Formation of a Company and Company Document

Subject: Commerce

Lesson: Formation of a Company and Company Document

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Introduction

As discussed in lesson 1, one of the important features of a company is that it is an 'artificial person' created by law. Company Law contains various provisions to form a company. In this chapter we will discuss the various stages of formation of a company. The process of formation starts when a person conceives an idea to form a company and ends when a company gets a certificate from the Registrar of Companies after complying with the various provisions relating to the formation of a company. 'Formation of a Company' has been divided into four stages: Promotion, Registration, Capital Subscription and Commencement of Business. Out of the four stages, the first two stages 'Promotion and Registration' are necessary for both public and private companies. A private company can start operating its business immediately after registration, but a public company has to pass through two more stages- capital subscription and commencement of business. A public company can raise funds from the public by issuing shares. After following all the legal provisions of public issue, which are specified in The Company's Act, a public company can start operating its business. All these stages are discussed in detail in this lesson.

3.1 Promotion

The very first stage in the formation of a company is promotion. This stage begins when the idea to form a company comes in the mind of a person. The person who conceives the idea is called a 'promoter'. The Companies Act does not provide a definition of a promoter. However, the dictionary meaning of the term promoter is 'a person who promotes new trading companies.

When an idea comes in the mind of a promoter, the first thing he / she does is to carry out a detailed investigation about the profitability of the project he / she wishes to undertake. The promoter then estimates the expected income and expenses and tries to find out the sources for raising the funds for the company to be formed by him. If he / she is confident that the project is profitable he / she then proceeds further to form a company.

Figure 3.1: The promoter

A promoter can take the help of other persons in order to form a company. It is not necessary that a promoter has to be a single person. There can be a group of people who come together to form a company. Also, it is not necessary that a person should take active part in the formation of company from the beginning. A person can join the existing promoters at any stage and become a co-promoter.

People who help a promoter in a professional capacity cannot be called promoters, but people who help a promoter out of professional capacity can be regarded as promoters. This can be explained with the help of the following illustrations.

Illustration:

Ram is a solicitor of Rinku Yadav who is a promoter. Rinku Yadav purchases a land for the proposed company and Ram carries out all the legal formalities pertaining to the purchase of the land. As Ram purchases the land on behalf of Rinku Yadav in his professional capacity therefore he is not a promoter.

Illustration:

Ram is a solicitor of Rinku Yadav who is a promoter. Ram introduces his clients to Rinku Yadav and encourages them to buy shares of the proposed company. Introducing his clients to Rinku Yadav for buying shares is not Ram's professional duty. As a solicitor his job is to look after the legal matters of the company rather than to sell the shares of proposed company. Thus, he will be considered a promoter.

A promoter does various things to get the company promoted. Some of these are discussed below:

1. Appoint bankers, solicitors, brokers for the company.
2. Prepare the memorandum and the articles of association of the company, get it printed and registered.
3. Find the persons who are ready to sign the memorandum and articles of association.
4. Enter into preliminary contracts with underwriters, suppliers of raw material, plant and machinery etc.

The stage of promotion starts when a promoter conceives the idea to form a company and ends when the company is formed and is handed over to the directors.

3.1.1 Legal Position of a Promoter

A promoter has to perform various tasks to form a company. He holds a very important position and has wide powers relating to the formation of a company. Since a promoter has to perform various duties, his/her legal position is quite clear. A promoter stands in a fiduciary position (position of trust and confidence) towards company which is to be formed. It is expected that whatever promoters do, will be in the best interest of the company. The fiduciary position gives rise to two important duties of a promoter which are as follows:

Figure 3.2: Legal Position of a Promotor

1) Promoter should not make any secret profits

If a promoter makes any profit during the formation of the company then that profit must be disclosed. A promoter is not allowed to make any secret profits.

Case Law 1

Glukstein Vs Barnes -[(1900) A.C.240]
The objective of promoters was to purchase a property called Olympia and then re-sell this Olympia to a company which was to be formed by them. The promoters acquired the debentures of Olympia at a discount, and then they bought Olympia company for 1,40,000 Pounds. Out of 1,40,000 Pounds debentures were repaid in full(which they acquired at discount) and therefore, syndicate made a profit of 20,000 Pounds. Then they promoted a new company by selling old Olympia to it for 1,80,000 Pounds. Promoters earned profit of 40,000 Pounds (1,80,000 – 1,40,000). Profit of 40,000 Pounds was revealed in the prospectus, but not the profit of 20,000 Pounds. Held- The profit of 20,000 Pounds which was not disclosed to the public had to be refunded to the company by the promoters.

2) A promoter must disclose all material facts of sale of his property to the proposed company.

If a promoter sells his/her property to the proposed company for a profit, then he/she must disclose the profit made to the Board of Directors or to the prospective shareholders by mentioning the details in the prospectus or the articles of association. If the promoter fails to disclose the profit then the proposed company can either rescind the contract or it can accept the contract and then recover the profits made from the promoters.

Figure 3.3: Disclosing sale of property

Case Law 2

Erlanger Vs. New Sombrero Phosphate Company - [(1878) 3A.C.1218]
In this case Erlanger was head of the syndicate (group of promoters) who purchased an island containing phosphate mines for 55,000. The objective of syndicate was to purchase property from Erlanger and to sell it to the new Company to be formed by them. Syndicate purchased phosphate mines (cost 55,000) for 1,10,000 and got the transactions approved by BOD containing fictitious persons as its directors , and was also approved in the meeting of shareholders, but no material facts were disclosed . Later when the company went into liquidation, the liquidators filed a suit against Erlanger to recover the profits made by him. Erlanger tried to defend on the ground that the directors had full knowledge about this sale of property, but his plea was rejected and it

was held that the company was entitled to rescind the contract and recover the purchase money from Erlanger**.**

3.1.2 Promoter's Liability

If a promoter makes any secret profits then the company can take action against the promoter in two ways:

i. It can file a case against the promoter and recover the profit along with interest;or
ii. It can return the property to the promoter and recover the purchase money.

Figure 3.4: Secret Profits

A promoter may also be held liable for the following acts:

1. A promoter has to issue 'Prospectus' if he is forming public company and public is invited to subscribe for shares of the company. In case there is misrepresentation in prospectus (Sec.62) then he/she may be imprisoned for upto 2 years or fine of Rs. 50,000 may be imposed on him/her.
2. According to Sec.543 "when the company is being wound-up then official liquidator of the company may make promoters liable for misfeasance or breach of trust" and according to Sec.478 & 519 "the Company law Tribunal may also order for the public examination of promoters."

Illustration:

Ram, a promoter formed a company and earned a profit of Rs.1,00,000 by selling his own property to the company. He did not disclose this profit to the board of directors and to the shareholders of the company. After eight years due to financial problems the directors decides to wind up the company. The liquidator while checking the accounts found that Ram earned a profit of Rs.1,00,000 which he did not disclosed. Therefore, the liquidator can file case against Ram in court for breach of trust or misfeasance.

