



**Integrated Professional  
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# **Business Laws, Ethics and Communication**



**Board of Studies**  
**The Institute of Chartered Accountants of India**  
*(Set up by an Act of Parliament)*

# PAPER 2

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## **BUSINESS LAWS, ETHICS AND COMMUNICATION**



**BOARD OF STUDIES  
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA**

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# PREFACE

## **Business Laws, Ethics and Communication**

Laws and rules, in general, regulate the relationship between business and profession. In specific, an accounting student should have knowledge of the legal framework, which influences business transactions. This paper on Law, Ethics and Communication intends to make the students aware of legal background relating to business and company law. Besides, in today's scenario, ethics forms a core part and principle of any profession and it is indeed imperative for the students of Chartered Accountancy to know the value of ethics in business. Further, a student needs to develop good business communication skills and a sound understanding of related legal deeds and documents. The syllabus is, therefore, comprehensive and has been segregated into three parts with Section A covering Business Laws and the Company Law, Section B covering Business Ethics and Section C covering Business Communication. This paper prescribes a working level knowledge of all the segments covered.

## **Part - I**

### **The Scope of Business & Company Law**

The content of this section has been discussed in six chapters, which are as under:

1. **The Indian Contract Act, 1872:** One of the oldest in the Indian law regime, passed by the legislature of pre-independence India, it received its assent on 25<sup>th</sup> April 1872. The statute contains essential principles for formation of contract along with law relating to indemnity, guarantee, bailment, pledge and agency. The Law of Contracts does not involve or bind the state or persons that are not parties to the contract. It is, therefore, said to be a part of "Private Law". It contains a number of limiting principles subject to which the parties may create rights and duties for themselves. Hence, contracts are voluntary and require an exercise of the will of the parties.

2. **The Negotiable Instruments Act, 1881:** History of negotiable instruments began in England as "bills of exchange" whereby merchants were able to exchange money while keeping their money safe in the banks. A "negotiable instrument" is a signed writing containing an unconditional promise to pay an exact sum of money. It includes bill of exchange, cheque, promissory note, or other written contract for payment that may serve as a substitute for money. It is simple in form and easy to transfer. Transfer of a negotiable instrument, accomplished by delivery or endorsement and delivery, gives the new holder of the contract the right to enforce fulfillment in his own name. Negotiable instruments made payable to bearer is transferred by delivery; those made payable to order are transferred by endorsement and delivery. Like commercial paper, negotiable instruments were developed to meet the needs of trade. They are used by businessmen to facilitate long-distance transactions and to avoid the cash transactions.

This Act, based on the English common law, came into force on the first day of March 1882. Negotiable Instruments Act 1881 has been amended several times incorporating requisite provisions. Recently, the Act was amended by Negotiable Instruments (Amendments and Miscellaneous Provisions) Act, 2002 and the same has been included in the study material.

3. **The Payment of Bonus Act, 1965:** The term Bonus means extra amount in money, bonds or goods over what is normally due. The term is applied especially to payments to employees either for production in excess of the normal (wage incentive) or as a share of surplus profits. The wage incentive was designed during the late 19th century not only to increase production but also to reward the more skillful and energetic workers.

The Payment of Bonus Act, 1965 intends to provide for the payment of bonus to persons employed in certain establishments and for matters connected therewith. It came into force on September 25, 1965.

4. **The Employees Provident Fund & Miscellaneous Provisions Act, 1952:** The EPF & MP Act, 1952 was enacted by Parliament and came into effect from March 14, 1952. This Act was moved by the State to ensure welfare measures for labourers. The Directive Principles of State Policy under the Constitution of India provides that the State shall, within the limits of its economic capacity, make effective provision for securing the right to work, to education and to public assistance in cases of unemployment, old-age, sickness & disablement and undeserved want. As the Act carries great importance in providing welfare measures to employees in an organization, students of the noble profession of Chartered Accountancy should know the mechanism of this statute. Recently, the Government has increased the EPF interest rate further to 9.5%.

5. **The Payment of Gratuity Act, 1972:** Gratuity is an amount (as a lump sum payment) which is paid by an employer to his employee for his past services when the employment is terminated. When the employment comes to an end due to the retirement or superannuation of the workers, it becomes a good help to the workers; it becomes a good help to the affected employee to meet the new situation, which often comes due to reduction in regular earnings or even total stoppage of earnings. In case of death of the worker, it provides financial assistance to the members of his family for their survival, if they have no other means for support. Thus, this gratuity scheme serves as an instrument of social security as well as a reward to a person who sacrifices his whole life for the betterment, development and prosperity of an establishment and thereby for the Nation. The Payment of Gratuity Act came into force on 16<sup>th</sup> September, 1972.

## **COMPANY LAW**

With the intention of giving first hand working exposure in Company Law, a few chapters of the Companies Act, 1956 from Section 1 to 197 are covered. Students, at this level, have to gain a working knowledge of the provisions of the Companies Act, 1956.

## **Developments in the Companies Act, 1956**

The Companies Act has undergone drastic changes recently in tune with the international developments and reforms in the corporate law regime. Many of the relevant corporate laws witnessed several changes to bring more transparency, disciplined governance, simplification and rationalization of laws and procedure.

**Concept Paper on Company Law:** The Government has undertaken an exercise to revise the Companies Act, 1956 so as to simplify the law in order to address the changes that are taking place in the national and international scenario. It has brought out a Concept Paper on Company Law.

The approach given in the Concept Paper specifies the following objects:

- (a) To bring the Corporate Laws in consonance with the changes that has occurred in the area of economic development.
- (b) To delete the redundant provisions and to regroup the scattered provisions relating to specific subjects.
- (c) To condense, simplify and rationalize the provisions of company law.
- (d) To delink the procedural aspects from the substantive law.
- (e) To give an overview of the form of the re-codified Companies Bill containing only 289 sections and a few schedules in place of existing 781 sections and 15 schedules.

An Expert Committee under the Chairmanship of Dr. J. J. Irani has been constituted to advise the Government on the new Company Law and a new Bill on Company Law is expected to be introduced in Parliament. On passage of the Bill, it will usher in a new era in the history of company law in India.

