the date of passing of the resolution for voluntary winding up [Sec. 308]. From the date of commencement of voluntary winding up, the company cannot carry on its business except so far as necessary for the beneficial winding up of its business. However, the corporate state and corporate powers of the company shall continue until it is dissolved [Sec. 309].

It may be pointed out that any prosperous and solvent company may be wound up, if the company passes a resolution to that effect. No reasons need to be given in the resolution. Articles of the company cannot prevent the exercise of this statutory right. Even this right cannot be interfered by any Court by means of an injunction or otherwise [*British Water Gas Syndicate v. Notts Derby Water Gas Co Ltd*, (1889) WN 204].

Other Provisions Regarding Voluntary Winding Up

The other important provisions with respect to voluntary winding up are as follows:

1. Appointment and Remuneration of Company Liquidator: The company in its general meeting shall appoint a Company Liquidator from the panel prepared by the Central Government.

The company in its general meeting shall also recommend the fee to he paid to the Company Liquidator [Sec. 3 10(1)].

2. Cessation of Board's Powers: On the appointment of a Company Liquidator, all the powers of the Board of directors, the managing or whole-time. directors and manager, if any, shall cease except for the purpose of giving notice of appointment of the Company Liquidator to the Registrar [Sec. 313].

3. Appointment of Committees: A company in its general meeting may appoint such committees as considered appropriate to supervise the voluntary liquidation and assist the Company Liquidator in discharging his functions [Sec. 315].

4. Arrangement Binding on Company and Creditors: Sometimes, an arrangement is entered into between the company (which is about to be or is in the course of being wound up) and its creditors. Such an arrangement shall be binding on the company and on the creditors if (i) it is sanctioned by a special resolution of the company and (ii) acceded to by three-fourth in value of the creditors of the company. If any creditor or contributory within 3 weeks from the completion of the arrangement, applies to the Tribunal, then the Tribunal may amend, vary, confirm or set aside the arrangement [Sec. 321].

5. Cost of Voluntary Winding Up: All costs, charges and expenses properly incurred in the winding up, including the fee of the Company Liquidator, shall, subject to the rights of secured creditors, if any, be payable out of the assets of the company in priority to all other claims [Sec. 323].

Dissolution of Company and Other Requirements

In case of voluntary winding up, the provisions relating to dissolution of the company are as follows:

I. Resolution for Dissolution: Final general meeting of the company shall consider the final winding up report of the Company Liquidator. If the majority of the members of the company are satisfied that the company should be wound up, they may pass a resolution for its dissolution [Sec. 318(2)].

2. Filing Report, Books, etc., and Application for Dissolution to Tribunal: Within 2 weeks after the meeting, the Company Liquidator shall file the following to the Tribunal:

(i) Report of the winding up.

(ii) The books and papers of the company relating to the winding up.

(iii) An application in the prescribed manner for passing an order of dissolution of the company [Sec. 318 (4)].

3. Sending Copies of Accounts, Resolution etc., to Registrar: Within 2 weeks after the meeting, the Company Liquidator shall send the following to the Registrar:

(i) A copy of the final winding up accounts of the company.

(ii) A return in respect of each meeting and of the date thereof.

(iii) Copies of the resolutions passed at the meetings [Sec. 318 (4)].

4. Dissolution Order by Tribunal: If the Tribunal is satisfied, (after considering the report of the Company Liquidator) that the process of winding up has been just and fair, the Tribunal shall pass an order for dissolving the company within 60 days of the receipt of the application [Sec. 3 18(5)].

5. Filing Copy of the Order to Registrar: The Company Liquidator shall file a copy of the order of dissolution with the Registrar within 30 days of the order [Sec. 318(6)].

6. Publication of Order in Gazette: The Registrar, on receiving the copy of the order passed by the Tribunal shall forthwith publish a notice in the Official Gazette that the company is dissolved [Sec. 318(7)].

7. Punishment: If the Company Liquidator fails to comply with these provisions he shall be punishable with fine which may extend to ` l Iakh [Sec. 318(8)].

CONSEQUENCES OF VOLUNTARY WINDNG UP

Following shall be the consequences of voluntary winding up:

1. Effect on the Company's Business: From the commencement of the voluntary winding up, the company shall cease to carry on its business, except as far as required for the beneficial winding up of such business [Sec. 309].

2. Effect on Corporate Existence: The passing of resolution for voluntary winding up does not put an end to the corporate existence of the company. The corporate status and corporate powers of the company shall continue until it is dissolved. The corporate status and powers of the company shall continue to remain unaffected until its dissolution even if the articles otherwise provide.

3. Effect on Powers of Directors, MD or WD and Manager: On the appointment of a liquidator, all the powers of the Board of directors and of the managing or manager and whole-time directors shall cease except for the purpose of giving notice to the Registrar of the appointment of the liquidator [Sec. 313].

4. Effect on Employees: The passing of the resolution for voluntary winding up generally operates as notice of discharge of the employees of the company if the company's business is immediately discontinued after passing the resolution. If the company is registered as insolvent, the resolution shall also operate as notice of discharge of employees. However, such resolution shall not operate as such notice in the following cases:

(i) If the company's business is continued by the Company Liquidator for its beneficial winding up even after passing of the resolution.

(ii) If the winding up of the company is with a view to its reconstruction.

5. Application of Property: On voluntary winding up, the assets of a company shall be applied in satisfaction firstly of its overriding preferential payments and then its other liabilities *pari passu*. Thereafter, the surplus of assets, if any remains, shall be distributed among the members according to their rights and interests in the company, unless the articles otherwise provide [Sec. 320].

6. Transfer of Shares and Alteration of Status of Members Void: In the case of a voluntary winding up, any transfer of shares in the company (not being a transfer made to or with the sanction of the Company Liquidator) and any alteration in the status of the members of the company, made after the commencement of the winding up, shall be void [Sec. 334(1)].

7. Effect on Shareholders and Contributories: A shareholder of a company limited by shares is liable only to pay the unpaid amount, if any, on the shares held by him in the company. He is also liable to pay all the unpaid calls. His liability continues even after winding up of the company. But after winding up of the company, such shareholder is described as contributory and is liable as contributory. The liability of a contributory does not arise out of a contract but because his name appears in the register of members.

8. Effect On creditors where the company is solvent [Sec. 324].

9. Effect on creditors where the company is insolvent [Sec. 325].

10. Effect of floating charge [Sec. 332].

11. Statement as to winding up on documents [Sec. 344].

These points at S. No. 8 to 11 have already been discussed under the head 'Consequences of Winding order by Tribunal'.

COMPANY LIQUIDATOR IN VOLUNTARY WINDING UP

1. Appointment and Fee: Where a resolution of voluntary winding up is passed, the company in its general meeting shall appoint a Company Liquidator. He shall be appointed from the panel prepared by the Central Government for the purpose of winding up its affairs and distributing the assets of the company. The company shall also recommend the fee to be paid to the Company Liquidator.

Where the creditors have passed a resolution for winding up of the company, the appointment of the Company Liquidator shall be effective only after it is approved by the majority of creditors in value of the company. Where such creditors do not approve the appointment of such Company Liquidator, creditors shall appoint another Company Liquidator. Then they shall also pass suitable resolution with regard to the fee of the Company Liquidator [Sec. 3 10(1)]. .

2. Declaration by Company Liquidator: On appointment, the Company Liquidator shall file a declaration in the prescribed form within 7 days of the date of appointment. The declaration shall be disclosing conflict of interest or lack of independence in respect of his appointment, if any, with the company and the creditors. Such obligation of the Company Liquidator shall continue throughout the term of his or its appointment [Sec 310(4)].

3. Notice of Appointment to Registrar: The company shall give notice to the Registrar of the appointment of a Company Liquidator along with his name and particulars within 10 days of such appointment [Sec. 312].

4. Removal and Filling Vacancy: A Company Liquidator appointed by the company may be removed by the company and if appointed by the creditors, may be removed by them. Before removing, a notice shall be given to him in writing, stating the grounds of his removal from his office. Where a reply to the notice is received, three-fourth members of the company or three-fourth of creditors in value shall consider the reply in their meeting and decide to remove the Company Liquidator. Then he shall have to vacate his office.

If a vacancy occurs by death, resignation, removal or otherwise in the office of the Company Liquidator, the company or the creditors as the case may be shall fill the vacancy [Sec. 311]. The company shall give notice to the Registrar of every vacancy occurring in the office of Company Liquidator and of the name of the Company Liquidator appointed to fill every such vacancy within 10 days of such appointment r the occurrence of such vacancy [Sec. 312].

POWERS AND DUTIES OF COMPANY LIQUIDATOR

The powers and duties of a Company Liquidator in voluntary winding up are as follows [Sec.314]:

1. To Perform Functions and Duties Determined by Company or Creditors.

2. To Settle List of Contributories: The Company Liquidator shall settle the list of contributories, which shall be prima fade evidence of the liability of the persons named therein to be contributories.

3. Call General Meeting: The Company Liquidator shall call general meetings of the company for the purpose of obtaining the sanction of the company by ordinary or special resolution, as the case may require, or for any other purpose he may consider necessary.

4. Maintain Books of Accounts: The Company Liquidator shall maintain regular and proper books of account in such form and in such manner as may be prescribed.

5. Preparing and Filling Statement of Accounts: The Company Liquidator shall prepare quarterly statement of accounts in such form and manner as may be prescribed. He shall also file such statement of accounts duly audited within 30 days from the closing of each quarter with the Registrar. If the Company Liquidator fails to do so, he shall be punishable with fine which may extend to five thousand for every day during which the failure continues.

6. Payment of Debts and Adjustment of Rights: The Company Liquidator shall pay the debts of the company. He shall adjust the rights of the contributories among themselves.

7. Observing Due Care and Diligence: The Company Liquidator shall observe due care and diligence in the discharge of his duties. If the Company Liquidator fails to comply with the above powers and duties except stated in point number 5, he shall be punishable with fine which may extend to ` 10 lakh [Sees. 3 14(1) to (8)]. In addition, a Company Liquidator in voluntary winding up shall also have the following powers.

8. Reporting Quarterly Progress: The Company Liquidator shall report quarterly on the progress of winding up of the company to the members and creditors. He shall also call a meeting of the members and the creditors as and when necessary. However, at least one meeting each of creditors and members in every quarter shall be called. If the Company Liquidator fails to comply with this provision, he shall be punishable, in respect of each such failure with fine which may extend to ` 10 lakh [Sec. 316].

9. Reporting Examination of Persons: Sometimes, the Company Liquidator is of the opinion that a fraud has been committed by any person in respect of the company. In such a case, he shall immediately make a report to the Tribunal and the Tribunal shall, without prejudice to the process of winding up, order for (under Section 210) investigation. On consideration of the report of such investigation, the Tribunal may pass such order and give such directions as it may consider necessary. The directions may include that such person shall attend before the Tribunal on a day appointed by it for that purpose and be examined as to the promotion or formation or the conduct of the business of the company or as to his conduct and dealings as officer thereof or otherwise [Sec. 317].

10. Making Final Winding Up Report: As soon as the affairs of a company are fully wound up, the Company Liquidator shall prepare a final report of the winding up. The report shall be showing that the property and assets of the company have been disposed of and its debt fully discharged or discharged to the satisfaction of the creditors. Thereafter, the Company Liquidator shall call a final general meeting of the company for the purpose of laying the final winding up accounts before it and giving any explanation therefore [Sec. 318(1)].

11. To Accept Shares etc., as Consideration for Sale of Property: Sometimes, the business or property of a company under voluntarily winding up is proposed to be transferred or sold to another company (transferee company). In such a case, the Company Liquidator of the transferor company may, with the sanction of a special resolution, or an authority in respect of any particular arrangement, do any of the following things:

(a) Receive by way of compensation for the transfer or sale the shares, the policies, or other like interest in the transferee company. These shall be used for distribution among the members of the transfer or company.

(b) Enter into any other arrangement whereby the members of the transferor company may, in lieu of receiving cash, shares, policies or other like interest or in addition thereto participate in the profits of or receive any other benefit from the transferee company. However, no such arrangement shall be entered into without the consent of the secured creditors. Any such transfer, sale or other arrangement shall be binding on the members of the transfer or company.

12. To Distribute Property: Subject to the provisions of this Act as to overriding preferential payments (under Section 326), the assets of a company shall on its winding up be applied in satisfaction of its liabilities *pari passu* and, subject to such application shall (unless the articles otherwise provide), be distributed among the members according to their rights and interests in the company [Sec. 320].

13. To Apply to Tribunal to have Questions Determined etc.: The Company Liquidator or any contributory or creditor may apply to the Tribunal to do any of the following:

(a) To determine any question arising in the course of winding up of a company.

(b) To exercise the powers as to the enforcing of calls, the staying of proceedings or any other matter which it might exercise if the company were being wound up by the Tribunal.

(c) To set aside any attachment, distress or execution put into force against the estate or effects of the company after the commencement of the winding up.

The Tribunal, if satisfied on an application that the determination of the question or the required exercise of power or the order applied for will be just and fair, may allow the application on such terms and conditions as it thinks fit or may make such other order on the application as it thinks fit.

14. To Disclaim Onerous Property: The Company Liquidator may with the leave of the Tribunal, at any time within 12 months after the commencement of the winding up or such extended period as may be allowed by the Tribunal disclaim the onerous property. Such property may consist of the following:

(a) Land of any tenure, burdened with onerous covenants.

(b) Shares or stocks in companies.

(c) Any other property which is not saleable or is not readily saleable by reason of the fact that the possessor of the property is bound to perform certain onerous Act or to pay any sum of money.

(d) Unprofitable contracts.

9.4 PROVISIONS APPLICABLE TO EVERY MODE OF WINDING UP

1. Overriding Preferential Payments: In the winding up of a company, the following dues or debts shall be paid in priority to all other debts:

(a) Workmen's dues.

(b) Debts due to secured creditors to the extent such debts rank *pari passu* with the unrealized debts of secured creditors and dues of workmen.

In case of winding up of a company, the sums towards wages or salary [referred to in Section 325(l)(b)] which are payable for a period of 2 years preceding the winding up order or such other prescribed period shall be paid in priority to all other debts (including debts due to secured creditors), within a period of 30 days of sale of assets.

The above debts payable shall be paid in full before any payment is made to secured creditors. Thereafter debts payable shall be paid in full. If the assets are insufficient to meet them in full, these debts shall be paid proportionately [Sec. 326].

2. Preferential Payments: In a winding up (subject to the provisions of Section 326), following dues and debts shall be paid in priority to all other debts:

(a) All revenues, taxes, cesses and rates due from the company to the Central Government or a State Government or to a local authority at the relevant date. Such amount must have become due and payable within 12 months immediately before that date.

(b) All wages or salary or commission. These shall include wages payable for time or piece work and salary earned wholly or in part by way of commission of any employee in respect of services rendered to the company. Such amount may be due for a period not exceeding 4 months within 12 months immediately before the relevant date. Moreover, the amount payable under this clause to any workman shall not exceed such amount as may be notified.

(c) All accrued holiday remuneration becoming payable to any employee on the termination of his employment before or by the winding up order or the dissolution of the company.

(d) All amount due in respect of contributions payable during the period of 12 months immediately before the relevant date under the Employees' State Insurance Act, 1948 or any other law. Such dues shall not be considered if the company is being wound up voluntarily merely for the purposes of reconstruction or amalgamation with another company.

(e) All amount due in respect of any compensation or liability for compensation under the Workmen's Compensation Act in respect of the death or disablement of any employee. These dues shall not be considered if the company, has at the commencement of winding up, under a contract with any insurer under the said Act, rights capable of being transferred to and vested in the workmen.

(f) All sums due to any employee from the provident fund, the pension fund, the gratuity fund or any other fund for the welfare of the employees, maintained by the company.

(g) The expenses of any investigation in so far as they are payable by the company [Sec. 327].

3. Liabilities and Rights of Certain Persons Fraudulently Preferred: If anything is made, taken or done by a company which is being wound up shall be invalid as a fraudulent preference of a person interested in property mortgaged or charged to secure the company's debt, in such a case, without prejudice to any rights or liabilities arising apart from this provision, the person preferred shall be subject to the same liabilities and shall have the same rights as if he had undertaken to be personally liable as a surety for the debt to the extent of the mortgage or charge on the property or the value of his interest, whichever is less [Sec. 331].

4. Liability for Fraudulent Conduct Business: Sometimes, in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company or any other persons or for any fraudulent purpose. In such a case, the Tribunal, on the application of the Official Liquidator, or the Company Liquidator or any creditor or contributory of the company may declare that any person, who is or has been a director, manager, or officer of the company or any persons who were knowingly parties to the carrying on of the business in the manner aforesaid shall be personally responsible, without any limitation of liability, for all or any of the debts or other liabilities of the company as the Tribunal may direct [Sec. 339].

9.5 SUMMARY

Winding up of a company is a process by which the life of the company is brought to an end. After the winding up in over, the Registrar removes the name of the company from the Register of Companies and this fact is published in the official Gazette. A company can be wound up by the Tribunal and voluntarily.

9.6 KEYWORDS

Winding up: It is a process of which the dissolution of a company is brought about.

Contributory: He is a person liable to contribute to the assets of the company in case of its winding up.

Dissolution: It is that stage of a company when the business affairs of the company have been completely wound up.

Company Liquidator: He is a person appointed from a panel of professionals maintained by the Central Government.

9.7 SELF ASSESSMENT QUESTIONS

1. Define winding up of a company. Describe the various modes of winding up of a company.
2. Explain the circumstances under which a company can compulsorily be wound up the Tribunal. Also state the consequences of a winding up order by the Tribunal.
3. Under that circumstances the Tribunal can order for winding up of a Company? State the legal provisions in respect of compulsory winding up.
4. What are the powers and duties of a company liquidator in case of winding up by the Tribunal?
5. Under what circumstances a company can be wound up voluntarily? Explain the consequences of voluntary winding up.

6. How is a Company Liquidator appointed under voluntary winding up? Explain the powers and duties of Company Liquidator under voluntary winding up.

9.8 SUGGESTED READINGS

- R. Suryanarayanan, Company Law Ready Reckoner, Commercial Law Publishers, Delhi.
- D.K. Jain, Company Law, Ready Reckoner, Bharat Law House Pvt. Ltd., Delhi.
- Avtar Singh, Company Law, Eastern Book Company, Lucknow.
- A.K. Mujumdar and G.K. Kapoor, Company law and Practice, Taxmann Publishing House, New Delhi.
- M.C. Kuchhal, Modern Indian Company Law, Delhi.

LESSON:10

INDIAN CONTRACT ACT 1872: ESSENTIALS OF VALID CONTRACT, OFFER AND ACCEPTANCE

STRUCTURE

10.0 OBJECTIVES

After going through this lesson, you should be able to:

(i) Explain the origin and importance of Indian Contract Act 1872;

(ii) Define a contract and explain the essentials of a valid contract;

(iii) Discuss the various kinds of contracts;

(iv) Understanding the meaning of offer and explain its essentials;

(v) Describe the relationship between offer and acceptance;

(vi) Explain the essentials of a valid acceptance; and

(vii) Describe when communication of offer and acceptance and their revocation is complete.

10.1 INTRODUCTION

Law of contract is the most important branch of Business Law. It would have been very difficult to carry on trade or commerce in the absence of this law. It is not only the business community which is concerned with the law of contracts, but it affects every person. Contract is considered as the foundation of the civilised world. Every one of us enters into a number of contracts from sunrise to sunset. When a person drinks a cup of tea, or rides a bus, or goes to the cinema to see a movie or purchases the goods, or gives a loan to friend, etc. he enters into a contract though he may be unaware of it. Such contracts create legal rights and obligations. The law of contract is mainly concerned with the enforcement of these rights and obligations.

The law of contract determines the circumstances in which a promise or an agreement shall be legally binding on the person making it. It is concerned with rights in *personam* as distinguished from rights in *rem*. For example, if X is entitled to receive a sum of money from Y, this right can only be exercised by X and not by others. This is a right in *personam*. On the other hand, if X owns a plot of land and Y is the immediate neighbour, the right of X to have complete possession and enjoyment of land is available not only against Y but against the whole world. This right of X is known as the right in *rem*.

An agreement is the most significant and essential to make a contract. Agreement* arises from proposal and its acceptance. There must be a definite offer by one party and its acceptance by the other to create an agreement. Proposal and acceptance become effective only when they are communicated. An agreement is created when an offer in accepted.

10.2 INDIAN CONTRACT ACT, 1872

The laws of contract in India is contained in the Indian Contract Act, 1872. This Act is based mainly on English Common Law which is to a large extent made up of judicial precedents. It extends to the whole of India except the State of Jammu and Kashmir and came into force on the first day of September 1872. The Act is not exhaustive. It does not deal with all the branches of the law of contract. There are separate Acts which deal with contracts relating to negotiable instruments, transfer of property, sale of goods, partnership, insurance, etc.

The provisions of Indian Contract Act are subjection to some assumptions underlying the Act which include: (i) Subject to certain limiting principles, there shall be freedom of contract to the contracting parties and the law shall enforce only what the parties have agreed to be bound. The law shall not lay down absolute rights and liabilities of the contracting parties. Instead it shall lay down only the essentials of a valid contract and the rights and obligations it would create between the parties in the absence of anything to the contrary agreed to by the parties; and (ii) Expectations created by promises of the parties shall be fulfilled and their non-fulfilment shall give rise to legal consequences. If the plaintiff asserts that the defendant undertook to do a certain act and failed to fulfil his promise an action at law shall apply.

10.3 DEFINITION OF CONTRACT

A legally binding agreement is called a contract. In other words, a contract is an agreement which will be enforced by the courts. Salmond defines contract as, "an agreement creating and defining obligation between the parties". Halsbury defines a contract to be, "an agreement between two or more persons which is intended to be enforceable at law and is constituted by the acceptance by one party of an offer made to him by the other party to do or abstain from doing some act".

Section 2(h) of the Indian Contract Act defines a contract as, "An agreement which is enforceable at law". This definition has two important components which constitute the basis for a contract. They are: (1) An agreement, and (2) Legal obligation. We shall now examine these elements in detail.

1. **Agreement:** Every promise and every set of promises, forming the consideration for each other, is an agreement [Sec. 2 (e)]. Thus it is clear from this definition that a promise is an agreement. What is a promise? The answer to this question is contained in Section 2(b) which defines the term:"When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. A proposal, when accepted, becomes a promise". An agreement, therefore, comes into existence only when one party makes a proposal or offer to the other party and that other party signifies his assent (i.e., gives his acceptance) thereto. In short, an agreement is the sum total of 'offer' and 'acceptance'.

On analysing the above definition, the following characteristics of an agreement become evident:

(a) *Plurality of persons:* There must be two or more persons to make an agreement because one person cannot enter into an agreement with himself.

(b) *Consensus-ad-idem*: Both the parties to an agreement must agree about the subject matter of the agreement in the same sense and at the same time.

2. Legal Obligation: As stated, an agreement to become a contract must give rise to a legal obligation. Obligation is an undertaking to do or to abstain from doing some definite act. The obligation must be such as is enforceable by law. In other words, it must be a legal obligation and not merely moral, social or religious. To take an example, "Please, come to my house", says Ram to Mohan, "and we shall go out for a walk together". Mohan came to the house of Ram but Ram could not leave the house because of some important engagement. Mohan cannot sue Ram in damages for his not fulfilling the promise, the reason being that there had been no intention between Mohan and Ram to create any legal obligation by the agreement as made between them. In the circumstances, there was in eye of law, no contract between Ram and Mohan.

Similarly, an another kind of obligation which does not constitute a contract is the arrangement made between husband and wife. Such agreements are purely domestic and are not intended to create legal relationship.

The Leading case on this point is **Balfour v. Balfour (1919)**

Facts of the case are: Mr. Balfour was employed in Ceylon. Mrs. Balfour owing to ill health, had to stay in England and could not accompany him to Ceylon. On the accusation of leaving her in England for medical treatment Mr. Balfour promised to send her □ 30 per month while he was in abroad. But Mr. Baulfour failed to pay that amount. So Mrs. Balfour filed a suit against her husband for recovering the said amount. The court held that it was a mere domestic agreement and that the promise made by the husband in this case was not intended to be a legal obligation. Hence the suit filed by Mrs. Barfour was dismissed since there was no contract enforceable in a court of law.

Decision of the Case

(a) Agreements which do not create legal relations are not contracts.

(b) Agreements between husband and wife in domestic affairs is not a contract.

It may be noted that the law of contract deals only with such obligations which spring from agreements. Obligations which are not contractual in nature are outside the scope of the law of contract. For example, obligation to maintain wife and children, obligation to comply with the orders of a court and obligation arising from a trust do not fall within the scope of The Contract Act. Sir John Salmond has rightly observed. "The law of contract is not the whole law of agreements, nor is it the whole law of obligations. It is the law of those agreements which create obligations and those obligations which arise from an agreement".

10.4 ESSENTIAL OF A VALID CONTRACT

It must be remembered that all agreements are not contracts. Only that agreement which is enforceable at law is a contract. In other words, the parties to the agreement must have intended that it shall have legal consequences and be legally enforceable. An agreement which is not enforceable at law cannot be a contract. Thus, the term 'agreement' is more wider in scope than contract. All contracts are agreements but all agreements are not contact.

An agreement, to be enforceable by law, must possess the essential elements of a valid contract as contained in Section 10 of the Indian Contract Act. According to Section 10, "All agreements are contract if they are made by the free consent of the parties, competent to contract, for a lawful consideration and with a lawful object and are not expressly declared to be void". As the details of these essentials form the subject matter of our subsequent lesson, it is proposed to discuss them in brief here.

The essential elements of a valid contract are as follows:

1. **Offer and acceptance:** There must be a 'lawful offer' and a 'lawful acceptance' of the offer, thus resulting in an agreement. The adjective 'lawful' implies that the offer and acceptance must satisfy the requirements of the Contract Act in relation thereto.

2. **Intention to create legal relations:** There must be an intention among the parties that the agreement should be attached by legal consequences and create legal obligations. Agreements of a social or domestic nature do not contemplate legal relations, and as such they do not give rise to

a contract. An agreement to take dinner at a friend's house is not an agreement intended to create legal relations and therefore is not a contract. Agreements between husband and wife also lack the intention to create legal relationship and thus do not result in contracts.

Example: H promises his wife W to get her a saree if she will sing a song. W sang the song but H did not bring the saree for her. W cannot bring an action in a court to enforce the agreement as it lacked the intention to create legal relations.

In commercial agreements an intention to create legal relations is presumed. Thus, an agreement to buy and sell goods intends to create legal relationship, hence is a contract, provided other requisites of a valid contract are present. But if the parties have expressly declared their resolve that the agreement is not to create legal obligation, even a business agreement does not amount to a contract. The case of Rose & Frank Co. vs Crompton and Brothers Ltd., provides a good illustration on the point.

In the above case, R company entered into an agreement with company, by means of which the former was appointed as the agent of the latter. One clause of the agreement was a follows: "This arrangement is not entered into as a formal or legal agreement and shall not be subject to legal jurisdiction in the law courts". It was held that there was no intention to create legal relations on the part of parties to the agreement and hence there was no contract.

3. **Consensus ad idem:** The minds of both the parties must be *ad idem*. In other words, the two parties must have agreed about the subject matter of the contract at the same time and in the same sense. For instance, if A who owns two cars, one Ford and the other Honda city, offers to sell B one car, A intending it to be the Ford, B accepts the offer thinking that it is the Honda city, there is no consensus and hence no contract.

4. **Competency of Parties:** The parties to the agreement must be competent to contract. If either of the parties to the contract is not competent to contract, the contract is not valid. According to Section 11, following are the persons who are competent to contract:

(a) who have attained the age of majority according to the law to which they are subject;

(b) who are of sound mind;

(c) who are not disqualified from contracting by any law to which they are subject.

5. **Lawful consideration:** The next essential element of a valid contract is the presence of 'consideration'. Consideration has been defined as the price paid by one party for the promise of the other. An agreement is legally enforceable only when each of the parties to it gives something and gets something. The something given or obtained is the price for the promise and is called 'consideration'. Subject to certain exception, gratuitous promises are not enforceable at law.

The consideration may be an act (doing something) or forbearance (not doing something) or a promise to do or not to do something. It may be past, present or future. But only those considerations are valid which are lawful. The consideration is lawful, unless it is forbidden by law; or is of such a nature that, if permitted it would defeat the provisions of any law; or is fraudulent; or involves or implies injury to the person or property of another; or is immoral; or is opposed to public policy (Sec. 23).

6. **Free Consent:** An agreement must have been made by free consent of the parties. A consent may not be free either on account of mistake in the minds of the parties or on account of the consent being obtained by some unfair means like coercion, fraud, misrepresentation or undue influence. In case of mutual mistakes, the contract would be void, while in case the consent is obtained by unfair means, the contract would be voidable.

7. **Lawful object:** For the formation of a valid contract, it is also necessary that the parties to an agreement must agree for a lawful object. The object for which the agreement has been entered into must not be fraudulent or illegal or immoral or opposed to public policy or must not imply injury to the person or property of another (Sec. 23). If the object is unlawful for one or the other reasons mentioned above, the agreement is void. Thus, when a landlord knowingly lets a house to a prostitute to carry on prosecution, he cannot recover the rent through a court of law.

8. **Written and Registered:** According to the Indian Contract Act, a contract may be oral or in writing. But in certain special cases, it lays down that the agreement to be valid, must be in writing or/and registered. For example, it requires that an agreement to pay a time barred debt must be in writing and an agreement to make a gift for natural love and affection must be in writing and registered (Sec. 25). Similarly, certain other Acts also require writing or/and registration to make the agreement enforceable by law which must be observed. Thus, (i) an arbitration agreement must be in writing as per the Arbitration and Conciliation Act, 1996; (ii) an agreement for a sale of

immovable property must be in writing and registered under the Transfer of Property Act, 1882 before they can be legally enforced.

9. **Not declared to be void:** The agreement must not have been declared to be expressly void. Agreements mentioned in Sections 24 to 30 have been expressly declared to be void.