3. If there are more than one promoters then they all are jointly and severally liable. If the other party files a case against one promoter then he/she can claim contribution from other co-promoters.

Figure 3.5: Jointly Liable

Illustration:

Four persons Mohan, Sohan, Shyam and Rohan decide to form a company. While forming the company they made a secret profit and did not disclose this fact to the directors of the company. The directors came to know about this fact after sometime and decided to file a case against Mohan. If the court orders Mohan to return the profit alongwith interest, then Mohan has a right to claim this amount from Sohan, Shyam and Rohan in appropriate ratio.

In case a promoter dies then amount can be recovered from his estate

Illustration:

As given in the above example, in case Rohan dies then amount can be recovered from his legal heirs.

2. The company may grant the promoter a lump sum amount either in cash or in the form of shares.

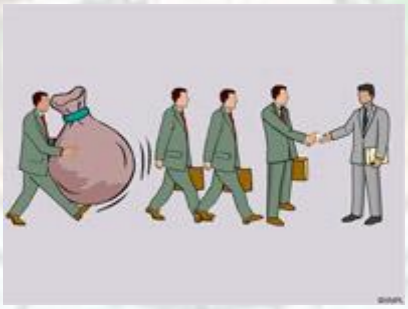
Figure 3.7: Lump sum: Cash or Shares

Illustration:

Sonu formed a company and directors decide to give him remuneration of Rs.1,00,000 cash or shares worth Rs.1,00,000 which will be free of cost.

3. The promoter may purchase a company or any property and sell the same to the company at an inflated price. (Provided full disclosure have been made).

Illustration

Ram,a promoter purchased 5 computers for Rs.20,000 each and sold it to the company for Rs.30,000.He earned a total profit of Rs. 50,000(150000-100000) and disclosed it to the directors.

4. The promoter may take commission at a fixed rate on shares sold.

Illustration:
Rajinder formed a company with share capital of Rs.10,00,000 which consisted of 100000 shares of Rs10 each.He sold 60000 shares of the company.If his commission is 3% he will get Rs.1,80,000(3% of Rs.6,00,000).

5. The promoter may purchase the un issued shares of the company within a fixed period at par which are likely to be sold at premium in future.

Illustration:

Mohan, a promoter formed a company and issued at par 50000 shares out of 75000 shares of Rs.100 each.Directors predicted that these shares can be sold of Rs.150 each in future.Mohan can buy these shares at Rs.100 each(out of unissued shares) by way of remuneration.

3.1.4 Pre-incorporation Contracts and Provisional Contracts

Pre-incorporation Contracts:

Pre-incorporation contracts are contracts which are entered by the promoter on behalf of the company before the company is incorporated. Such contracts are not binding on the company i.e. company can neither sue nor it can be sued by the other party. This is so because, to make the contract valid, two consenting parties are necessary to contract and as the company is not in existence before incorporation therefore it cannot enter into a contract in its own name. Since company is not a party to the contract therefore it is the promoters who are personally liable for such contracts.

Figure 3.8: Contract before Incorporation

The legal position of pre-incorporation contracts can be discussed under two heads:

1. Position before 1963
2. Position after 1963

1) POSITION BEFORE 1963:
Before 1963 the status of pre-incorporation contracts was as follows:

i. Before 1963 the companies were not bound to fulfill pre-incorporation contracts.This was so because the promoters were generally extravagant in their promises and if the company was bound by their promises then it was a heavy burden for the company to fulfill those promises.**Pre-incorporation contracts were not binding on the company.**

Illustratur:
Ramu a promoter of a company entered into a contract with the supplier of a machinery for purchase of machinery for the company which is to be formed by him. Price of machinery was far above the market price. When the company was formed the directors had to fulfill the contract and so were obliged to pay the price of the machinery to the supplier.

ii. If the company is requested to enforce the contract, then company is not bound to make it valid because the company was not in existence when the contract was entered by the promoter.

Figure 3.9: Position before 1963

Illustration:

Yakub, a promoter decides to form a company Anuj Enterprises. He enteres into various contracts which are to be fulfilled after the company is registered. Since, while entering into contracts Anuj Enterprises does not exist, therefore the other parties cannot file case against the company to fulfill the contract.

Case Law 3

Re English and Colonial Produce Company Ltd. - [(1906) 2Ch.435.]

A solicitor prepared the Memorandum of Association and Articles of Association of a proposed company on the instructions of promoters who became directors of company after registration (company was formed). The solicitor also paid registration fees and certain other expenses relating to registration. When the company was formed he claimed his fees and expenses he has incurred from the directors of the company. It was held that the company was not bound to pay the fees and expenses as the company was not in existence when the expenses incurred**.**

iii. **Company also has no right to sue the other party to enforce the contract**

Illustration:
As given in the above illustration Anuj enterprises also cannot file case against the other parties because the company did not exist when the contract was made.

Case Law 4

Natal Land Company vs. Pauline Colliery Syndicate - [(1904) A.C.120]
In this case Natal Land Company agreed for a contract with Ms. Colliery, who was an agent of syndicate, to grant a lease of certain mining property for three years. The syndicate formed the company, but Natal Land Company refused to grant lease. Syndicate filed a case against Natal Land Company. It was held that syndicate was not entitiled to enforce the contract.

3) POSITION AFTER 1963:

In 1963 a Specific Relief Act was passed to help promoters to carry out the work of incorporation. Earlier prior to incorporation all contracts were void and no party could sue each other for the non performance of the contract. People hesitated to enter into contracts with the promoters of proposed company. Promoters also were not willing to accept the huge responsibility because there was uncertainty whether the company would fulfill the terms of the contract or not.Due to all these reasons a Specific Relief Act was passed in 1963.

Figure 3.10: Position after 1963

The Sec 15 of Specific Relief Act 1963, provided that "where the promoters of a public company have made a contract before its incorporation for the company and if the contract is necessary to fulfill the objects which is mentioned in the object clause of the memorandum then the company can be enforced to fulfill the contract after it is formed." Sec.19(e) of Specific Relief Act 1963 also provided that the third party can also enforce the company to fulfill the contract

Provisional contracts:

Provisional contracts are contracts which are entered after incorporation of the company but before getting certificate of commencement of business. Provisional contracts become binding automatically after getting certificate of commencement of business. Only public companies are required to enter into provisional contracts. Private companies can start their business immediately after incorporation, therefore, provisional contracts doesn't arise in case of private companies.

Illustration:

Bharat Electricals Ltd. is registered as a public company. Since it is a public company it can start its business only after raising the capital from public. All the contracts which are entered by Bharat Electricals Ltd. after getting Certificate of Incorporation but before getting Certificate of Commencement of business will be called provisional contracts.

3.1.5 Table 3.1- Difference between Pre-incorporation Contracts and

Provisional Contracts:

Pre-incorporation Contracts

1) These contracts are made before incorporation.