**The Companies (Second Amendment) Act, 2002:** All the provisions of this amendment Act has not yet come into force. However, Section 2 on amended definitions, and Section 6 relating to formation/constitution and powers of National Company Law Tribunal and Appellate Tribunal came into force with effect from 1<sup>st</sup> April 2003 and the same has been included in this study material.

## **The Companies (Amendment) Act, 2006**

In context of the rapid developments witnessed in technology, the Ministry of Company Affairs decided to (carried out so far by the Ministry and its field offices) take recourse to the use of contemporary information technology and computers. It was felt that the earlier efforts at computerization had not yielded the desired efficiency in operation of the system and an operating system that took into account contemporary technology was necessary. Therefore, it was decided to implement a comprehensive e-governance system and programme (MCA 21) to achieve the above objective. To enable the students to have an understanding of the programme, a chapter – *Company Law in a Computerized Environment* has been included.

## **Part - II**

### **Ethics**

The world community is earnestly and eagerly seeking answers to fundamental questions relating to ethics and morality in the conduct of businesses especially in the light of corporate frauds that has been taking place from time to time. All professionals play a dual role i.e. being the principal and an agent to their customers in discharge of their functions. Often, there is a conflict of interests in every aspect of professional life, which represents an ethical dilemma or *dharmasankat*, and it arises fundamentally due to conflicting roles played by individuals and institutions. The emphasis is how to live and deal effectively with such situations. A number of factors such as natural environment, work culture, protecting the consumers at large and issues revolving around accounting and finance principles come into consideration and, therefore, it is important to understand the ethical issues in business and to know how to resolve them.

As part of the learning process, the students in this section are exposed to an introduction to business ethics, corporate governance, corporate social responsibility, and issues relating to environment, ethics in workplace, marketing, accounting, finance and protection of consumer.

## **Part - III**

### **Communication**

Communication is a sine qua non for any business activity. With the emergence of new technological advances in information and knowledge, an important skill that is required is creating an environment that enables the business to connect and have contacts with its stakeholders. To build long lasting business relationships with the customers, communication should be clear, crisp and with clarity. To achieve success, professionals need to assess and respond to communication situations that occur constantly. Business Communication usually starting with oral form need to be materialized in a written form in the form of deeds and documents for which model varies with the nature of agreement. This section introduces the students to the elements of communication, communication in business environment and the preparation of legal deeds and documents.

# SYLLABUS

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## PAPER – 2 : BUSINESS LAWS, ETHICS AND COMMUNICATION

*(One paper – Three hours – 100 Marks)*

**Level of Knowledge:** Working knowledge

### **PART I – BUSINESS LAWS ( 60 MARKS )**

#### **Objective:**

To test working knowledge of business laws and company law and their practical application in commercial situations.

#### **Contents**

##### **Business Laws (30 Marks)**

1. The Indian Contract Act, 1872
2. The Negotiable Instruments Act, 1881
3. The Payment of Bonus Act, 1965
4. The Employees' Provident Fund and Miscellaneous Provisions Act, 1952
5. The Payment of Gratuity Act, 1972.

##### **Company Law (30 Marks)**

The Companies Act, 1956 – Sections 1 to 197

- (a) Preliminary
- (b) Board of Company Law Administration — National Company Law Tribunal; Appellate Tribunal
- (c) Incorporation of Company and Matters Incidental thereto
- (d) Prospectus and Allotment, and other matters relating to use of Shares or Debentures
- (e) Share Capital and Debentures
- (f) Registration of Charges



- (g) Management and Administration – General Provisions – Registered office and name, Restrictions on commencement of business, Registers of members and debentures holders, Foreign registers of members or debenture holders, Annual returns, General provisions regarding registers and returns, Meetings and proceedings.
- (h) Company Law in a computerized Environment – E-filing.

**Note:** If new legislations are enacted in place of the existing legislations, the syllabus would include the corresponding provisions of such new legislations with effect from a date notified by the Institute.

## **Part II – : ETHICS (20 Marks)**

### **Objective:**

To have an understanding of ethical issues in business.

### **Contents:**

#### **1. Introduction to Business Ethics**

The nature, purpose of ethics and morals for organizational interests; Ethics and Conflicts of Interests; Ethical and Social Implications of business policies and decisions; Corporate Social Responsibility; Ethical issues in Corporate Governance.

#### **2. Environment issues**

Protecting the Natural Environment – Prevention of Pollution and Depletion of Natural Resources; Conservation of Natural Resources.

#### **3. Ethics in Workplace**

Individual in the organisation, discrimination, harassment, gender equality.

#### **4. Ethics in Marketing and Consumer Protection**

Healthy competition and protecting consumer's interest.

#### **5. Ethics in Accounting and Finance**

Importance, issues and common problems.

### **Part III – COMMUNICATION (20 Marks)**

**Objective:**

To nurture and develop the communication and behavioural skills relating to business

**Contents:**

**1. Elements of Communication**

- (a) Forms of Communication: Formal and Informal, Interdepartmental, Verbal and non-verbal; Active listening and critical thinking
- (b) Presentation skills including conducting meeting, press conference
- (c) Planning and Composing Business messages
- (d) Communication channels
- (e) Communicating Corporate culture, change, innovative spirits
- (f) Communication breakdowns
- (g) Communication ethics
- (h) Groups dynamics; handling group conflicts, consensus building; influencing and persuasion skills; Negotiating and bargaining
- (i) Emotional intelligence - Emotional Quotient
- (j) Soft skills – personality traits; Interpersonal skills ; leadership

**2. Communication in Business Environment**

- (a) Business Meetings – Notice, Agenda, Minutes, Chairperson’s speech
- (b) Press releases
- (c) Corporate announcements by stock exchanges
- (d) Reporting of proceedings of a meeting

**3. Basic understanding of legal deeds and documents**

- (a) Partnership deed
- (b) Power of Attorney
- (c) Lease deed
- (d) Affidavit
- (e) Indemnity bond
- (f) Gift deed
- (g) Memorandum and articles of association of a company
- (h) Annual Report of a company

# **BUSINESS LAWS, ETHICS AND COMMUNICATION**

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**PART I**

**BUSINESS**

**LAWS**

# CHAPTER 1

## THE INDIAN CONTRACT ACT, 1872

### UNIT - I : BACKGROUND

#### Learning objectives

After studying this unit, you would be able to -

- ◆ Understand the meaning of the terms 'agreement' and 'contract' and note the distinction between the two.
- ◆ Note the essential elements of a contract.
- ◆ Be clear about various types of contract.
- ◆ Understand the concept of offer and acceptance and rules of communication and revocation thereof.