10. **Certainty:** Section 29 of the Contract Act provides that "agreements, the meaning of which is not certain for capable of being made certain, are void". In order to give rise to a valid contract, the terms of the agreement must not be vague or uncertain. It must be possible to ascertain the meaning of the agreement, for otherwise, it cannot be enforced.

Example: A agrees to sell B a hundred tons of oil. There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty.

11. **Possibility of Performance:** Yet another essential feature of a valid contract is that it must be capable of performance. Section 56 lays down that "an agreement to do an act impossible in itself is void". If the act is impossible in itself, physically or legally, the agreement cannot be enforced at law.

Example: A agrees with B to discover treasure by magic. The agreement is not enforceable.

All the elements mentioned above must be present in order to make a valid contract. If any one of them is absent, the agreement does not become a contract.

10.5 KINDS OF CONTRACTS

From the point of view of Enforceability

From the point of view of enforceability, a contract may be valid or voidable or void or unenforceable or illegal.

1. **Valid contract:** An agreement enforceable at law is a valid contract. An agreement becomes a contract when all the essentials of a valid contract as laid down in Section 10 are fulfilled. A offers to sell his house for ` 10,000 to B. B agrees to buy it for this price. It is a valid contract.

2. **Void contract:** A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable. It is a contract without any legal effects. A contract may be valid at the time when it is made but it may become void subsequent to its formation Thus, a contract with one who had been an alien friend but later on becomes an alien enemy would be a case of a void contract.

However, a void contract is not necessarily unlawful, it is destitute of legal effects. The law will not enforce such a contract, nor can it be made valid by the parties.

A void contract should be distinguished from void agreement. An agreement not enforceable at law is a void agreement. In the case of a void agreement, no contract comes into existence. An agreement with a minor is void. But in the case of void contract, a contract does come into existence but subsequently ceases to be enforceable by law. An agreement which is void never matures into a contract. An agreement which becomes illegal in the course of performance is a case of a void contract, while an agreement which is null and void *ab initio* is a case of a void agreement.

3. **Voidable contract:** According to Section 2(i), "an agreement which is enforceable by law at the option of one or more of the parties thereto, but not at the option of the other or others, is a voidable contract". Thus, a voidable contract is one which is enforceable by law at the option of one of the parties. Until it is avoided or rescinded by the party entitled to do so by exercising his option in that behalf, it is a valid contract.

Usually a contract becomes voidable when the consent of one of the parties to the contract is obtained by coercion, undue influence, misrepresentation or fraud. Such a contract is voidable at the option of the aggrieved party i.e., the party whose consent was so caused (Section 19 and 19A). But the aggrieved party must exercise his option of rejecting the contract (i) within a reasonable time, and (ii) before the rights of third parties intervene, otherwise the contract cannot be repudiated.

Example: A. threatens to shoot B if he does not sell his new Hero motor cycle to A for ` 2,000. B agrees. The contract has been brought about by coercion and is voidable at the option of B.

4. **Unenforceable contract:** It is a contract which is otherwise valid, but cannot be enforced because of some technical defect like absence of a written form or absence of a proper stamp. Such

contracts must be sued upon by one or both of the parties. Such contracts cannot be proved in the court. Such contracts will not be enforced by the courts until and unless the defect is rectified.

Other circumstances under which a contract becomes voidable: The Indian Contract Act has laid down certain other situations also under which a contract becomes voidable. For example,

(i) When a contract contains reciprocal promises, and one party to the contract prevents the other from performing his promise, then the contract becomes voidable at the option of the party so prevented (Sec. 53).

Example: A contracts with B that A shall whitewash B's house for ` 1000. A is ready and willing to execute the work accordingly, but B prevents him from doing so. The contract becomes voidable at the option of A.

(ii) When a party to the contract promises to do a certain thing within a specified time, but fails to do it, then the contract becomes voidable at the option of the promisee, if the intention of the parties was that time should be of the essence of the contract (Sec. 55).

Example: X agrees to sell and deliver 10 bags of wheat to Y for ` 2,500 within one week. But X does not supply the wheat within the specified time. The contract becomes voidable at the option of Y.

Consequences of rescission of voidable contract: Section 64 lays down the rights and obligations of the parties to a voidable contract after it is rescinded. The Section states that when a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is a promisor. If the party rescinding a voidable contract has received any benefit from another party to such contract, he must restore such benefit, so far as may be, to the person from whom it was received. For example, when a contract for the sale of a house is avoided on the ground of undue influence, any money received on account of the price must be refunded. Notice that the Section aims at placing both the parties to a voidable contract, after its rescission, on the same footing as for there had been no contract at all. But it must be remembered that the benefit which is to be restored must have been received under the contract.

5. **Illegal Contract:** A contract which is either prohibited by law or otherwise against the policy of law is an illegal contract. It is void *ab initio*. Thus, a contract to commit dacoity is an illegal contract and cannot be enforced at law. An illegal contract should be distinguished from a void contract. Both are unenforceable at law but there is something more in an illegal contract. Every illegal contract is a void contract but every void contract may not be illegal contract e.g. a wagering agreement is void but not illegal or an agreement with a minor is void but not illegal. Every void contract is not illegal unless its object or consideration is (a) immoral or (b) opposed to public policy etc. A void contract does not affect a collateral contract.

Difference between voidable contract and void agreement

1. A void agreement has from the very beginning no legal effects. It is unenforceable at law. A voidable contract is one in which one of the parties may affirm or reject at his option. It is valid and enforceable till it is repudiated or rescinded.

2. The defect in the case of voidable contract is curable and may be condoned. But a void agreement is void *ab initio* and its defects are incurable.

3. In the case of a void agreement, even a third party cannot acquire any right from person claiming under such contract while in the case of voidable contract, a third party can acquire a valid title from a person claiming under such a contract.

4. Since a void agreement is unenforceable at law, there does not arise any question of compensation on account of the non-performance of the agreement. But in case of a voidable contract, a person is entitled to compensation for loss or damages suffered by him on account of the non-performance of the contract.

5. A voidable contract does not affect the collateral transaction. But where the agreement is void on account of illegality of the object, the collateral transaction will also become void.

Contracts Classified on the basis of performance

1. **Unilateral Contract:** A unilateral contract is one in which a promise on one side is exchanged for an act on the other wide. In such contracts, one party to the contract has performed his part and an obligation is outstanding against the other party. Thus, where a doctor in a private

clinic, examines a patient and gives the medicine, the patient alone remains liable to pay the fees. It is a case of unilateral contract.

2. **Bilateral Contract:** In such a contract, a promise on one side is exchanged for a promise on the other. It is a contract in which there is an obligation on the part of both the parties to do or to refrain from doing a particular act. A promises to paint a picture in return for which B promises to pay ` 500. Here a promises to paint the picture and B promises to pay. Each party is thus both a promisor and a promisee.

3. **Executed contract:** A contract is said to be executed when one party to the contract has performed his share of the obligation and the other party is still to perform his share of the promise. In executed contracts, the contract does not come into existence until one party to it has done all that he can be required to do. Thus, where A advertises a reward of ` 500 to anyone who finds his missing dog, and when B knowing the offer brings the missing dog, A becomes liable to pay ` 500.

4. **Executory contract:** It is a contract where some future act is to be done. It is one which is either wholly unperformed, or there remains something to be one of both the sides. Thus, where an agreement is made to build a house in six months, it is an executory contract.

Kinds of Contracts from the Point of View of Mode of Creation

From the point of view of mode of creation, a contract may be anyone of the following types:

1. **Express Contract:** Where both the offer and acceptance constituting an agreement enforceable at law are made in words spoken or written, it is an express contract. For example A tells B on telephone that he offers to sell his car for ` 1,00,000 and B in reply informs A that he accepts the offer, there is an express contract.

2. **Implied Contract:** Where both the offer and acceptance constituting an agreement enforceable at law are made otherwise than in words i.e., by acts and conduct of the parties, it is an implied contract. Thus, where A, coolie in uniform takes up the luggage of B to be carried out of the railway station without being asked by B, and B allows him to do so, then the law implies that B agrees to pay for the services of A, and there is an implied contract. Similarly, where M, a professional shoe shiner starts polishing the shoes of N without being requested to do so, and N

allows M to polish his shoes knowing that M expects to be paid for the service, there comes into existence an implied contract and N is under obligation to pay to M.

3. **Constructive or quasi-Contract:** It is a contract in which there is no intention on either side to make a contract, but the law imposes a contract. In such a contract, rights and obligations arise not by any agreement between the parties but by operations of law. Thus, a finder of lost goods is under an obligation to find out the true owner and return the goods. Similarly, where certain books are delivered to a wrong addressee, the addressee is under an **10.6 MEANING OF AN OFFER**

An offer is also called a proposal. According to Section 2(a) proposal is defined as person "When one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other person to such act or abstinence, he is said to make a proposal."

According to Pollock, "The expression of person's willingness to become according to his expressed views, a party to an agreement is called an offer or proposal."

The person who makes the proposal is called the 'offerer' or promisor and the person to whom the offer is made is called the 'offeree' or promises. The offeree expresses his willingness to do or 'not to do' something with a view to obtain acceptance of the other party. Thus it is clear that there may be 'positive' or 'negative' act.

Examples

(i) X offers to sell his T.V. to Y for ' 2,000. This is an offer/proposal. X is the offerer or proposer and Y is the offeree or promisee.

(ii) A offers to sell his car to B for ' 70,000. A is making an offer to do something i.e., to sell his car. It is a positive act.

10.7 CHARACTERISTICS OR ESSENTIALS OF AN OFFER OR PROPOSAL

A proposal must have following essentials in order to constitute a valid proposal:

(i) There must be two parties: A party makes proposal to other party. Therefore, a proposal requires minimum two parties. No person can make an offer to himself.

(ii) For doing a work or for not doing a work: The proposal may be for doing a work or for not doing a work.

(**iii) With a view to obtain acceptance:** The offer must be made with a view to obtain the acceptance of the other party, then only it can be said to be an offer.

1**0.8 LEGAL RULES REGARDING OFFER**

Following are the essential rules as to offer:

(i) Clear, Complete, Definite and Final: An offer must be clear, complete, definite and final. It should not be vague. All the material terms must be clear. No contract can come into existence if the terms of the offer are vague or loose and indefinite. Both the parties could be clear about the legal consequences arising out of a contract. A vague offer does not convey what it exactly means. Thus, an offer by X to Y to pay the latter a certain the latter marrying X's daughter is no offer, because the amount to be paid is not certain.

(ii) Creating Legal Obligation: An offer must create legal obligations. Due to it offers to domestic nature and social offers are not binding. An offer must create legal relationship between the parties.

(iii) Offer may be Specific or General: When offer is made to general public, it in called general offer. It can be accepted by any one satisfying the terms of offer. A specific offer is one which is made to a particular person. It can be accepted by the person to whom it has been made.

Example: X offers to sell his car to Y for ' 1,00,000. This is a specific offer made to Y. It is Y alone who can accept this offer.

A general offer is made to the world at large and can be accepted by any person.

Example: X advertised in a newspaper that he would give ' 500 to anyone who finds and returns his lost cow.

(iv) Communication of Special Condition of an Offer: No body can make an offer to himself. It must always be communicated to the offeree. If there is no communication there is no acceptance resulting in the agreement or contract.

No body can accept an offer about which he is not aware. For example, B finds A's lost cow but has not seen the advertisement offering the reward and has proceeded to return the cow to A, B cannot claim the reward as he is unaware about it.

(v) Offer must be in the form of request, not an order: Offer must be in the form of request and not as an order.

Example: X offers Y to sell his cow for ‘ 3,000 and says if reply is not received within 10 days, it shall be assumed that you are not interested. It is not a legal offer.

(vi) Proposal must be made with a view to obtain assent: The offer must be made with an intension to obtain the consent of the other party to do or to abstain from doing the act.

Example: X says Y, "I may sell my car if I can get ` 80,000 for it". It is not an offer.

(vii) Proposal may be Express or Implied: An offer may be express or implied from the conduct of the parties or circumstances. An express offer is made by words spoken or written. An implied offer is considered to be implied from the conduct of the parties or from the circumstances.

Example of express offer

(i) X says to Y, "will you buy my cow ` 5,000? It is an express offer.

(ii) X by a letter asks Y to purchase his horse for ‘ 70,000. It is a written offer.

Examples of implied offer

(i) Public transport, like, Railways, Haryana Roadways in Haryana

(ii) Public Telephones or Weighing Machines in public places like Railway Stations. These all offer their services for a certain amount, which is implied.

(viii) Invitation to make Proposal is not a Proposal: A proposal must be distinguished from an invitation to proposal. In the case of an "Invitation to proposal" the aim is merely to circulate information to negotiate business with anybody. Such invitations are not proposals and do not become promises.

The display of goods in a shop is an invitation to proposal. Catalogues held for sale at the price quoted are not proposals. It is an attempt to induce and not a proposal in itself. The display of goods on the shelves of a self service shop is an invitation to offer. Advertisement for sale or auction of goods, notice for tender, railway time table are only an invitation to proposal and not the proposals.

(ix) Offer should not impose an unnecessary obligation to communicate non-acceptance: An offer cannot say that if acceptance is not communicated by next Monday the offer would be considered as accepted.

(x) Offer must be distinguished from a mere declaration of intention: A declaration of intention to make an offer is regarded as an invitation to offer.

Example: An advertisement for sale of car in a newspaper is an offer for sale.

10.9 MEANING OF ACCEPTANCE

A contract is created on the acceptance of a proposal. Acceptance indicates the willing ness of the party to whom the offer has been made to agree to the terms of offer. According to Section 2 (b) of the Indian Contract Act, 1872, "When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted."

On the basis of above definition, it can be concluded that acceptance is the act of providing consent to the offer. An offer when accepted becomes a promise and creates an agreement. According to Section 2 (e), "The person making the proposal is called the promisor and the person accepting the proposal is called the promise". An acceptance must be communicated to the offeror in order to complete the acceptance. The acceptor should do something to signify his intention to accept. Fall of the hammer in the case of an auction sale is amounted to acceptance.

Effect of Acceptance: When an offeree agrees to an offer, it is said to be his acceptance. Acceptance is the readiness of offeree to abide by the terms of offer. When an offer is accepted it becomes an agreement and a contract. Thus, an acceptance forms an agreement and a contract. When an offer is accepted, it creates legal rights and obligations on both the parties.

Types of Acceptance or How it is Made: Following are the types of acceptance:

1. Express Acceptance: The assent may be express or implied. It is express when it is communicated in writing or by words of mouth.

2. Implied Acceptance: When offer in accepted by performance of some required act or by conduct, it is known as implied acceptance. Implied acceptance is also called as acceptance by conduct or mental acceptance. It is also a valid acceptance and forms a valid agreement.

10.10 RELATIONSHIP BETWEEN OFFER AND ACCEPTANCE

In the view of Sir William Amsan, an acceptance is to offer what a lighted match is to train of gun powder. He exemplified the relationship between an offer and acceptance with a train of gun powder and a lighted match. Sir William Amsan viewed that a train of gun powder cannot do explosion unless a lighted match is brought in contract with a train of gun power, the gun powder explodes and once it has exploded, it cannot be undone. However, the man who is leading the train may remove the gun powder before match is brought to its contract.

An offer has not meaning in itself unless it is accepted. Acceptance makes an offer meaningful and converts it into a promise or an agreement. Once the offer is accepted, it cannot be withdrawn. An offeror can revoke his offer before its acceptance.

Who any Accept? Who can accept an offer, it is an important question. In this connection, nature of proposal should be considered.

1. In case of General Offer: When an offer in made to the world at large, it is known as general or ordinary offer. It can be accepted by anyone by complying with the terms of the offer. For example, Ram loses his cow and announces a reward of ‘ 1000 to anyone who will bring his cow to him. This offer can be accepted by anybody. One who will find the cow and will give it to Ram, he will get the reward as he accepted the offer.

2. In case of Specific Offer: An offer which can be accepted only by the person to whom the offer is made, it is called as specific offer. This can be accepted only by the person to whom it is made.

10.11 ESSENTIALS OF A VALID ACCEPTANCE

There are some rules which make the acceptance effective so as to give rise to a valid contract. Section 6 to 7 provide the following essential elements of a valid acceptance:

1. Acceptance must be absolute and unqualified [Section (7) (1)]: To convert an offer into promise, an acceptance must be absolute and unqualified. Therefore, this is the first rule regarding the valid acceptance that “acceptance must be absolute and unqualified.” It must be according to the exact terms of the offer. An acceptance with a variation or alternation however slight, it may be not an acceptance and it will make the acceptance of this kind invalid. A qualified and conditional acceptance amounts to a counter offer and rejection of the original offer.

Example: A offers to B to sell his scooter for ‘ 10,000. In response B says yes. It is a legal acceptance.

But if in the above case B replies “I can pay ¹ 8,000 for it.” It is counter offer, not acceptance.

2. Acceptance must be in accordance to prescribed Manner [Section 7(2)]: Where the offeror has prescribed a particular mode of acceptance, then the acceptor should follow the mode. If no mode is prescribed by the proposer, then the acceptance must be provided according to some usual and reasonable mode.

Example: X sends an offer to Y through post and asks for an acceptance over telephone. Y should accept the offer over telephone. However, if Y accepts the offer by a letter, then X may insist that the acceptance should be in the prescribed mode. But if X does not insist then X is bound by the acceptance.

3. Acceptance must be within the prescribed time and in the absence of a prescribed time, it must be within reasonable time: A proposal must be accepted within the prescribed time or within a reasonable time, if no time is fixed. What is reasonable time will depend upon facts and circumstances of each and every case.

Example: X offers his car for ‘ 70,000 to Y upto Monday next by 5 p.m. Y does not accept the offer upto Monday next by 6 p.m. There is no acceptance.

4. Acceptance must be made before the offer expires or it revoked: The offer should be accepted before it expires or is revoked or withdrawn by the party making the offer. If an offer has lapsed, it lapses forever unless it has been revived again.

Example: X made an offer to Y on Sunday which was to be accepted within the next five days. Y accepted the offer on sixth day. There is not a valid acceptance as the offer had lapsed.

5. Proposal must be accepted to whom it is made: Acceptance can be provided by the person to whom the proposal is made. However, in the case of a general offer, acceptance can be given by any member of the public.

Example: X offers Y to sell his cow. It cannot be accepted by any one except Y because it is specific offer.

6. Acceptor must be aware of the proposal: An acceptor must be aware of proposal. Unless an offerer has been made aware of or communicated about the proposal, it cannot be accepted.

In one case, a person had traced the cow without knowing of the reward. Later on he could not claim the reward as he was not aware of the reward. Therefore, acceptance without an offer is not a valid acceptance.

7. Communication of acceptance: Acceptance must be communicated like an offer. Here mental acceptance not evidenced by words or conduct is, in the eyes of law, no acceptance. Making one's mind cannot be enough but one should make up one's mind and inform the offerer that he has done so.

Example: P was appointed as a principal of a school. One of the members of the Governing Body privately informed him that he had been appointed as a Principal. But no official communication was sent. Later, the Governing Body did not appoint him as the Principal. P filed a suit against the Governing Body, the court held that P could not do so as there was no communication of acceptance.

8. Silence cannot be a mode of acceptance: Silence cannot amount to acceptance.

Example: X writes to Y, "I offer you my T.V. for ` 5,000. If I do not hear from you by Wednesday next, I shall presume that you have accepted my offer." Even if Y does not reply, there cannot be a binding contract as law does not impose unnecessary burden on the acceptor to communicate his non-acceptance.

Acceptance of an offer may sometimes be inferred from silence. Although as a rule silence is not an acceptance, but in the following cases silence may be indicative of assent:

(i) Where the offeree having reasonable opportunity to reject the offered goods takes the benefit of them.

Example: K landlord served a noticed on the tenant demanding enhancement of rent of house. The tenant did not protest and continued to occupy the premises. The conduct of the tenant amounts to acceptance of the proposal to pay the rent at a higher rate.

(ii) Where because of previous dealings, the offeree has given the offeror reason to understand that the silence was intended by the offeree as a manifestation of assent.

9. Acceptance must be made with an intention to fulfil the terms: Acceptance of offer must be made in such circumstances as to show an intention on the part of the acceptor to fulfil the terms of the promise.

10. Acceptance subject to formal contract: Acceptance subject to formal contract is valid only when the formal contract has been signed by both the parties.

11. An agreement to enter into an agreement in future is not contract: An agreement to enter into an agreement in future does not create obligations.

In the case of Lofus Vs. Reberts (1902) 18 T.L.R. 532 an actress was employed to give some performances. The agreement provided that if the play was performed in London, she would be employed at a salary to be mutually agreed upon. The court held that there was no contract.

12. Acceptance by performing condition or receiving consideration: An acceptance become complete when conditions are performed or consideration is received.

13. Acceptor should be ready and competent to fulfil the contract: Acceptance should be provided in such circumstances which show that acceptor is ready and competent to fulfil the promise.

14. Proposal through Agent: If an offeror present his offer through his agent, acceptor can provide his acceptance to the agent.

10.12 COMMUNICATION OF OFFER AND ACCEPTANCE

According to Section 3 of Indian Contract Act, "The communication of proposals, the acceptance of proposals and the revocation of proposals and acceptances, respectively, are deemed to be made by any act or omission of the party proposing accepting or revoking by which he intends to communicate such proposal, acceptance or revocation or which has the effect of communicating it". Thus, there are two modes of communication: Communication by an act, and communication by omission of an act. Communication by an act includes words, in writing as well as oral and a conduct of communicator, communication by omission of an act implies such conduct or abstinence which conveys his willingness.

Communication of all offers (except general offer) and acceptances in essential. If the parties are physically present and negotiate, an agreement comes into existence the moment, the offereee gives his absolute and unqualified acceptance. If the parties are at a distance and the offer and acceptance are sent and received through post, rules contained in Sections 4 and 5 will apply.

Communication of Offer [Section 4]: The communication of a proposal is complete upon it when to the knowledge of the person to whom it is made.

Section 4 indicates that actual communication of the offer is not essential. It is sufficient if the offer comes to the knowledge of the offeror.

It an offer is sent by post, its communication will be complete when the letter making the offer reaches the offeree. The offer is completed at the place where it was received.

Example: X and Y are talking face to face. X offers to sell his horse to Y for a certain price. Communication of offer is complete as soon as Y listens to it.

Communication of Acceptance [Section 4]: The completion of communication of acceptance has following two aspects:

(a) As against the proposer: The communication of acceptance is complete, as against the proposer, when it is put into a course of transmission to him, so as to be out of the power of the acceptor.

(b) As against Acceptor: The communication of acceptance is complete against the acceptor when it comes to the knowledge of the proposer.

Example: A proposes by a letter to sell his scooter to B at a certain price. B accept A's proposal by letter sent through post. The communication of acceptance is complete as agreement when the letter is posted in the letter box duly stamped and addressed, as against B and when the letter is received by A.

Communication of Acceptance based on Different Court Decisions: Following things is important regarding the communication of acceptance based on different decisions:

1. Acceptance or Contract over Telephone or Telex: When offer and acceptance are made over teleprinter or telephone, the question arises as to

when in such cases the contract is concluded. In the case of Entores Ltd. Vs. Miles for East Corporation (1955) 2 All E.R. 493, the court held that communication made by means of telephones or telex are virtually instantaneous and stand on a different footing. The contract will be complete when the acceptance is received by the offeror and the contract is made at the place where the acceptance is received.

Contracts over telephone or teleprinter have the same effect as oral agreements. However, the offeror may not properly hear the acceptance on telephone because of some defect in communication.

In case of Kahhiyalal Vs. Dineshwarehandre (1955) 1, All E.R. 493, it was held that if the words of acceptance are inaudible and are not heard by the offeror, then the acceptance is incomplete and no contract would be formed until the acceptor repeats his acceptance so that offeror can hear and understand it.

Example: X makes a proposal from the third floor of the house to Y who is standing on the roadside. Y replies back accepting X's offer but because of the noise Y's acceptance is not clearly heard by X. There is no contract at the moment. However, if Y wants to make a contract he should repeat his acceptance so that X can hear and understand. The contract will be complete only when X has clearly heard and understood Y's reply.

2. Acceptance by post: When acceptance is sent by post, it is complete as against the offeror, when the letter is dropped in the letter box. In this case it is assumed the post office is like an agent of the proposer.

3. Delay in post office: If acceptor has posted his letter of acceptance but was delayed in post office, the posting of the letter shall be treated as an acceptance.

4. Wrong Address on the letter of acceptance: If acceptor has furnished wrong address, he will be bound.

5. Communication of acceptance in the case of an agent: If an offeror presents his offer through his agent and acceptor provides his acceptance to the agent, this acceptance shall be treated as communication to the offeror.

6. Place of Contract: Place of contract is very important because jurisdiction of the court is decided on the base of it. Place of contract shall be determined as under:

(i) If proposal and acceptance is done on a specific place.

(ii) If acceptance is given over telephone or telex at place of proposer.

(iii) If acceptance is given through post-place of acceptor.

Difference between English Law and Indian Law: The English law on communication of offer, acceptance and revocation by post differs in some respects. In England, post offer is treated as agent of the party making an offer to take the offer to the offeree and to bring back the acceptance.

Therefore, acceptance cannot be revoked in the English Law. But in India post office is treated as the agent of both parties i.e. offeror and offeree.

Communication of revocation of proposal and Acceptance [Section 4]

(a) Against the person who makes it: The communication of a revocation of an offer or an acceptance is complete as against the person who made it, when it is put into a course of transmission to the person to whom it is made, and when it comes to his knowledge.

Examples

) V offer by letter, to sell a house to P at a certain price. P accepts the proposal by a letter sent by post.

(ii) V revokes his offer by telegram. The revocation is complete as against V, when the telegram is dispatched, and as against V, when it reaches him.

Revocation of Proposal and Acceptance [Section 5 and 6]

Revocation of proposal: According to Section 5 of the Act, "A proposal may be revoked at any time before the communication of its acceptance is complete as against proposal, but not afterwards.

An offer can be revoked at any time before acceptance. Letter revoking the proposal must be received before the letter of acceptance in posted.

In the case of N. Sesharatanam V. Sub-Collector, (1992) SC 132, a landlord named N' had offered land for acquisition if a certain lumpsum amount was paid. Before the acquisition officer could accept it, he withdrew his offer, in this case revocation was held valid.

Revocation of offer at Auction sale: A bid is an offer and an acceptance of a bigger bid indicates rejection of the preceding lower bid. A bid is not binding on either side till it is consented to. Any bid may be withdrawn at any time before the fall of the hammer.

Revocation of standing offer: Standing offer or tender is deemed as an invitation to offer. Tender is treated as a contract only when the other party places as actual order for the supply of goods. A continuous or standing offer may be revoked as to future orders but an order already placed cannot be revoked.

10.13 REVOCATION OF OFFER AND ACCEPTANCE

(a) Revocation of an offer

An offer may come to an end by revocation or rejection or lapse. According to Section 6, revocation of proposal may be made in the following modes:

1. By Notice of Revocation: [Section 6(1)]: A proposal may be revoked by the communication notice of revocation before acceptance is complete as against the proposer. An offer made in writing may be revoked by words or mouth. A notice of revocation must be communication to the offeree. It will be effective only when that the offeree has actual knowledge of the revocation.

Case Study: The case of Joravarmuli Champa Lal v. Jeygo Paldus Ghanshamdas AIE 1992 Mad 486 is important in this regard.

At an auction sale, J made the highest bid for G's goods. He withdrew the bid before the fall of the hammer. G knocked down the goods in favour of J. G sued J for the price of goods. In this case it was held that J's bid was no more than offer and he was entitled to withdraw the same before it was accepted.

2. By the Lapse of Specified time: [Section 6(2)]: Section 6(2) of the Act says that if time is prescribed for the acceptance of the proposal, it will lapse by not being accepted within the time prescribed or if no time is so prescribed by the lapse or reasonable time. What is a reasonable time, it will depend upon the facts and circumstances of each case.

Case Study: In the case of Head v. Diggen (1828) 3 M & R 97, D offered to sell goods to H on Wednesday and agreed to give him three days time to accept. H accepted the offer on Sunday, but by that time D had sold the goods. In this case, it was held that the offer had lapsed.

3. By making a counter offer: An offer comes to an end when the offeree makes a counter offer. Where an offer is accepted with some modification or with some condition not forming part of the offer, such acceptance amounts to a counter offer. An offer once rejected cannot be reconsidered.

4. By the non-fulfilment of a condition precedent to acceptance: An acceptance must be absolute, i.e. all the conditions of the offer must be fulfilled.

Example: X applied for 500 shares of a company on the condition that he should be appointed as a manager of the company. The company allotted him shares but did not appoint him as a manager. The offer in this case lapsed as the company did not fulfil the condition precedent to acceptance.

5. By Death or Insanity of the propose: An offer is revoked by the death or insanity of the offerer if the fact of his death or insanity comes to the knowledge of the acceptor before acceptance. Under English law, death of the proposer revokes an offer even if acceptance is made in ignorance of the death.

Example: A makes an offer to B. B comes to the knowledge that A has died, in this case proposal is revoked.

6. Revocation by not accepting the proposal in the made prescribed: If a proposal is not accepted according to the mode prescribed, the offeror can reject such acceptance. Such acceptance must be rejected by giving notice to the offeree within a reasonable time. However, if offeror does not raise any objection he is deemed to have accepted the proposal.

7. By the non-acceptance of the offer according to the prescribed or usual mode: The offer will also be treated as revoked if it has not been accepted according to the mode prescribed or if mode is not prescribed according to the usual mode.

8. By destruction of subject matter or by subsequent illegality: A proposal lapses if subject matter of it gets destroyed or becomes illegal after it is made and before it is accepted.

Example: A offer B to sell his cow for ‘ 5,000. Cow dies before making an acceptance of proposal. It shall be treated as revocation of proposal.

(b) Revocation of Acceptance (Section 5)

According to Section 5 of the Act an acceptance can be revoked at any time before the communication of acceptance is complete as against the acceptor and not afterwards.

Example: X proposes, by a letter sent by post, to sell his car to Y. Y accepts the proposal by a letter sent by post. After it reaches, the same day Y revokes his acceptance through telegram.

X receives telegram before opening the letter. But the letter reaches before telegram due to this reason, acceptance may not be revoked.