2) A company is legally bound by such contracts only if company adopts such contracts after incorporation on same terms and conditions.

3) Such contracts arise in case of public company as well as private company.

Provisional Contracts

1) These contracts are made after incorporation but before getting the certificate of commencement of business.

2) Provisional contracts automatically become binding on public companies.

3) Such contracts arise only in case of public company.

3.2 Incorporation or Registration

The second stage in the formation of the company is incorporation or registration. In this stage the promoter does the following:

1. Apply for the availability of name of the company to the registrar.
2. Prepares the documents Memorandum of Association and Articles of Association of the company and get them registered.
3. Files with the registrar, the written consent of the directors who are willing to be appointed as first directors of the company.
4. Along with these documents a promoter also submits the address of the registered office of the company, details of directors, manager and secretary of the company.
5. Obtains the Corporate Identity Number.
6. Files with the registrar the 'Statutory Declaration' which is made by the legal authority stating that all the legal requirements have been complied by the promoter.

After scrutinizing all the documents filed by the promoter the registrar enters the name of the company in the Register of Companies and charges a registration fee. The registrar then issues the "Certificate of Incorporation".

According to Sec.35 of Companies Act 'Certificate of Incorporation' issued by the Registrar "is a conclusive evidence that all the requirements relating to registration have been complied by the company and the company is authorized to be registered under the Act."

Once Certificate of Incorporation is issued by Registrar, nobody can question the validity of this certificate even if the certificate is wrongly issued.

Case Law 5

Moosa vs. Ibrahim - [(1913) I.L.R. 40 Cal. 1(P.C)]

Memorandum of a public company must have signatures of seven persons then only this document can be registered. In this case memorandum of association of company was signed by two adults and by one guardian of five members who were minors. The Registror, registred the company and issued the certificate of incorporation. Since, statutory requirement of minimum number of members were not fulfilled in this case but still it was held that registration cannot be cancelled and validity of certificate cannot be challenged on any grounds.

Case Law 6

Jubilee Cotton Mills Ltd. vs. Lewis - [(1924) A.C.958]

In this case the Registrar issued a certificate of incorporation on January 8 but dated it January 6 on the certificate by mistake. On January 6 the company made an allotment of shares to Lewis. The court held that allotment was valid even if shares are allotted before incorporation.

Sec.35 applies for all types of companies whether it is private or public. If a company is incorporated with illegal objects then its objects will not become legal by issuance of this certificate, but company cannot continue to carry on the business with same objects. A company only had to change its objects and continue its business with new objects.

A private company can start their business after getting 'certificate of incorporation' but a public company has to pass through two more stages which are discussed below:

3.3 Capital Subscription

After getting the company incorporated the promoter of a public company make arrangements for obtaining the capital for the company. A promoter may or may not invite public to subscribe for shares. Public subscription is necessary only when large amount of capital is required. Two options are available to promoters:

Figure 3.11: Capital Subscription

i. If public is invited to subscribe for shares then prospectus will be issued, or ;
ii. If public is not invited then deliver a statement in lieu of prospectus to the Registrar of Companies.

According to Sec.69 of Companies Act, if prospectus has been issued, company can allot shares to public if it receives minimum subscription within 120 days after the date of first issue of the prospectus. If company fails to receive minimum subscription then, application money has to be refunded within next 10 days. If money is not returned within due date then company and the directors can be liable to return the amount to the shareholder with interest at the rate of 6% p.a.

According to SEBI, a company must receive minimum subscription within 60 days of closing of subscription list. If company fails to receive minimum subscription, then, application money has to be refunded within 8 days otherwise company and directors shall be liable to return the same with interest @15% p.a (Sec.69 of Companies Act and SEBI Guidelines lay down different provisions regarding receiving of minimum subscription)

Illustration:

Kangra Public Ltd. got certificate of incorporation on 6thJune 2009. Since it is a public company it has two options- to invite public to apply for shares of the company or arrange capital from its internal resoures. If it issues shares to public it is called capital subscription stage.

3.4 Commencement of Business

After receiving the minimum subscription the promoter of public company will apply to the registrar for Certificate of Commencement of Business. If the company has issued prospectus then provisions of Sec. 149(1) of Companies Act will be followed. A promoter will file following declarations to the Registrar of Companies:

Figure 3.12: Commencement of Business

a. That shares payable in cash have been allotted up to the amount of minimum subscription mentioned in the prospectus.
b. That every director has paid in cash the application and allotment money on his shares.
c. That no money is refundable to the applicants in case they are unable to receive permission from recognized stock exchange.
d. Statutory declaration by one of the directors or secretary, that all requirements relating to formation of company have been complied with.

According to Sec.149(2) of Companies Act, "If public company has not issued prospectus then only points (b) and (d) have to be followed."
After receiving the declarations from the promoter the Registrar will scrutinize these documents. If documents are proper then Registrar will issue Certificate of Commencement of Business.

If a public company starts its business without obtaining this certificate then every director has to pay fine of Rs.5,000/- for everyday of default.

Illustration:
Continuing with the above example,when Kangra Public Ltd. receives minimum subscription as per provisions then it will apply for Certificate of Commencement of business. After getting this certicate the public company can start its business.

3.5 Memorandum of Association

As discussed earlier, promoter of a company has to prepare some documents to get the company registered. Memorandum of Association is one of them. Memorandum governs the relationship between the company and the outside world. According to Sec.2(28) of Companies Act "Memorandum means the memorandum of association of a company as originally framed or altered from time to time in pursuance of any provision of company laws or of this Act".

Figure 3.13: Memorandum of Association

Lord Cairns while ruling the famous case of Ashbury Railway Carriage and Iron Company Ltd Vs. Riche has defined memorandum more precisely "the memorandum of association of a company defines the limitation on the powers of the company, it contains in it both that which is affirmative and that ambit and extent of vitality and power which by law are given to the corporation and it states, if it is necessary to state, negatively, that nothing shall be done beyond that ambit".Thus, Memorandum specifies the limit beyond which a company cannot go.

Basically, there are two purposes of memorandum:

a. Various stakeholders of the company i.e. creditors, suppliers, shareholders etc. can find out the purposes for which their money is going to be used.
b. They can evaluate the powers of the company and extent of risk in dealing with the company.

Memorandum must be:

i. Printed
ii. Divided into paragraphs
iii. Numbered consecutively
iv. Signed by each subscriber in presence of at least one witness.