Any commercial activity requires 'understanding' among people concerned. This understanding is often reduced into writing to give effect to the intention of the parties. Such formal versions are known as contracts. These contracts define the rights and obligations of various parties to facilitate easy performance of the contractual obligations.

The Indian Contract Act 1872 codifies the legal principles that govern such 'contracts'. The Act basically identifies the ingredients of a legally enforceable valid contract in addition to dealing with certain special type of contractual relationships like indemnity, guarantee, bailment, pledge, quasi contracts, contingent contracts etc.

#### 1.1 WHAT IS A CONTRACT?

While all contracts are agreements, all agreements are not contracts. An agreement which is legally enforceable alone is a contract. Agreements which are not legally enforceable are not contracts but remain as void agreements which are not enforceable at all or as voidable agreements which are enforceable by only one of the parties to the agreement.

The above observation would raise a question in our minds as to what is the exact meaning of the words 'agreements' and 'contracts'.

An Agreement is a promise or a commitment or set of reciprocal promises or commitments. An Agreement involves an offer or proposal by one person and acceptance of such offer or

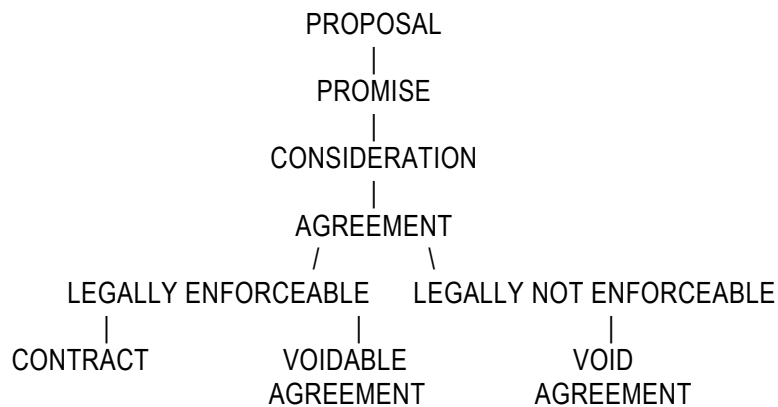


proposal by another person. If the agreement is capable of being enforced by law then it is a contract.

Now let us take a look at the definitions as per the Act. Section 2[b] while defining a 'promise' provides that "when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. Proposal when accepted becomes a promise".

Section 2[e] of the Act defines an agreements as 'every promise and every set of promises forming consideration for each other. Section 2[h] of the defines the term contract as "an agreement enforceable by law".

The above discussion can be diagrammatically represented as follows:



## 1.2 ESSENTIALS OF A VALID CONTRACT

Now let us discuss the various essential elements of a valid contract.

In terms of Section 10 of the Act, "all agreements are contracts 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".

Thus in order to create a valid contract, the following elements should be present

1. Intention to create legal obligation through offer and acceptance should be present.
2. Free consent of the parties is necessary.
3. Competency or capacity to enter into contract must be ensured.
4. Lawful consideration should be present and
5. Lawful object should be the subject matter of contract.



The above important elements may be further analysed as under:

1. In the first place, there must be an offer and the said offer must have been accepted. Such offer and acceptance should create legal obligations between parties. This should result in a moral duty on the person who promises or offers to do something. Similarly this should also give a right to the promisee to claim its fulfillment. Such duties and rights should be legal and not merely moral.

*Case law:*

In *Balfour v. Balfour*, a husband promised to pay maintenance allowance every month to his wife, so long as they remain separate. When he failed to perform this promise, she brought an action to enforce it. As it is an agreement of domestic nature, it was held that it does not contemplate to create any legal obligation.

2. The second element is the 'consent' of the parties. 'Consent' means 'knowledge and approval' of the parties concerned. This can also be understood as identity of minds in understanding the term viz consensus ad idem. Further such a consent must be free. Consent would be considered as free consent if it is not vitiated by coercion, undue influence, fraud, misrepresentation or mistake. Wherever the consent of any party is not free, the contract is voidable at the option of that party.

*Illustration:-* A threatened to shoot B if he (B) does not lend him Rs. 2000 and B agreed to it. Here the agreement is entered into under coercion and hence voidable at the option of B.

1. The third element is the capacity of the parties to make a valid contract. Capacity or incapacity of a person could be decided only after reckoning various factors. Section 11 of the Indian Contract Act elaborates on the issue by providing that a person who

- (a) has not attained the age of majority,
- (b) is of unsound mind and
- (c) is disqualified from entering into a contract by any law to which he is subject,

should be considered as not competent to enter into any contract. Therefore law prohibits (a) Minors (b) persons of unsound mind [excluding the Lucid intervals] and (c) person who are otherwise disqualified like an alien enemy, insolvents, convicts etc from entering into any contract.

2. The fourth element is presence of a lawful 'consideration'. 'Consideration' would generally mean 'compensation' for doing or omitting to do an act or deed. It is also referred to as 'quid pro quo' viz 'something' in return for another thing'. Such a consideration should be a lawful consideration.

*Example:-* A agrees to sell his books to B for Rs.100, B's promise to pay Rs. 100 is the consideration for A's promise to sell his books and A's promise to sell the books is the consideration for B's promise to pay Rs.100.



3. The last element to clinch a contract is that the agreement entered into for this purpose must not be which the law declares to be either illegal or void. An illegal agreement is an agreement expressly or impliedly prohibited by law. A void agreement is one without any legal effects.

For Example: Threat to commit murder or making/publishing defamatory statements or entering into agreements which are opposed to public policy are illegal in nature. Similarly any agreement in restraint of trade, marriage, legal proceedings etc are classic examples of void agreements.

### **1.3 TYPES OF CONTRACT**

Now let us discuss various types of contracts

#### **1. Void Contracts**

Section 2 (j) states as follows: "A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable". Thus a void contract is one which cannot be enforced by a court of law.