10.14 SUMMARY

A contract is an agreement enforceable by law. An agreement is enforceable by law, if it is made by the free consent of the parties who are competent to contract and the agreement is made with a lawful object and is for a lawful consideration, and is not hereby expressly declared to be void. All contracts are agreements but all agreements are not contracts. Agreements lacking any of the above said characteristics are not contracts. A contract that ceases to be enforceable by law is called 'void contract', but an agreement which is enforceable by law at the option of one party thereto, but not at the option of the other is called 'voidable contract'.

A contract is an agreement enforceable by law. When one person signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal or offer. Offer may be expressly made or may even be implied in conduct of the offeror, but it must be capable of creating legal relations and must intend to create legal relations. The terms of offer must be certain or at least be capable of being certain. Acceptance of offer must be absolute and unqualified and must be according to the prescribed or usual mode. If the offer has been made to a specific person, it must be accepted by that person only, but a general offer may be accepted by any person.

10.15 KEYWORDS

Contract: A contract is an agreement creating and defining obligations between the parties.

Agreement: An agreement is the sum total of offer and acceptance.

Valid Contract: A valid contract is one, which satisfied all the requirements prescribed by the law for the validity of a contract.

Void Contract: It is one which was legal and enforceable which it was entered into but has subsequently become void because of certain reasons.

Voidable Contract: A voidable contract is a contract which can be avoided or set aside at the option of one of the parties to the contract.

Implied Contract: Where the proposal or acceptance is made otherwise than in words, it is an implied contract.

Offer: A communication by one person to another of his willingness to do or abstain from doing with the objective of getting the acceptance of the other.

Acceptance: The consent of the parties to whom the offer has been made.

Revocation: Taking back of an offer or acceptance.

Agreement: Every promise and every set of promises forming consideration for each other.

10.16 SELF ASSESSMENT QUESTIONS

1. "An agreement enforceable by law is a contract". Discuss the definition and bring out clearly the essentials of a valid contract.

2. "All contracts are agreements, but all agreements are not contracts". Discuss the statement explaining the essential elements of a valid contract.

3. What do you understand by the terms 'void' and 'voidable' contracts? Discuss the rights and obligations of the parties to a void contract and to a voidable contract after its rescission.

4. Distinguish between:

   (a) Void and Voidable contracts

   (b) Void agreements and Void contracts

   (c) Void and Illegal agreements

5. X invited Y and his family to dinner on a certain night. Y accepted X's invitation. On the date fixed Y drove with his family from Sector 13 to Industrial Area and found his house locked. They waited upto 9.30 p.m. but the host did not turn up. They left the place and had their meals in Piccadilly in Sector 17. The cost of meal came to Rs. 5000. Can Y recover the amount?

6. Define the term 'offer'. What are the rules regarding a valid offer?

7. Define the term 'acceptance'. Discuss legal formalities relating to a valid acceptance.

8. Give the meaning and different types of acceptance. Also discuss the r elationship of offer and acceptance.

9. "A contract is formed when the acceptor has done something to signify his intention to accept, not when he has made up his mind to do so." Discuss the statement.

10. Discuss the meaning of offer and acceptance. When is communication of an offer and acceptance complete? How and when can a proposal be revoked?

11. How and on what grounds does an offer stand revoked? Is there any time limit after which a revocation of an offer cannot be made?

10.17 SUGGESTED READINGS

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers, New Delhi.

S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi.

Avtar Singh, Priciples of Mercantile Law, Eastern Book Co., Lucknow.

M.C. Shukla, A Manual of Mercantile Law, S. Chand & Co., New Delhi.

LESSON : 11

FREE CONSENT, CONSIDERATION AND CAPACITY OF PARTIES

STRUCTURE

11.0 OBJECTIVES

A careful study of this lesson will enableyou to:

a) Understand the meaning of consent and identify the cases where the consent is not said to be free;

b) Explain the meaning of consideration and identify the cases where consideration of an agreement is unlawful; and

c) Identify the persons who are not competent to enter into contracts.

11.1 INTRODUCTION

According to Section 13, 'Two or more persons are said to have consented when they agree upon the same upon the same thing in the same sense'. A contract which is regular in all other respects may still fail because there is no real consent to it by one or both of the parties. There is no consensus ad idem or meeting of the minds. According to Section 10 of Indian Contract Act, 'Consideration' is one of the essential elements of a valid contract. The fact of its existence serves to distinguish those promises by which the promisor intends to be legally bound from those which are not seriously meant.

An essential element of a valid contract according to Section 10, is that the contracting parties must be 'competent to contract'. Section 11 lays down that "Every person is competent to contract who is of the agr of majority according to the law to ehich he is subject, and who is of sound mind, and is not disqualified from contracting by any law to which he is subject". Thus a person is competent to contract under:

(a) if he is not a minor, according to the law to which he is subject,

(b) if he is not of unsound mind, and

(c) if he is not disqualified from contracting by any law to which he is subject.

11.2 DEFINITION OF FREE CONSENT

The term 'free consent' may be defined as the consent which is obtained by the free will of the parties, and neither party was forced or induced to give his consent. If the consent is there but it is not free or real, then the contract will be voidable at the option of the party whose consent is not free. The term 'free consent' is defined in Section 14 of the Indian Contract Act, which reads as under:

Consent is said to be free when it is not caused by-

1. Coercion, as defined in Section 15, or

2. Undue influence, as defined in Section 16, or

3. Fraud, as defined in Section 17, or

4. Misrepresentation, as defined in Section 18, or

5. Mistake, subject to the provisions of Sections 20, 21 and 22.

Consent is said to be so caused when it would not have been given but for the existence of such coercion, undue influence, fraud, misrepresentation or mistake."

11.3 ELEMENTS WHICH AFFECT THE CONSENT OF THE PARTIES

According to Section 14, the following elements affect the consent of the parties:

1. Coercion
2. Undue influence
3. Fraud
4. Misrepresentation
5. Mistake

The consent obtained by any of the above elements is not free consent. It may be noted that in the first four elements mention above (i.e., coercion, undue influence, fraud and misrepresentation), the consent is there but it is not free. But in the last element (i.e., mistake), there is no consent at all because there is no identity of minds. The effect of 'no free consent' and 'no consent at all' on the contract may be stated as under:

a) When the consent is not free, then the contract is voidable at the option of the party whose consent is not free. A voidable contract is enforceable at the option of the party whose consent was not free.

b) When there is no consent, then the contract is void ab initio (i.e., from the very beginning). In fact, no contract will come into existence in such a case. A void contract being void ab initio, is not enforceable at the option of either party.

Thus, there is lot of difference between 'no free consent' and 'no consent at all'. In the following cases, there is complete absence of consent (a) when there is error as to the nature of the contract itself, (b) when there is error as to the identity of the parties, (c) when there is error as to the subject-matter of contract.

1. COERCION:

What is coercion in India is 'duress' under English law, but coercion covers much wider field. Duress is limited to actual violence or threats of violence to the person, or imprisonment or the threat of criminal proceeding to the person coerced or those near or dear to him, such as his wife, children or parents. Threats to property are not duress. Coercion, on the other hand, may be against person or property, and the person coerced may be any person, not necessarily the party to the contract or his wife, parent or child.

In Multhiah Chettiar v. Karuppan Chetti (1927 50 Mad. 786), an agent refused to hand over the account books, bonds etc., of the business to his successor agent unless the principal gave him a release of all liabilities during the term of his agency. The principal did so but later succeeded in the suit to declare the release deed as vitiated by coercion.

It should, however, be noted that mere threat by one person to another to prosecute him does not amount to coercion. There must be a contract made under the threat, and that contract should be one sought to be avoided because of coercion (Ramchandra v. Bank of Kohlapur, 1952 Bom. 715). It may be noted that coercion may proceed from any person, and may be directed against any person, even a stranger, and also against goods e.g., by unlawful detention of goods.

2. UNDUE INFLUENCE:

Section 16 of our Contract Act states that a contract is induced by undue influence where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other.

It further states that a person is deemed to be in a position to dominate the will of another (i) where he holds a real or apparent authority over the other, or (ii) where he stands in a fiduciary relation to the other; or (iii) he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness or mental or bodily distress.

It is clear from this definition that contracts which may be rescinded for undue influence fall into two categories. *Firstly,* those where is no special relationship between the parties. *Secondly*, those where a special relationship exists.

Undue influence is a kind of "mental coercion", it destroys the free agency of one and constrains him to do which is against his will, and which he would not have done if left to his own judgement and volition, so that his act becomes the act of the one exercising the influence, rather than his own act.

Where no relationship between parties exists. Where no special relationship exists between the contracting parties, the plaintiff (i.e. the party influenced) must prove two things: (i) that the other party was in a position to dominate his will, (ii) that the contract was substantially unfair giving the dominant party unfair advantage.

Where special relationship exists. In the second class of cases, undue influence is presumed either because of an exceptional authority one has over the other or he stands in a fiduciary position to the other and owes a duty to give that other a disinterested advice. The possibility that he may put his own interest uppermost is so obvious that he comes under a duty to prove that he has not abused the position.

Whether fiduciary or confidential relationship exists or not, the question is always the same - was undue influence used to procure the contract or gift? But the burden of proof is different. If B seeks to avoid a contract with A, then in the absence of any confidential relationship, the entire onus is on B to prove undue influence, but if he shows the existence of such relationship, the onus is on A to prove that undue influence was not used. A must rebut the presumption of undue influence.

To discharge the onus that he did not employ undue influence, the party must show that the other party to whom he owed the duty in fact acted voluntarily, in the sense that he was free to make an independent and informed estimate of the expediency of the contract or other transaction. The other party received independent advice before he completed the contract.

Example: A, having advanced money to his son B during his minority, upon B's becoming major obtained, by misuse of parental influence, a bond from B for a greater amount than the sum due in respect of the advance. A employed undue influence.

Purda Nishin Woman

The law throws around a Purda Nishin woman a special cloak of protection, and demands that person who deals with her must show affirmatively and conclusively that the deed was not only executed by, but was explained to, and was really understood by the lady. It must also be proved that no coercion or undue influence was exercised on her, either by the party to the transaction or by a third party, and that she had executed the document of her free will. The reason is that the ordinary presumption that a person understands the document to which he has affixed his name does not apply in the case of Purda Nishin Woman. But a lady, whether Hindu or Muslim, who is claiming to be Purda Nishin must prove complete seclusion; and some degree of seclusion is not sufficient to entitle her to get special protection.

Difference between Coercion and Undue Influence

Following are the differences between coercion and undue influence:

(i) *Moral and Physical Force.* In undue influence, the influence is due to moral pressure whereas in coercion it is due to physical force. Undue influence is sometimes marked as 'moral coercion' which is distinct from 'physical coercion' or coercion in true sense.

(ii) *Relationship between Parties.* In the case of undue influence, there must be certain relationship between the parties which places one party in a position to dominate the will of the other i.e. undue influence is between the parties to the transaction, the promise procures the promisor's constant by undue influence. Coercion need not proceed from the promisee nor need it be directly against the promisor, that is, existence of certain relationship is not necessary in case of coercion.

(iii) *Way of obtaining consent.* In undue influence, the consent is obtained by dominating the will of the giver and the consent is freely given under the belief that he is not to be put to any loss by giving such consent. In case of coercion, the consent is obtained by committing or threatening to commit an offence, and the person is forced to give his consent.

(iv) *Legal consequences.* Where the consent of the promisor is procured by coercion, the contract is voidable at his option but where the promisor's consent is procured by undue influence, the contract is either voidable or court may enforce it in a modified form.

(v) *Character of the consent.* Briefly, undue in influence is of a moral character and is more subtle and intangible; coercion is chiefly of a physical character and is of an avowedly violent character.

3. FRAUD:

1. the suggestion as to a fact, of that which is not true, by one who does not believe it to be true;
2. the active concealment of a fact by one having knowledge or belief of the fact;
3. a promise made without any intention of performing it;
4. any other act fitted to deceive; and
5. any such act or omission as the law specially declares to be fraudulent.

But mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence to speak or unless his silence is, in itself, equivalent to speech.

In the words of Lord Herschel, Fraud is an untrue statement made knowingly, or without belief in its truth, or recklessly, careless whether it be true or false with intent to deceive.

In simple terms, fraud is false statement or wilful concealment of a material fact with intent to deceive another party. The party deceived or defrauded can avoid the contract and also claim damages.

Characteristics of Fraud. The essential characteristic of fraud are following:

(a) There must be representation or assertion and it must be false, or there must be active or wilful concealment of a material fact. If there is an actual false statement, the case is simple. A, intending to deceive B, falsely represent that the television set he is offering for sale is German made, when it is in fact a locally made set. If concealment is alleged mere non-disclosure of material facts, however morally censurable, does not render a contract voidable. Mere silence is not misrepresentation, unless silence is in itself equivalent to speech, or where it is the duty of person keeping silence to speak; as where a fiduciary relation exists between the contracting parties or the contract requires utmost good faith. Disclosure is also essential where part-truth amounts to falsehood. If part only of facts is disclosed, and the undisclosed part so modifies the part disclosed as to render it, by itself, substantially untrue, there is a duty to disclose the full facts. Non-disclosure will amount to fraud.

(b) The representation must be of fact. The assertion must be of fact and not a mere expression of opinion, or hearsay, or puffery of flourishing description.

Thus, if A, who is about to sell a horse to B, says that the horse is a beauty and is worth ` 10,000 that is A's opinion and B is at liberty to reject it. But if in fact he paid only ` 5000 for it, then A has misstated a fact, and if B has been induced by that statement to buy the horse, he may rescind the contract on the ground of fraud.

(c) There must be knowledge of the falsehood of the representation or a reckless disregard as to its being true or false. In a reckless misstatement, the person is not sure as to the fact in his own mind; he feels a doubt, yet he represents to the other party, as if he is certain about the truth of the fact represented by him. Such misrepresentation is fraud. Also a promise made without an intention of performing it is fraud. To buy goods with the preconceived idea of getting goods without paying for them is fraud.

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(d) The representation must be made with the object of inducing the party deceived to act upon it. The assertion must be made with the intention of inducing one to act on the assertion who does so act. This means that there is an inducement in fact and the assertion is one which necessarily influenced and induced the party to act. The party misled must not have exercised his own skill of judgement.

(e) The representation must in fact deceive. The representation must be acted upon as it was intended to be acted upon so that the party misled is actually deceived. A deceit which does not deceive is not fraud.

(f) The plaintiff must be thereby damnified. It is a common saying that "there is no fraud without damage", for an action being one of deceit, and unless the plaintiff and sustained damage or injury, no action will lie. The damage may consist of actual and temporal injury, that is, some losses of money or money's worth, or some tangible detriment capable of assessment.

4. MISREPRESENTATION:

An untrue statement or misrepresentation may be either (i) Innocent, or (ii) Wilful or Deliberate with intention to deceive and is called Fraud.

Innocent Misrepresentation: Innocent misrepresentation is a misstatement made innocently and with an honest belief as to its truth. It is sometimes called "Invalidating Misrepresentation". The effect of innocent misrepresentation of fact is that the party misled by it may repudiated the contract and (i) raise the misrepresentation as defence to any action the other party may bring against him, or (ii) sue for rescission of the contract and restitution of anything he has transferred to the misrepresenter.

Damages of Misrepresentation: Generally, the injured party cannot get damages for innocent misrepresentation. But in the following exceptional cases he can get damages:

(a) From promoters or directors who made such misrepresentation in a prospectus under Company Law;

(b) Against an agent who commits a breach of warranty of authority;

(c) From a person who (at the Court's discretion) is stopped from denying a statement he has made where (i) he made a positive statement intending that it should be relied on, and (ii) the innocent party did rely on it, and thereby suffered damage.

What to be proved?: It should be remembered that in order to avoid a contract on the ground of misrepresentation, it is necessary to prove that (i) there was a representation or assertion, (ii) such representation induced the party aggrieved to enter into contract, (iii) the assertion was of fact (and not of law, as ignorance of law is no excuse); (iv) the statement was not a mere opinion, or hearsay, or commendation (i.e. reasonable praise) or tradesman's "puff", (v) the statement, which has become or turned out to be untrue, was made with an honest belief in its truth.

Effect: In an innocent misrepresentation, the party aggrieved may avoid the agreement, even though the statement was true at the time it was made but became untrue later by reason of change of circumstances.

Difference between Misrepresentation and Fraud

The main difference between fraud and misrepresentation is that in fraud the person making misrepresentation does believe it to be true and in misrepresentation he does not believe it to be true. In both the cases, it is a misstatement of facts which mislead the promisor. Misrepresentation (often called innocent misrepresentation) differs form fraud (often called fraud or wilful misrepresentation) in following respects:

(i) *Intention of the Party.* Fraud generally implies that there is an intention to deceive whereas misrepresentation may be innocent. Thus both in fraud and misrepresentation, there is statement which is false, but the distinction between them mainly turns round the intention of the party. A false statement without any intention to deceive would be misrepresentation but a false statement deliberately or recklessly made to deceive another is a case of fraud.

(ii) *Additional action for damages.* Fraud gives right to an action for deceit, in addition to its effects of avoidance of the contract, and the party aggrieved can recover damages if he has sustained any in consequence of fraud practised upon him by the other party. Misrepresentation merely goes to avoid the contract.

(iii) *Discovery of truth by ordinary diligence.* If consent to an agreement is caused by passive fraud (fraudulent silence) or innocent misrepresentation, the contract is not voidable if the representee had the means of discovering truth with ordinary diligence. But where consent to an agreement is caused by active fraud, the contract is truly voidable even though the party defrauded had the means of discovering with ordinary diligence.

5. MISTAKE:

The general common law rule is that mistake made by one or both parties in making a contract has no effect on the validity of contract. For example, an error of judgement is not an operative mistake and does not affect the validity of the contract. If A buys an article thinking it is worth ` 10, when in fact it is worth only ` 5, the contract is good and A must bear the loss if there has been no misrepresentation by the seller.

Mistake of fact

Section 20 of the Contract Act provides: "When both the parties to an agreement are under a mistake as to a matter of fact essential to agreement, the agreement is void". Thus, to be operative (so as to render the contract void) the mistake must be (i) on the part of both the parties, (ii) of fact and not of law or opinion, and (iii) so fundamental as to negate mistake of fact, the contract would be void. Such a mistake prevents the formation of any contract at all, and the court will declare it void. But as Section 22 provides unilateral mistake of fact will not render the contract voidable.

Mistake of law

If there is mistake of law of land, the contract is binding because everyone is deemed to have knowledge of his own law, and ignorance of law is no excuse. But mistake of foreign law and mistake of private rights are treated as mistakes of fact, and are excusable. The laws of a foreign country require to be proved in Indian courts as ordinary fact, and so a mistake of foreign law makes the contract void. Similarly, if a contract is made in ignorance of private rights, it would be void, e.g. where A buys property which already belongs to him.

Operative Mistake of Fact

Operative mistakes may be classified into the following categories:

a) Mistake as to the nature of the contract itself.

b) Unilateral mistake, i.e. mistake made by one party only.

c) Bilateral mistake, where both parties make a mistake, which may be either
(i) Common Mistake, or (ii) Mutual Mistake.

Common mistake occurs where both parties have made the same mistake and may also be designed as identical bilateral mistake. Mutual Mistake occurs where both parties make a different mistake and may also be called non-identical bilateral mistake. These are clearly differentiated in following paragraphs between themselves and contrasted with unilateral mistake.

a) Mistake as to a nature of contract

The general rule is that a person who signs as instrument is bound by its terms even if he has not read it. But if a person signs a contract in the mistaken belief that he is signing a document of a different nature, there will be a mistake which avoids the contract. The mistake must be as to the nature of the contract and not merely as to the contents of the document, and also the mistake must be due to either (a) the blindness, illiteracy, or senility of the person signing, or (b) a trick or fraudulent misrepresentation by the other party as to the nature of the document.

b) Unilateral Mistake

Unilateral mistake occurs when one of the parties to a contract is mistaken as to some fundamental fact concerning the contract and the other party knows this. This latter requirement is important because if B does not know that A is mistaken, the contract is good. Unilateral mistakes may be of two types: (i) regarding identity of party and (ii) unilateral mistake of offeror.

(i) Identity of party: The cases of unilateral mistake are mainly concerned with mistake by one party as to the identity of the other party. It is rule of law that if a person intends to contract with A, B cannot give himself if any rights under if. Here, when a contract is made in which personalities of the contracting parties are or may be of importance, no other person can interpose and adopt the contract.

For example, where M intends to contract only with A but enters into contract with B, believing him to be A, the contract is vitiated by mistake, as there is no Consensus ad idem.

Remember that mistake as to identity of the person with whom the contract is made will operate to nullify the contract only if:

(a) the identity is of material importance to the contract, and

(b) the mistake is known to the other party, i.e. he knows that it is not intended that he should become a party to the contract but some other person is intended.

In Cundy V. Lindsay (1878 3 A.C.459), one Blenkarn by imitating the signature of a reputable firm called Blenkarn and Son, induced Lindsay to supply him with goods on credit, which he afterwards sold to Cundy, an innocent purchaser. Lindsay claimed the recovery of the goods, or their value from Cundy. It was held that the contract between Blenkarn and Lindsay was void for mistake, and that no property passed to Cundy. Cundy was liable to Lindsay from the value of the goods.

(ii) Unilateral mistake of offeror where the offeror makes a material mistake in expressing his intention, and the offeree knows, or is deemed to know of the error, the mistake is operative and the contract is void.

In Hartog v. Colin Shields (1939 3 E.R.566). H claimed damages for breach of contract, alleging that C had agreed to sell him 30,000 Argentinian hare skins and had failed to deliver them. C contended that there was a material mistake in the offer and that H was well aware of this mistake when he accepted the offer. The mistake alleged by C was the skins were offered at certain prices per pound instead of per piece. In the negotiations preceding the agreement, reference had always been made to prices per piece, and it was also the custom of the trade. Held, the contract was void expressed C's real intention; H must have known that is was made under a mistake.

c) Bilateral Mistake

A bilateral mistake, as observed earlier, arises when both parties to a contract are mistaken as regards a fact essential to the contract. They may have made a common or identical mistake; or a mutual or non-identical mistake.

Following may be cases of bilateral mistakes:

(i) Common mistake as to the existence of the subject-matter. Where both parties believe the subject matter of the contract to be in existence at the time of the contract but in fact it is not in existence, there is operative mistake and the contract is void.

If A agrees to sell his car to B, and unknown to them both the car had at the time of the sale been destroyed by fire, then the contract will be void because A has innocently undertaken an obligation which he cannot fulfil.

But where the circumstances are such that the seller is deemed to have warranted the existence of the goods, the seller is probably liable to the buyer for breach of contract if the goods are non-existent.

(ii) Common mistake as to a fact fundamental to the agreement. Where the parties have made a contract based on a common misapprehension relating to the fundamental subject matter of the contract there is 'operative mistake'. This means that the contract actually made is essentially different from the contract the parties intend to make.

(iii) Mutual or non-identical mistake as to the identity of the subject-matter. Where the parties are both mistaken as to a fundamental fact concerning the contract but each party has made a different mistake, there is a mutual or non-identical mistake.

Thus, if A offers to sell his Ambassador Car, and B agrees to buy thinking A means his Fiat Car, there is a bilateral mistake which is mutual or non-identical. The contract does not come into existence under such a mistake, because there is no consensus ad idem. The parties have negotiated completely at cross-purposes and they were never in agreement.

(iv) Mistake as to quality of subject-matter or promise. Mistake as to the quality raises difficult question. If the mistake is bilateral and because of the mistake the thing does not possess the quality bargained for the contract is obviously void. But if the mistake is only unilateral difficulty arises. Mere mistake as to quality of the subject matter of a contract does not invalidate it, but mistake of one party to the promise of the other party as to quality of subject matter, known to that other party, does invalidate the contract. Such a question generally arises in cases of sale of goods. The principle commonly applicable is caveat emptor-Let the buyer beware. There is generally no obligation on a contracting party to enlighten the other party even where he knows or suspects there is a misapprehension.

For example, A offers to sell a watch to B, and B thinking it is a gold watch, offers Rs. 5000 for it. A knowing the watch is not gold, accepts B's offer without enlightening him. The contract is binding, provided A made no representation in the matter.

But where a party knowing that the other was labouring under a mistake "snatches a bargain" by hurriedly closing the transaction, this unilateral mistake will enable the party to avoid the contract.

(v) Mistake through non-disclosure in contracts of utmost good faith or uberrimae fidei. A contract uberrimae fidei is a contract of utmost good faith. In such a contract, the law imposes a special duty to act with the utmost good faith, i.e. to disclose all material information. Failure so to disclose all facts truthfully renders the contract voidable at the option of the party. Here silencer can amount to misrepresentation.

Contracts *unberrimae fidei* **(utmost good faith)** are-

(a) Contracts of insurance of all kinds. The assured must disclose to the insurer all material facts; and non-disclosure or misstatement will render the contract of insurance void (Ratan Lal v. Metropolitan Co., 1959 Pat. 413).

(b) Contracts to take shares in a company under a prospectus. When a company invites the public to subscribe for its shares by means of a prospectus, it is under statutory obligation to disclose truthfully the various matters set out in the Companies Act. Any person responsible for the non-disclosure of any of these matters is liable to damages. Also, the contract to take shares is voidable where there is a material non-disclosure in the prospectus.

(c) Contracts for the sale of land. The vender is under a duty to purchaser to show good title to the land he has contracted to sell. He must, therefore, disclose all defects in title. This duty does not extend to physical defects in the property itself.

(d) Contracts of family arrangements. When members of a family make agreements or arrangements for the settlement of the family property, each member of the family must make full disclosure of every material fact within his knowledge.

(e) Suretyship and partnership contracts. Contracts of suretyship and contracts of partnership, though often described as contracts unberrimae fidei, are not properly so described; they do not require utmost good faith at their formation. In both cases, after the contract has been made there is a duty of utmost good faith on the parties to disclose to each other all material facts coming to light after the making of the contract.

11.4 MEANING OF CONSIDERATION

It may be defined as the price for which the promise of the other is bought. It is something which is of some value in the eyes of law. It may be some benefit to the plaintiff or some detriment to the defendant. It is also used in the sense of *quid pro quo* i.e. something in return.

Section 2(d) of the Indian Contract Act defines consideration as:

(a) when at the desire of the promisor,

(b) the promisee or any other person,

(c) has done or abstained from doing, or does or abstains from doing, or
promises to do or abstain from doing,

(d) something, such act or abstinence or promise is called a consideration
for the promise.

The definition of consideration as given in Section 2(d) is a simple and practical definition. It is something of value which the promisee has given, gives or promises to give in return for the promise. It does not mean payment of money only. Forbearance to sue is good consideration. A promise can be a consideration for another promise. A single consideration may support more than one promise. It can also consist in performance. Settlement of dispute can be a good consideration for the promise. Similarly, if the promisee gives up any legal right, he gives sufficient consideration to support the other party's promise. Thus, refraining from smoking, gambling or drinking would supply the consideration needed to support another person's promise to pay a certain sum of money to the one who refrained. But the mere doing of a thing which a person is already legally bound to do is no consideration for a new promise in his favour.

Example: X agrees to sell his horse to Y for ` 10,000. Here X's promise to sell his horse is for Y's consideration to pay ` 10,000. Similarly, Y's promise to pay ` 10,000 is for X's consideration to sell his horse to Y.

11.5 ESSENTIALS OF VALID CONSIDERATION

The essentials of a valid consideration are discussed as follows:

1. It must move at the desire of the promisor: In order to constitute legal consideration, the act or abstinence forming the consideration for the promise must be done at the desire or request of the promisor. Thus acts done or services rendered voluntarily, or at the desire of third party, will not amount to valid consideration so as to support a contract. The logic for this may be found in the worry and expense to which every one might be subjected, if he were obliged to pay for services, which he does not need or require.

Example: A advanced money to B on an undertaking given by his father and obtain promissory notes for the amount advanced. On a suit to recover the amount, it was held that these pronotes were without consideration in as much as the advances were not made at the request of B. (Raja of Venkatagiri v. Krishnaya AIR 1948 P.C. 150).

A promise to subscriber to a public or a charitable object is unenforceable because there is not benefit to the promisor. But where the other party has undertaken a liability on the faith of the promise made by the promisor, it is enforceable.

The leading case on this point is *Kedar Nath v. Gori Mahomed (1886)*

Decision : An Act done at the request of the promisor is a good consideration to supply the promise.

Facts on the case are: X had agreed to subscribe ` 100 towards the construction of a Town Hall at Hawrah. Y the secretary of the committee, on the faith of the promise called for plans and entrusted the work to contractors and undertook liability to pay them. X refused to pay the promised amount and Y brought a suit against him. It was held that though the promise was to subscribe to a charitable institutions and there was no benefit to X, yet it was supported by consideration in that Y, the promisor suffered a detriment in having undertaken a liability to the contractors on the faith of the promise made by X.

But where nothing has been done in furtherance of the object of the fund raised, a promised subscription is not legally recoverable.

2. Consideration may move from the promisee or any other person: The important feature of the definition of consideration in Section 2 (d) is that the act which is to constitute a consideration may be done by the promise or any other person. It means that as long as there is a consideration for a promise, it is immaterial who has given it. It may move from the promisee, or if the promisor has no objection, from any other person. This is wider than the concept of England, where consideration can move only from the promisee. Consideration moving from a third party who is minor is no consideration.

Example: X, Y and Z enter into an agreement under which X pays ` 1,000 to Y and Y agreed to build a house for Z. Here Z is a party to the contract but stranger to consideration and can enforce the contract.

3. Consideration may be past, present or future:

When something is done or suffered before the date of the agreement, at the desire of the promisor, it is called 'past consideration'. It must be noted that past consideration is good consideration only if it is given by the promisee, 'at the desire of the promisor'.

Example: A teaches the son of B at B's request in the month of January, and in February B promises to pay A a sum of ` 500 for his services. The services of A will be past consideration.

When the consideration for a promise is given simultaneously with the promise, it is called present consideration. A present consideration consists in doing or abstaining from doing something. A promise to give time to a debtor is good consideration. Present consideration arises where there is a promise to pay for goods sold and delivered.