3.5.1 Contents of Memorandum of Association

According to Sec.13 of Companies Act memorandum must contain the following clauses:

1. According to this clause a public company must add word 'limited' at the end of its name and private company must add word 'private limited' at the end of its name. However, Sec.25 companies are allowed to drop the word 'limited' in their name. A company is free to choose any name it likes but the name should not be identical nor resemble with name of existing company.If the name is identical to another company and the intention of company is to take advantage of name of already existing company,then, the court may grant injunction in such case.**Name Clause**
2. **Registered Office Clause** This clause states the name of state where registered office of the company is situated. The domicile of company depends on the place where the company is registered. All the important documents of the company are kept at this office. It is the official address of the company and all the communications are done through this office.
3. **Objects Clause** This is the most important clause of memorandum. It states the object of the company for which it is formed. A company cannot do anything which is not mentioned in the object clause of memorandum. If a company does anything which is not mentioned in the object clause then such acts are called ultra-vires act. A compan y is not allowed to indulge in those acts which are

Figure 3.14: Reason for forming a company

ulra-vires the company. While drafting object clause the company should consider following points:

a. The objects of the company should not be illegal.
b. They should not include anything which are in contravention of Companies Act.
c. They should not include anything which is against public policy.
d. Objects must be clearly defined.
e. They must specify the main objects as well as ancillary objects. (which help in the achievement of main objects)

4. This clause state the liability of members of the company. Liability of members of a limited company can be:**Liability Clause**
    1. Limited, or
    2. Unlimited

    Limited liability can be further divided into two:
    i. Limited by shares, or
    ii. Limited by guarantee Liability clause must be mentioned in case of those companies where liability of members is limited. But for unlimited companies it is not necessary to mention this clause.

Capital Clause

This clause states the amount of share capital with which a company is registered. This is known as authorized capital of the company. A company cannot issue more share s then it is authorized to do according to the limit specified in the memorandum. Stamp duty and registration fees are calculated on the basis of authorized capital of the company.

Figure 3.15: Authorized Capital

Association Clause

In this clause the persons who have signed the memorandum i.e the subscribers give a declaration that they desire to form a company and agree to take shares which are mentioned against their names. Every subscriber must take atleast one share each. The memorandum of association must be sighned by atleast two persons in case of private company and seven persons in case of a public company. The subscribers of memorandum appoint first directors of the company. If directors cannot be appointed then they themselves become directors of the company till directors are elected in the first Annual General Meeting of the company.

3.5.2 Alteration of Memorandum of Association

Memorandum is required at the time of registration of company. Since, o a company is registered on the basis of this document, therefore, clauses of this document should not be changed frequently. Memorandum can be altered by following the provisions laid down in the Companies Act.

Figure 3.16: Alteration of Memorandum of Association

I. Alteration of Name Clause
Alteration of Name Clause can be done as follows:

1. Special Resolution : If a company wants to change its name then special resolution is required to be passed and approval of Central Government in writing is to be obtained .If company wants to delete the word 'private' at the end of its name then only special resolution has to be passed and approval of Central Government is not necessary.
2. Ordinary resolution : If the name of company is identical with any other company then name can be altered by passing ordinary resolution and approval of Central Government in writing is to be obtained.

Registration: Within 30 days of passing of resolution,a copy of resolution shall be filed with the Registrar.A copy of order of Central Government must also be filed with the Registrar within 3 months of the order.After receiving both the documents Registrar will enter the new name and will issue a fresh certificate and memorandum will be altered accordingly.

Illustration:

Ansh Ltd. was incorporated on June 15, 2009.A similar company with same name and same objects was incorporated on July31,2009.Then the company which was incorporated on July 31,2009 must change its name. For this change the company has to pass an ordinary resolution and also has to obtain approval of Central Government.

II. Alteration of Registered Office Clause
A company can change its registered office by following the procedure given below:

Figure 3.17: Change of Address

1. Change within the same city
If a company wants to change location of its registered office from one place to another within local limits then Board of Directors will have to pass a resolution and notice should be given to the Registrar within 30 days of change.

Illustration:
A company is registered in Delhi and its registered office is located at Connaught Place. If company wants to shift its registered office to Nehru Place in Delhi then the office address can be changed by passing a resolution by the Board of Directors.

Change from one city to another city in the same state If a company wants to shift its registered office from one city to another within the same state then ,a special resolution should be passed at the meeting of shareholders. The copy of resolution must be filed with the Registrar within 30 days of passing resolution.

Illustration:
A company shifts its registered office from Kanpur to Noida, both the cities come under Uttar Pradesh. This can be done by passing special resolution in general meeting.

III. Alteration of Object Clause

Alteration of object clause can be discussed under two heads:

1. Substantive limits
2. Procedural Limits

    1. 1) Substantive limits – Sec. 17(1) of Companies Act provides that object clause can be altered only for the purposes mentioned below:
        i. To conduct its business more economically or efficiently.
        ii. To attain its main purpose by new or improved means.
        iii. To enlarge or change the local area of its operations.
        iv. To carry on some business which under the existing circumstances may conveniently be combined with the business of the company.
        v. To restrict or abandon any of the objects specified in the memorandum.
        vi. To sell or dispose the whole or any part of the undertaking.
        vii. To amalgamate with any other company or body of persons.

1. Procedural Limits: To alter the object clause:
    i. A special resolution must be passed at the General Meeting of the company and approval of Central Govt. is required.

ii. And a copy of special resolution alongwith a copy of altered memorandum must be filed with the Registrar within one month of passing it.

The Registrar will register the documents and will issue a certificate within one month of registration.

IV. Alteration of Liability Clause

The liability of members cannot be increased unless the member gives in writing either before or after alteration of memorandum. If the company is a club or association, and company decides to increase the subscription amount then written consent is not necessary.

Figure 3.18: Increasing Liability of Members

Liability of a director or managing director or a manager can be made limited if

a. Articles contain provision to do so.
b. Special resolution must be filed within 30 days.
c. Person concern gives in writing.

Liability of shareholders of unlimited companies can be made limited by passing special resolution and getting the sanction from the court

V. Alteration of capital clause

Alteration of Capital clause can be done by any one of the following:

i. Alteration of Share Capital
ii. Reduction of Share Capital
iii. Variation of the rights of the shareholders
iv. Re-arrangement of share capital

3.6 Articles of Association

The second most important document which is required at the time of registration is Articles of Association. This document contains rules & regulations for the internal management of the company. It contains the manner in which the objectives are to be achieved as mentioned in Memorandum of Association. It lays down the guidelines for administration and management of the company.

Figure 3.19: Articles of Association

Memorandum of Association of different companies have similar clauses i.e. they contain all the six clauses which are numbered and divided into paragraphs. But Articles are not required to be framed in the same manner by different companies. Contents of articles may vary substantially.

Articles are framed according to the provisions contained in the memorandum. They are subordinate to memorandum. Alteration of memorandum is not an easy task but articles can be altered whenever the management thinks fit.

Sometimes it is possible that memorandum and articles may contain a provision which lead to conflict between the two documents, then, in that case, Memorandum will supersede articles. Articles are generally followed when clauses stated in the memorandum are not clear and then by going through the Articles the doubt is cleared.