Examples : There are a number of agreements, which are specifically identified by the Act itself as void. These are

- (a) Where both parties to an agreement are under a mistake of fact [Section 20]
- (b) When the consideration or object of an agreement is unlawful [Section 23],
- (c) An agreement without consideration [Section 25],
- (d) An agreement in restraint of- marriage [Section 26], trade [Section 27], legal proceedings [Section 28] and agreement by way of wager [Section 30] are instances of void contract.

It may be added by way of clarification here that when a contract is void, it is not a contract at all but for the purpose of identifying it , it has to be called a [void] contract.

#### **2. Voidable Contract**

Section 2[i] defines a voidable agreement which is enforceable by law at the option of one or more parties but not at the option of the other or others is a voidable contract.

This in effect means where one of the parties to the agreement is in a position or is legally entitled or authorized to avoid performing his part, then the agreement is treated and becomes voidable. Such a right might arise from the fact that the contract may have been brought about by one of the parties by coercion, undue influence, fraud or misrepresentation and hence the other party has a right to treat it as a voidable contract.

At this juncture it would be desirable to know the distinction between a void contract and a voidable contract. The distinctions lie in three aspects namely definition, nature and rights. These are elaborated hereunder



**(a) Definition**

A void contract cannot be enforced at all. A voidable contract [is an agreement] which is enforceable only at the option of one of the parties but not at the option of the other. Therefore 'enforceability' or otherwise, divides the two types of contracts.

**(b) Nature**

By nature, a void contract is valid at the time when it is made but becomes unenforceable and thus void on account of subsequent developments or events like supervening impossibility, subsequent illegality etc., Repudiation of a voidable contract also renders the contract void. Similarly a contingent contract might become void when the occurrence of the event on which it is contingent becomes impossible.

On the other hand voidable contract would remain valid until it is rescinded by the person who has the option to treat it as voidable. The right to treat it as voidable does not invalidate the contract until such right is exercised. All contracts caused by coercion, undue influence, fraud, misrepresentation are voidable. Generally, a contract caused by mistake is void.

**(c) Rights**

As regards rights of the parties, in the case of a void contract there is no legal remedy for the parties as the contract cannot be performed in any way. In the case of voidable contract the aggrieved party has a right to rescind it within a reasonable time. If it is so rescinded, it becomes void. If it is not rescinded it is a valid contract.

**3. Illegal Contracts**

Illegal contracts are those that are forbidden by law. All illegal contracts are hence void also. Because of the illegality of their nature they cannot be enforced by any court of law. In fact even associated contracts cannot be enforced. Contracts which are opposed to public policy or immoral are illegal. Similarly contracts to commit crime like **supari** contracts are illegal contracts.

The above discussion shows that illegal contracts are at par with void contracts. The Act specifies several factors which would render an agreement void. One such factor is unlawful nature of contract or the consideration meant for it. Though illegal agreements and void agreements appear similar they differ in the following manner:

- (a) *Scope:* All illegal agreements are void. However void agreements might not be illegal at the time of entering but would have become void because of some other factors. For example, where the terms of the agreement are uncertain the agreement would not be illegal but might be treated as void. An illegal contract would encompass a void contract where as a void contract may not include in its scope illegal contracts.





- (b) *Nature and character:* Illegal agreements are void since the very beginning they are invariably described as void ab initio. As already emphasized under the scope, a contract by nature, which is valid, can subsequently change its character and can become void.
- (c) *Effect on collateral transactions:* In the case of illegal contract, even the collateral transactions namely transactions which are to be complied with before or after or concurrently along with main contract also become not enforceable. In contrast in the case of voidable contracts the collateral transactions can be enforced despite the fact that the main contract may have become voidable, to the extent the collateral transactions are capable of being performed independently.
- (d) *Penalty or punishment:* All illegal agreements are punishable under different laws say like Indian Penal Code etc. Whereas parties to void agreements do not face such penalties or punishments.

Further classification of contracts according to the formation is also possible. Under this sub-classification the following contracts fall:

#### **4. Express Contracts**

A contract would be an express contract if the terms are expressed by words or in writing. Section 9 of the Act provides that if a proposal or its acceptance of any promise is made (even) in words the promise is said to be express.

#### **5. Implied Contracts**

Implied contracts in contrast come into existence by implication. Most often the implication is by law and or by action. Section 9 of the Act contemplates such implied contracts when it lays down that in so far as such proposal or acceptance is made otherwise than words, the promise is said to be implied. For instance 'A' delivers goods by mistake at the warehouse of 'B' instead of that of 'C'. Here 'B' not being entitled to receive the goods is obliged to return the goods to 'A' although there was no such contract to that effect.

#### **6. Tacit Contracts**

Tacit contracts are those that are inferred through the conduct of parties. A classic example of tacit contract would be when cash is withdrawn by a customer of a bank from the automatic teller machine [ATM]. Another example is where a contract is assumed to have been entered into with taciturnity when a sale is given effect to at the fall of hammer in an auction sale.

Further classification of contracts is possible on the basis of their performance. They are:



### 7. Executed Contract

The consideration in a given contract could be an act or forbearance. When the act is done or executed or the forbearance is brought on record, then the contract is an executed contract.

### 8. Executory Contract

In an executory contract the consideration is reciprocal promise or obligation. Such consideration is to be performed in future only and therefore these contracts are described as executory contracts.

### 9. Unilateral Contract

Unilateral contracts is a one sided contract in which only one party has to perform his duty or obligation.

### 10. Bilateral Contracts

A Bilateral contract is one where the obligation or promise is outstanding on the part of both the parties.

Now let us take a look at yet another type of classification of contracts from the view point of English Law.

The English law classifies contracts as (i) Formal contracts and (ii) Simple contracts.

Formal contracts are further classified as (a) contract of record and (b) contract under seal.

**(a) Contract of record:** A contract of record derives its binding force from the authority of court. The authority of court is invariably through judgment of a court or by way of recognizance. The judgment of a court is technically not a contract as it is not based on the agreement between parties. However the judgment is binding on all the persons who are litigants. The judgment creates certain rights on certain persons and obligation on certain other persons. A recognizance, on the other hand is a written acknowledgement of a debt due to the state generally in the context of criminal proceedings.