A future or executory consideration is a promise to do or give something in return in future for the promise then made. It is also called a promise for the promise. Mutual promises to marry, a promise to do working return of promise of payment are examples of future consideration.

Example: A promises to deliver goods to B when the ship arrives and B promises to pay A ` 1000 against the receipt of goods. This is a case of future consideration, which is to be performed by both the parties when the ship arrives.

4. It need not to be adequate: The law of contract nowhere laid down that consideration should be adequate to the promise. What is required is that there must be some consideration for the promise. Adequacy is for the parties to decide at the time of making the agreement. Inadequacy of consideration is no ground for refusing the performance of the promise, unless it is evidence of fraud. It should be of some value in the eyes of law. Even a smallest consideration is sufficient provided it has some value. If a man gets what he contracted for, the court will not inquire whether it was an equivalent to the promise which he gave in return. Where in an agreement the consent of the promisor has been freely given, an inadequacy of the consideration will not render it unenforceable. For example, A agrees to sell his house worth ` 90,000 to B for ` 9,000. A's consent to the agreement was freely given, the agreement is a contract not withstanding the inadequacy of the consideration.

Consideration must be real: Though consideration need not be adequate, it must be of some value in the eyes of law, i.e., it must be real and competent. Where consideration is physically impossible, illegal, uncertain or illusory, it is not real and therefore shall not be a valid consideration.

(i) *Physically impossible:* A promise to do something which is physically impossible, e.g., to make a dead man alive or to run at a speed of 200 kilometres per hour, does not form valid consideration.

(ii) *Legally impossible:* A promise to do something which is illegal, e.g., a promise for illegal cohabitation does not amount to good consideration.

(iii) *Uncertain consideration:* A promise to do something which is too vague and uncertain, e.g., a promise to pay such remuneration "as shall be deemed right", is no consideration in the eye of law.

(iv) *Illusory consideration:* Again, an illusory or deceptive consideration does not amount to a valid consideration. Consideration is illusory if it consists in a promise to perform a public duty, or to perform a contract already made with the promisor.

Example: A (the plaintiff) received a subpoena (a kind of summon) to appear at a trail as a witness on behalf of B (the defendant). B promised him a sum of money for his trouble. On default by B, A filed the suit for the recovery of the promised sum. It was held that A being under a public duty to attend and give evidence, there was no consideration for the promise and hence the promise is unenforceable (Callins vs Godefroy).

11.6 EXCEPTIONS: NO CONSIDERATION, NO CONTRACT

Consideration being one of the essential elements of a valid contract, the general rule is that "an agreement made without consideration is void". But there are a few exceptions to the rule where an agreement without consideration will be perfectly valid and binding. These exceptions are as follows:

1. **Agreement made on account of natural love and affection:** An agreement made without consideration is enforceable if, it is (i) expressed in writing, and (ii) registered under the law for the time being in force for the registration of documents, and is (iii) made on account of natural love and affection, (iv) between parties standing in a near relation to each other. Thus there are four essential requirements which must be complied with to enforce an agreement made without consideration, as per Section 25(1).

Example: A for natural love and affection, promises to give his son B, ` 1,000. A puts his promise to B into writing and registers it. This is a valid contract.

It should, however, be noted that mere existence of a near relation between the parties does not necessarily import natural love and affection. Thus where a Hindu husband, after referring to quarrels and disagreement between him and his wife, executed a registered document in favour of his wife, agreeing to pay for separate residence and maintenance, it was held that the agreement was void for want of consideration because it was not made out of natural love and affection. [Rajlakhi Devi vs Bhootnath) (1990), 4,C.W. N. 488].

2. **Compensation for services rendered:** According to Section 25(2), agreement made without consideration may be valid if it is a promise to compensate wholly or in part a person who has already voluntarily done something of the promisor or something which the promisor was legally compliable to do. To apply this rule, the following essentials must exist:

(a) the act must have been done voluntarily;

(b) for the promisor or it must be something which was the legal obligation of the promisor;

(c) the promisor must be in existence at the time when the act was done';

(d) the promisor must agree now to compensate the promisee.

A promise to pay for past services voluntarily rendered would be enforceable under this rule. If, however, something has not been done voluntarily, this clause will not apply. Thus, where the services were rendered by the advocate on request and were not voluntarily it was held that this clause had no application. The promisor should be in existence at the time when the service is rendered. Work done by the promoters of a company before its formation cannot be said to have been done for the company. Such a clause in the articles of association is not binding unless it is subsequently confirmed by the company.

3. **Agreement to pay a time-barred debt:** Sec. 25 (3) expressed that where there is an agreement, made in writing and signed by the debtor or by his authorised agent, to pay wholly or impart a debt barred by the law of limitation, the agreement is valid even though it is not supported by any consideration. A time barred debt cannot be recovered and therefore a promise to repay such a debt is without consideration, hence the importance of the present exception.

But before the exception can apply, it is necessary that:

(i) the debt must be such of which the creditor might have enforced payment but for the law for the limitation of suits [Sec. 25(3)];

(ii) the promisor himself must be liable for the debt;

(iii) there must be an 'express promise to pay' a time barred debt as distinguished from a mere 'acknowledgement of a liability' in respect of a debt; and

(iv) the promise must be in writing and signed by the debtor or his agent.

Example: A owes B ` 1,000, but the debt is barred by the Limitation Act. A signs a written promise to pay B ` 500 on account of the debt. This is a contract.

4. **Completed gifts:** Explanation 1 to Section 25 provides that the rule 'No consideration, no contract' shall not affect validity of any gifts actually made between the donor and the donee. Thus if a person gives certain properties to another according to the provisions of the Transfer of Property Act, he cannot subsequently demand the property back on the ground that there was no consideration.

5. **Agency:** There is one more exception to the general rule. It is given in Section 185 which says that no consideration is needed to create on agency. Consideration is defined to be the price for which the promise of the other is bought.

11.7 CAPACITY OF CONTRACTING PARTIES

Capacity to contract implies competence of the parties to contract. Section 11 of the Contract Act specifies that "Every person is competent to contract, who is of the age of majority according to the law to which he is subject and who is of sound mind and is not disqualified from contracting by any law to which he is subject". Thus, following persons are incapable of contracting:

(1) A minor.

(2) A person of unsound mind.

(3) Persons disqualified from contracting by any other law.

11.7.1 MINOR

A minor is a person who is not a major. According to The Indian Majority Act, 1875, a minor is one who has not completed his or her 18th year of age. A person attains majority on completing his 18th year in India. In the following two cases, a person continues to be a minor until he completes the age of 21 years.

(a) Where a guardian of a minor person or property has been appointed under the Guardians and Wards Act, 1890; or

(b) Where the superintendence of a minor's property is assumed by a Court of Words.

Law relating to minor's agreements

A minor has an immature mind and cannot think what is good or bad for him. Minors are often exploited and their properties stolen. As such he must be protected by law from any exploitation or ill design.

But at the same time, law should not cause unnecessary hardship to persons who deal with minors.

A minor's agreement being void is wholly devoid of all effects. When there is no contract there should be no contractual obligation on either side. The various rules regarding minor's agreement are discussed below.

1. **An agreement with or by a minor is void:** Section 10 of the Contract Act requires that the parties to a contract must be competent and Section 11 says that a minor is not competent. But neither section makes it clear whether the contract entered into by a minor is void or voidable. Till 1903, courts in India were not unanimous on this point. The Privy Council made it perfectly clear that a minor is not competent to contract and that a contract by a minor is void *ab initio*.

2. **No ratification:** An agreement with minor is completely void. A minor cannot ratify the agreement even on attaining majority, because a void agreement cannot be ratified. A person who is not competent to authorise an act cannot give it validity by ratifying it. Thus, where a minor borrowed a sum of money by executing a simple pronote for it and after attaining majority executed a second pronote in respect of the original loan plus interest thereon, a suit upon the second pronote was not maintainable.

If on coming of age, a minor makes a new promise and not merely an affirmation of the old promise, for a fresh consideration, the new promise will be binding.

3. **Beneficial agreements are valid contracts:** Any agreement which is of some benefit to the minor and under which he is required to bear no obligation, is valid. In other words, a minor can be a beneficiary e.g., a payee, an endorsee of a promise under a contract. Thus money advanced by a minor can be recovered by him by a suit because he can take benefit under a contract. The Hindu Minority and Guardianship Act, 1956, also provides to the same effect, namely a natural

guardian is empowered to enter into a contract on behalf of the minor and the contract would be binding and enforceable if the contract is for the benefit of the minor.

Example: A duly executed transfer by way of sale or mortgage in favour of a minor, who has paid the whole of the consideration money, is enforceable by him or by any other person on his behalf.

Contracts of apprenticeship and service by a minor: A contract of apprenticeship stands on a different footing than an agreement of service by a minor. A contract of apprenticeship is valid and binding upon a minor because such a contract is protected by the Apprentices Act, 1961, provided the case falls within the terms of that Act. The Act, inter alia, provides that the minor must not be less than fourteen years of age and the contract must be entered into on behalf of the minor by his guardian. The Act was passed with a view to enabling children to learn trades, crafts and employment, by which, when they come to full age, they may gain a livelihood. So far as an agreement of service by a minor is concerned, it is void because a minor's promise to serve would supply no consideration for the promise of the defendant to pay him/her a salary.

4. Liability for necessaries: The case of necessaries supplied to a minor or to any person whom such minor is legally bound to support is governed by Section 68 of the Indian contract Act. A claim for necessaries supplied to a minor is enforceable at law. But a minor is not liable for any price that he may promise and never for more than the value of the necessaries. There is no personal liability of the minor, but only his property is liable. A minor is also liable for the value of necessaries supplied to his wife.

"What is a necessary article", is to be determined with reference to the status and circumstances of the particular minor. Objects of mere luxury are not necessaries, nor are objects, which though of real use are excessively costly. Food and clothing may be taken as simple examples of necessaries. The necessaries would also include the infant's lodging expense, medical attendance, cost of defending a minor in civil and criminal proceedings. Loans taken by a minor to obtain necessaries also bind him. But where a minor is engaged in trade, contracts entered into by him for trading purposes are not for necessaries and are not binding on him.

Not only must the goods supplied be such as are suitable to the minor's status, they must also be actually necessary. Ten suits of clothes are necessaries for a minor whereas even three suits may not be deemed necessary for another.

The whole question turns upon the minor's status in life. Utility rather than ornament is the criterion.

Example: Inman an infant undergraduate in Cambridge bought eleven fancy waistcoats from Nash. He was at the time adequately provided with clothing. Held the waistcoats were not necessary and the price could not be recovered.

The following have been held to be necessaries:

(i) Livery for an officer's servant.

(ii) Horse, when doctor ordered riding exercise.

(iii) Goods supplied to a minor's wife for her support.

(iv) Rings purchased as gifts to the minor's fiancee.

(v) A racing bicycle.

On the other hand, following have been held not to be necessaries:

(i) Goods supplied for the purpose of trading.

(ii) A silver-gift goblet.

(iii) Cigars and tobacoo.

(iv) Refreshment to an undergraduate for entertaining.

5. The rule of estoppel does not apply to a minor: Where a minor by misrepresenting his age has induced the other party to enter into a contract with him, he cannot be made liable on the contract. There can be no estoppel against a minor. In other words, a minor is not estoppled from pleading his infancy in order to avoid a contract. It has been held by a Full Bench of the Bombay High Court in the case of Gadigeppa v. Balangowda (A.I.R. 193, BOM 561) that where an infant represents fraudulently that he is of majority age and thereby induces another to enter into a contract with him, then in an action founded on the contract, the infant is not estopped from setting up infancy. The court may, however, require the minor to compensate the other party on the ground of equity. This is based on the rule that a minor can have no privilege to cheat men.

Fraudulent misrepresentation as to age by an infant will operate against him in certain cases. If a minor obtains property or goods by misrepresenting his age, he can be compelled to restore it but only so long as the same is traceable in his possession.

If by misrepresenting himself to be of full age, has obtained money from a trustee and given release, the release is good and he cannot compel the trustee to make payment a second time.

6. No Specific performance: A minor's contract being absolutely void, there can be no question of the specific performance of such a contract. A guardian of minor cannot bind the minor by an agreement for the purchase of immovable property; so the minor cannot ask for the specific performance of the contract which the guardian had no power to enter into.

7. Liability for torts: A minor is liable in tort. Thus, where a minor borrowed a horse for riding only he was held liable when he let the horse to one of his friends who jumped and killed the horse. Similarly, a minor was held liable for his failure to return certain instruments which he had hired and passed on to a friend. But a minor cannot be made liable for a breach of contract by framing the action on tort. You cannot convert a contract into a tort to enable you to sue an infant.

8. Partnership: A minor being incompetent to contract cannot be a partner in a partnership firm, but under Section 30 of the Indian Partnership Act, he can be admitted to the benefits of partnership.

9. Minor agent: A minor can be an agent (Sec. 184). He shall bind the principal by his acts done in the course of such an agency, but he cannot be held personally liable for negligence or breach of duty. Thus in appointing a minor as an agent, the principal runs a great risk.

10. Minor and insolvency: A minor cannot be adjudicated as an insolvent, for, he is incapable of contracting debts. Even for necessaries supplied to him, he is not personally liable, only his property is liable (Sec. 68).

11. Contract by minor and adult jointly: Where a minor and an adult jointly enter into an agreement with another person, the minor has no liability but the contract as a whole can be enforced against the adult.

12. Minor shareholder. A minor, being incompetent to contract, cannot be a shareholder of the company. A company can also refuse to register transfer or transmission of shares in favour of a minor unless the shares are fully paid. It follows from it that a minor, acting through his lawful guardian, may become a shareholder of the company, in case of transfer or transmission of fully paid shares to him. Logically also, if a minor could legally hold property in his name, it would be wrong to debar him from holding fully paid up shares in his own name.

11.7.2 PERSONS OF UNSOUND MIND

Section 11 disqualifies a person who is not of sound mind from entering into a contract. Contracts made by persons of unsound mind like a minor's contract are void. The reason is that a contract requires assent of two minds but a person of unsound mind has nothing which the law recognises as a mind.

Section 12 deals with the question as to what is sound mind for the purpose of entering into a contract. It lays down that, "A person is said to be of sound mind for the purpose of making a contract if, at the time when he makes it he is capable of understanding it and of forming a rational judgement as to its effect upon his interests".

The Section further states that:

(i) "A person who is usually of unsound mind, but occasionally of sound mind, may make a contract when he is of sound mind." Thus a patient in a lunatic asylum, who is at intervals of sound mind, may contract during those intervals.

(ii) "A person who is usually of sound mind, but occasionally of unsound mind, may not make a contract when he is of unsound mind". Thus, a sane man, who is delirious from fever, or who is so drunk that he cannot understand the terms of a contract, or form a rational judgement as to its effect on his interest, cannot contract while such delirium or drunkenness lasts.

Unsoundness of mind may arise from: (a) *Idiocy* – It is God given and permanent, with no intervals of saneness. The mental powers of an idiot are completely absent because of lack of development of the brain; (b) *Lunacy or Insanity* – It is a disease of the brain. A lunatic loses the use of his reason due to some mental strain or disease. Of course he may have lucid intervals of sanity: (c) *Drunkenness* – It produces temporary incapacity, till the drunkard is under the effect of intoxication, provided it is so excessive as to suspend the reason for a time and create impotence of mind; (d) *Hypnotism* – It also produces temporary incapacity, till the person is under the impact of artificially induced sleep; (e) *Mental decay on account of old age,* etc.

Effects of agreements made by persons of unsound mind: An agreement entered into by a person of unsound mind is treated on the same footing as that of minor's and therefore an agreement by a person of unsound mind is absolutely void and inoperative as against him but he can derive benefit under it (Jugal Kishore vs Cheddu, 1903, ALL L.J.43). The property of a person of unsound mind is, however, always liable for necessaries supplied to him or to any one whom he is legally bound to support, under Section 68 of the Act.

11.7.3 DISQUALIFIED PERSONS

The third type of incompetent persons, as per Section 11, are those who are "disqualified from contracting by any law to which they are subject". These are:

1. Alien enemies: An alien living in India is competent to contract with citizens of India. He can maintain an action on a contract entered into by him during peace time. But if a war is declared, an alien enemy cannot enter into any contract with an Indian citizen. Contracts entered into before the declaration of war are either stayed or terminated but contracts entered into during the war are unenforceable.

2. Foreign sovereigns and ambassadors: These persons are immune from the jurisdiction of local courts, unless they voluntarily submit to its jurisdiction. These persons have right to contract but can claim the privilege of not being sued. The rules regarding suits by or against foreign sovereigns are laid down in Sections 84 to 87 of Civil Procedure Code.

Example: E, who was a diplomat and was on the staff of a foreign embassy rented a house belonging to M.M sued him for arrears of rent. It was held that no action could be brought against him as he was protected by diplomatic privileges. [Engelke v. Musman (1928) A.C. 433].

3. Convict: A convict is one who is found guilty and is imprisioned. During the period of imprisonment, a convict is incompetent (a) to enter into contracts, and (b) to sue on contracts made before conviction. On the expiry of the sentence, he is at liberty to institute a suit and the Law of Limitation is held in abeyance during the period of his sentence.

4. Married women: Married women are competent to enter into contracts with respect to their separate properties (*Stridhan*) provided they are major and are of sound mind. They cannot enter into contracts with respect to their husbands' properties. A married woman can, however, act as an agent of her husband and bind her husband's property for necessaries supplied to her, if he fails to provide her with these.

5. **Insolvents:** An insolvent cannot enter into a contract as his property vests in the official receiver or official assignee. This disqualification of an insolvent is removed after he is discharged.

6. **Joint-stock company and corporation incorporated under a special Act:** A company/corporation is an artificial person created by law. It cannot enter into contracts outside the powers conferred upon it by its Memorandum of Association or by the provisions of its special Act as the case may be. Again, being an artificial person (and not a natural person) it cannot enter into contracts of a strictly personal nature e.g. marriage.

11.8 SUMMARY

Mistake, misrepresentation, fraud, coercion and undue influence are the elements which affect the consent of the parties. Mistake generally takes place where the concerned parties are not fully aware of the terms of the agreement and they take the terms in a different sense. In an innocent misrepresentation, the party aggrieved may avoid the agreement, even though the statement was true at the time it was made but became untrue latter by reason of change of circumstances. An agreement, in which the consent is caused by coercion, is voidable at the option of the party whose consent was so obtained. When a party enters into a contract under any kind of mental pressure, unfair influence or persuasion by the superior party, the undue influence is said to be employed.

Section 2(d) of the Contract act defines consideration as "When, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promise is called a consideration for the promise. Essentials of valid consideration are (i) it must at the desire of promisor, (ii) it may move from the promisee or any other person, (iii) it may be past, present or future, (iv) it need not be adequate, (v) it must be real and (vi) It must be lawful. No one but the parties to a contract can sue or be sued under it. A third person cannot demand performance of a duty or obligation under it even though he has a direct interest in such performance except in certain recognised cases. An agreement made without consideration is void.

An agreement will be a contract if it is entered into by parties who are competent to contract. Every person is competent to contract who is of the age of majority according to the law to which he is subject, and who is of sound mind and is not disqualified from contracting by any law to which he is subject. An infant or a minor is a person who is not a major.

Section 11 disqualifies a person who is not of sound mind from entering into a contract. A person is said to be of sound mind for the purpose of aiming a contract if, at the time when he makes it he is capable of understanding it and of forming a rational judgement as to its effect upon his interests.

Unsoundness of mind does not mean weakness of mind or loss of memory. It means not only lack of capacity to understand the terms of the contract but also lack of understanding to realise the effect of the terms of the contract. There is always a presumption in favour of sanity.

The third type of incompetent persons, as per Section 11, are those who are "disqualified from contracting by any law to which they are subject". These include Alient enemies, foreign sovereigns and ambassadors, convict, married women, insolvents and joint-stock company and corporation incorporated under a special act.

11.9 KEYWORDS

Mistake: Mistake may be defined as incorrect belief about something.

Misrepresentation: Misrepresentation is a false representation which is made innocently.

Free Consent: Free consent is the consent which is obtained by the free will of the parties, and neither party was forced or induced to give his consent.

Coercion: It means forcibly compelling a person to enter into a contract.

Undue Influence: It means the unfair use of one's superior power in order to obtain the consent of a person who is in a weaker position.

Minor: A minor is a person who has not attained the age of majority.

Estoppel: It means prevention of a claim or ascertain by law.

Persons of Unsound Mind: A person of unsound mind is one who is not of sound mind.

Alien: An alien is a person who is foreigner to the land.

11.10 SELF ASSESSMENT QUESTIONS

1. State when a consent is not said to be free. What is effect of such consent on the formation

of a contract?

2. A contract caused by mistake is void. Explain with illustrations.

3. What is fraud? Distinguish it with misrepresentation.

4. What remedies are available to a person induced to enter into a contract by (a) misrepresentation which is not fraudulent, (b) fraud.

5. "Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud". Explain.

11.11 SUGGESTED READINGS

K.R. Balchandari, Business Law for Management, Himalaya Publication House, New Delhi.

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers, New Delhi.

S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi.

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LESSON-12

DISCHARGE AND BREACH OF CONTRACT

STRUCTURE

12.0 OBJECTIVES

After reading this lesson, you should be able to

a) Explain the circumstances under which a contract is said to be discharged.

b) Discuss the impossibility of performance as a mode of discharge of contract.

c) Explain the breach of contract as a mode of discharge of contract.

d) Discuss the remedies available to an aggrieved party on the breach of contract.

12.1 INTRODUCTION

A valid contract creates certain obligations on all the contracting parties, and the parties become liable to fulfil their respective obligations. When the parties fulfil their respective obligations, their liability under the contract, comes to an end and the contract is said to be discharged. Thus, the discharge of a contract means that the parties are no more liable under the contract. In other words, when the rights and obligations created by the contract come to an end, the contract is said to be discharged. The discharge of a contract may, therefore, be defined as the termination of contractual relationship between the parties.

12.2 MODES OF DISCHARGE OF A CONTRACT

Contracts may be discharged by any one of the following modes (for details see chart):

(a) By Performance

(b) By Consent or Agreement

(c) By Impossibility of Performance

(d) By Lapse of Time

(e) By Operation of Law

(f) By Breach of Contract

12.2.1 DISCHARGE BY PERFORMANCE

The obvious mode of discharge of a contract is by performance, for that is what the contract parties had contemplated at the time of entering into it. Every person who is bound by an obligation must be ready to perform it at the time when he had promised to perform it. According to Section 37 of the Contract Act, the parties to a contract must perform their respective promises, unless such performance is dispensed with or excused under the provision of this Act or of any other law. A person who is bound to perform a contract must be ready to perform it at the time when he has undertaken to do so. When a contract is performed, the parties are discharged and the contract is terminated. Performance may be of two types-actual and attempted.

a) *Actual Performance* - When the parties of the contract perform their promises, it is called actual performance. After such a performance the contract is discharged. It is the most common way of discharge of a contract.

b) *Attempted Performance* - Attempted performance or tender takes place when a person who is bound to perform a promise is ready and willing to perform and has offered to perform his promise at proper time and place but the other party does not accept performance. In such a case, the contract is discharged of the wrongful refusal to accept the performance.

12.2.2 DISCHARGE BY MUTUAL AGREEMENT OF CONSENT

By agreement of all parties to the contract, or waiver or release by the party entitled to performance, a contract may be discharged. The discharge by consent may be expressed or implied; and an expressed consent may be given at the time of the formation of the contract or subsequently. For example, it may be agreed at the time of making the contract that on the happening of an event, one or both parties will be absolved from performance. A buyer may be given the option to return the goods sold within a specified period of time, if certain conditions are not fulfilled.

Express consent subsequently to the formation of the contract may be given by waiver, release, abandonment, novation, remission, alteration, rescission and in English law, by accord and satisfaction. Each one of these methods

is dealt with here. Sections 62 and 63 expressly provide for these methods and are reproduced here:

"If the parties to a contract agree to substitute a new contract for it or to rescind of alter it, the original contract need not be performed." Section 62.

"Every promisee may dispense with or remit, wholly or in part, the performance of the promisee made to him, or may extend the time for such performance, or may accept instead of it any satisfaction which he thinks fit." Section 63.

The analysis of these sections reveal that the original contract is discharged when the parties enter into a fresh contract in place of original contract. And the following are the important methods for the discharge of a contract by a fresh contract:

a) **Novation:** Novation occurs when a new contract is substituted for an existing contract, either between the same parties or between different parties, the consideration mutually being the discharged of the old contract.

A owes money to B under a contract. It is agreed between A, B and C that B shall henceforth accept C as his debtor, instead of A. There is novation. The old debt of A to B is at an end, a new debt from C to B has been contracted.

A common example of novation arises in the case of partnership contracts. For a valid novation it is not enough that a new promisor agrees to assume original promisor's obligation, the promisee too should consent to the change.

The following pre-requisites must be established by a party to make out a case of novation: (i) the old contract, (ii) The existence of liability under that contract, (iii) The assent of all parties to the extinguishment of liability under the old contract, (iv) The assent of the all the parties to the creation of the liability under the new contract and (v) the validity of the new contract.

A novation is ought to be before the time of performance expires, otherwise, there would be breach of contract, and the parties will by the new contract be only trying to adjust the remedial rights, which arises out of the breach of the old contract.

(b) Alteration: Alteration of a contract takes place when one or more of the terms of the contract are changed. Alteration is valid when it is made with the consent of all the parties to the contract. Where, however, an alteration of written contract is made by one party to the contract without the consent of the other party and of a material fact, so that the legal effect of the instrument is changed, the contract is discharged and the other party is also discharged from his duties.

Example: A agreed to supply to B 50 bags of rice at the rate of ` 100 per bag. The delivery was to be made in five equal installments, the first supply was to commence from 1st June. Subsequently, A and B entered into an agreement that the delivery would be made in two equal installments and the price would be ` 105 per bag. In this case, the old contract is discharged and the parties become bound by the contract with changed terms.

Following are various rules regarding the discharge of contract by alteration (i) Alteration must be by a party to the contract, or a stranger while the document is in the possession of a party of the contract, and for his benefit. But exception is made if it is caused by mistake or accident

(ii) It must be in a material part-what alternation can be said to be material depends upon the character of the instrument and other circumstances of the case.

(c) Rescission: A contract may be rescinded by agreement between the parties at any time before it is discharged by performance or in some other way. For example, a contract for the sale of goods can be discharged by mutual agreement between the buyer and the seller at any time before delivery of the goods or payment of the price.

Rescission may also take place in the following manner:

Where a party to contract fails to perform his obligation, the other party can rescind the contract without prejudice to his rights to receive compensation for breach of contract. In avoidable contract, one of the parties has the option of rescinding the contract.

Examples

(i) A promises to deliver certain goods to B on a certain date. Before the date of performance, A and B mutually agree that the contract will not be performed. The parties have rescind the contract.

(ii) A was induced to enter into an agreement by concern. He can rescind the contract.

(d) Remission: Remission is the acceptance of a lesser sum than what was contracted for. Sec. 63 specifically provides for remission of performance of promise. Thus, the law in India is different from that in England. In the later country, remission must be supported by a fresh consideration. In India, under Sec.63, a promisee may remit or give up a part of his claim and a promise to do so is binding even though there is no consideration for doing so.

Examples

(i) A owes B ` 5,000. A pays to B and B accepts in full satisfaction ` 2,000. The whole debt is discharged.

(ii) A owes B ` 5,000. C pays to B ` 1,000 and B accepts them in satisfaction of his claim on A. This payment is discharge of the whole claim.

(e) Waiver: Waiver means the intentional relinquishment of a right which a person is entitled to. A party may waive its rights under the contract, whereupon the other party is released from its obligations. In the case of an executory contract, (e.g., an agreement to sell and buy), each party may excuse the other from paying for or from buying the goods. In the case of unilateral promise, the party entitled to performance may waive performance of it.

Example: A promised to paint a picture for B. Afterwards, B forbade him to do so. In this case, B has waived his right to claim the performance. And thus, A is no longer liable to perform the promise. However, the party who has waived the compliance with a particular condition, may withdraw his waiver by giving reasonable notice.

(f) Acceptance of any other satisfaction: Sometimes, the party entitled to claim performance accepts any other satisfaction instead of the performance of the contract. In such cases, the other party is discharged from the performance of his liability under the contract. Section 63 of the Indian Contract Act provides for this provision. According to this section, the party who has the right to demand performance, may accept any other satisfaction, which he thinks fit, instead of the performance of the promise made to him. And such acceptance, discharges the whole obligations under the contract.

Example: A owed B, under a contract, a sum of money, the amount of which had not been ascertained. Without ascertaining the amount, A gave ` 2000 to B. And B accepted this amount in satisfaction of the sum due under the contract. In this case, A is discharged of the whole debt due under the contract, whatever may be its amount.

12.2.3 DISCHARGE BY IMPOSSIBILITY OF PERFORMANCE

The law relating to discharge by impossibility of performance of a contract is laid down in Sec.56 of the Contract Act. Section 56 states:

“An agreement to do an act impossible in itself is void. A contract to do an act which, after the contract is made becomes impossible, or by reason of some extent which the promisor could not present, unlawful becomes void when the act becomes impossible or unlawful".

Where one person has promised to do something which he knew, or with reasonable diligence, might have known, and which the promisee did now know to be impossible or unlawful, such promisor must make compensation to such promisee for any loss which such promisee sustains through the non-performance of the promise.

Examples:

a) A agrees with B to discover treasure by magic. The agreement is void.

b) A and B contract to marry each other. Before the time fixed for the marriage, A goes mad. The contract becomes void.

c) A contracts to marry B, being already married to C, and being forbidden by the law to which he is subject to practise polygamy. A must make compensation to B for the loss caused to her by the non-performance of his promise.

This section covers a wide range of causes and lays down certain clear rules. It is clear from the different parts of the section that impossibility is of various kinds. The impossibility may be absolute, i.e. inherent in the nature of the matter promised; or it may exist only relatively to the ability and circumstances of the promisor. The former is objective, (viz., inherent in the nature of the thing to be done) and discharges the contract. The latter is subjective impossibility, i.e. it is due to the inability of the individual promisor to perform his promise, and does not discharge a contractual duty.