Case Law 7

Re, South Durban Brewery Company - [(1885),31 Ch.D261]

In this case the capital clause of memorandum was silent whether the company wants to issue different classes of equity shares or only one class of shares, however, in articles it was mentioned that company will have different classes of shares. So doubt was cleared by going through the Articles of Association of the company**.**

3.6.1 Contents of Articles of Association

Articles must provide explanation of following provisions:

1. Share capital and its sub-division into different classes
2. Lien on shares
3. Provision relating to Calls of shares
4. Provision relating to transfer of shares
5. Provision relating to transmission of shares
6. Provision relating to forfeiture of shares
7. Provision relating to surrender of shares
8. Conversion of shares into stock
9. Procedure of issuing share certificates
10. Procedure of issuing share warrants
11. Alteration of share capital
12. Conduct of General Meetings
13. Appointment of Directors, their remuneration, qualification required, powers and proceedings of meeting of Board of Directors.
14. Dividends and reserves
15. Accounts and Audit
16. Borrowing powers
17. Appointment of Auditors, their powers, duties, remuneration etc.
18. Appointment of Managing Director, Manager and Secretary, their powers, duties, qualifications, remuneration etc.
19. Procedure of winding up.

3.6.2 Companies in which Articles are compulsory (Section. 26)

For the following companies Articles are compulsory:

1. Unlimited companies.
2. Companies limited by guarantee
3. Private companies limited by shares.

As required in memorandum, the articles also must be: (Section 30)

1. Printed
2. Divided into paragraphs and numbered consecutively
3. Signed by each subscriber who have also signed memorandum of association in presence of at least one witness.

3.6.3 Alteration of Articles of Association

According to Sec. 31 of Companies Act a company can alter its articles by passing a special resolution. A copy of special resolution must be filed with the Registrar within 30 days of passing resolution, along with the company must also file a copy of altered articles. The altered Articles will be effective from the date it is registered by Registrar of Companies. If the company wants to alter its articles from retrospective effect (back date), company can do so provided the alteration is in best interest of the company. Articles can be freely altered but certain limitations are imposed on the companies while altering articles which are discussed below.

3.6.4 Limitations on Altering the Articles

1) Articles must not violate the provisions of the Companies Act. Companies Act had laid down certain rules & regulations according to which companies had to operate. A

company can not alter articles and adopt a policy which are not in accordance of Companies Act for their own convenience.

Figure 3.20: Limitations – Altering the Articles

According to section 69(4) all the application money must be deposited in separate bank account. Every company must open a separate Bank Account to deposit the application money received from the shareholders during public issue. A company cannot deposit the application money in the same account which is being operated by the company.

2) Alteration of articles must be in accordance with the provisions contained in the memorandum. While altering the articles a company must take care that change in articles are not in conflict with memorandum because in case of conflict, memorandum will supersede articles, change in articles will become ineffective.

3) Alteration should be done according to the order passed by the Company Law Tribunal. A company may have to alter its articles by order of Company Law Tribunal under section 397 or 398. Alteration in Articles must be done in the same manner as ordered by Company Law Tribunal.

4) Alteration should not sanction anything which is illegal.

5) Alteration will not be valid if it constitutes fraud on minority shareholders. If the company alter its Articles only for the benefit of majority shareholders then they are not allowed to do so. If such thing happens then court may intervene and restrain the company to alter the articles.

6) Alteration must be bonafide for the benefit of the company as a whole. The court will not allow alteration if it is not for the benefit of the company. If the alteration is for the benefit of the company and if some members do not agree even then alteration will be valid.

7) Alteration in breach of contract. Sometimes when a company wishes to alter its articles and this alteration results in breach of contract, then company can alter its articles but then the company is liable to damages to the other party who is adversely affected due to alteration.

8) Central Government approval in certain cases.Although articles can be altered by passing a special resolution but some alteration require approval of Central Government. Which are discussed below:

i. When a public company has to be converted into private company.
ii. When a company wants to alter the provisions of articles relating to appointment or reappointment of a managing or whole time director or of a director who is liable to retire by rotation in case of a public company.

iii. Alteration resulting in increasing in the remuneration of any director including a managing or whole-time director in case of a public company.

3.6.5 Binding effect of Memorandum and Articles

Company and its members are bound by provisions contained in memorandum and articles. According to section 36 to Companies Act "subject to the provisions of the Act, the memorandum an d 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 (agreements) on its and his part to observe all the provisions of memorandum and of the articles." All the members of the company must follow these

Figure 3.21: Bound by Provisions of Memorandum & Articles

provisions as if they have signed the documents personally. A member cannot refuse to abide by memorandum & articles. This binding effect can be discussed under four heads:

1) Company bound to the members

A company must follow the provisions of Articles relating to the members of a company. Any member can sue the company if the company does not follow the Articles. He can go to court and obtain injunction order resulting the company to do acts ultra vires the articles.

Case Law 8

Johnson vs. Lytthe's Iron Agency - [(1877),5Ch.687]
The company forfeited the shares of Johnson and did not follow the provisions of forfeiture mentioned in the Articles of the company. Johnson filed a case against the company and court restrained the company to forfeiture the shares.

2) Members bound to the company
Members of company are also bound by provisions contained in Memorandum & Articles of the company.

Case Law 9

Boreland Trustees vs. Steel Brothers & Co. Ltd - [(1901),1Ch.279]

In this case Articles of a company provided that if member becomes bankrupt then his shares will be sold at a price fixed by the directors. Boreland, who was holding 73 shares

became bankrupt. His trustees claimed that they are not bound by the articles. But the court held that his trustees cannot claim the shares of the company and hence must sell the shares fixed by the board.

3) Members bound to the members

All the members are bound by Articles, which contains that members are bound to each other. If a member does anything which is not in accordance with Articles of the company, then other member can file a suit against that member without involving company as a party.

Case Law 10

Rayfield vs. Hand - [(1852)2.W.L.R.851]

The articles of company provides that if members wants to transfer their shares then directors must purchase the shares equally between them at a fair value. A member who wish to transfer the shares informed the directors. But directors refused to purchase the shares. Court held that directors must take the shares, and they are bound by the provision contained in the Articles.

4) Company or members bound to the outsiders

Any outsider cannot take any legal action against the company by referring the memorandum and articles of the company. Articles are framed for internal use i.e. it contains rules & regulations for the company as a whole.

Case Law 11

Eley vs. The Positive Government Life Assurance Co - (1876),1Ex.D.88

The Articles provided that Eley will be appointed as solicitor of the company and cannot be removed from office except for misconduct. After sometime he became member of the company. Eley worked as solicitor but after sometime he was removed from office without any charge of misconduct. Since, Eley was now also a member he file suit against the company for breach of contract. Court held that when Eley was appointed solicitor he was an outsider. And an outsider cannot claim anything from the company as articles did not constitute any contact between the company and on outsiders.

3.7 The Doctorine of Ultra Vires

Doctrine of ultra-vires is related to the object clause of memorandum of association. Ultra vires act are those which a company is not authorised to do. Ultra-vires Act are null & void and the company is not bound by such acts. All the acts of the company, which it is going to perform to achieve the main objectives are mentioned in the objects clause of memorandum. A company cannot exceed the powers specified in the memorandum. This doctrine was framed in order to protect the interest of shareholders and third parties who have purchased the shares of the company or have entered into contracts with the company of any kind after going through the object clause of memorandum.