**(b) Contract under seal:** A contract under seal is one which derives its binding force from its form alone. It is in writing, duly signed and sealed and delivered to parties. It is also referred to as a deed or a specialty contract.

Simple contracts as against formal contracts are devoid of all the formalities referred above.

## 1.4 PROPOSAL / OFFER

It has been explained in the previous paragraphs that a proposal or a promise backed by legal consideration is an agreement and such an agreement, if legally enforceable, becomes a contract. It would therefore be clear that the starting point of this chain is a proposal or a promise. It is proposed now to discuss as to what is a proposal/offer, what are the types of offer, etc.



The word 'proposal' and the word 'offer' mean one and the same thing and therefore are used interchangeably. In terms of Section 2(a) of the Act "a person is said to make a proposal when he signifies to another his willingness to do or abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence". It must be appreciated that 'doing' an act and 'not doing an act' both have the same effect in the eyes of the law, though one is a positive act and the other is a negative act.

Hence there are two important ingredients to an offer. Firstly, it must be expressions of willingness to do or to abstain from doing an act. Secondly the willingness must be expressed with a view to obtain the assent of the other party to whom the offer is made.

This can be illustrated as follows:

- (a) Where "A" tells "B" that he desires to marry 'B' by the end of 2006, there is no offer made unless, he also asks "will you marry me?", conveying his willingness and tries to obtain the assent of 'B' in the same breadth.
- (b) Where "A" offers to sell his car to "B" it conveys his willingness to do an act. Through this offer not only willingness is being conveyed but also an intention to obtain the assent can be seen.

#### **Classification of offer**

Offer can be classified as general offer, special offer, cross offer, counter offer, standing/open/continuing offer. Now let us examine each one of them.

**(a) General Offer:** It is an offer made to public at large with or without any time limit. In terms of Section 8 of the Act anyone performing the conditions of the offer can be considered to have accepted the offer (*Carlill v. Carbolic Smoke Ball*). Until the general offer is retracted or withdrawn, it can be accepted by anyone at any time as it is a continuing offer.

**(b) Special offer:** Where an offer is made to a particular and specified person, it is a specific offer. Only that person can accept such specific offer, as it is special and exclusive to him. [*Bottom v. Johns*]

#### **(c) Cross offer**

As per section 2(b), when a person to whom proposal (offer) is made signifies his assent, the proposal is said to be accepted. Thus, assent can be only to a 'proposal'. If there was no proposal, question of its acceptance cannot arise. For example, if A makes a proposal to B to sell some goods at a specified price and B, without knowing proposal of A, makes a proposal to purchase the same goods at the price specified in the proposal of A, it is not an acceptance, as B was not aware of proposal made by A. It is only cross proposal (cross offer). And when two persons make offer to each other, it can not be treated as mutual acceptance. There is no binding contract in such a case [*Tin v. Haffmen & co. 1873*]



**(d) Counter offer:** Upon receipt of an offer from an offeror, if the offeree instead of accepting it straightway, imposes conditions which have the effect of modifying or varying the offer, he is said to have made a counter offer. Counter offers amounts to rejection of original offer.

**(e) Standing or continuing or open offer:** An offer which is made to public at large and if it is kept open for public acceptance for a certain period of time, it is known as standing or continuing or open offer. Tenders that are invited for supply of materials and goods are classic examples of standing offer.

#### **Rules relating to offer**

Following are the rules for a valid and legal offer:

- (a) The 'offer' must be with intent to create a legal relationship. Hence if it is accepted, it must result in a valid contract. An invitation to join a friend for dinner is a social activity. This does not create a legal relationship or right or obligation.
- (b) The offer must be certain and definite. It must not be vague. If the terms are vague, it is not capable of being accepted as the vagueness would not create any contractual relationship. For Example, where 'A' offers to sell 100 quintals of oil, without indicating what kind of oil would be sold, it is a vague offer and hence cannot create any contractual relationship. If however there is a mechanism to end the vagueness, the offer can be treated as valid. For example, in the above example if 'A' does not deal in any oil but only in gingilee oil and this is known to every one, the offer cannot be treated as vague offer. This is for the reason that the trade in which 'A' is, is a clear indicator providing a mechanism to understand the terms of offer.
- (c) The offer must be express or implied.
- (d) The offer must be distinguished from an invitation to offer.
- (e) The offer must be either specific or general.
- (f) The offer must be communicated to the person to whom it is made. Otherwise the offeree cannot accept the offer. He cannot accept the offer because he is not aware of the existence of the offer. Such a situation does not create any legal obligation or right on any one.
- (g) The offer must be made with a view to obtaining the consent of the offeree.
- (h) An offer can be conditional but there should be no term in the offer that non-compliance would amount to acceptance. Thus the offeror cannot say that if non-acceptance is not communicated by a certain time the offer would be treated as accepted.



### **WHAT IS INVITATION TO OFFER?**

An offer and invitation to offer are not one and the same. The difference between the two must be appreciated. An offer is definite. It is an intention towards a contract. An invitation to offer is an act precedent to making an offer. It is done with intent to generally to induce and negotiate. An invitation to offer gives rise to an offer after due negotiation and it cannot be per se accepted.

In an invitation to offer there is no expression of willingness by the offeror to be bound by his offer. It is only a proposal of certain terms on which he is willing to negotiate. It is not capable of being accepted as it is.

When there is advertisement by a person he has a stock of books for sale, it is an invitation to offer and not an offer. This advertisement is made to receive offers and to further negotiate.

In terms of Section 2[a] of the Act, it is very clear that an offer is the final expression of willingness by the offeror to be bound by the offer if it is accepted by the other party. Hence the only thing that is required is the willingness of the offeree to abide by the terms of offer.

The test to decide whether a statement is an offer invitation to offer is to see the 'intention'. If a person who makes the statement has the intention to be bound by it as soon as the other accepts, he is making an offer. If he however intends to do some other act, he is making only an invitation to offer. Thus the intention to be bound is the important thing, which is to be seen.

In *Harvey vs. Face* [1893] AC 552 Privy Council succinctly explained the distinction between an offer and an invitation to offer. In the given case, the plaintiffs through a telegram asked the defendants two questions namely,

- (i) Will you sell us Bumper Hall Pen? and
- (ii) Telegraph lowest cash price.