The performance may be impossible as a matter of fact; or it may be impossible by the rules of law. The impossibility may exist at the time of contracting either with or without the knowledge of the parties or it may arise subsequently to the making of the contract, and in the latter case, it may be caused by events beyond the control of the parties or it may be caused by some act of the promisor or promisee.

(i) Impossibility at the Time of Contract

A contract to perform something that is obviously impossible, e.g. a promise to ride a horse to the moon, is void because there is no consideration for the contract. Here both parties were aware of the impossibility. It may be that at the time of the agreement both parties were ignorant of impossibility. In such a case also the contract is void on the ground of mistake.

(ii) Subsequent or Supervening Impossibility

Para 2 of Sec.56 provides that subsequent or supervening impossibility or illegality will make the contract void in certain circumstances and the contract will be discharged. Supervening impossibility may occur in many ways, some of which are explained below:

(a) Destruction of Subject Matter: When there is a contract in respect to a particular subject matter which is later destroyed without the fault of the parties, the contract is discharged.

In Taylor v. Caldwell (1863) 122 E.R. 299, the leading case on this point, a music hall was agreed to be let out for a series of events on certain days. The hall was burn down before the date of the first event. The contract was held to have become void and the owner of the hall was absolved from liability to let the hall as promised. Blackburn J. observed in this case as follows: “In contracts in which the performance depends on the continued existence of given person or thing, a condition is implied that the impossibility of performance arising from the perishing of the person or thing shall excuse the performance".

(b) Non-existence of a state of things necessary for performance: When a contract is entered into on the basis of the continued existence of a certain state of things, the contract is discharged if the state of things changes or cases to exist. In this case there is no destruction of any property affected by the contract, but the use of that property contemplated by the contract has became impossible

In Krell v. Henry (1903) 2 K.B. 740, H hired a room from K for two days. The room was taken for the purpose, as both parties well known, of using the room to view the coronation procession of Kind Edward VII, although the contract contained no reference to the coronation. Owing to the King's illness the procession was abandoned. Held, that H was excused from paying rent for the room, as the existence of the procession was the basis of the contract, and its cancellation discharged the contract.

(c) Death or Personal Incapacity: Where the personal qualification of a party is the basis of the contract, the contract is discharged by death or physical disablement of that party. In other words, the death or illness of a particular person whose action is necessary for the promised performance discharges the duty to render that performance.

In Robinson v. Davidson (1871) L.R. 6 Ex. 269 R contracted with D that D should play the piano at a concert given on a specific day. D was ill on the day in question and unable to perform. The contract was discharged and D's illness excused him from performance.

(d) Discharge by supervening illegality: A contract which is contrary to law at the time of its formation is void. But if after the making of the contract, owing to an alteration of the law or the act of some person armed with statutory authority the performance of the contract becomes impossible, the contract is discharged. This is so because the performance of the promise is prevented or prohibited by a subsequent change in the law.

In Baily v. De Crespignay (1869) L.R. 4 Q.B. 180, D leased some land to B and convenanted that he would not erect any but ornamental buildings upon the adjoining land. A railway company, under statutory powers, took this adjoining land and built a railway station on it. Held, D was excused from performance of his convenient, because the railway company's statutory power had rendered it impossible.

On the other hand, if at the time of the making of the contract, compulsory powers are in existence, the exercise of which may affect the contract, a party knowing of those powers cannot rely on the fact that they are subsequently exercised as a defence to his breach of contract. The exercise of the compulsory powers was event which might have been anticipated and guarded against in the contract. Also, a continuing contract is not discharged by a prohibitive regulation which may be determined or varied and leaves a substantial part of the contract capable of execution. So, where a notification regulating retail prices was issued which did not make performance of the contact impossible or unlawful, the parties were not discharged. But if a contract to be performed in a foreign country becomes illegal owing to a change in the law of that country, the contract is discharged.

(e) Declaration of War: A contract entered into during war with an alien enemy is void ab initio. A contract entered into, before the war commence, between citizens of countries subsequently at war remains suspended during the pendency of the war, provided it does not involve intercourse with the alien enemy or is not helpful to him or his country. Such a contract will be revived and may be enforced at the end of the war. If a contract entered into before the outbreak of the war amounts to aiding the enemy in the pursuit of war, it would be abrogated or discharged and not merely suspended. It will also be discharged if it cannot remain suspended, e.g., the contract involves the continuous performance of mutual duties.

Case which are not covered by the Doctrine of Supervening Impossibility (Impossibility not an Excuse)

Apart from the cases mentioned above, impossibility does not discharge contracts. Therefore, impossibility of performance is as a rule not an excuse from performance. He who agrees to do an act should do it unless absolutely impossible which may happen in any one of the ways discussed above. It may be stated, as a general rule, that impossibility to perform arising subsequently to the agreement will not, as a rule discharge the promisor, because when there is positive contract to do a thing which is not unlawful, the promisor must perform it or pay damages for not doing it, although the performance becomes unexpectedly burdensome or even impossible on account of unforeseen events. The supervening event should destroy the contract itself. Merely making the contract difficult cannot attract Section 56. Some of the circumstances in which a contract is not discharged on the ground of supervening impossibility are stated here:

(a) Difficulty of Performance: The mere fact that performance is more difficult or expensive or less profitable that the parties anticipated, does not discharge the duty of performance. Increased or unexpected difficulty and expense do not, as a rule excuse from performance.

Example: A promised to send certain goods from Bombay to Antwerp in September. In August war broke out, and the shipping space was not available except at very high rates. Held, the increased freight rates did not excuse performance.

(b) Commencial Impossibility: Commencial impossibility to perform a contract will not discharge the contract. A contract cannot be said to be impossible of performance because expectation of higher profits is not realised. A promisor's contractual duty is not discharged because the outbreak of war makes it expensive to procure the necessary materials.

(c) Failure of third party: The principle of supervening impossibility does not extend to the case of a third person on whose work the promisor relied.

(d) Partial Impossibility: Partial impossibility rarely discharges a promisor beyond the extent of the impossibility. This, if the state of things in question is not the sole basis of the contract, so that there will still remain a substantial portion, through not all, of what was contract for, the contract will not discharged. In other words, where there are several purposes for which a contact is made is made, failure of one of the objects does not terminate the contract.

In H.B. Steamboat Co. V.Hutton (1903) 2 K.B. 683, the company agreed to let a boat to H to view naval review at the coronation and to cruise round the fleet. Owing to the King's illness the navel review was cancelled, but the fleet was assembled and boat might have been used for the intended cruise. Held, the company were not discharged from performance as the naval was not naval was not the sole basis of the contract.

(e) Strikes, lockouts and civil disturbances: Strikes, lockouts and disturbances like riots do not terminate contracts unless there is a clause in the contract providing that in such cases the contract is not to be performed or that the time of performance is to be extended.

The lessee of certain salt pans failed to repair them according to the terms of his contract, on the ground of a strike of the workmen, Held, a strike of workmen is not sufficient reason to excuse performances of a term of the contract.

The Doctrine of Frustration

The Common law of England stated with the harsh doctrine that unless the parties expressly stipulated to the contrary, impossibility was no defence to an action for breach of a contract. In course of time, however, exceptions were introduced to modify the severity of the Doctrine. In English cases, it has been now held that when the common object of a contract cannot longer be carried out, the court may declare the contract to be at an end. This is known as the Doctrine of Frustration. The doctrine developed in England under the guise of reading implied to stick to a contract the purpose of which has disappeared.

Thus, when the performance depends on the continued existence of a given person or thing, a condition is implied that impossibility of performance arising from the perishing of the person or thing shall excuse performance. If the act became impossible subsequently be reason of some event which the promisor could prevent, the contract is discharged. This is based on the *maixm les non cogit ad imposibilia* - the law does not compel the impossible. This discharge of a contract rendered impossible of performance by external causes beyond the contemplation of the parties is known as frustration.

Frustration, as said above, is device by which the rules as to absolute contracts are reconciled with a special exception which justice demands. It has become a gloss on the older theory of impossibility which has greatly developed under the guise of reading “implied terms” into contracts. Therefore, as observed by Lord Radcliffe, Frustration occurs whenever the law recognises that without default of either party, a contractual obligation has become incapable of being performed because circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract. *Non haec in foedera veni*- “It was not this that I promised to do".

Furthermore, under the doctrine of frustration, the fundamental assumption underlying the contract becomes impossible. The performance of the contract may do not be actually impossible, but if the contract cannot be performed as originally contemplated by the parties, there is frustration. In such a case, there is a frustration of the object of the contract. Where, for instance, goods were seized as prize and then released and transshipped so that they arrived two years late, the arrival was not such as was contemplated by the parties. The discharge of a contract by reason of frustration follows automatically when the relevant event happens and does not depend on the volition or election of either party. The doctrine applies if the disturbing cause goes to the extent of substantially preventing the performance of the whole contract. Thus, a contract may become frustrated or impossible of performance by an Act of Legislature, or by operation of law; it may be discharged by a subsequent declaration of war, or by emergency regulations.

Indian Law Regrading Frustration

In India, the law is codified and Sec. 56 which deals with the subject provides for discharges of contract by impossibility of performance or frustration. Para 1 And 2 Sec. 56 read as follows.

“An agreement to do an act impossible in itself is void”.

“A contract to do and act which after the contract is made, becomes impossible, or by reason of some event which the promisor could not prevent, unlawful, becomes void when the act becomes impossible or unlawful...”

It is clear from the language of the section that it departs from the English law to a large extent and lays down positive rules of law which according to English decisions are only matter of construction depending on the intention of parties. There is no question of reading implied terms of contract is equivalent to supervening impossibility or illegality. The point of frustration raises some difficulties but a pronouncement of the Supreme Court has clarified the position.

In Satyabrat Ghose V. Mugneeram Bangur & Co., who were the owners of a large track of land started a scheme for its development for residential purposes and accordingly divided in into a large number of plots for the sale of which they invited offers from intending buyers. The company’s plan was to accept a small portion of the price by way of earnest money from the buyers at the time of agreement, construct the roads and drains itself and within one month after their completion call upon the buyers to complete the construction by paying one-third of the price at the time of the registration and the balance within 6 years bearing interest 6 percent per annum, time being deemed the essence of the contract.

B entered into a contact on those terms with M & Co., on 5-8-1919 and later on assigned the contract to S. Shortly prior to that assignment a portion of the land covered by the scheme was requisitioned for military purposes by the Government under the Defence of India Rules, and later the rest of the land was also requisitioned. M & Co., thereupon informed B that the land pertaining to the scheme was taken possession of by the Government and there was no knowing how long the Government would retain possession and that the company could not, therefore, take up the construction of roads and drains during the continuance of the war and possible for many years after its termination. The company also wrote to B to treat the contract as cancelled and take back the earnest money. This letter was handed over by B to his assignee S, who asserted that the company was bound by the contract and could not resile. S filed a suit for declaration that the contract dated 5-8-19 was subsisting and that S, as assignee of B, was entitled to get the conveyance executed and registered by the company on payment of consideration mentioned in the agreement and in the manner and under the conditions specified therein. The company contended that the contract of sale became discharged by frustration as it became impossible of performance by reason of supervening events. On appeal, the Supreme Court held that it could not be said the requisition order vitally affected the contract or made its performance impossible and accordingly the appeal was allowed and the suit was decreed.

The law relating to frustration in India as laid down by the Supreme Court in Satyabrat Ghose's case may be summed up as follows:

" The Court in India should look primarily to the law as embodied in Sections 32 and 56 of the Indian Contract Act. Indeed, the above sections of the Contract Act embrace the whole of the Indian law on the subject. Sec. 32 applies in cases of contingent contract and Sec. 56 covers the rest. Under either, however, impossibility is the central or dominating idea and the determinating factor. "*The essential idea upon which the doctrine of frustration is based is that of immpossibility of performance of the contract.*" In fact, impossibility and frustration are after used as interchangeable expressions. The changed circumstances made performance of it as they did not promise to an impossibility. The doctrine of frustration is in reality an aspect or part of the law of discharge of contract by reason of supervening impossibility or illegality of the act agreed to be done and hence comes within the purview of Sec. 55.

In deciding cases in India the only doctrine that we have to go by is that of supervening impossibility as laid down in Section 56, taking work impossible in its practical and not literal sense.

Section 56 days down a rule of positive law and does not leave the matter to be determined according to the intention of the parties. Therefore, in India, the doctrine of frustration is applied not on the ground that parties themselves agreed to an implied term which operated to release them from performance of the contract. The relief is given by the Court on the ground of subsequent impossibility when it finds that the whole purpose or the basis of a contract was frustration by the intrusion of occurrence of an unexpected event or change or circumstances which was beyond what was contemplated by the parties at time when they entered into the agreement. When such an event or change of circumstances occurs which is so fundamental as to be regarded by law as striking at the root of the contract as a whole, is the Court which can pronounce the contract to be frustration and at an end.

In applying this rule, the Court has to examine the nature and terms of the contract before it and the circumstances under which it was made and to determine whether or not the disturbing element which is alleged to have happened in the particular case has substantially prevented the performance of the contract as a whole. If the answer be in the affirmative, the contract will stand dissolved or discharged by virtue of Sec.

Effects of Subervening Impossibility or Frustration

Sections 56 and 65 of the Indian Contract Act expressly provide for the consequences of the impossibility of performance as follows:

1. When the performance of a contract becomes subsequently impossible or illegal, the contract becomes void. (Section 56, para 2)

2. When a contract becomes void, any person who has received and advantage under it must restore it, or make compensation for it to the person from whom he received it.

3. Where one person has premised to do something which he knew or with reasonable diligence, might have known, and which the promisee did not know to be impossible or unlawful, such promisor must make compensation to such promisee for any loss which such promisee sustains through the non-performance of the promise(Section 566, para 3).

12.2.4 DISCHARGE BY LAPSE OF TIME

The Limitation Act, in some circumstances, affords a good defence to suit for breach of contract, and in fact terminates the contracts by depriving the party of his remedy at law. For example, where a debtor has failed to repay the loan on the stipulated date, the creditor must file the suit against him within three years of the default. If the three years expire and he takes no action, he will be barred from his remedy, and the other party is discharged of his liability to perform. The period of limitation for simple contracts is three years in India and six years in England, and in the case of special contracts it is twelve years.

Example: A borrowed ` 5000 from B, a moneylender, and agreed to repay the loan on 31st March 2013. On 31st March, 2013, A failed to repay the loan. But B did not take any legal action against A till 31st March, 2016. In this case, B cannot recover the amount of loan from A as the limitation period for the recover of loan is three years from the date of default, which has expired. And thus, A is discharged from his liability to pay the loan.

12.2.5 DISCHARGE BY OPERATION OF LAW

Discharge under this head may take place as follows:

(a) By Death

Where contract requires personal skill or ability, the contract is terminated on the death of the promisor. In case of other contracts, the rights and liabilities of a deceased person are transferred to his legal representatives.

Example: A, an expert, agreed with B to translate some part of book from French to English. A died before the translation work started. In this case, the contract is of personal nature as it involves the personal qualification of the promisor (A). And thus, the contract is discharged on the death of A.

(b) By Merger

Where the parties embody the inferior contract in a superior contract, when between the same parties, new contract is entered into, and security of a higher degree, or a higher king is taken, the previous contract merges in the higher security. Where securities of the same kind of degree are taken there is no merger.

Example: A gave his land on lease to B. Subsequently, B bought the land which he was holding under the lease. In this cease, B becomes the owner of the property and his rights as a lessee merge into his rights as the owner. And thus, his rights as a lessee vanish, and are not to be enforced.

(c) By the unauthorised alteration of terms of the contract

Where a party to a contract in writing makes any material alternation without the knowledge and consent of the other, the contract can be avoided by the other party. An alternation even by a stranger will entitle the other party to avoid the contract, but where the alteration is due to mere accident or is not material, contract cannot be avoided.

Example: A contracted to sell his plot of 500 sq. yards to B for ` 100,000. The sale deed was executed which was in possession of A. Before the registration of the sale deed, A altered the deed and made it a deed for the sale of 300 sq. yards plot for ` 100,000. In this case, the contract is discharged and B is not bound to purchase the plot.

(d) By insolvency

The Insolvency Act provides for discharge of a contract under particular circumstances. So where the Insolvency Court passes an order discharging the insolvent, this order exonerates or discharges him from liabilities on all debts incurred previous to his adjudication.

(e) Right and liability vesting in the same person

Where rights and liabilities under a contract vest in same person, the contract is terminated and other parties to contract are discharged. For example, when a bill of exchange passes in the hands of the acceptor, the parties are discharged.

12.2.6 DISCHARGE BY BREACH OF CONTRACT

We have seen that contract must strictly perform according to its terms. But where the promisor has neither performed his contract nor tendered performance and where the performance is not excused by consent, express or implied, or where the performance is defective, there is a breach of the contract by him. Which entitles the other party to file a suit. If the contract is unilateral, the only remedy for the other party is to claim relief for beach and also in certain circumstances is exonerated from liability to perform his part of the contract.

The breach of contract may be (i) actual (ii) constructive or anticipatory. The actual breach may take place (a) at the time when performance is due, or (b) when actually performing the contract. The constructive or anticipatory breach of contract, i.e. a breach before the time for performance has arrived, may also take place in two ways, namely, (a) by the promisor doing an act which makes the performance of his promise impossible to perform his promise.

(i) Actual breach of Contract

(a) Actual Breach of Contract at the time when Performance is due- Where a person fails to perform a contract, when performance is due the other party can hold him liable for breach. But, if a party who has failed to perform the contract at the appointed time, subsequently expresses willingness to perform the question whether he can do so or not would depend upon whether time was of the essence of the contract or not. In all mercantile contracts time is the essence of the contract and breach of contracts results on failure to perform within the limited time. This is specially so in shipping contracts. In a sale of goods, subject to rapid fluctuations of market price, the time of delivery is of the essence. There are other transactions, e.g. contract relating to sale of land in which time is not deemed to be of the essence unless parties specially stipulate to the effect. But the terms of the contract, or the nature of the property sold, will determine whether time was of the essence or not. In the case of sale of a house to be immediately occupied or sale of a business as a going concern, time is not of the essence and the party express willingness to perform it after the appointed time, the law permits him to do so subject to payment of compensation for failure or due performance. The party accepts that he intends to claim compensation otherwise he is deemed to have waived the right to compensation (Sec. 55)

(b) Actual Breach during the Performance of the contract- Where a party apparently performs the promise but the other party says that it is not a proper performance according to the contract, the question arises whether there is a breach of the contract exonerating the other party from performance of his part of the bargain. If breach is of a condition vital to the contract, the contract is discharged and the other party need not perform his part of the bargain. In the case of sale of goods by description, unless the goods answering to the description are offered, the buyer is not bound to take delivery or to pay for them. But if the breach is only of a collateral term (non-essential condition), this will not exonerate the party from performance of his part of the bargain, but only entitle him to claim damages. Where the buyer has obtained possession of goods and his right of enjoyment is disturbed in any way, he can claim damages caused by the breach of the implied warranty of quiet possession. Where the promisor had made more than one promise, or a divisible promise his repudiation must either be of the whole contract, or of a part of it which is a condition precedent to the promisee's liability, else the promisee will not be entitled to treat such repudiation as equivalent to the breach of the whole contract.

(ii) Constructive or Anticipatory Breach of Contract

It may sometimes happens that even before the time of performance arrives the promisor may do some act which makes the performance impossible or may definitely renounce the contract or show his intention not to perform it. Thus where A promised to assign to B within 7 years from the date of promise all his interests in 4 houses for ` 10,000 and before the end of the years assigned all his interests to another person, it was held that without waiting for the 7 years to elapse B could sue for breach of the promise.

In another case, a carrier was engaged in April to accompany his employer on a tour of three months to commence on June, 1. On May 11 the employer wrote to the courier that he had changed his mind and declined his services but refused to make him an compensation. On May 22 the courier brought his action for breach of contract, and the defence was that there could be no breach before June 1. It was held that the courier was entitled to treat the letter of May 11, equivalent to breach of contract.

It is to be note that a constructive or anticipating breach of contract does not give rise to a right of action, unless the promisee elects to treat it as equivalent to actual breach, Thus, instead of bringing an immediate action as in the examples given above, the promisee may treat the conduct, act or notice of the promisor as inoperative, and wait for the time when the contract is to be performed, and then hold the promisor responsible for all the consequence of non-performance. But in that case the promisee keeps the contract alive for the benefit of the promisor not only to complete the contract in spite of previous repudiation, but also to avail himself any excuse for non-performance which may have come into existence before the time fixed for performance.

12.3 REMEDIES FOR BREACH OF CONTRACT

Where there is a breach of contract on the part of one party, the injured party becomes entitled to anyone or more of the following reliefs:

1. Rescission of the contract with the result that the injured party is freed from all obligations under the contract;
2. Suits for damages;

3. Suit upon a quantum meruit;
4. Suit for specific performance of the contract; and
5. Suit for an injunction.

1. Rescission

In one party has broken his contract, the other party may treat the breach as discharge, and refuse to perform his part of the contract. He may also successfully defend an action for non-performance, or an action brought for specific performance. Sec.75 further entitles him to compensation for any damage he may have sustained through the non-fulfillment of the contract.

For instance, A singer, contracts with B manager of a theatre, to sing at his theatre for two nights in every week during the next two months, and B engages to pay her ` 1000 for each nights's performance. On the sixth night, A willfully absents herself from the theatre, and B in consequence, rescinds the contract. B is entitled to claim compensation for the damage which he has sustained through the non-fulfillment of the contract.

2. Damages

Where a contract has been broken, the party who suffers by such breach is entitled, under Sec.73 to receive from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when make the contract, to be likely to result from the breach of it.

But compensation is not to be given for any remote or indirect loss or damage sustained by reason of the breach. Compensation is also available against a party for breach of a quasi-contract. Sec73 is based on the leading case of Hadley V. Baxendale (1854) 9 Ex. 34 the facts the which are as follows:

The plaintiff, an owner of a mill, delivered a broken shaft to the defendant common carrier to take to a manufacturer to copy it and make a new one. The carrier delayed delivery of the shaft beyond a reasonable time, as a result of which the mill was idle for a longer period than should have been necessary. The plaintiff did not make known to the defendant carrier that delay would result in a loss of profits. Held, the carrier was not liable for loss of profits during the period of delay.

Alderson, B observed in this case, "When two parties have made a contract, which one of them has broken, the damage which the other party ought to receive in respect of such breach should be either such as may fairly be considered as arising naturally, i.e., according to the usual course of things from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both the parties at the time the contract was entered into as a probable result of the breach". This statement of law is known as the Rule in Hadley v. Baxendale.

The principle enunciated in Sec. 73 is that a party who suffers by the breach of contract is entitled to:

a) Such damages as naturally arose in the usual course of things, as a result of the breach;

b) And if he claims special damages for any loss sustained (which would not ordinarily flow from the breach) he must prove that the other party knew at the time of making the contract that the special loss was likely to result from the breach of the contract;

c) Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach; and

d) Compensation for quasi-contract as damage is the same as for a contract.

Liquidated Damages and Un-liquidated Damages

Where there is breach of contract by one party, the other party is entitled to sue for damages. Therefore, unless the court passes a decree for a specified amount, the claim for damages is merely a right to sue and not a debt or actionable claim. Consequently, this claim can be assigned or transferred, since it is not a debt under the law.

Liquidated damages are damages agreed upon by the parties in the contract itself to be paid by the party breaking the contract in case of breach. The plaintiff has only to prove the breach of contract, and no proof of loss is required. But liquidated damages must appear to be a genuine pre-estimate of the loss that will be caused to one party if the contract is broken by the other. Where no damages are fixed by the contract, but the amount of compensation claim for a breach of contract is left be assessed by the court, damages claimed are called unliquidated damages.

Unliquidated damages may be classified as follows:

a) Ordinary Or Compensatory Damages

In deciding a suit for damages, the court has to answer two questions: (I) Proximity and remoteness of damage (ii) Measure of damages. The Judge has to first decide whether or not the damage has resulted from proximate consequences of the breach, for remote consequences are not regarded. Once the court has decided that the damage is sufficiently proximate, it will the turn to the measure of damages, that is the amount of money that will compensate the plaintiff. The question of remoteness of damage is governed by the maxim recognised in Hadely v. Baxendale and Sec. 73 of Contract Act.

Thus, if the damage of loss suffered by reason of the breach of the contract is remote or indirect no compensation would be allowed. The aggrieved party, however, would in case of breach of contract, be entitled to recover compensation for damage or loss caused to him thereby, if such loss or damage arose naturally and directly in the usual course of things from such breach, of which the parties to the contract knew, at the time of making the contract, to be likely to result from breach of contract. The first part of this rule states the case for ordinary damages and the later concerns with special damages.

In Hadley v. Baxendale, the common negligence delayed delivery of the broken shaft to the manufacturer. The plaintiff did not make known to the defendant, the common carrier, that for want of the shaft the mill would remain idle which would result in a loss of profit. The plaintiff was held entitled to recover damages for delay in delivery but not for loss of profits occasioned by the closure of the mill since there was no way the common carrier could have been foreseen that the mere absence of a shaft would cause the closure for the mill. The mill-owner could have recovered damages for loss of profit if he had informed the carrier of the likely result of delayed delivery.

Measure of damages

The measure of damages is the estimated loss directly and naturally resulting in the ordinary course of events, from the breach of contract. The injured party is to be put in the same financial position as he would have been if the contract had been performed according to its terms.

In the case of sale and purchase, the damages, payable would be the difference between the contract price and the market price at the date of the breach. The damages are calculated as on the date of breach and any subsequent change of circumstances tending to an increase or reduction of damage cannot be taken note of.

Example: A cow was sold with condition that it was free from disease. The cow was suffering from foot and mouth disease at the time of sale. Not only the cow die but it also infected other cows of the buyer. Held damages could be recovered for the entire loss.

b) Special Damages

Special damages are those resulting from a breach of contract under some special circumstances. If at the time of entering into a contract, a person has notice of special circumstances which make special loss the likely result of the breach in the ordinary course of things, than upon his breaking the contract and the special loss following the breach, he will be required to make good the special loss. If therefore there be any special damage which is attributable to the wrongful act, then special damages, if proved, will be awarded. Hence if an unusual damage is likely to be sustained as the result of a breach of contract, its nature should be communicated to the other party before the contract is made so that he contracts subject to the prospective liability. Thus, if in Hadley v. Baxendale, the mill-owner had told the carrier that delay would result in a loss of profits through stoppage of the mill, he would have recovered damages for such a loss.

(c) Exemplary or Punitive Damages

These damages are sum awarded beyond the pecuniary loss sustained by the injured party. Ordinarily, damages for breach of contract are intended to compensate the plaintiff, not to punish the defendant. The object of exemplary damages is to punish the defendant and to deter him and others from similar conduct in the future. Award of exemplary damages is made in only two cases: (i) Breach of promise of marriage cases, (ii) where a bank wrongfully dishonors a customer's cheque.

In a breach of promise to marry, the amount of the damages will depend upon the extent of injury to the party's feelings. It is really and additionally sum known as a solatium awarded to the jilted women as a solace for her injured feelings.

In the case of wrongful dishonor of a cheque of a customer who is a trader the rule is the smaller the cheque dishonored the greater the damage.

(d) Nominal Damages

Nominal damages consist of a small of money, e.g., a rupee. They are a token award where there has been an infringement of contractual right, but no actual loss has been suffered. These damages are awarded to establish the right to decree for breach of contract.

(e) Contemptuous Damages

Damages are said to be contemptuous, when the court finds that a breach has been committed, but that the breach is so insignificant or petty that a reasonable man would not have filed a suit. A rupee or even less may be awarded to mark the court's disapproval of the plaintiffs conduct in bringing the action. The law does not take account of trifling things; and where it does, it awards also something of a contemptuous character. Such damages have been awarded to male plaintiffs in breach of marriage actions.

Liquidated Damages and Penalty

Where the parties have fixed at the time of contract the damages that would be payable in case of breach, a question may arise (in English law at least) whether the provision amounts to "liquidated damages" or a "penalty". Courts in English give effect to liquidated damages, but they relieve against penalty.

The test of the two is that where the amount fixed is a genuine per-estimate of the loss in case of breach; it is liquidated damages and will be allowed, and if the amount fixed is without any regard to probable loss, but in terrarium, is a penalty and will not be allowed.

In Indian law, there is no such difference between liquidated damage and penalty, as Sec. 74 specifically provides payment of only "reasonable" compensation.

The party suffering from breach is entitled to get the actual damages he has suffered. With regard to the amount named in the contract, the compensation payable is the reasonable amount up to the stipulated amount whether it is by way of liquidated damages or penalty.

a) A contracts with B to pay B ` 1,000 if he fails to pay B ` 500 on a given day. A fails to pay B ` 500 on that day. B is entitled to recover from A such compensation not exceeding `

1000 as the Court considers reasonable.

Example: A contracts with B that, if A practices as a surgeon within Calcutta he will pay B ` 5,000 A practices as a surgeon in Calcutta. B is entitled to such compensation, not exceeding ` 5000 as the court considers reasonable.

Payment of Interest

With regard to the payment of interest, the following rules have been laid down:

1. Payment of interest in case of default. Where a contract provides that the amount should be paid by a particular date and in default, it will be payable with interest, the court will give effect to the stipulation if the interest is reasonable. Where the interest is exorbitant, the Court will give relief.

2. Payment of interest as higher rate. Where the contract provides that in default of the payment of the principal by a stated date enhanced interest should be payable, if the enhanced interest is made payable from the date of default and is reasonable, it is regarded compensation and is allowed. But if the enhanced interest is exorbitant, e.g. increase from 12 percent to 75 percent, it will be penalty and relief will be granted against it.

3. Payment of compound interest. The Court do not lean towards compound interest, they do not award in the absence of stipulation but where there is a stipulation for its payment it is the absence of disentitling circumstances, allowed i.e. it will be allowed only if it is the absence of disentitling circumstances allowed, it will be allowed only if it is not an enhanced rate.