Case Law 12

Doctrine of ultra-vires was first laid down in popular case of Ashbury Railway carriage & Iron Co. Ltd. vs. Riche - [(1875),L.R.7H.L.653]

In this case a company was formed whose job was to make railway carriages and wagons, and all kinds of railway plant, fittings, machinery & rolling stock. The objective was to sell all these parts or to lend on hire. Company entered into a contract with Riche for financing the construction of railways in Beljium. This contact was also approved in the meeting of shareholders. Since, the objective of the company was to manufacture parts and not fi nancing, the company itself repudiated the contract on the ground that it was ultra-vires. Riche filed a case against the company for breach of contract and claimed damages.

The court held that since act was ultra-vires the company, hence it is null & void. Riche cannot force the company to fulfill the contract, because it is beyond the powers of company to carry on business of financing.

3.7.1 Effect of Ultra Vires Transactions

Directors of a company enter into various transactions to achieve the main objective of the company, during this it is possible that directors may do ultra-vires act intentionally or unintentionally. Consequences of ultra-vires acts are discussed below.

Figure 3.23: Void Contract

Contract is void

Transactions which are ultra-vires the company are void and hence, company & outsider have no legal ri ghts against each other. A company cannot perform such contracts even if all the shareholders of a company approve it in the meeting.

Illustration:

1. The objective of Geet Ltd Company is to make plastic products therefore it cannot do the business of manufacturing products made of steel. However the company enters into a contract with Ghanshyam who is a supplier of steel to provide steel (raw material) to the company so that the company could manufacture steel glasses. Ghanshyam supplies the raw material but the company fails to make full payment to Ghanshyam. Ghanshaym cannot take any legal action against the company for the performance of contract.

2. **Injunction**
   If a company does any ultra-vires act then shareholders of the company can go to court and may get injunction order restraining the company to perform any ultra-vires acts.

3. **Personal liability of directors**
   If directors of a company make any ultra-vires payment on behalf of the company, then directors are liable to restore the funds of the company. Funds of company should be utilized only for the purpose mentioned in Memorandum.

Case Law 13

Re Sharpe - [(1892)1Ch.154.]
The directors of the company paid interest out of capital which they were not authorised to do so according to the memorandum. The liquidator came to know about this fact during the winding up of the company. Court held that liquidator had power to recover money from the directors.

4. **Liability for breach of warranty of authority**

   If directors induce an outsider to enter into ultra-vires acts then they will be liable to the third party for the loss, if third party is not aware of irregularity. Thus, directors will be personally liable for the breach of warranty of authority.

Case Law 14

Weeks vs. Propert - [(1873),L.R,8CP427]

In this case company was authorised to borrow 60,000 pounds by issuing debentures. Company borrowed this amount in full. But directors still borrowed 500 ponds from Weeks and issued debentures to him. Since, the directors borrowed more than what they

were authorised to do, it was held that loan was ultra-vires and therefore, company is not liable to refund the money. The directors were personally liable to Weeks as directors exceeded the powers which Weeks was unaware of.

Ultra-vires acquired property

If a company acquires a property to fulfill a contract which is ultra-vires the company, then company have full right over that property because the property comes in the category of corporate capital.

Case Law 15

National Telephone Co. Vs. Constables of St. Peter Port.

In this the telephone company purchased the wires to lay down the wires in a area, which they were not authorised to do. Constables of that area cut the wires of company as this act was ultra-vires the company. Court held that telephone company can recover damages done to wires as it was property of the company.

Ultra-vires contracts

Ultra-vires contracts are null and void. Company cannot file case against the other party for performance of ultra vires contracts,similarly the other party cannot take action against the company.Two parties cannot take legal action against each other, but in some situations outsiders can claim their money or supplies from the company. These situations are discussed below:

i. If the company takes an ultra-vires loan and uses it to pay off the lawful debts of the company. The person who has given ultra-vires loan will have right to recover his loan from the company.
ii. If the company has acquired property or goods by virtue of ultra-vires acts and property or goods still exists and can be traced. Then the person can reclaim it.
iii. If company lends money to someone which they are not authorised to do. Company can recover the money from the debtor.

Ultra-vires torts

A company is liable for the wrong acts committed by employees of company while doing there job for the company, provided:

i. When tort is committed which comes within the scope of object clause of the company.
ii. It is committed by the employees when they were in the employment of the company.

Illustration:

Surya Transport Company had power to run trucks. It started operating Charted buses which company was not authorised to do by its memorandum. The driver of charted bus injured a person negligently. Person who was injured sued the company for damages. Court held that company was not liable for damages because appointment of driver to run charted bus was ultra-vires committed by the officers of the company.

Whenever a person wants to enter into a contact with the company he must go through the memorandum and articles of the company. Bo th these documents are public

documents and anyone can read these documents by paying a nominal fees. Every person who is dealing with the company is presumed to have read these documents and have knowledge of the contents of memorandum and articles of the company. This is known as "Doctrine of Constructive Notice".

Figure 3.24: Understanding MOA & AOA

Illustration:

Ganko Ltd. was a public company The Articles of company contained a clause that a document will be valid only if it is signed by a secretary, working director and a managing director. Mahesh accepted a mortgage deed given by the company which was signed by a secretary and working director but not by Managing Director. Court held that Mahesh cannot claim his money from the company and the deal is invalid.

3.9 The Doctrine of Indoor Management

Doctrine of indoor management is limitation on 'Doctrine of Constructive Notice'. It says that persons dealing with the company assume that directors and officers have followed all the provisions of memorandum and articles of company while entering into contracts.

Figure 3.25: Borrowing Money

Case law 16

Doctrine of Indoor management was first laid down in famous case of 'Royal British Bank vs. Turquand' - [(1856),6E&B327]
The directors of the company were authorised by its articles to borrow money provided a resolution is passed in the general meeting of the company. Directors borrowed money from Turquand with out passing resolution at the general meeting. Court held that company is liable to return the money to Turquand as he assumed that company has followed rules & regulations while entering into contracts.

This limitation was imposed on Doctrine of constructive notice because it is not possible for the outsiders to enquire into the internal proceedings of the company. In order to maintain healthy relations with the company the outsiders are reluctant to ask for necessary sanctions and approvals from the directors or officers of the company. So outsiders assume that company had followed all the provisions to give contract a legal status.

Illustration:
Woodcraft Ltd. was a private company .The Articles of the company contained a clause that in case the company borrows fund from outside then the company must pass a ordinary resolution in the general meeting. The directors borrowed money from Vikas without passing resolution. Directors must return the money to Vikas, even if proper procedure for borrowing funds was not followed.

3. Forgery
A company is not liable for forgery committed by its officers. The consent of company is not present at all in forgery cases. No consent, no transaction.