The defendants replied through telegram that the "lowest price fro Bumper Hall Pen is £900". The plaintiffs sent another telegram stating "we agree to buy Bumper Hall Pen at £900..." However the defendants refused to sell the property at the price.

The plaintiffs sued the defendants contending that they had made an offer to sell the property at £900 and therefore they are bound by the offer.

However the Privy Council did not agree with the plaintiffs on the ground that while plaintiffs had asked two questions, the defendant replied only to the second question by quoting the price but did not answer the first question but reserved their answer with regard to their willingness to sell. Thus they made no offer at all. Their Lordships held that the mere statement of the lowest price at which the vendor would sell contained no implied contract to sell to the person who had enquired about the price.



The above decision was followed in *Mac Pherson vs Appanna* [1951] A.S.C. 184 where the owner of the property had said that he would not accept less than Rs.6000/- for it. This statement did not indicate any offer but indicated only an invitation to offer.

Similarly when goods are sold through auction, the auctioneer does not contract with any one who attends the sale. The auction is only an advertisement to sell but the items are not put for sale though persons who have come to the auction may have the intention to purchase.

Following are instances of invitation to offer to buy or sell:

- (i) An invitation by a company to the public to subscribe for its shares.
- (ii) Display of goods for sale in shop windows.
- (iii) Advertising auction sales and
- (iv) Quotation of prices sent in reply to a query regarding price.

### 1.5 ACCEPTANCE

The significance of “acceptance of a proposal so as to form an agreement has been discussed in previous paragraphs. Let us analyse various issues concerning ‘acceptance’ now,

Meaning: In terms of Section 2(b) of the Act, “ A proposal or offer is said to have been accepted when the person to whom the proposal is made signifies his assent to the proposal to do or not to do something”. In short, act of acceptance lies in signifying one’s assent to the proposal.

#### Relationship between offer and acceptance

According to Sir William Anson “**Acceptance is to offer what a lighted match is to a train of gun powder**”. The effect of this observation is that what acceptance triggers cannot be recalled or undone. But there is a choice to the person who had the train to remove it before the match is applied. It in effect means that the offer can be withdrawn just before it is accepted. Acceptance converts the offer into a promise and then it is too late to revoke it. This means as soon as the train of gun powder is lighted it would explode. Gun powder [the train] itself is inert, but it is the lighted match [the acceptance] which causes the gun powder to explode. The significance of this is an offer by itself cannot create any legal relationship but it is the acceptance by the offeree which creates a legal relationship. Once an offer is accepted it becomes a promise and cannot be withdrawn or revoked. An offer remains an offer so long as it is not accepted, but becomes a contract as soon as it is accepted.

#### Rules governing acceptance

##### (1) Acceptance must be absolute and unqualified:

As per Section 7 of the Act, acceptance is valid only when it is absolute and unqualified and is also expressed in some usual and reasonable manner unless the proposal prescribes the



manner in which it must be accepted. If the proposal prescribes the manner in which it must be accepted, then it must be accepted accordingly. The above view will be clear from the following example:

'A' enquires from 'B', "Will you purchase my car for Rs. 2 lakhs?" If 'B' replies "I shall purchase your car for Rs.2lakhs, if you buy my motorcycle for Rs. 50000/-, here 'B' cannot be considered to have accepted the proposal. If on the other hand 'B' agrees to purchase the car from 'A' as per his proposal subject to availability of valid Registration Certificate / book for the car, then the acceptance is in place though the offer contained no mention of R.C. book. This is because expecting a valid title for the car is not a condition. Therefore the acceptance in this case is unconditional.

**(2) The acceptance must be communicated**

To conclude a contract between the parties, the acceptance must be communicated in some perceptible form. Any conditional acceptance or acceptance with varying or too deviant conditions is no acceptance. Such conditional acceptance is a counter proposal and has to be accepted by the proposer, if the original proposal has to materialize into a contract. Further when a proposal is accepted, the offeree must have the knowledge of the offer made to him. If he does not have the knowledge, there can be no acceptance. The acceptance must relate specifically to the offer made. Then only it can materialize into a contract. The above points will be clearer from the following examples,

- (a) M offered to sell his land to N for £ 280. N replied purporting to accept the offer but enclosed a cheque for £ 80 only. He promised to pay the balance of £ 200 by monthly installments of £ 50 each. It was held that N could not enforce his acceptance because it was not an unqualified one. [Neale vs. Merret [1930] W. N. 189].
- (b) A offers to sell his house to B for Rs. 1000/-. B replied that, " I can pay Rs.800 for it. The offer of 'A' is rejected by 'B' as the acceptance is not unqualified. B however changes his mind and is prepared to pay Rs.1000/-. This is also treated as counter offer and it is upto A whether to accept it or not. [Union of India v. Bahulal AIR 1968 Bombay 294].

A mere variation in the language not involving any difference in substance would not make the acceptance ineffective. [Heyworth vs. Knight [1864] 144 ER 120].

**(3) Acceptance must be in the prescribed mode:**

Where the proposal prescribes the mode of acceptance, it must be accepted in that manner. Where the proposal does not prescribe the manner, then it must be accepted in a reasonable manner. If the proposer does not insist on the proposal being accepted in the manner in which it has to be accepted, after it is accepted in any other manner not originally prescribed, the proposer is presumed to have consented to the acceptance. Sometimes the acceptor may agree to a proposal but may insist on a formal agreement, in which case until a formal agreement is drawn up there is no complete acceptance.



- (4) The acceptance must be given within a reasonable time and before the offer lapses.
- (5) Mere silence is not acceptance. The acceptor should expressly accept the offer. Acceptance can be implied also. Acceptance must be given only by that person to whom it is made, that too only after knowing about the offer made to him.
- (6) **Acceptance by conduct:**

As already elaborated above, acceptance has to be signified either in writing or by word of mouth or by performance of some act. The last of the method, namely 'by some act' has to be understood as acceptance by conduct. In a case like this where a person performs the act intended by the proposer as the consideration for the promise offered by him, the performance of the act constitutes acceptance. In other words, there is an acceptance by conduct.

For example, where a tradesman receives an order from a customer, and the order is executed accordingly by the trader, there is an "acceptance by conduct" of the offer made by the customer. The trader's subsequent act signifies acceptance.