3. Suit for Quantum Meruit

Quantum meruit as much as he has earned. Suing on quantum meruit is the suing for the value of so much as is done. The injured party can use for quantum meruit, i.e. if the injured party has done can estimate at a money value of so much as he has already done.

A places an order with B for the supply of 100 chairs to be delivered by installments. B delivers 20 chairs when A informs him that he will require no more. In this case A’s erudition discharges B from the obligation to supply the remaining chairs. He can sue A for the breach of contract for the value of 20 chairs already supplied. The later will be called suit for quantum meruit.

4. Suit for Specific Performance

Instead of or addition to awarding damages to the injured party, a decree for specific performance may be granted. Specific performance means the actual carrying out by the parties carrying out their agreement. This remedy, however, is discretionary and will not granted in the following cases:

(i) Where monetary compensation is an adequate remedy.

(ii) Where the Court can not supervise the execution of the contract, e.g. a building contract.

(iii) Where the contract is for personal services.

(iv) Where one of the parties is a minor.

Specific performance is usually granted in contracts connected with land, e.g. purchase of particular plot of house, or to take debentures in company. In the case of sale of goods, it will only be granted in the case of specific goods and is not ordered as a rule unless the goods are unique and cannot easily be purchased in the marked or are of special value to the party suing by reason of personal or family associations.

5. Suit for Injunction

An injunction is a mode of securing the specific performance of a negative terms of the contract. It is an order of the court whereby an individual is required to refrain from the further doing of the act complained of. It may be used to prevent many wrongful acts, e.g. torts, but in the context of contract, the remedy will be granted to enforce a negative stipulation in a contract in case where damages would not be an adequate remedy. Thus, where a party to a contract is doing something which he had promised not to do, the court may in its discretion, issue and order to the defendant restraining him from doing what he promised not to do. Its application may be extended to contracts where is no actual negative stipulation but where one may be inferred. In Metropolitan Electric Supply Company v. Ginder (1901) 2 Ch. 799, G agreed to make the whole electric required by his premises from the plaintiffs. Held, this was in substance an agreement not to take energy from any other person and it could be enforced by injunction.

12.4 SUMMARY

When the rights and obligations created by the contract come to an end, the contract is said to be discharged. The various modes in which a contract may be discharged are by performance, impossibility of performance, agreement, operation of law, lapse of time and breach. The contract is said to be discharged when parties to a contract perform their respective obligations which they have agreed to. Sometimes, the performance of a contract is impossible. In such cases, the contract is discharged because the parties cannot perform their respective obligations. A contract may be discharged by mutual agreement of the concerned parties. The important methods for discharge of a contract by a fresh contract are novation, rescission, alternation, remission, waiver and acceptance of any other satisfaction. In certain circumstances, the contract is discharged by the operation of law. If the contracts is not performed and the aggrieved party does not enforce his rights within the limitation period, then he is debarred from enforcing the contract. If any party fails to perform his obligation, there occurs a breach of contract. And the other party (the aggrieved or injured party) can enforce his rights in the Court of law. Suit for rescission, damages, quantum meruit, specific performance and injuctions are the remedies available to the aggrieved party.

12.5 KEYWORDS

Breach of Contract: A breach of contract occurs if any party refuses or fails to perform his part of the contract or by his act makes it impossible to perform his obligation under the contract.

Restitution: It is return of the benefit received by one party to the contract from the other under a void contract.

Injunction: Injunction is generally granted to prevent the breach of an obligation arising out of a contract.

Discharge of Contract: It is the termination of contractual relationship between the parties.

Novation: Novation is the substitution of existing contract for a new contract.

Rescission: It is the cancellation of the contract.

Remission: Remission is the acceptance of lesser fulfillment of the terms of the promise.

12.6 SELF ASSESSMENT QUESTIONS

1. State the circumstances under which a contract is said to be discharged.
2. What is meant by supervening impossibility. Discuss its effect in the performance of a contract.
3. Explain the law of frustration of contract. Give illustrations.

4. Write a note on discharge of contract by consent.
5. Does an impossibility which arises subsequent to the formation of a contract excuse the promisor from performing the contract in all cases?
6. Explain ‘breach of contract’ as a mode of discharge of contract.
7. What remedies are available to an aggrieved party on the breach of a contract.
8. What are consequences of breach of a contract?
9. What are the principles usually followed to access damages for breach of a contract.
10. “If a contract is broken, the law will endeavor so for as money can do it, to place the injured party in the same position as if the contract had been performed.” Comment.
11. Under what circumstances is a party entitled of specific performances?

12.7 SUGGESTED READINGS

S.K. Aggarwal, Business Law, Galgotia Publishing Company, New Delhi.

G.K. Varshney, Elements of Business Law, S Chand & Co., New Delhi.

S.R. Davar, Mercantile Law, Progressive Corporation Pvt. Ltd., Mumbai.

K.R. Balchandari, Business Law for Management, Himalaya Publication House, New Delhi.

LESSON : 13

SALE OF GOODS ACT: AN INTRODUCTION

STRUCTURE

13.0 OBJECTIVES

After reading this lesson, you should be able to

a) Define a contract of sale of goods and state its essentials.

b) Make a distinction between sale and agreement to sell, and sale and hire purchase.

c) Define the goods and explain various types of goods.

d) State the rules governing the passing of title to the goods from the seller to the purchases.

e) Define bailment and explain its features.

13.1 INTRODUCTION

Most of economic activities involve buying and selling of movable goods. The sale of goods may on cash or credit basis. The goods may be sold on the spot or there may be a promise to sell the some in future. The law relating to the sale of goods or movable goods in India is contained in the Sale of Goods Act, 1930. Before the passing of the present Act, the law relating to the sale of goods was contained in Chapter VII of the Indian Contract act, 1872. The provisions of Chapter VII were found to be unsatisfactory and the present Act was passed with the main object of making the provisions more clear. The Act came into force on Ist July, 1930.

13.2 CONTRACT OF SALES OF GOODS

A contract of sales of goods is a contract whereby the sellers transfers or agrees to transfer the property in goods to the buyer for a price (Section 4).

The term ‘Contract of Sale’ is a generic term and includes:

i) Sales; and

ii) Agreement to sell

Where the seller transfer the property in the goods immediately to the buyer, it is a sale. But where the transfer of the property in the goods is to take place in a future time subject to some conditions thereafter to be fulfilled, the contract is called an agreement to sell. An agreement to sell becomes a sale when the time passed as the conditions are fulfilled subject to which the property in the goods is to be transferred.

13.3 ESSENTIALS OF A CONTRACT OF SALE

The general provisions of Indian Contract Act continue to be applicable to the contract of sales of goods in so far as they are not inconsistent with the express provisions of Sale of Goods Act (Section 3). Thus, for example, the provisions of Contract Act relating to capacity of the parties, free consent, agreements in restraint of trade, wagering agreements and measure of damages continue to be applicable to a contract of sale of goods. But the definition of consideration stands modified to the extent that in a contract of sale of goods, consideration must be by way of ‘price’ i.e., only money consideration [Section 2(10) and 4]

The following are the essentials of the contract of sale:

1. Contract

The word contract means an agreement enforceable at law. It presumes free consent on the part of the parties who should be competent to contract. Thus, a compulsory transfer of goods is not a sale. The agreement must be made for a lawful consideration and with a lawful object. In other words, all the essential elements of a valid contract must also be present in a contract of sale.

2. Two Parties

To constitute a contract there must be two parties, viz., a buyer and a seller, as a person cannot buy his own goods. According to Section 4(1), there may be a contract of sale between one part-owner and another, e.g. if A and B jointly own a typewriter, A may sell his ownership in the typewriter to B, thereby making B sole owner of the goods. Similarly, a partner may buy the goods from the firm in which he is a partner and vice-versa. There is, however, one exceptional case when a person may buy his own goods. Where a person's goods are sold in execution of a decree, he may himself buy them, so as to save them from a transfer of ownership to someone else (Moore vs Singer Manufacturing Co.).

Example: A partnership firm was dissolved and the surplus assets, including the stock in trade, were divided among the partners, in spite. Held, it was not a sale as the partners themselves were the joint owners of the goods and they could not be both sellers and buyers [State of Gujarat v Raman Lal S & Co, AIR (1965) Guj Co].

There are certain other exceptions to the rule that the same person cannot be both a purchaser and a seller. These are:

a) A part owner can sell his share to the other part owner so as to make the other part owner the sole owner of the goods

b) A partner may also buy the goods from the firm in which he is a partner and vice-versa.

c) Where a pawnee sells the goods pledged with him on non-payment of bill money, the pawnor may himself buy such goods.

d) In case there is a sale by auction, the seller may reserve right of making a bid at the auction and may thus purchase his own goods.

3. Transfer of Property

Property means 'ownership'. Transfer of property in the goods is another essential of a contract of sale of goods. A mere transfer of possession of the goods cannot be termed as sale. To constitute a contract of sale, the seller must either transfer or agree to transfer the property in the goods to the buyer.

4. Goods

According to Section 2(7), "goods means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale". Thus, every kind of movable property except actionable claim and money is regarded as 'goods'. Goodwill, trade marks, patents right, copyrights, electricity, water, gas, decree of a court of law are all regarded as goods. Shares and stock are also included in goods. With regard to growing crops, grass and things attached to or forming part of the land, such things are regarded as goods as soon as they are agreed to be separated from the land. Thus where trees were sold so that they could be cut out and separated from the land and then taken away by the buyer, it was held that there was a contract for sale of movable property or goods (Kursell vs Timber Operators & Contractors Ltd). But contracts for sale of things 'forming part of the land itself' are not contracts for sale of goods. For example, a contract for the sale of coal mine or building stone quarry is not a contract of sale of goods.

Money is not regarded goods because it is the medium of exchange through which goods can be bought. Old and rare coins, however, may be treated as goods and sold as such.

5. Price

To constitute a valid contract of sale, consideration for transfer must be money paid or promised. Where there is no money consideration the transaction is not a contract of sale, as for instance goods given in exchange for goods or as remuneration for work or labour. Further, there is nothing to prevent the consideration from being partly in money and partly in goods or some other articles of value. For example, when an old car is returned to the dealer for a new one and the difference is paid in cash, that would be a sale.

13.4 SALE AND AN AGREEMENT TO SELL

SALE

The term 'contract of sale' is a generic term and includes both a 'sale' and an 'agreement to sell' Sale: where under a contract of sale the property in the goods is immediately transferred at the time of making the contract from the seller to the buyer, the contract is called a 'sale' [Sec 4(3)]. It refers to an 'absolute sale', e.g., an outright sale on a counter in a shop. There is immediate conveyance of the ownership and mostly of the subject matter of the sale as well (delivery may also be given in future). It is an executed contract.

AN AGREEMENT TO SELL

Where under a contract of sale the transfer of property in the goods is to take place at a future time or subject to same condition thereafter to be fulfilled, the contract is called 'an agreement to sell' [Section 7(3)]. It is an executory contract and refers to a conditional sale.

Examples

(i) On 1 January, X agrees with Y that he will sell Y his scooter on 15 January for a sum of ` 4,000. It is an agreement to sell, since X agrees to transfer the ownership of the scooter to y at a future time.

(ii) X buys some furniture for ` 5,000 and agrees to pay for that in the monthly installments, the ownership to pass to him on the payment of second installment. There is an agreement to sell for the furniture dealer.

The Sales of Goods Act does not prescribe any particular form to constitute a valid contract of sale. A contract of sale of goods can be made by mere offer and acceptance . The offer may be made either by the seller or the buyer and the same must be accepted by the other . Neither payment nor delivery is necessary at the time of making the contract of sale. Further, such a contract may be amide either orally or in writing or partly orally and partly in writing or may be even implied from the contract of the parties.

13.5 DIFFERENCE BETWEEN SALE AND AGREEMENT TO SELL

A contract for sale of goods is a contract whereby the seller transfers or agrees to transfer the property in the goods to the buyer for a price. Therefore, the effect of a contract of sale is the transfer of property in the goods from the seller to the buyer. In the sale of goods, the property in them is transferred from the seller to the buyer immediately, but where an agreement of sale is entered into, the property in the goods passes only after the seller has fulfilled certain conditions subsequently [Section 4(3)]. Thus, whether a contract of sale of goods is an absolute sale or an agreement to sell, depends on the fact whether it contemplates immediate transfer from the seller to the buyer or the transfer is to take place in future date. The following are the points of difference between them:

(i) Transfer of Property

In a sale, the property in the goods passes from the seller to the buyer immediately so that the seller is no more the owner of the goods sold. In an agreement to sell, the transfer of property in the goods is to take place at a future time or subject to certain conditions to be fulfilled. In this sense, a sale is an executed contract and an agreement to sell is an executory contract.

(ii) Risk of Loss

In a sale, the buyer immediately becomes the owner of the goods and the risk as a rule passes to the buyer; under an agreement to sell, the seller remains the owner and the risk is with him. Thus under a sale, if the goods are destroyed the loss falls on the buyer, even though the goods are in the possession of the seller. But, under an agreement to sell, the loss will fall on the seller in the case of destruction of goods even though they are in the possession of the buyer.

(iii) Consequences of Breach

In case of sale, if the buyer wrongfully neglects or refuses to pay the price of the goods, the seller can sue for the price, even though the goods are still in his possession. In case of an agreement to sell, if the buyer fails to accept and pay for the goods, the seller can only sue for damages and not for the price, even though the goods are in the possession of buyer.

(iv) Insolvency of the Buyer

In a sale, if the buyer is adjudged an insolvent, the seller in the absence of a lien over the goods is bound to deliver the goods to the Official Receiver or Assignee. The seller, will, however, be entitled to a rateable dividend for the price of the goods. On the other hand, in an agreement to sell, when the buyer becomes insolvent before he pays for the goods, the seller may not part with the goods.

(v) Insolvency of the Seller

In a sale, if the seller becomes insolvent, the buyer being the owner is entitled to recover the goods from the Official Receiver or Assignee. In an agreement to sell, if the buyer, who has paid the price, finds that the seller has become insolvent, he can only claim a rateable dividend and not the goods because property in them has not yet passed to him.

(vi) Right to Resale

In a sale, the property is with the buyer and as such the seller (in possession of goods after sale) cannot resell the goods. If he does so, the subsequent buyer having knowledge of the previous sale does not acquire a title to the gods. The original buyer can sue and recover the goods from the third person as owner, and can also sue the seller for the breach of contract as well as for the tort conversion.

On the other hand, in an agreement to sell, the property in the goods remains with the seller and as such he can dispose of the goods as he likes and the original buyer can sue him for the breach of contract only. In this case, the subsequent buyer gets a good title to the goods, irrespective of his knowledge of previous sale. Further, goods forming the subject matter of an agreement to sell can also be attached in execution of a decree of a court of law against the seller.

13.6 DISTINCTION BETWEEN SALE AND HIRE PURCHASE

The difference between a contract of sale and hire purchase agreement are given below:

1. Nature of Contract

A sale is an executed contract in which the ownership is transferred from the seller to the buyer as soon as the contract entered into.

In a hire purchase agreement it becomes the property of the buyer only after a certain agreed number of installments is paid till then the hire purchaser stands in the position of the bailee and not the owner of the goods.

2. Termination of the Contract

In a sale, the buyer cannot terminate the contract and as such is bound to pay the price of the goods. On the other hand, the hire-purchase has an option to terminate the contract at any stage, and cannot be forced to pay the further installments.

3 Insolvency of the Buyer

In a sale of seller takes the risk of any loss resulting from the insolvency of the buyer. But in a hire purchase the owner is not at any risk because if the hirer does not pay any installments the seller has a right to take back the goods.

4. Implied Conditions and Warranties

A sale is subject to the implied condition and warranties provided under the Sale of Goods Act 1930. A hire purchase agreement is not subject to such implied warranties and conditions. It is however, subject to the implied conditions provided in the hire purchase agreement.

5. Effect of Payments

In a sale even if the payment is made by the buyer in installments the amount payable by the buyer to the seller is reduced, for the payment made by the buyer to the seller is towards price of the goods. The installments paid by the hire purchase are regarded as payment towards the price of the goods till the option to purchase the goods is exercised.

6. Resale

The buyer in a sale can resell the goods. But the hire purchase cannot resell unless he has paid all the installments of hire.

13.7 GOODS-SUBJECT MATTER OF CONTRACT OF SALE

Goods form the subject matter of a contract of sale. According to Section 2(7), "goods" means every kind of movable property other than actionable claims and money; and includes stocks and shares, growing crops, grass and things attached to or forming part of land which are agreed to be severed before sale or under the contract of sale. Trade marks, copy rights, patent rights, goodwill, electricity, water, gas are all goods.

Actionable claim and money are not goods. An actionable claim is something which can only be enforced by action in a Court of law. A debt due from one person to another is an actionable claim and cannot be bought or sold as goods. It can only be assigned. Money here means current money and not old rare coins.

The definition of the term 'goods' also suggests that it includes stocks and shares, growing crops, grass and things attached to or forming part of land which are agreed to be severed from land before sale. Growing crops and grass are included in the definition of the term 'goods' because they are to be severed from land. Trees which are agreed to be severed before sale or under the contract of sale are goods [Badri Prasad v State of MP, AIR (1970) SC 706]

Goods may be classified into various types as shown below:

1. Existing goods
2. Future goods
3. Contingent goods

1. Existing goods: Goods earned and possessed by the seller at the time of the making of the contact of sale are called existing goods. Sometimes the seller may be in possession but may not be the owner of the goods e.g. sale of goods by a mercantile agent. Existing goods may again be either specific or ascertained or unascertained.

a) Specific Goods: These are the goods which are identified and agreed upon at the time a contract of sale is made. To be specific, the goods must be actually identified; it is not sufficient that they are capable of identification, e.g. if X who owns a number of horses, promises to sell one of them, the contract is for unspecified goods.

b) Ascertained Goods: These are the goods which are identified in accordance with the agreement after the contract of sale is made. Though commonly used as similar in meaning to specific goods, these are not always the same.

c) Unascertained Goods: It means generic goods. These goods can be defined by description or even by sample. The seller in the use of a contract for the sale of unascertained goods has the option, rather the right to supply any goods of the kind or the quality contracted for. He is not bound to deliver any particular goods and he may furnish any goods answering their description in the contract.

2. Future Goods

Goods to be manufactured, produced or acquired by the seller after the making of the contract of sale are called 'future goods' [Sec 2(6)]. These goods may be either not yet in existence or be in existence but not yet acquired by the seller. It is worth noting that there can be no present sale of future goods because property cannot pass in what is not owned by the seller at the time of the contract. So even if the parties purport to effect a present sale of future goods, in law it operates only as an 'agreement to sell [Sec 6(3)].

Example: X agrees to sell to Y all the mangoes which will be produced in this garden next year. It is contract to sale of future goods, amounting to 'an agreement to sell'.

3. Contingent Goods

Goods, the acquisition of which by the seller depends upon an uncertain contingency are called 'contingent goods' [Sec. 6(2)]. Obviously, they are a type of future goods and therefore, a contract for the sale of contingent goods also operates as 'an agreement to sell' and not a 'sale' so far as the question of passing of property to the buyer is concerned. In other words, like the future goods, in the case of contingent goods also the property does not pass to the buyer at the time of making the contract. It is important to not that a contract of sale of contingent goods is enforceable only if the event on the happening of which the performance of the contract is dependent happens, otherwise the contract becomes void.

13.8 ASCERTAINMENT OF PRICE

'Price' means the monetary consideration for sale of goods' [Section 2(10)]. By virtue of Section 9, the price may be (1) fixed by the contract, or (2) agreed to be fixed in a manner provided by the contract, e.g. by a valuer, or (3) determined by the course of dealings between the parties.

When it cannot be fixed in any of the above ways, the buyer is bound to pay to the seller a reasonable price. What is a reasonable price is a question of fact in each case?

Section 10 provides for the determination of price by a third party. Where there is an agreement to sell goods on the terms that price has to be fixed by the third party and he either does not or cannot make such valuation, the agreement will do void. In case the third party is prevented by the default of either party from fixing the price, the party at fault will be liable to the damages to the others to the other part, who is not at fault. However, a buyer who has received and appreciated the goods must pay a reasonable price for them in any eventuality.

13.9 STIPULATIONS AS TO TIME

Stipulations as to time in a contract of sale fall under the following two heads:

1. Stipulations related to time of payment
2. Stipulations not relating to time of payment, e.g. delivery of goods etc.

Stipulations relating to time of payment are not of the essence of a contract of sale, unless a different intention appears from the contract. As regards other stipulations, time may be of the essence of the contract but this essentially depends on the terms of the contract. In a contract of sale, stipulations other than those relating to the time of payment are regarded as of the essence of the contract. Thus if a time is fixed for the delivery of goods, the delivery must be made at the fixed time, otherwise the other party is entitled to put an end to the contract.

13.10 CAPACITY TO BUY AND SELL

A sale of goods means transfer of ownership of the goods by the seller to the buyer.

‘Buyer’ means a person who buys or agrees to buy goods and ‘seller’ means a person who sells or agrees to sell goods. The two terms ‘buyer’ and ‘seller’ are complementary and represent the two parties to a contract of sale of goods.

In every contract of sale, there is an implied condition on the part of the seller that in the case of sale he has a right to sell the goods and in the case of an agreement to sell he will have a right to sell the goods at the time when the property in them is to pass.

Usually the owner of the goods or his agent may sell the goods. If a person has no title to the goods or otherwise does not have a right to dispose of certain goods, the buyer of such goods has a right to reject them and to claim back the price if the same has already been paid and refuse to pay if the price has not been paid till then. The leading case on this point is Rowland v Divall (1923). In this case, C purchased a motor car from D, and after using it for sometime he was compelled to return it to the true owner, it becoming clear that D had obtained the car by theft. It has held that D had not fulfilled the condition as to title and C was, therefore, entitled to recover the purchase money from D.

Lack of title to the goods is not the only factor because of which the seller may not have a right to sell the goods. If a vendor is stopped by process of law from selling, he has not the right to sell the goods. Accordingly a sale which would be a breach of patent, copyright, or trade mark may be repudiated by the buyer.

In Niblett v Confectioners’ Materials Co Ltd (1921) the sellers sold to the buyers tins of condensed milk c.i.f. from New York to London. Some of the tins were bearing the labels marked “Nissly Brand” which was the trade mark of a third person, Nestle Co. At the instance of the Nestle Co. the Commissioners of customs detained the goods. The buyers had to remove those labels before taking delivery of those tins of condensed milk. The buyers suffered a loss because they had to sell the tins of milk without proper labels at a lower price. The buyers sued the sellers to claim compensation. The court held that the sellers had made a breach of condition that they had a right to sell the goods and as such they were bound to pay damages for the loss suffered by the buyers. Further, Section 27 of the Act of the true owner states:

Transfer of Title by Non-Owners

The general rule contained in Sec 27 is subject to the provisions of this Act. Various exceptions to this rule have been mentioned in this Act and the Indian Contract Act and in those exceptional situations the seller of the goods may not be having a good title to the goods, yet the buyer of the goods gets a good title to them. The exceptions are:

1. Sale by a mercantile agent (Sec. 27)

A mercantile agent means an agent having in the customary course of business as such agent authority either to sell goods, or to consign goods for the purposes of sale, or to buy goods, or to raise money on the security of goods [Sec 2(9)]. Thus as a rule of mercantile agent having an authority to sell goods conveys a good title to the buyer. But by virtue of this provision (provision to Sec. 27) a mercantile agent can convey a good title to the buyer even though he sells goods without having any authority from the principal. To do so, provided the following conditions are satisfied:

a) he should be in possession of the goods or documents of title to the goods in his capacity as mercantile agent and with the consent of the owner.

b) he should sell the goods while acting in the ordinary course of business.

c) The buyer should act in good faith without having any notice, at the time of the contract, that the agent has no authority to sell.

Examples

F entrusted his car to a mercantile agent for sale at a stated price and not below that. The agent sold it to S, a bonafide purchaser, below the reserve price and misappropriated the proceeds. S resold the car to K, the defendant. Held, S obtained a good title to the car from the mercantile agent and he conveyed a good title to K and therefore, F was not entitled to recover the car from K (Folkes v s King).

In Pearson v Rose & Young Ltd, the plaintiff gave possession of his motor car to Hunt, a mercantile agent, to know if the same could be sold. He did not actually authorise Hunt to sell the same. Hunt took the registration book relating to the car from the plaintiff by trick and then sold the car without the plaintiff's authority or knowledge. Hunt sold the car to X, X sold it to Y and Y sold the same to the defendants. The plaintiff sued the defendants to claim damages for conversion on the ground that Hunt had no authority to sell and, therefore, no good title could be passed to any subsequent transferee.

It was observed that though Hunt got possession of the car as a mercantile agent but not the registration book. The sale of a second hand car without the registration book could not be considered to be in the ordinary course of business. It was held that for passing a good title, Hunt should have obtained the possession of the car as well as registration book with the consent of the owner, in the absence of which Hunt was not able to pass a good title to his transferee or the subsequent buyers.

It is also necessary that the mercantile agent must have obtained the possession of the goods or the documents of title in his capacity as a mercantile agent and not in any other capacity. If he is in possession in any other capacity he cannot convey a good title.

2. Transfer of title by Estoppel

Generally the owner of the goods can question the title of the transferee by contending that the seller did not have a right to sell the goods. Sometimes the law of estoppel may apply against the owner of the goods and he may not be allowed to deny seller's authority to sell. The closing words of the rule contained in Sec. 27 are as under:

Unless the owner of the goods is by his conduct precluded from denying the sellers authority to sell.

As noted above, sometimes the law of estoppel may apply against the owner of the goods and he may be estopped from denying seller's right to sell the goods. In other words, because of application of rule of estoppel against him he may not be able to assert that the seller of the goods did not have a right to sell and thus the buyer may have a good title even though the seller of the goods did not actually have a right to sell them. When the owner of the goods by his act or omission makes the buyer to believe that the seller of those goods has a right to sell them, subsequently he cannot deny the existence of such a right in the seller.

In reference to sale of goods, estoppel may arise in any of the following ways:

i) The owner standing by, when the sale is effected, or

ii) Still more, by his assisting the sale, or

iii) By permitting goods to go into the possession of another with all the insignia of possession thereof and apparent title, or

iv) If he has otherwise acted or made representations so as to induce the buyer to alter his position to his prejudice.

Example: M, the owner of a wagon allowed one of his employees K, to have his name painted on it. M did so for the purpose of inducing the public to believe that the wagon belonged to K. C purchased the wagon from K in good faith. C acquires a good title as M is estopped from denying K's authority to sell (O'Connor v Clark).

3. Sale by One of Joint Owners

Sale by one of the joint owners constitutes another exception to the rule of nemo dat quod non habet. According to Sec 28, if one of the several joint owners is in sole possession of the goods with the permission of the other co-owners a sale by him will convey a good title to the buyer who buys in good faith and at the time of buying has no notice of the fact that such a joint owner has no authority to sell.

4. Sale by a Person in Possession of Goods under a Voidable Contract

Section 29 deal with the case of a sale by a person who has obtained possession of goods under a voidable contract. It provides that a person in possession of goods under a voidable contract which has not been canceled can transfer a good title to the buyer who buys the goods in good faith. This exception is limited to contracts of sale voidable under Sections 19 and 19A of the Contract Act) voidable on the ground of coercion, fraud, misrepresentation and undue influence. It does not extend to all voidable contracts. Further, if the contract under which the seller obtains goods is void, then even an innocent buyer of the gods from such a seller does not acquire title to the goods.

5. Sale by Seller in Possession after Sale

Where a seller, after having sold the goods, continues to be in possession of the goods or of the documents of title to them and again sells or pledges them either himself or through a mercantile agent, he will convey a good title to the buyer or the pledgee provided the buyer or the pledgee acts in good faith and without notice of the previous sale. For the application of this exception, it is essential that the possession of the seller must be as seller and not as hirer or bailee.

6. Sale by the Buyer in Possession

Section 30(2) deals with a case where the buyer is in possession of the goods but the property in them has not passed to him. This section says that if a buyer has obtained the possession of the goods or the documents of title to them with the consent of the seller any sale, pledge or other disposition thereof to any person will convey a good title to the transferee provided the person receiving the goods was acting in good faith and without any notice as regards any lien or other right of the original seller in respect of those goods.

In Cahn v Pockett's Bristol Steam Channel Co, A sold certain copper to B and forwarded to him the bill of exchange along with the bill of lading which was endorsed in blank with a view to have the acceptance or the payment of the bill of exchange. B, who was insolvent, did not accept the bill of exchange. Instead of returning the bill of lading and the dishonored bill of exchange to A, he transferred the bill of lading to C, who took the same in good faith and for consideration. It was held that since B had obtained the bill of lading with the consent of A, the transfer by B could convey a good title to C, and the right of A to stop the goods in transit was defeated.

7. Resale by an Unpaid Seller

Where an unpaid seller who has right of lien or stoppage in transit resells the goods, the buyer acquires a good title thereto as against the original buyer, even though the resale may not be justified in the circumstances, i.e. no notice of the resale has been given to the original buyer. Thus, a buyer at a resale acquires a good title.

8. Sale by finder of Goods - Sec 169, Indian Contract Act

According to Sec. 71, of Indian Contract Act, the finder of goods is subject to the same responsibility as the bailee. He is to take due care of the goods while they are in his possession and also to return them when their owner has been found. According to Sec. 169 of the Contract Act, however, if the owner cannot with a reasonable diligence be found or if he refuses upon demand, to pay the lawful changes of the finder, the finder may sell the goods -

(i) When the thing is in danger of perishing or of losing the greater part of its value, or

(ii) When the lawful changes of the finder, in respect of the thing found, amount to two-third of its value.

When the finder of goods sells them under the circumstances stated above, the buyer of such good gets a good title to them.

9. Sale by Pawnee - Sec. 176, Indian Contract Act

Normally the pawnee of the goods is under a duty to return them if the debt secured by such goods is paid back to him. He may retain such goods until the debt and interest thereon and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged are paid to him. According to Sec. 176 of Indian Contract Act, if the pawnor makes a default in the payment of the debt, the pawnee may either sue him for the debt or may sell the goods pledged on giving the pawnor reasonable notice of the sale. Upon such a sale being made by the pawnee the buyer of such gods acquires a good title to them.