Figure 3.26: Committing Forgery

Case law 19

Ruben vs. Great Fingall Ltd. - [(1906),A.C439]

The secretary of the company issued a share certificate by forging the signatures of two directors under the seal of the company. Company refused to accept him the shareholder. Since, the approval of company was not present, shareholder cannot claim his membership in the company

Negligence
If officers of the company commit any wrong act and circumstances have become suspicious but the outsider does not make an inquiry into it then protection under this doctrine is not available.

Case law 20

Anand Bihari Lal vs. Dinshaw & Co. - [(1942),A.I.R.Oudh417]

An accountant of a company transferred some property of company in favour of Anand Bihari lal. The transfer of property is beyond the scope of accountant's power.Hence,transfer is void.Court did not grant relief to Anand Bihari in this case.

3.10 Prospectus

The document prospectus is required if promoters of public company invite public to subscribe for shares or debentures of the company. If promoters of public company are confident that they will be able to raise funds privately then there is no need of public subscription. But if promoters are unable to raise capital then public is invited to subscribe for shares through prospectus.

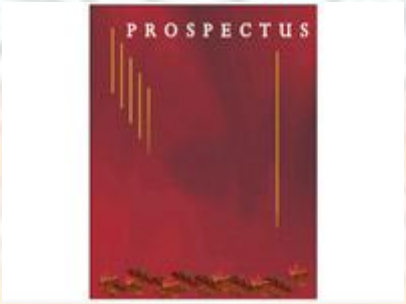

Figure 3.27: Prospectus

According to Section 2(36) "a prospectus means any document described or issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of a company."

Any document in writing which invite public to apply for shares is a prospectus. An oral invitation to subscribe for shares is not prospectus. Prospectus contains all the important information about the company, which are relevant for the shareholder. On the basis of information given in the prospectus a shareholder decide whether to invest in the company or not. Section 56 of Companies Act had specified the matters, which are to be disclosed in the prospectus.

3.10.1 Contents of a Prospectus

Prospectus is one of the most important document issued by the company. A person applies for the shares of the company on the basis of information supplied by the company through prospectus. While framing this document the company must ensure that all relevant facts, which are useful for decision making are printed in the prospectus. The format of prospectus given in Schedule II of the Companies Act, 1956 has been revised. The revised format has been made effective from 1st November, 1991.According to this format companies must fully disclose information regarding the company itself, management, proposed projects, risk factors of the issue etc. The prospectus issued by the companies should provide for following matters:

Matters to be specified. As per revised "Schedule II", a prospectus must contain at least the following particulars:

1. Name and address of registered office of the company.
2. The names and addresses etc., of company promoters and their background.
3. Names and addresses of the company secretary, legal advisor, auditors, lead managers, bankers and brokers to the issue appointed by the company.

Figure 3.28: Name & Address

4. Name and address of the trustee under debenture trust deed (in case of debenture issue).
5. The names, addresses and occupation of important position holders of the company i.e.manager, managing director and other directors (giving their directorships in other companies).
6. The size of present issue for which public will apply giving separately reservation for preferential allotment to promoters and others.
7. The main object for which company is formed,details about company's history and present business
8. The company must mention date of opening and closing of the subscription list and the date of earliest closing of the issue.
9. Company must obtain consent of directors, auditors, solicitors, managers to the issue, bankers to the company, bankers to the issue and experts.
10. Company must provide information about contents of the articles or any contract relating to the appointment of managing director or manager, the remuneration payable to him or them and the compensation, if any, payable to him or them for loss of office.

Figure 3.29: Compensation to Directors

11. Company should also specify amount payable on application and allotment of each share, along with details about availability of forms, prospectus and mode of payment.
12. Company should give details of option to subscribe for securities in the 'depository mode.'
13. The company must explain the procedure and time schedule for allotment and issue of share certificates.

14. The company should also mention rights, privileges and restrictions attached to several classes of shares.
15. Minimum Subscription Clause. The following statements must appear:
    a. For non-underwritten public issues : If the company does not receive the minimum subscription of 90% of the issued amount on the date of closure of the issue, or if the subscription level falls below 90% after the closure of issue on account of cheques having been returned unpaid or withdrawal of applications, the company shall forthwith refund the entire subscription amount received. If there is a delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest for the delayed period at the rate of 15% per annum, as prescribed in Section 73.
    b. For underwritten public issues : If the company does not receive the minimum subscription of 90% of the net offer to public including devolvement of Underwriters within 60 days from the date of closure of the issue, the company shall forthwith refund the entire subscription amount received. If there is delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest for the delayed period at the rate of 15% per annum, as prescribed under Section 73.

16. The names of Regional Stock Exchange and other stock exchange must be given where the company has applied for listing of present issue.
17. The names and addresses of the underwriters, underwritten amount, underwriting commission. A declaration by Board of Directors that the underwriters have sufficient resources to discharge their respective obligations must be attached alongwith.
18. The important details about the project, namely, its location, plant and machinery, technology, process etc.
19. The nature of the product(s) which the company will be dealing in —whether consumer or industrial.
20. Future prospects of the company.
21. Stock exchange quotations—the high/low stock exchange price in each of the last three years and monthly high/low during last six months (where applicable).
22. The company should give details about the particulars of public issues made during the last three years by the company and other listed companies under the same management.
23. Prospectus must also contain particulars of outstanding litigation and criminal prosecution.
24. It should also contain particulars of default, if any, in meeting statutory dues, institutional dues and towards instrument holders like debentures, fixed deposits, etc.

Reports to be included in Prospectus: Following reports must be included in prospectus:

(1) A report by the auditors of the company relating to profits and losses and assets and liabilities of the company, for the last five years.

(2) A report by the auditors of the company with respect to the rates of dividends, if any, paid by the company in respect of each class of shares-for the last five years.

Figure 3.31: Reports

(3) If the company proposes to acquire any business, a report by a Chartered Accountant, whose name should be disclosed in the prospectus, upon the profits and losses and assets and liabilities of the business, for the preceding five years.

(4) A similar report by a Chartered Accountant named in the prospectus, if the proceeds of the issue are to be applied in the acquisition of shares in any other company, about such company.

3.10.2 Statement in Lieu of Prospectus

As discussed earlier, promoters of public company may not invite public to subscribe for shares if promoters are confident that they can manage the funds privately. In that case promoters will have to file a 'statement in lieu of prospectus' instead of prospectus to the registrar for registration. A 'statement in lieu of prospectus' is prepared according to the provisions contained in schedule III of Companies Act. Information which is required to be specified in 'statement in lieu of prospectus' is similar to the information given in prospectus. The only difference is that 'statement in lien of prospectus' is not meant for public. A company can allot shares only when 'statement in lieu of prospectus' is signed by all directors and a copy is filed with the Register. Registrar will register this document and company can allot shares three days after registration of 'statement in lieu of prospectus'.