Section 8 of the Act very clearly in this regard lays down that " the performance of the conditions(s) of a proposal or the acceptance of any consideration of a reciprocal promise which may be offered with a proposal constitutes an acceptance of the proposal.

## **1.6 COMMUNICATION OF OFFER AND ACCEPTANCE**

The importance of 'offer' and 'acceptance' in giving effect to a valid contract was explained in the previous paragraphs. One important common requirement for both 'offer' and 'acceptance' is their effective communication. Effective and proper communication prevents avoidable revocation and misunderstanding between parties. The communication part of it assumes importance because parties are separated by and distance. In which case the modes of communication like, post/courier, telegram, fax, email, telephone etc., become very relevant because the method of communication would also decide the 'time' of 'offer' and 'acceptance'. The Act gives a lot of importance to "time" element in deciding when the offer and acceptance is complete.

### **Communication of offer:**

In terms of Section 4 of the Act, " the communication of offer is complete when it comes to the knowledge of the person to whom it is made". Therefore knowledge of communication is of relevance. Knowledge of the offer would materialize when the offer is given in writing or made by word of mouth or by some other conduct. This can be explained by an example. Where 'A' makes a proposal to 'B' by post to sell his house for Rs. 5 lakhs and if the letter containing the offer is posted on 10<sup>th</sup> March and if that letter reaches 'B' on 12<sup>th</sup> March the offer is said to have been communicated on 12<sup>th</sup> March when B received the letter. Thus it can be summed up that when a proposal is made by post, its communication will be complete when the letter containing the proposal reaches the person to whom it is made.





**Communication of acceptance:**

There are two issues for discussion and understanding. They are: what are the modes of acceptance and when is acceptance complete?

Let us first consider the modes of acceptance. Section 3 of the Act prescribes in general terms two modes of communication namely, (a) by any act and (b) by omission, intending thereby to, to communicate to the other or which has the effect of communicating it to the other.

Communication by act would include any expression of words whether written or oral. Written words will include letters, telegrams, faxes, emails and even advertisements. Oral words will include telephone messages. Again communication would include any conduct intended to communicate like positive acts or signs so that the other person understands what the person 'acting' or 'making signs' means to say or convey.

Communication can also be by 'omission' to do any or something. Such omission is conveyed by a conduct or by forbearance on the part of one person to convey his willingness or assent. However silence would not be treated as communication by 'omission'

Communication of acceptance is also done by conduct. For instance, delivery of goods at a price by a seller to a willing buyer will be understood as a communication by conduct to convey acceptance. Similarly one need not explain why one boards a public bus or drop a coin in a weighing machine. The first act is a conduct of acceptance and its communication to the offer by the public transport authority to carry any passenger. The second act is again a conduct conveying acceptance to use the weighing machine kept by the vending company as an offer to render that service for a consideration.

The other issue in communication of acceptance is about the effect of act or omission or conduct. These indirect efforts must result in effectively communicating its acceptance or non acceptance. If it has no such effect, there is no communication regardless of which the acceptor thinks about the offer within himself. Thus a mere mental unilateral assent in one's own mind would not amount to communication. Where a resolution passed by a bank to sell land to 'A' remained uncommunicated to 'A', it was held that there was no communication and hence no contract. [Central Bank Yeotmal vs Vyankatesh (1949) A. Nag. 286].

Let us now come to the issue of when communication of acceptance is complete. In terms of Section 4 of the Act, it is complete,

- (i) As against the proposer, when it is put in course of transmission to him so as to be out of the power of the acceptor to withdraw the same;
- (ii) As against the acceptor, when it comes to the knowledge of the proposer.

Where a proposal is accepted by a letter sent by the post, the communication of acceptance will be complete as against the proposer when the letter of acceptance is posted and as against the acceptor when the letter reaches the proposer. For instance in the above example,



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if 'B' accepts, A's proposal and sends his acceptance by post on 14<sup>th</sup>, the communication of acceptance as against 'A' is complete on 14<sup>th</sup>, when the letter is posted. As against 'B' acceptance will be complete, when the letter reaches 'A'. Here 'A' the proposer will be bound by B's acceptance, even if the letter of acceptance is delayed in post or lost in transit. The golden rule is proposer becomes bound by the contract, the moment acceptor has posted the letter of acceptance. But it is necessary the letter is correctly addressed, sufficiently stamped and duly posted. In such an event the loss of letter in transit, wrong delivery, non delivery etc., will not affect the validity of the contract. However from the view point of acceptor, he will be bound by his acceptance only when the letter of acceptance has reached the proposer. So it is crucial in this case that the letter reaches the proposer. If there is no delivery of the letter, the acceptance could be treated as having been completed from the viewpoint of proposer but not from the viewpoint of acceptor. Of course this will give rise to a piquant situation of only one party to the contract being treated as bound by the contract though no one would be sure as to where the letter of acceptance had gone.

### **Communication of special conditions:**

Sometimes there are situation where there are contracts with special conditions. These special conditions are conveyed tacitly and the acceptance of these conditions are also conveyed by the offeree again tacitly or without him even realizing it.

For instance where a passenger undertakes a travel, the conditions of travel are printed at the back of the tickets, sometimes these special conditions are brought to the notice of the passenger, sometimes not. In any event, the passenger is treated as having accepted the special condition the moment he bought his ticket.

When someone travels from one place to another by air, it could be seen that special conditions are printed at the back of the air ticket in small letters [in a non computerized train ticket even these are not printed] Sometimes these conditions are found to have been displayed at the notice board of the Air lines office, which passengers may not have cared to read. The question here is whether these condition can be considered to have been communicated to the passengers of the Airlines and can the passengers be treated as having accepted the conditions. The answer to the question is in the affirmative and was so held in *Mukul Datta vs. Indian Airlines* [1962] AIR cal. 314 where the plaintiff had traveled from Delhi to Kolkota by air and the ticket bore conditions in fine print.

Yet another example is where a launderer gives his customer a receipt for clothes received for washing. The receipt carries special conditions and are to be treated as having been duly communicated to the customer and therein a tacit acceptance of these conditions is implied by the customer's acceptance of the receipt [*Lily White vs. R. Muthuswami* [1966] A. Mad. 13].