10. Sale by Authorised Officer

In some cases, a special power of sale is given to officers of court, liquidators of companies, receivers insolvent's estate, custom officers for duties remaining unpaid, etc. All these persons are not owners, yet they sell properties of others, and convey a better title to the buyers than they themselves possess.

13.11 SUMMARY

Contract of sale is a contract by which the ownership of movable goods is transferred from the seller to the buyer. Where the property in the goods is immediately transferred to the buyer, the contract of sale is called a sale. Where the property in goods is to be transferred to the buyer at some future date or on the fulfillment of a certain condition, the contract of sale is called an agreement to sell. Only the goods can be the subject-matter of contract of sale. The goods may be classified into existing, future and contingent goods. There can be no valid sale of goods without the price. Stipulation relating to time of payment are not of the essence of a contract of sales unless a different intention appears from a contract. A seller cannot give a better title than that of his own. If the title of the seller is defective the buyer's title will also be subject to the same defect.

13.12 KEYWORDS

Contract of Sale: A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price.

Goods: Goods means every kind of movable property other than actionable claims and money and includes stock and shares growing crops, grass and things attached to or forming part of the land which he agreed to be severed before the sale or under the contract of sale.

Sale: Where under a contract of sale the property in the goods is transferred from the seller to the buyer, the contract is called a sale.

Agreement to Sell: Where the transfer of the property in the goods is to take a place at a future time or subject to some condition thereafter to be fulfilled the contract is called an agreement to sell.

Future Goods: These are the goods which are not in existence at the time of contract of sale.

Price: The money paid for the purchase of goods is called the price.

Hire Purchase Agreement: A hire purchase agreement is an agreement under which the owner delivers his goods on hire basis to a person called 'hirer' for his use.

13.13 SELF ASSESSMENT QUESTIONS

1. What is a contract of sale? State its essential characteristics
2. Define the term ‘goods’. Explain different types of goods.
3. Distinguish between:
   a) Sale and agreement to sell
   b) Sale and bailment
4. “A seller cannot convey a better title to the buyer than he himself has”. Discuss this rule of law and point out the exception.

13.14 SUGGESTED READINGS

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.

S.C. Aggarwal, Company Law, Dhanpat Rai Publications, New Delhi.

S.K. Aggarwal, Business Law, Galgotia Publishing Company, New Delhi.

G.K. Varshney, Elements of Business Law, S Chand & Co., New Delhi.

LESSON NO. : 14
CONDITIONS AND WARRANTIES

STRUCTURE

14.0 OBJECTIVES

After reading this lesson, you should be able to:

a) Define the condition and warranty and differentiate between them.

b) State the circumstances in which a condition is reduced to the status of a warranty.

c) Discuss the implied conditions and warranties recognized by the Sales of Goods Act.

d) Explain the rule of Caveat Emptor.

14.1 INTRODUCTION

A contract of sale of goods is made by an offer by the seller and its acceptance by the buyer. When forming a contract, a party may make a statement with a view to inducing the other party to enter into the contract. Such statements when made before entering into the contract are known as representations. Such representations are generally about the nature, quality and fitness of goods. Such a representation may be a mere expression of an opinion of the seller and may not form a part of the contract of sale. For example, where a jewellery seller, while praising a particular diamond ring, states that the diamond is very lucky and anyone who shall purchase it must become wealthy, his statement, being commendatory in nature, does not form part of the contract and its breach does not give rise to any legal consequences. On the other hand, when a representation forms a part of the contract of sale and the other party relies upon it, such a representation is called a stipulation within the meaning of Section 12 of the Sale of Goods Act. However, all stipulations are not of equal importance. Some of these stipulations may go to the very root of the contract and their breach may frustrate the very purpose of the contract, while others are not so vital that their breach may seem to be a breach of the contract as such.

14.2 CONDITION

The term 'condition' is defined under Section 12(2) of the Sale of Goods Act, which reads as under:

"A condition is a stipulation essential to the main purpose of the contract, the breach of which gives the aggrieved party a right to treat the contract as repudiated".

Thus, a condition is an important representation made by the seller the non-fulfillment of which defeats the very purpose of the buyer and he/she has the right to terminate the contract.

Example: A consulted B, a car dealer, and told him that he wanted to purchase a car 'suitable for touring purpose'. B, suggested that a 'Bugatti' car would be fit for the purpose. Relying upon this statement, A bought a 'Bugatti' car. Later on, the car turned out to be unfit for the touring purpose. A wanted to reject the car and demanded the refund of the price. It was held that A was entitled to reject the car and to have the refund of the price. In this case, the suitability of the car, for touring purpose, was a condition of the contract. It was so important that its non-fulfillment defeated the very purpose for which A bought the car.

14.3 WARRANTY

According to Section 12(3) of the Act, a warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not a right to reject the goods and treat the contract as repudiated or broken. Thus, a warranty is not of that importance as a condition. It is not essential to the main purpose of the contract of sale. It is only collateral to the main purpose of the contract. Even if it turns out to be untrue, the buyer cannot put an end to the contract. The remedy available is to claim damages from the seller.

In brief, where the fulfillment of the main purpose of the contract depends on the fulfillment of the stipulation, the stipulation is condition and where it is not so, the stipulation is only a warranty. There is no specific rule as to which stipulation is a condition and which one is a warranty. Section 12(4) of the Act states "whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract as a whole. The court is not guided by the terminology used by the parties to the contract. A stipulation may be a condition though called a warranty in the contract". Thus the court has to look to the intention of the parties by referring to the terms of the contract, its construction and surrounding circumstances to judge whether a stipulation was a condition or a warranty.

Examples

(a): A person purchases a vehicle which is warranted quiet and smooth to drive. If the vehicle turns out to be noisy and inconvenient to drive, the buyer's only remedy is to claim damages. But if instead of buying a particular vehicle, a person asks a dealer to supply him with a quiet and smooth vehicle and the dealer supplies the person with a noisy one, the stipulation is a condition, and the buyer can return the vehicle. Besides, the buyer can also claim damages for breach of the contract.

(b): A made a contract for the sale of cashew-nuts. According to the terms of sale, the total bad nuts shall not exceed 20 per cent of the total. The purchaser entered into the contract relying upon the description. The above term being a basic element of the description of the goods agreed to be supplied, the purchaser was entitled to reject the goods if the bad nuts exceeded the stipulated percentage. He could also claim back the part of price paid to the seller. [Antony Thomas v Ayuppuni Mani; 1959 Kerala LT 1271]

From the above examples, it is clear that an exactly similar term may be a condition in one contract and a warranty in another, depending upon the construction of the contract as a whole.

14.4 DISTINCTION BETWEEN A CONDITION AND WARRANTY

The points of distinction between a Condition and a Warranty may be summed up as under:

1. A condition is a stipulation which is essential to the main purpose of the contract. A

warranty is a stipulation which is collateral to the main purpose of the contract.

2. A breach of condition gives right to repudiate or rescind the contract and also a right to claim damages. Breach of warranty provides right to claim damages only. A breach of warranty does not entitle a buyer to reject the goods.

3. A breach of condition may be treated as a breach of warranty by the aggrieved party and accordingly the aggrieved party may not repudiate the contract. But a breach of warranty cannot be treated as a breach of condition.

14.5 CHANGE OF A CONDITION INTO A WARRANTY

Section 13 deals with cases where breach of condition would be treated as a breach of warranty only and as a consequence, a contract is not avoided. The buyer has to be contended with a claim for damages only. These cases are as follows:

I. Where the buyer elects to treat breach of condition as a breach of warranty. This is to say, he only claims damages and does not elect to repudiate the contract.

II. Where the buyer altogether waives the performance of the condition. Once the buyer has waived his right, he cannot afterwards insist on its fulfillment. Waiver may be express or implied.

III. Where the contract of sale is non-severable/indivisible and the buyer has accepted either the whole goods or any part thereof. In such a case, a breach of any condition by seller can only be treated as a breach of warranty, unless there is a term of the contract, express or implied, to the contrary. Indivisible contracts are those where price for a lot, comprising goods of different qualities, as such is fixed and not fixed per unit or per bag or per ton, etc.

Taking possession or delivery of the goods does not amount to their acceptance. According to Section 42, the buyer is deemed to have accepted the goods:

a) When the seller is intimated by him about the acceptance of goods; or

b) When he does any act in relation to goods which is inconsistent with the ownership of the seller, e.g. the buyer puts his mark on goods; or

c) When he continues to retain the goods even after the lapse of reasonable time without intimating the seller that he has rejected them.

d) Where the fulfillment of any condition or warranty is excused by law by reason of impossibility or otherwise.

14.6 STIPULATION AS TO TIME

The stipulations as to time may be of two types :

i) As to time of payment;

ii) Other stipulations as to time e.g., with regard to the performance of the contract.

Regarding the importance of various stipulations as to time, Section 11 of the Act provides as under:

Unless a different intention appears from the terms of the contract, stipulation as to time of payment are not deemed to be of the essence of a contract of sale. Whether any other stipulation as to time is of the essence of the contract or not depends on the terms of the contract.

It may be noted that the general rule stated in Section 11 is that the time of payment of the price is not deemed to be of the essence of the contract. Therefore, in case of delay in the payment of the price by the buyer, the seller cannot avoid the contract for that reason but he can only claim compensation for the same. The parties are, however, free to express a different intention in their contract. They may make the time of the payment of the price as of the essence of the contract.

Stipulations as to time, except as regards time of payment are usually of the essence of the contract. Where the parties to the contract stipulate that time as regards delivery of goods, payment or any other factor shall form the essential terms of the contract, time shall than be regarded as a condition in construction of a contract for sale of the goods, breach of which shall provide right to the aggrieved party to cancel the contract.

Example: A sold certain goods to B. The payment was to be made on delivery of goods. It was held that delivery was subject to the condition of payment and the condition being broken, A had the right to bring an action for the recovery of goods. [Bishop v Shillitoz Band A 329]

14.7 EXPRESS AND IMPLIED CONDITIONS AND WARRANTIES

(SECTION 14-17)

In a contract of sale of goods, conditions and warranties may be either (i) express or (ii) implied. Parties may expressly provide any conditions or warranties in their contract. Besides, certain conditions and warranties, as provided in Section 14 to 17, are impliedly there in every contract of sale of goods unless the parties agree to the contrary. Implied conditions and warranties are enforced on the ground that the law presumes that the parties have incorporated them into their contract though they have not put them into it in express words. The implied conditions and warranties provided in the Act are binding in every contract of sale unless they are inconsistent with any express conditions are warranties agreed to by the parties. The implied conditions and warranties recognized by the Act are as follow:

Implied Conditions

1. Condition as to Title (Section 14 (a))

In a contract of sale, unless the circumstances of the contract are such as to show a different intention, there is an implied condition on the part of the seller that-

(a) in the case of sale, he has a right to sell the goods, and

(b) in the case of an agreement to sell, he will have a right to sell the goods at the time when the property is to pass.

Example: R bought a car from D and used it for four months. D had no title to the car and consequently R had to hand it over to the true owner. Held, R could recover the purchase money (Rowland v Divall, (1923) 2 K.B.500).

Want of title to the goods is not the only factor because of which the seller may not have a right to sell the goods. If a vendor can be stopped by process of law from selling, he has not the right to sell. If the goods sold bear labels infringing the trade mark of a third person, the seller has no right to sell them.

It may further be noted that where a seller having no title to the goods at the time of the sale, subsequently acquires the title (e.g. by paying off the true owner) before the buyer seeks to repudiate the contract, that title feeds the defective titles of both the original and subsequent buyers and it will then be too late for the buyer to repudiate the contract (Patten vs Thomas Motors).

2 Condition as to Description (Section 15)

Sometimes, the goods are sold by description. In such cases, the implied condition is that the goods shall correspond with the description. The term ‘correspondence with description’ means that the goods purchased by the buyer must be the same which were described by the seller. If subsequently, it is discovered that the goods do not correspond with the description, the buyer may reject the goods and claim the refund of the price, if already paid.

Example: A purchased from B a car, which he had never seen. B described the car as a ‘brand new’. However, on delivery, A found that the car was used and repainted. And thus A returned the car to B. It was held that the sale was by description and the car did not correspond with the description. In this case, A was entitled to reject the car.

It may, however, be noted that the buyer can reject the goods only if the sale is by description, and the goods do not correspond with the description. The buyer is given the right to reject the goods because a person cannot be compelled to buy a thing different from the thing he contracted to buy. In Bower v Shand (1877) 2 AC 455, Lord Blackburn emphasized this condition in the following words:

“If you contract to sell peas you cannot oblige a party to take beans. If the description of articles tendered is different in any respect it is not the article, bargained, and the other party is not bound to take it".

It will be interesting to know, that the term ‘sale by description’ has not been defined in the Sale of Goods Act. However, it generally means the sale when the goods are described in the contract as of particular kind or class, e.g., Basmati Rice, Long staple Cotton, Desi Wheat, etc. The sale will also be by description when the identity or quality of the thing is describe, e.g., Brand New Car, Maruti Swift Model etc. The term ‘sale by description’ includes the following situations:

(a) Sometimes, the buyer has never seen the goods but he buys on the basis of description given by the seller. In such cases the goods must correspond with the description given by the seller.

Example: A purchased a sewing machine which he had never seen. The seller (B) described the machine as “Brand New”. But on delivery, A found that the machine was extremely old. In this case, the sale is by description, and A is entitled to reject the machine as it does not correspond with the description given by the seller.

(b) Where the buyer has seen the goods but he relies not on what he has seen but what was stated to him and the deviation of the goods from the description is not apparent.

Example: In an auction sale of a set of napkins and table cloths, these were described as "dating from the seventeenth century". The buyer bought the set after seeing it. Subsequently he found the set to be an eighteenth century set. Held he could reject the set (Nicholson & Venn v Smith Marriott, (1947) 177 L.T. 189).

Thus, once it is proved that the sale is by description, then the goods must correspond with the description. If they do not correspond, the buyer may reject them and the seller cannot take the defence by saying that they will serve the buyer's purpose.

But where the goods correspond with the description, the buyer is bound to take the delivery for whatever worth they may be otherwise.

3. Sale by Sample (Sec 17)

The sale is by sample where there is a term in the contract express or implied to that effect. There are three implied conditions when the goods are supplied according to the sample-

i) that the bulk shall correspond with the sample in quality;

ii) that the buyer shall have a reasonable opportunity of comparing the bulk with the sample;

(iii) that the goods shall be free from any defect, rendering them unmerchantable, which would have been apparent on reasonable examination of the sample.

Example: A agreed to sell to B two parcels of wheat. The sample of wheat was shown to B. The buyer (B) went to A's warehouse to examine the wheat. One parcel, which was lying in the seller's (A's) warehouse, was shown to B. But A refused to show the other parcel to B, which was not in the warehouse. It was held that the buyer could put an end to the contract. [Lorymere v Smith (1822) 1 B & C 1].

4. Sale by Sample as well as Description (Section 15)

When the goods are sold by sample as well as description it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description.

Sometimes there may be a difference between the sample and the description of the goods. In such a case, the fact that the goods supplied conform to the sample but do not agree with the description entitle the buyer to reject the goods because the fundamental condition in every contract is that the goods should correspond to the description.

In Wallis v Pratt there was a contract of sale by sample of seed described as "English Sainfoin". but the "seller giving no warranty express or implied as to growth, description, or any other matters." The seed was sown and when the crop was ready it was discovered the seed supplied and the sample shown were not of "English Sainfoin" seed but of "giant sainfoin" seed. It was held that there was a breach of condition and the buyer was entitled to recover damages.

5. Condition as to quality or fitness (Section 16)

Normally, in a contract of sale, there is no implied condition as to quality or fitness of the goods for a particular purpose. The buyer must examine the goods thoroughly before he buys them in order to satisfy himself that the goods will be suitable for the purpose for which he is buying them.

The implied condition as to quality or fitness will operate if the following conditions are satisfied:

(i) The buyer requires the goods for a particular purpose.

(ii) The buyer makes known to the seller that particular purpose.

(iii) the seller's business is to sell such goods, whether he is the actual producer or not.

The particular purpose for which the goods, are required has to be made known to the seller. This may be done either expressly or impliedly. A particular purpose is the purpose expressly or impliedly communicated to the seller, for which the buyer buys the goods. Where an article is fit for one particular purpose alone, and turns out to be unsuitable for that purpose, when used, it is easy to see that the condition as to fitness has been broken. But where an article is capable of being applied to a variety of purposes,. the buyer must notify the specific purpose he has in mind, and if this is not shown, the buyer will have no remedy because it was unfit for that purpose.

Example: A who had no special knowledge of hot water bottles went to the shop of a chemist and asked for a hot water bottle. He was shown a bottle which the chemist said will not stand boiling water but was intended to hold hot water. A bought the bottle. After a few days, while using it, it burst and injured his wife. It was found that the bottle was not fir for use as a hot water bottle and therefore, the chemist was liable for damages. [Priest v Last (1903) 2 KB 148]

Where, however, the goods are sold under its patent or trade name, there is no implied condition as to its fitness for any particular purpose. Thus, when a patent smoke consuming furnace was ordered by the plaintiff by its patent name, for his brewery and the same being forwarded to him proved useless, it was held that the buyer had no cause of action against the seller. But the situation will be quite different where the buyer asks the seller to supply an article of a named make and indicates to the seller that he relies on his skill and judgement, for its being fit for a particular purpose. Implied condition as to quality or fitness will apply even though the article is described in the contract by its trade name.

6. Implied Condition of Merchantable Quality

Section 15 provides that when the goods are bought by description there is an implied condition that the goods supplied shall answer that description. According to this Section, there is a further implied condition in such a case that the goods supplied shall be of merchantable quality . Where;

(i) the goods are bought by description

(ii) from a seller who deals in the goods of that description
(whether he is the manufacturer/producer or not)

There is an implied condition that the goods shall be of merchantable quality. The term 'merchantable quality' has not been defined in the Act. It means that the article is of such quality and in such condition that a reasonable man acting reasonably would after a full examination accept it under the circumstances of the case in performance of his offer to buy that article, he buys for his own use or to sell again.

The goods should be immediately saleable under the description by which they are known in the market. Merchantability, however, does not mean that the goods should be of first quality.

Goods may be unmerchantable not only because of some defect in their physical condition, but also, because of some other circumstances as for example:

(i) where they infringe a trade mark, or

(ii) the use of them is dangerous or injurious in a way not to be expected from goods of the kind, or

(iii) they are unfit for use.

Examples: P asked for a bottle of Stone's Ginger Wine at D's restaurant. While P was drawing the cork, with a cork screw, the bottle broke at the neck and injured him. It was held that the sale was by description and since the bottle was not of merchantable quality. P was entitled to recover damages. [Morelli v Fitch and Gibbons (1928), 2 KB 636]

All such defects as make the goods unmerchantable are of two kinds, called patent defects and latent defects. Patent defects are those which can be found on examination by a person of ordinary intelligence with the exercise of due care. Latent defects are those which cannot be discovered on such examination. There is an implied condition on the seller's part that the goods are free from latent defects.

In case of patent defects where an opportunity is afforded to the buyer to examine the goods, but the buyer makes only a casual examination of the goods, this will amount to an examination within the meaning of this section, and the seller would not be liable to for the defects which such an examination ought to have revealed.

Example: B went to T's warehouse to buy some glue. The glue was stored in barrels and every facility was given to B for its inspection. B did not have any of the barrels opened, but only looked at the outside. He then purchased the glue. Held, as an examination of the inside of the barrels would have revealed the nature of the glue, and as B had an opportunity of making the examination, there was no condition as to merchantable quality [thornett & Fehr v Beers & Sons, 1919 1 K.B. 486]. **Comparison between the condition as to the fitness of goods for buyer's purpose, and condition as to merchantability.**

The following table gives the comparison between the two:

Sr No.	Condition as to Fitness of Goods for Buyer's Purpose	Condition as to Merchantability
1.	The buyer must rely on the	The buyer is not required to rely

	skill and judgement of the seller	on the skill and judgement of the seller.
2.	When the goods are sold under patent or trade name then the condition as to fitness for buyer's purpose is not applicable i.e., it is excluded.	When the goods are sold under patent or trade name, then the condition as to merchantability is applicable, i.e. it is not excluded
3.	There may be cases in which the goods are not fit for buyer's use but they may be merchantable.	There may not be such cases.

7. Condition as to Wholesomeness

In the case of eatables and provisions, in addition to the implied condition as to merchantability, there is another implied condition that the goods shall be wholesomness.

Example: F bought milk from A. The milk contained germs of typhoid fever. F's wife took the milk and got infection as a result of which she died. Held, F could recover damages [Frost v Aylesbury Dairy Co Ltd., (1905) 1 K.B. 608]

Condition implied by Custom

An implied condition as to quality or fitness for a particular purpose may also be annexed by the usage of trade in the locality concerned [Sec. 16 (3)].

Implied Warranties

It is a warranty which the law implies into the contract of sale. In other words, it is the stipulation which has not been included in the contract of sale in express words. But the law presumes that the parties have incorporated it into their contract. It will be interesting to know that implied warranties are read into every contract of sale unless they are expressly excluded by the express agreement of the parties. These may also be excluded by the course of dealings between the parties or by usage of trade [Section 62]. It may be noted that sometimes there is conflict between the express and implied warranties. In such cases, the express terms shall prevail and the implied terms shall not be considered.

1. Warranty of Quiet Possession

In every contract of sale the first implied warranty on the part of the seller is that "the buyer shall have and enjoy quiet possession of the goods." If the quiet possession of the buyer is in any way disturbed by a person having a superior right than that of the seller, the buyer can claim damages from the seller. Since disturbance of quiet possession is likely to arise only where the seller's title to goods is defective, this warranty may be regarded as an extension of the implied condition of the provided for by Section 14 (a).

In the case of Mason v Bhumingham, the plaintiff purchased a second hand typewriter for pound 20 from the defendant. She thereafter spent a sum pound 11-10sh., for getting it overhauled and putting in order. Unknown to the parties the typewriter had been stolen and the plaintiff was compelled to return the same to its true owner. In an action by the plaintiff against the defendant it was held that the defendant had made a breach of warranty implied in a contract of sale of goods that the buyer shall have and enjoy quiet possession of the goods. The plaintiff was entitled to recover not only the sum of pound 11-10sh, the amount spent on overhauling, as the same was the loss arising naturally in the usual course of things.

2. Implied Warranty of Freedom from Encumbrances

There is an implied warranty on the part of the seller that the goods are free from any charge or encumbrance. A breach of this warranty will occur when the buyer discharges the amount of encumbrance. This warranty will not apply where such Encumberances are declared to the buyer when the contract is made or he has notice of them. Where there is a breach of this implied warranty, the remedy of the buyer is to sue for damages.

Example: A, the owner of the watch pledges it with B. After a week, A obtains possession of the watch from B for some limited purpose and sells it to C. B approaches C and tells him about the pledge affair. C has to make payment of the pledge amount to B. There is breach of this warranty and C is entitled to claim compensation A.

3. Disclosure of Dangerous Nature of Goods

There is another implied warranty on the part of the seller that in case the goods are inherently dangerous or they are likely to be dangerous to the buyer and the buyer is ignorant of the danger, the seller must warn the buyer of the probable danger. If there is a breach of this warranty, the seller will be liable in damages.

In Clarke v Army and Navy Co-operative Society Ltd. (1903) 1 K.B. 155, C purchased a tin of disinfectant powder from A. A knew that the tin was to be opened with special care otherwise it might prove dangerous. He also knew that C was ignorant about it but did not warn C. C opened the tin whereupon the disinfectant powder flew into her eyes causing injury. Held, A was liable in damages to C as he should have warned C of the probable danger.

14.8 DOCTRINE OF CAVEAT EMPTOR

Caveat Emptor means "let the buyer beware", i.e. the buyer must take care. As a general rule, the buyer purchased goods after satisfying himself as to quality and fitness and, therefore, the buyer purchases the goods at his own risk, relying upon his own skill and judgement. In a contract for sale of goods there is no implied warranty or condition as to quality or fitness for any particular purpose of goods and therefore, the buyer purchased the goods at his risk relying on his own skill and judgement (Section 16)

Example: A purchase a horse from B. A needed the horse for riding but he did not mention this fact to B. The horse is not suitable for riding but is suitable only for being driven in the carriage. Caveat emptor being the rule. A can neither reject the horse nor can he claim any compensation from B.

This rule applies to the purchase of specific goods, for example, a horse or a picture where the buyer can exercise his own judgement it applies also whenever the buyer voluntarily chooses what he buys. But it has no application in any case, in which the seller has undertaken and the buyer has left it to the seller, to supply goods to be used for a purpose known to both parties at the time of the same.

Example: There was sale by sample by a woolen manufacturer of cloth to merchant who was also a tailor. The buyer required the cloth for making special uniforms but this fact was not made known to the seller. Owing to latent defect in the cloth which was also there in the sample, it was unfit for the purpose. But there was nothing to show that it was unfit for other purposes. It was held that the buyer was without remedy. [Jones v Padgelt, (1890). 24 Q.B.D. 650]

Exception to the 'Doctrine of Caveat Emptor'

In certain circumstances however, the doctrine has no application. They are as follows:

i) If the seller has made a false representation relating to the goods and the buyer has relied upon it to his detriment.

ii) When the seller has deliberately concealed a defect which is not apparent on the reasonable examination of the goods.

Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which he requires the goods and relies on the seller's skill or judgement and the goods are of a description which it is in the course of the seller's business to supply, the seller must supply the goods which shall be fit for the buyer's purpose [Sec. 16 (1)]

In the case of a contract for the sale of a specified article under its patent or other trade name, there is no implied condition that the goods shall be reasonably fit for any particular purpose (Sec. 16 (1)]

Where the trade usage attaches an implied condition or warranty as to quality or fitness and the seller deviates from that, the doctrine of caveat emptor does not apply and the seller is liable in damages [Sec. 16 (3)]

Where goods are bought by description from a seller who deals in such goods, there is an implied condition that the goods shall be of 'merchantable quality'. Where, however, the buyer has examined the goods there is no such implied condition as regards defects which such examination could have revealed.

In Jackson v Rotex Motor and Cycle Co. (1910-2 K.B.), where a person ordered motor horns from a manufacturer of horns and the horns were damaged, it was held that the buyer was entitled to reject the horns.

It should be noted that goods are merchantable if they are fit for any one of the several purposes for which the goods may ordinarily be used.

14.9 SUMMARY

A condition is defined as a representation made by the seller which is so important that its non-fulfillment defeats the very purpose of the buyer. Warranty is a representation made by the seller which is not of that importance as a condition. Sometimes, a condition is changed to the status of a warranty and in such cases, the buyer loses the right to reject the goods on the ground of breach of condition. The importance of time in a contract of sale is contained in Section 11 of the Sale of Goods Act. In a contract of sale of goods, conditions and warranties may be either express or implied. Implied conditions and warranties are enforced on the ground that the law presumes that the parties have incorporated them into their contract though they have not put them into it in express words. In a contract of sales of goods, there is no implied condition or warranty as to quality or fitness for any particular purpose of goods and therefore, the buyer purchased the goods at his risk relying on his own skill and judgement.

14.10 KEYWORDS

Condition: It is defined as a representation made by the seller which is so important that its non-fulfillment defeats the very purpose of the buyer.

Warranty: Warranty may be defined as a representation made by the seller which is not of that importance as a condition.

Cavet Emptor: It means that a buyer purchases the goods at his own risk.

Implied Condition: It is a condition, which the law implies into the contract of sale.

Express Warranty: It is a warranty which has been expressly agreed upon by both the parties at the time of contract of sale.

14.11 SELF ASSESSMENT QUESTIONS

1. Define the terms 'Condition' and 'Warranty'. Explain the difference between the two.

2. Discuss the provision of the Sales of Goods Act relating to the implied conditions in a contract of sale by sample.

3. "Let the buyer beware". Comment.

4. State the conditions in a contract for the sale of goods (i) by description (ii) required for a particular purpose.

14.12 SUGGESTED READINGS

P.P.S. Gogna, Mercantile Law, S.Chand & Company, New Delhi.

N.D. Kapoor, Company Law, Sultan Chand & Sons, New Delhi.

S.C. Aggarwal, Company Law, Dhanpat Rai Publications, New Delhi.

G.K. Varshney, Elements of Business Law, S Chand & Co., New Delhi.

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LESSON NO. : 15
RIGHTS OF UNPAID SELLER

STRUCTURE

15.0 OBJECTIVES

After reading this lesson, you should be able to:

a) Explain when the seller of goods is deemed to be an unpaid seller.

b) State the rights of unpaid seller against the goods.

c) Discuss the rights of unpaid seller against the buyer personally.

15.1 INTRODUCTION

The seller of goods is deemed to be an 'unpaid seller':

(a) When the whole of the price has not been paid or tendered.

(b) When a bill of exchange or other negotiable instrument (such as cheque) has been received as conditional payment, and it has been dishonoured [Section 45(1)].

The term 'seller' includes any person who is in the position of a seller (for instance, an agent of the seller to whom the bill of lading has been endorsed, or a consignor or agent who has himself paid, or is directly responsible for the price) [Section 45(2)].

The above definition of unpaid seller states the following:

(i) The seller shall be called an unpaid seller even when only a small portion of the price remains to be paid.

(ii) It is for the non-payment of the price and not for other expenses, that a seller is termed as an unpaid seller.

(iii) Where the goods have been sold on credit, the seller cannot be called as an unpaid seller during the credit period unless the buyer becomes insolvent. On the expiry of credit period if the price remains unpaid, then only the seller will become an unpaid seller.

(iv) Where the full price has been tendered by the buyer and the seller has refused to accept it, the seller cannot be called as unpaid seller.

Example: State whether the seller is an unpaid seller or not in each of the following alternative cases :

(a) X sold some goods to Y for ` 10,000. Y paid ` 9000 but failed to pay the balance.

(b) X sold some goods to Y for ` 10,000 and received a cheque for the full price as conditional payment. On presentment, the cheque was dishonoured by the Bank.

(c) X sold some goods to Y for ` 10,000 on a credit of one month. One month has not yet expired.