A private company is not required to prepare 'prospectus' or 'statement in lieu of prospectus' because a private company never invite public to subscribe for shares of the company.

Illustration:
The promoters of Tanmay Ltd. decided to raise funds for the company on their own by borrowing from their friends. Therefore they are not required to issue prospectus But, since it is a public company it has to file 'Statement in lieu of prospectus' and get it registered by the Registrar.

3.10.3 Shelf Prospectus

Companies (Amendment) Act, 2000 has introduced a new concept of 'Shelf Prospectus' in Section 60A of the Act. It defines shelf prospectus as a prospectus 'which is issued by any financial institution or bank for one or more issues of the securities or class of securities specified in that prospectus'. According to section 60A following are the provisions of issue of shelf prospectus:


ICICI Bank

Figure 3.32: Shelf Prospectus of ICICI Bank

1. This prospectus can be issued only by financial institutions or banks i.e. by only those concerns whose business is financing.
2. This shelf prospectus is valid for one year from the date of issue of first prospectus. If within a year a company wants to offer securities to the public then they are not required to prepare fresh prospectus.
3. Within a period of one year of issue of shelf prospectus if a company wishes to offer new securities to the public then company has to file 'information memorandum'. Information memorandum provides updated information about the company. It provides information about new charges created by the company and change in financial position which have occurred between the first offer of securities and current offer.
4. An information memorandum must be issued alongwith shelf prospectus whenever company offer securities to the public.
5. Information memorandum must be updated every time company offer new securities to the public within a period of one year. Prospectus will constitute of two documents ' shelf prospectus' and ' information memorandum'.

Section 60A was introduced because preparation of prospectus is very time consuming process. While preparing prospectus companies have to follow provisions of companies Act and SEBI Guidelines, which requires that all relevant information must be specified in the prospectus. In order to minimize the burden of promoters the companies Act introduced this concept. Public issue which used to be very tedious task now has become much more easier.

3.10.5 Mis-statements in Prospectus

When an investor wants to purchase shares of a company then it is important for him to know whether it is profitable to invest in a company not. He can judge about the profitability of the company only if correct information is supplied to him by the

company. The company provides information by issuing a document called 'Prospects'. Prospectus contains all relevant information which are useful for the investor for decision-making. Since, on the basis of this document only a person purchase shares of

Figure 3.34: Mis-statements in Prospectus

company. Hence, prospectus must not contain any information which is untrue and misleading. A prospectus must fully disclose all material facts about the company. A prospectus should not only state everything correctly, but also, it should not omit any relevant fact which may affect the decision of the investor.

Case law 21

Rex vs. Kylsant - [(1932),1K.B.442]

The company issued a prospectus and all the statements were true. One of statement was that company had been paying dividend regularly at the rate of 5% to 8% for a number of years. But the truth was that company had been incurring trading losses since last seven years from the date of issue of prospectus. The company was paying dividends not from trading profits but out of accumulated earnings. This material fact was not disclosed in the prospectus. Court held that prospects was false because it did not state a fact which should have been disclosed by the managing director and chairman of company, and hence, was guilty of fraud.

If a person applies for the shares of the company on the basis of prospectus and has been allotted shares, and he finds that statement was untrue then remedies available to the investor can be discussed as below:

The person to whom shares have been allotted, who had applied on the faith of prospectus containing untrue statement, then that person can take action against either:

1) The company; or

2) The directors, promoters & experts.

1) Remedies against the company

If a person wants to take action against the company then two options are available to him:

i. Rescind the contract to take the shares.
ii. Claim damages

(i) **Rescind the contract to take the shares**

A shareholder can rescind the contract with the company and can get back his money with interest. A shareholder can do so only if following conditions are satisfied.

- It must be proved that prospectus was issued by the company or by someone authorised by the company in this behalf.
- There must be misstatement in the prospectus. If fact has been omitted, or if it contains misleading statement.
- The misrepresentation in prospectus must be so relevant that it affects the decision of the individual.
- The investor can rescind the contract only if he has purchased shares by relying on the prospectus and not from the open market.
- The investor must take action too rescind the contract within reasonable time and before the company goes into liquidation.

(ii) **Claim Damages:** A shareholder if does not want to rescind the contract then next option available to him is to claim damages from the company. But to claim damages he must prove that misstatement in prospectus was done fraudulently and intentionally to cheat the public. If a shareholder claim damages then he must return the shares to the company and must cancel his membership. Apart from five conditions which we have discussed in 'rescind the contract', three more condition must be fulfilled to claim damages:

Figure 3.35: Claim Damages & Settlement

- The persons acting on behalf of the company acted fraudulently.
- Persons who acted on behalf of the company have the authority to act on behalf of the company.
- The shareholder actually suffered a loss or damages.

2) The second option available to the investor is to take action against directors, promoters and experts. In that case there are three remedies available to him. The shareholder can claim:

i. Compensation for untrue statement (section 62)
ii. Damages for omissions (section 56)
iii. Damages for fraudulent misrepresentation under general law
iv. Criminal Liability

i) **Compensation for untrue statement**
Allottee can claim compensation from the person who were authorised to issue prospectus. Allottee must prove that prospectus contained misleading statement and he had actually suffered a loss. The action for damage must be taken within 3 years from the date of allotment. Allottee can claim compensation from the following persons:

- Every person who is a director of a company at the time of issue of prospects.
- Every person who has authorised himself to be named in the prospects as a director, or as having agreed to become a director, either immediately or after an interval of time.
- Every person who is a promoter of the company; and
- Every person who has authorised the issue of the prospectus.

Section

MPORTANT SECTIONS	
SECTION	**DESCRIPTION**
Sec.15(h) & Sec.19(e)	Pre-incorporation Contracts
Sec.35	Certificate of Incorporation
Sec.69	Minimum Subscription
Sec.13	Contents of Memorandum
Sec.17(1)	Substantive limits of Objects Clause
Sec.31	Alteration of Articles
Sec.60A	Shelf Prospectus
Sec.60B	Information Memorandum
Sec.62	Compensation for untrue statement
Sec.56	Damages for omissions

Formation of a Company and Company Document

Summary

Four stages in Formation of Company

- Promotion
- Incorporation
- Capital Subscription
- Commencement of Business

Duties of a Promoter

- Promoter should not make any secret profit.
- Promoter must disclose all material facts of sale of his property to the proposed company.

Legal Position of Pre-incorporation Contracts

- Position before 1963
- Position after 1963

Contents of Memorandum of Association

- Name Clause
- Registered Office Clause
- Objects Clause
- Liability Clause
- Capital Clause
- Association Clause

Binding effect of Memorandum and Articles

- Company bound to the members
- Members bound to the company
- Members bound to the members
- Company or members bound to the outsiders

Effect of Ultra-vires transactions

- Contract is void
- Injunction
- Personal liability of directors
- Liability of breach of warranty of authority
- Ultra vires acquired property
- Ultra vires contracts

- Ultra vires torts