(d) X sold some goods to Y for ` 10,000 on a credit of one month and one month has expired and the price remains unpaid,

(e) X sold some goods to Y for ` 10,000 on a credit of one month. Y became insolvent during the period of credit.

Solution:

(a) : X is an unpaid seller because the full price has not been paid.

(b) : X is an unpaid seller because the cheque received as conditional payment has been dishonoured.

(c) : X is not an unpaid seller because the credit period has not yet expired and the buyer has not yet become insolvent.

(d) : X is an unpaid seller because the price remains unpaid even after the expiry of credit period.

(e) : X is an unpaid seller because the buyer has become insolvent.

15.2 RIGHTS OF UNPAID SELLER

The rights of an unpaid seller may broadly classified under the following two categories :

1. Rights against the goods

2. Rights against the buyer personally

The various rights of an unpaid seller have been shown in figure 1

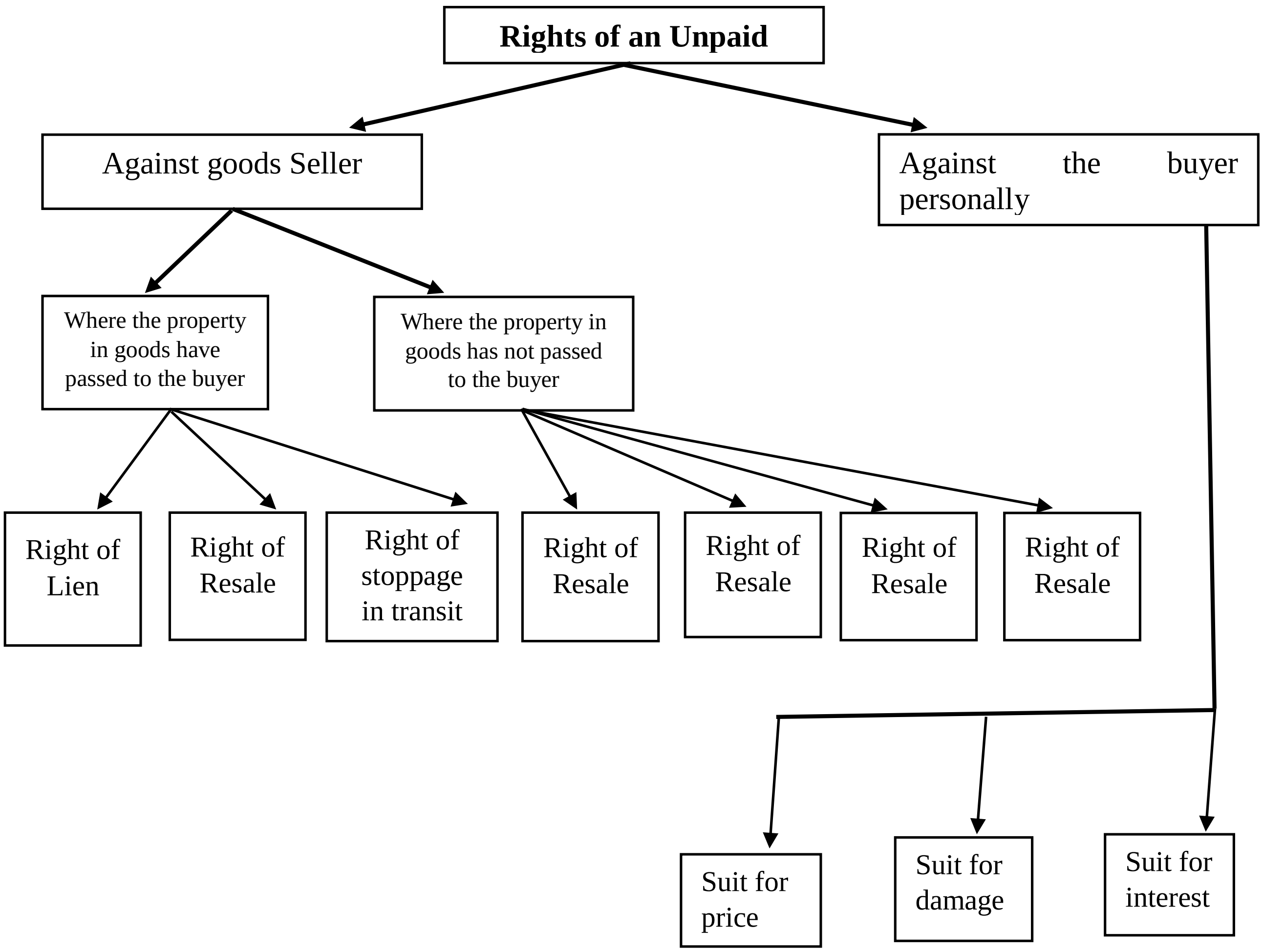

Figure 1

15.2.1 Rights of an unpaid seller against the goods

Sometimes, after the sale of the goods, the seller still has the possession of the sold goods. In such cases, an unpaid seller has certain rights against the goods. These rights may be discussed under the following two heads:

1. Where the ownership of the goods is transferred to the buyer.

2. Where the ownership of the goods is not transferred to the buyer.

1. Rights of unpaid seller against the goods where the property in the goods have passed

to the buyer

An unpaid seller has the following rights against the goods notwith standing the fact that the property in the goods has passed to the buyer:

(a) Right of lien;

(b) Right of stoppage of goods in transit; and

(c) Right of resale.

(a) **Right of Lien**

"Lien" is the right to retain possession of goods until certain charges due in respect of them are paid. The unpaid seller has the right to retain the goods until he receives their price. By way of exercise of this right, the seller can refuse to deliver the goods to the buyer until the payment of the price even though the ownership in the goods has already passed to the buyer. By a mere exercise of this right, the contract of sale of goods is not automatically rescinded. According to Section 47, this right can be exercised in the following situation:

(i) **When the goods have been sold without any stipulation as to credit** i.e., the sale of the goods has been on cash basis. It has already been observed under Section 32 that if there is no agreement to the contrary the payment of the price and the delivery of the goods are concurrent condition. It means that if the goods have not been sold on credit the seller expects that the buyer shall pay the price against the goods. The seller can refuse to deliver them to the buyer or in other words he can exercise the right of lien over these goods, if the buyer is not ready and willing to pay their price in exchange for the goods.

(ii) **When the goods have been sold on credit** the seller can exercise the right of lien on the expiry of the period of credit. As soon as the period of credit expires the price becomes due and the seller can exercise the right of lien thereafter. Even though originally the seller had agreed to sell them on credit but now since the price has become payable because of the expiry of the period of credit the seller can refuse to part with the goods until he is paid for them. For example, on Ist January A sells a horse to B and it is agreed that the buyer may take the delivery at any time he likes and the price is payable on Ist Mach. If the buyer has not taken the delivery of the goods by Ist March and he demands the delivery after this date, the seller can refuse to part with the horse until the buyer pays for them.

(iii) T**he seller can also exercise this right of lien when, before the delivery of the goods to him, the buyer becomes insolvent.** Even though the seller had sold the goods on credit and the period of credit has not yet expired but the buyer has become insolvent, the seller's right of lien can be exercised. When the goods are sold on credit the presumption is that the buyer shall maintain his solvency. If that condition can no more be satisfied, the seller is entitled to the exercise of this right. For example, the goods are sold on Ist January and the period of credit extends upto Ist March, if the buyer becomes insolvent on 15th January and he has not yet taken the delivery of the goods the seller may exercise his right of lien if the buyer demands delivery at any time after 15th January although originally he had agreed to deliver the goods to the buyer on credit. By the insolvency of the buyer during the period of credit the right of lien which may have been suspended earlier for the period of credit is revived and the credit granted earlier comes to an end.

The term 'insolvent' here does not mean a person who has been adjudged insolvent under the Insolvency Law. In Sale of Goods Act "a person is said to be insolvent who has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, whether he has committed an act of insolvency or not". [Section 2 (8)]

The right of lien is linked with possession and not with title. It is essentially a right over the property of another person. The unpaid seller's lien can be exercised only so long as the goods are in the actual possession of the seller or his agent. Once the possession is lost, the lien is also lost. The right of lien cannot be exercised during the currency of credit term. When the term expires, the unpaid seller may exercise the right of lien. The lien of the unpaid seller is for the price only; so when the price has been paid or tendered, he cannot retain possession of the goods any longer. Again the right of lien does not extend to other charges which the seller may have to incur for storing the goods during the exercise of the lien.

Example: A sold certain shares to B. The relative share certificates and transfer forms duly signed were handed over by the seller to the buyer against payment of price by cheque. The buyer became insolvent. It was held by the Privy Council that the seller had no lien on shares because his lien ceased when he parted with the possession. Bharucha *v*. Wadihah, 28 Bom. L.R. 777 (P.C.).

The right of lien is indivisible in nature, and so the buyer is not entitled to claim delivery of a portion of the goods on payment of a proportionate price. Further this right is available even after part delivery of the goods has been made, unless such part delivery is made under such circumstances as to show an agreement to waive the lien.

Example: A sells to B a certain quantity of sugar. It is agreed that three months credit shall be given. B allows the sugar to remain in A's warehouse til the expiry of the three months, and then does not pay for them. A may retain the goods for price.

Conditions for the Exercise of Right of Lien

The following are conditions precedent to the exercise of the right of lien:

(a) The ownership must have passed to the buyer.

(b) The goods must be in possession of the seller or under his control as bailee, etc.

(c) The possession of the goods by the seller must not expressly exclude the right of lien.

(d) The whole or part of the price must remain unpaid. It may be noted that the lien can be exercised only for price. Thus the seller cannot claim lien for godown charges, for storing of goods in exercise of his lien for price.

The lien of an unpaid seller is a particular one. It is the personal right which can be exercised only by him and not by his assignee or his creditors.

Part Delivery: Where an unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless such part delivery has been made under such circumstances as to show an agreement to waive the lien.

Thus in case of part delivery of the goods, the unpaid seller may exercise his right of lien on the reminder, but where part delivery has been made under circumstances as to show an agreement to waive the lien, the seller cannot exercise his lien. If for example, out of 100 bags of weighed which were to be supplied by the seller to the buyer, 20 have already been delivered to the buyer, the seller may exercise his right of lien over the other 80 bags. If, however, the buyers gets the whole of the goods weight but takes away only a part of them, the delivery of the part of the goods in such a case would operate as delivery of the whole and the seller's right of lien over the remaining goods would come to an end. Similarly if an essential part of the machinery has been delivered by the seller to the buyer, the seller cannot exercise his right of lien over the remaining parts.

Termination of lien: The unpaid seller's right of lien may be lost in any of the following ways:

(i) **By payment of price:** The right of lien comes to an end when the seller ceases to be an unpaid seller, i.e., when the buyer pays or tenders the price to the seller. It has been noted under Section 47(1) that the unpaid seller is entitled to exercise his right of lien until payment or tender of the price in respect of certain goods, the payment or tender of the price, therefore, terminates the seller's right to retain the goods. Merely obtaining the decree does not mean the payment of the price and, therefore, Section 49(2) states that unpaid seller, having a lien on the goods, does not lose his lien by reason only that he has obtained a decree for the price of the goods.

(ii) **By delivery to the carrier**: Since the right of lien is a right to retain the possession so long as the seller continues in possession the right would obviously come to an end when the seller loses the possession. The seller loses such a possession when he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the gods. Though the delivery of the goods to a carrier or the bailee for the purpose of transmission to the buyer results in end of lien but that results in the beginning of the right of stoppage in transit. Of course, the right of stoppage in transit cannot be exercised until the buyer has become insolvent.

For the termination of the lien the delivery to the carrier or some other bailee must have been made without reserving the right of disposal i.e. , a right of not delivering the goods to the buyer until he fulfils the required condition, generally that condition being the payment of the price, the seller can exercise his right of lien.

(iii) **By the buyer obtaining possession of the goods:** When the buyer or his agent lawfully obtains the possession of the goods the right of lien comes to an end. If the buyer, at the time of the contract of sale, is already in possession of the goods, although as a bailee for the seller, the seller cannot exercise a right of lien in respect of those goods. If the buyer once obtains the possession the right of lien comes to an end, and such a right cannot be exercised even if the seller again gets back the possession of those goods. Thus, where a refrigerator after being sold was delivered to the buyer and since it was not functioning properly, the buyer delivered two of its parts to the sellers for repairs, it was held that the seller could not exercise his lien over those parts.

(iv) **By waiver:** Unpaid seller's right of lien is also lost by waiver thereof. According to Section 46(1) (a) an unpaid seller gets his right of lien by implication of law. A party to a contract may waive his rights, expressly or impliedly, according to Section 62. Section 49(1)(c) expressly provides that the right of lien comes to an end by waiver thereof. Such a waiver may be presumed when the seller allows a period of credit to the buyer, or delivers a part of the goods to the buyer or his agent under the circumstances which show that he does not want to exercise his right of lien, or, when the seller assents to a sub-sale which the buyer may have made.

(v) **Disposition of the goods by the buyer**: According to Section 53, the unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods by the buyer. This general rule is subject to two exceptions:

(i) When the seller himself assents to a sub-sale or other disposition of the goods by the buyer.

(ii) When the buyer having lawfully obtained possession of document of title to the goods transfers the same to a transferee is good faith and for consideration and the transfer is by way of sale.

In the above stated two exceptional cases, the unpaid seller's right of lien comes to an end.

(b) **Right of stoppage of Goods in Transit (Sections 50-52)**

The second important right which is available to an unpaid seller is the right of stoppage in transit. The right to stoppage means the right to stop further transit of the goods, to resume possession thereof and to retain the same till the price is paid. The right can be exercised under the following circumstances:

(i) The seller must be unpaid.

(ii) The seller must have parted with the possession of the goods and the buyer must not have acquired it.

(iii) The buyer must be insolvent.

(iv) The property must have passed from the seller to the buyer.

The right of stoppage in transit arises only after the seller has parted with possession of the goods and the buyer has become insolvent. This right is only available when the goods are neither in the possession of the seller nor that of the buyer, but are in the possession of a middlemen for the purpose of transmission to the buyer.

Example: B, who had bought goods from M/s. Clark & Co. of Glasgow, instructed the sellers to send the goods by a certain named ship to Melbourne. Goods were first railed to London and then shipped to Melbourne, a mate's receipt being sent to buyers. On becoming insolvent, the sellers gave notice to the Rail Company to stop delivery to buyers, but it was too late. They then gave fresh notice to the shipowners claiming back the goods before the ship arrived at Melbourne. On arrival there, the receiver in bankruptcy of B demanded the bills of lading from the master. Held, the goods having been effectively stopped in transit, the trustee could not claim them. [Bathell *v.* Clark 19 Q.B.D. 553]

Duration of transit

The right of stoppage in transit can be exercised so long as the goods are in transit. It becomes important, therefore, to know as to what is the duration of transit, i.e., when transit begins and when it comes to an end. Section 51 provides rules regarding the same. According to sub section (1) the goods are deemed to be in the course of transit from the time when they are delivered to a carrier or other bailee for the purpose of transmission to the buyer. The transit continues until the buyer or his agent in that behalf takes delivery of them from such carrier or other bailee. It means that so long as the goods are with a carrier the transit continues.

In order that the right of stoppage in transit can be validly exercised the carrier carrying the goods must be a middleman rather than either the buyer's agent or seller's agent. If the carrier is the buyer's agent, delivery of the goods to him would defeat the right of stoppage in transit. On the other hand, if he is the seller's agent, the possession of the seller's agent is the possession of the seller and he can even exercise the right of lien over those goods. It is only when the carrier has the capacity of a carrier that the goods are deemed to be in transit for the purpose of the exercise of this right.

Section 51, sub section (5) provides that when the goods are delivered to a ship chartered by the buyer, it is a question depending on the circumstances of each case whether they are in the possession of the master as a carrier or as agent of the buyer. In Schotmans v. Lancashire & Yorkshire Ry. Co. there was delivery of the goods by the seller on board a ship belonging to the buyer. The bill of lading was also taken in buyer's order. It was held that in this case it amounted to the delivery of the goods to the buyer so that the seller was precluded from exercising his right of stoppage in transit.

In Turner v. The Trustees of Liverpool Docks the cargo of cotton was put on the board of the vessel belonging to the buyers, but the goods were made deliverable to the sellers or their order. Patterson J. giving judgement of the court observed that "there is no doubt that the delivery of goods on board of the purchaser's own ship is a delivery to him, unless the vendor protects himself by special terms, restraining the effect of such delivery. In the present case the vendors by the terms of the bill of lading, made the cotton deliverable at Liverpool, to their order or assigns, and there was not, therefore, a delivery of the cotton to the purchasers as owners, although there was a delivery on board their ship. The vendors still reserved to themselves, at the time of delivery to the captain, the jus disponendi of the goods, which he by signing the bill of lading acknowledged.

The transit is deemed to be at an end and the seller cannot exercise his right of stoppage in the following cases:

(i) When the buyer or his agent takes delivery after the goods have reached destination.

(ii) When the buyer or his agent obtains delivery of the goods before their arrival at the appointed destination.

(iii) When the goods have arrived at their destination and the carrier acknowledges to the buyer or his agent that he holds the goods on his behalf.

(iv) When the goods have arrived at their destination but the buyer instead of taking delivery requests the carrier to carry the goods to some further destination and the carrier agrees to take them to the new destination.

(v) When the carrier wrongfully refuses to delivery the goods to the buyer or his agent.

(vi) When part delivery of the goods has been made to the buyer with an intention of delivering the whole of the goods, transit will be at an end for the remainder of the goods also which are yet in the course of the transit.

The unpaid seller may exercise his right of stoppage in either of the following ways:

(a) By actually taking possession of the goods, or

(b) By giving notice of his claim to

    (i) the carrier, or

    (iii) other bailee in whose possession the goods are.

Such notice can be given either to the person in actual possession of the goods or to his principal. When the notice is given to the principal, the notice, to be effectual, must be given at such time and in such circumstances that the principal, by the exercise of reasonable diligence, may communicate it to the servant or agent in time to prevent a delivery to the buyer.

When notice of stoppage in transit is given by the seller to the carrier or other bailee in possession of the goods, he shall deliver the goods to, or according to the directions of the seller. It may be noted that the expenses of such recovery shall be borne by the seller (Section 52).

Wrongful refusal by the Carrier

If, even after a proper notice by the seller to the carrier for stopping the goods in transit, the carrier delivers them to the buyer, he shall be liable to the seller for conversion, i.e., wrongful appropriation of the goods to another. If after the transit has ended and the carrier wrongfully returns the goods to the seller, he is liable to the buyer for conversion.

Lien and Stoppage in Transit Distinguished

The points of distinction between these rights of an unpaid seller are stated as under:

(i) The seller's lien attaches when the buyer is in default whether he be solvent or insolvent, while the right of stoppage in transit arises only when the buyer is insolvent.

(ii) Lien is exercisable only when the goods are in actual possession of the unpaid seller, while stoppage in transit is available only after the seller has parted with the possession of the goods but are still passing through channels of communication for the purpose of reaching the hands of the vendee, i.e. they are in custody of an independent carrier.

(iii) The right of lien consists in retaining the possession of the goods, while the right of stoppage in transit consists in regaining the possession of the goods.

(iv) Lien ends where the right of stoppage commences. It means when the seller hands over the possession of goods to the carrier, his lien ends and the right of stoppage in transit commences.

Effect of Sub-Sale or Pledge By Buyer (Section 53)

The general rule is that the unpaid seller's right of lien or stoppage in transit is not affected by any sale or other disposition of the goods which the buyer may have made. However, there are two exceptions to this general rule. They are stated below:

(i) When the seller has assented to the sale or other disposition with the buyer may have made.

Example: A sold to B 80 maunds of grain out of a grainary. B then sold (out of these 80 maunds) 60 maunds to C. C after receiving from B the delivery order presented it to A. A told C that the grains would be delivered in due course, B then became insolvent. A's right against the 60 maunds is not lost since A recognised the title of C the sub-buyer (Knigths v. Wiffen).

(ii) When a document of title to goods (e.g., a bill of lading or railway receipt) has been issued or transferred to a buyer, and the buyer transfers the document to a person who takes the document in good faith and for consideration, then

- If such last mentioned transfer was by way of sale, the unpaid seller's right of lien or stoppage in transit is defeated, and
- If such last mentioned transfer was by way of pledgee, the unpaid seller's right of lien or stoppage in transit can only be exercised, subject to the rights of the pledge. But in this case the unpaid seller may require the pledgee to satisfy his claim against the buyer first out of any other goods or securities of the buyer in the hands of the pledge.

(c) **Right of Resale**

An unpaid seller can resale the goods under the following three circumstances:

(i) Where the goods are of a perishable nature.

(ii) Where the seller expressly reserves right of resale if the buyer commits a default in making the payment.

As a result of this resale, the original contract will be terminated but the seller will have a right to claim damages [Section 54 (4)].

(iii) Where the unpaid seller who has exercised his right of lien or stoppage in transit gives a notice to the buyer about his intention to resell and buyer does not pay or tender within a reasonable time.

Effects of resale with or without Notice (Sections 54 (2) and (3)] : The effects of resale with or without notice are summarized as under :

Rights	In case of resale after notice	In case of resale without notice
I Unpaid seller's right to recover the loss on the sale	Available	Not available
II Original buyer's right to recover the profit on resale	Not available	Available
III New buyer's (who buys in resale) right to acquire a good title	Available	Available

Example: X sold 10 tons of rice to Y at a rate of ` 40,000 per ton on a credit of one month. One month expired but Y did not pay. State the legal position in each of the following alternative cases:

(a) If X resold 10 tons of rice to Z at a rate of ` 50,000 per ton after giving a notice of resale Y.

(b) If X resold 10 tons of rice to Z at a rate of ` 30,000 per ton after giving a notice of resale Y.

(c) If X resold 10 tons of rice to Z at a rate of ` 50,000 per ton without giving a notice of resale to Y.

(d) If X resold 10 tons of rice to Z at a rate of ` 30,000 per ton without giving a notice of resale to Y.

Solution

(a) X is entitled to keep the profit of ` 1,00,000 with himself because the buyer cannot be allowed to take advantage of his own wrong i.e, breach of contract [Section 54 (2)]. Z shall get a good title against Y [Section 54 (3)].

(b) X is entitled to recover the loss of ` 1,00,000 from Y [Section 54(2)]. Z shall get a good title against Y [Section 54(3)].

(c) Y is entitled to the profit of ` 1,00,000 [Section 54(2). However, Z shall get a good title against Y [Section 54(3)].

(d) X is not entitled to recover the loss of ` 1,00,000 [Section 54(2)]. However, Z shall get a good title against Y [Section 54(3)].

2. Rights against the Goods where the Property in the Goods has not passed to the Buyer [Section 46(2)]

Where the property in goods has not passed to the buyer, the unpaid seller has, in addition to his other remedies, a right of withholding delivery similar to and coextensive with his rights of lien and stoppage in transit where the property has passed to the buyer [Section 46(2)].

15.2.2 Rights against the buyer personally

The unpaid seller, in addition to the rights against the goods as discussed above, has the following rights of action against the buyer personally.

(a) Suit for Price (Section 55)

Where under a contract of sale, the property in the goods has passed to the buyer and the goods have actually come into his possession, the unpaid seller's only remedy is a suit for the price.

Where under a contract of sale, the price is payable on a day certain irrespective of delivery and the buyer wrongfully neglects or refuses to pay the price, the seller may institute a suit for the recovery of the same, although the property in the goods may not have passed.

The right of the seller to recover the price, after the property has passed to the buyer, can be exercised irrespective of the fact that no delivery of the goods has yet been made to the buyer. In Dunlop v. Graot there was a contract for the sale of a certain quantity of iron and the delivery was to be made, if the buyer so required, between 3rd March and 30th April. The price was agreed to be paid by 30th April. By 30th April delivery of only a portion of the iron was made, as the buyer did not require the delivery of the remainder. It was held that the seller was entitled to recover the price of the whole of the iron and he was not required to show that he had appropriated any specific quantity of iron to the contract for completing the delivery of the remaining iron. When the buyer has obtained the possession of the goods the seller's sole remedy is an action for price. On the other hand, if the goods have not yet reached the actual possession of the buyer, the seller has, in addition to the right of recovery of price under Section 55 certain rights against the goods.

(b) **Suit for Damages for non-acceptance (Section 56)**

Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages (and not for full price) for non-acceptance. Now the question arises as to what shall be the basis or principles of estimating the damages to the claimed. The answer is provided by Section 73 of the Indian Contract Act. According to Section 73, the measure of damages is the estimated loss arising directly and naturally from the buyer's breach of contract.

The seller's remedy under the present section is a suit for damages rather than an action for the price of the goods. In Bungo Steel Furniture v. Union of India there was a contract for the supply of steel bins to the Govt. of India by the appellants. The Government wrongfully terminated the contract before the bins had been actually manufactured. It was held that, in this case, since, the property in the goods had not yet passed to the buyer (Govt.) the case was not covered by Section 55 and an action for the recovery of the price could not lie but appellants were entitled to recover damages from the Govt. for wrongfully refusing to accept the goods.

The calculation of damage in different situations is discussed below:

When the Goods have a Ready Market: We can discuss the question of damages when they have a ready market under the following two headings:

(i) *The Seller resells the Goods*: Where the goods have a ready market, the principle application is that the buyer will have to pay the loss that the seller has sustained on reselling of the goods on the day of the breach.

Example: If the difference between the contract price and the market price on the date of breach is nil, the seller can get only nominal damages (Charter v. Sullivan).

(ii) *The seller does not Resell*: If the seller does not resell, the difference between the contract price and market price on the day of breach is adopted as a measure of damages. This rule will apply even if the seller has actually incurred no loss or earned a lot, after selling it on a day other than the day of breach of contract (Bungo Steel Furniture v. Union of India).

Where Goods have no Ready Market: Where, however, the goods are of the type which have no ready market, the measure of damages shall depend upon the facts of each case.

Example: T Ltd., a car dealer, contracted to supply a motor-car to R. R refused to accept delivery. The market price in fact had fallen too much. Head that T Ltd. was entitled to damages for the loss of their bargain, viz., the profit they would have earned by selling that car (Thompson Ltd., v. Robinson).

Goods Deliverable in Instalments

Where the goods are deliverable in instalments, and the buyer refuses to accept one or the other or all the instalments, the difference in prices is to be reckoned for purposes of calculating damages on the day that a particular instalment was to be delivered.

(c) Suit for damages for Repudiation of the contract (Section 60)

Where buyer repudiates the contract before the due date of delivery, the seller may either treat the contract as subsisting and wait till the due date of delivery or he may treat the contract as rescinded and sue for damages for the breach.

(d) **Suit for Interest (Section 61)**

Where under a contact of sale, the seller tenders the goods to the buyer and the buyer wrongfully refuses to accept and pay for them, the court may award interest on the price from the date of the tender of the goods or from the date when the price is payable. If the goods are sold on credit, interest will run from the expiry of the credit. The rate of interest to be awarded is discretionary with the court. It may be noted that the seller can only recover interest when he is in a position to recover the price. When he only sue for damages, for breach of contract, he is not entitled to interest.

15.3 SUMMARY

A seller who has received only a part of the price is an unpaid seller. The rights of an unpaid seller is against the goods and against the buyer personally. On the transfer of the ownership of the goods to the buyer, an unpaid seller has right of lien, right of stoppage in an unpaid seller also has certain rights against the buyer. These rights are sit for price, suit for damages, suit for interest and suit for interest and suit for reputation of contract.

15.4 KEYWORDS

Unpaid Seller: A person who has sold goods to another person but has not been paid for the goods, or has been paid partially is called an unpaid seller.

Right of Lien: When the seller of goods has not been paid and the ownership of goods has been transferred to the buyer but the goods are in the possession of the seller, the seller has the right of retain the goods till he receives the price of goods from the buyer.

Stoppage in Transit: It means the stopping of the goods while they are in the course of transit.

Breach of Contract of Sale: When the buyer fails to pay the price or accept the goods, or the seller fails to deliver the goods, the breach is said to have occurred.

15.5 SELF ASSESSMENT QUESTIONS

1. When is a seller of the goods deemed to be an unpaid seller ? What are the rights against the goods and the buyer personally ?

2. Compare and contrast the unpaid seller's right of lien and stoppage in transit. Do you agree that right of stoppage in transit is an extension of right of lien ?

3. Describe the law relating to the right of resale available to an unpaid seller in the Sales of Goods Act, 1930.

4. "Sub sale by the buyer does not extinguish unpaid seller's right to the lien. "Comment.

5. What is meant by the right of stoppage in transit in respect of sale of goods ? When is the this right lost ? How is this right effected or exercised ?

6. Practical Problems

Decide the following problems, giving reasons:

(a) X sells goods to Y. Y pays to X through a cheque. Before Y could obtain the delivery of goods, his cheque has been dishonoured by the bank. X, therefore, refuses to give the delivery of goods until paid. Is X's action justified?

(b) A sells to B 80 quintals of grain out of a large quantity lying in his granary. B sells 60 quintals, out of those, the goods having not yet been certained, to C. Then C having a delivery order from B forwards it to A, who informs C that he will send the grain in due course. B then becomes solvent. Can A refuse to deliver the 60 quintals of grain to C? Give reasons for your answer.

(c) A is the owner for specific goods lying in N's warehouse. A sells those goods to B and takes from B a bill exchange for the price and hands over to B a delivery order addressed to N. B resells the goods to C and gives a delivery order but before C can obtain possession of the goods B becomes insolvent and A warns N not to deliver to anyone without A's order. Is A entitled to retain goods against C? Give reasons.

(d) A sells to B a quantity of sugar in A's warehouse. It is agreed that B shall get two months credit. B allows the sugar to remain in A's warehouse. B becomes insolvent before the expiry of the two months, and the Official Receiver demands delivery of the sugar without offering to pay. What are the rights of A?

15.6 SUGGESTED READINGS

S.S. Gulshan & G.K. Kapoor, Business Law, New Age International Publishers, New Delhi.

S.C. Kuchhal, Mercantile Law, Vikas Publishing House, New Delhi.

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M.C. Shukla, A Manual of Mercantile Law, S. Chand & Co., New Delhi.

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