In the cases referred above, the respective documents have been accepted without a protest and hence amounted to tacit acceptance.



**Standard forms of contracts:**

It is well established that a standard form of contract may be enforced on another who is subjectively unaware of the contents of the document, provided the party wanting to enforce the contract has given notice which, in the circumstances of a case, is sufficiently reasonable. But the acceptor will not incur any contractual obligation, if the document is so printed and delivered to him in such a state that it does not give reasonable notice on its face that it contains certain special conditions. In this connection, let us consider a converse situation. A transport carrier accepted the goods for transport without any conditions. Subsequently, he issued a circular to the owners of goods limiting his liability for the goods. In such a case, since the special conditions were not communicated prior to the date of contract for transport, these were not binding on the owners of goods [Raipur transport Co. vs. Ghanshyam [1956] A. Nag.145].

**1.7 COMMUNICATION OF PERFORMANCE**

We have already discussed that in terms of Section 4 of the Act, communication of a proposal is complete when it comes to the knowledge of the person to whom it is meant. As regards acceptance of the proposal, the same would be viewed from two angles. These are (i) from the viewpoint of proposer and (ii) the other from the viewpoint of acceptor himself. From the viewpoint of proposer, when the acceptance is put in to a course of transmission, when it would be out of the power of acceptor. From the viewpoint of acceptor, it would be complete when it comes to the knowledge of the proposer.

At times the offeree may be required to communicate the performance (or act) by way of acceptance. In this case it is not enough if the offeree merely performs the act but he should also communicate his performance unless the offer includes a term that a mere performance will constitute acceptance. The position was clearly explained in the famous case of Carlill Vs Carbolic & Smokeball Co. In this case the defendant a sole proprietary concern manufacturing a medicine which was a carbolic ball whose smoke could be inhaled through the nose to cure influenza, cold and other connected ailments issued an advertisement for sale of this medicine. The advertisement also included a reward of \$100 to any person who contracted influenza, after using the medicine (which was described as 'carbolic smoke ball'). Mrs. Carlill bought these smoke balls and used them as directed but contracted influenza. It was held that Mrs Carlill was entitled to a reward of \$100 as she had performed the condition for acceptance. Further as the advertisement did not require any communication of compliance of the condition, it was not necessary to communicate the same. The court thus in the process laid down the following three important principles.

- (i) an offer, to be capable of acceptance, must contain a definite promise by the offeror that he would be bound provided the terms specified by him are accepted;
- (ii) an offer may be made either to a particular person or to the public at large and



- (iii) if an offer is made in the form of a promise in return for an act, the performance of that act, even without any communication thereof, is to be treated as an acceptance of the offer.

### **1.8 REVOCATION OF OFFER AND ACCEPTANCE**

If there are specific requirements governing the making of an offer and the acceptance of that offer, we also have specific law governing their revocation.

In term of Section 4, communication of revocation (of the proposal or its acceptance) is complete.

- (i) as against the person who makes it when it is put into a course of transmission to the person to whom it is made so as to be out of the power of the person who makes it and
- (ii) as against the person to whom it is made, when it comes to his knowledge.

#### **The above law can be illustrated as follows:-**

If you revoke your proposal made to me by a telegram, the revocation will be complete, as for as you are concerned when you have dispatched the telegram. But as far as I am concerned, it will be complete only when I receive the telegram.

As regards revocation of acceptance, if you go by the above example, I can revoke my acceptance (of your offer) by a telegram. This revocation of acceptance by me will be complete when I dispatch the telegram and against you, it will be complete when it reaches you.

But the important question for consideration is when a proposal can be revoked? And when can an acceptance be revoked?. These questions are more important than the question when the revocation (of proposal and acceptance) is complete.

In terms of Section 5 of the Act a proposal can be revoked at any time before the communication of its acceptance is complete as against the proposer. An acceptance may be revoked at any time before the communication of acceptance is complete as against the acceptor.

#### **Revocation of proposal otherwise than by communication**

When a proposal is made, the proposer may not wait indefinitely for its acceptance. The offer can be revoked otherwise than by communication or sometimes by lapse.

#### **Following are the situations worth noting in this regard**

- (i) When the acceptor fails to fulfill certain conditions precedent to acceptance:- Where the acceptor fails to fulfill a condition precedent to acceptance the proposal gets revoked. This principle is laid down in Section 6 of the Act. The offeror for instance may impose certain



conditions such as executing a certain document or depositing certain amount as earnest money. Failure to satisfy any condition will result in lapse of the proposal. As stated earlier 'condition precedent' to acceptance prevents an obligation from coming into existence until the condition is satisfied. Suppose where 'A' proposes to sell his house to be 'B' for Rs. 5 lakhs provided 'B' leases his land to 'A'. If 'B' refuses to lease the land, the offer of 'A' is revoked automatically.

(ii) When the proposer dies or goes insane

Death or insanity of the proposer would result in automatic revocation of the proposal but only if the fact of death or insanity comes to the knowledge of the acceptor

(iii) When time for acceptance lapses

The time for acceptance can lapse if the acceptance is not given within the specified time and where no time is specified, then within a reasonable time. This is for the reason that proposer should not be made to wait indefinitely. It was held in *Ramsgate Victoria Hotel Co Vs Montefiore* (1866 L.R.Z. Ex 109), that a person who applied for shares in June was not bound by an allotment made in November. This decision was also followed in *India Cooperative Navigation and Trading Co Ltd Vs Padamsey Prem Ji*. However these decisions now will have no relevance in the context of allotment of shares since The Companies Act has several provisions specifically covering these issues

### **1.9 SELF- EXAMINATION QUESTIONS**

1. What are identified as essentials of a valid contract?
2. What is a tacit contract?
3. What are void contracts?
4. What is the legality of contracts brought as a result of coercion or undue influence or fraud or misrepresentation?
5. Though a void contract is valid when it is made, subsequently it becomes unenforceable. Why?
6. A voidable contract is voidable at the option of the aggrieved party and remains valid until rescinded by him. Is it correct?
7. There is a contract to commit crime, what type of contract is this?
8. When in a contract due to technical defects, one or both the parties cannot sue upon it, the contract is called -----(fill in the blank).
9. What is a general offer and a special offer?
10. Whether an acceptance of an invitation to an offer will result into a contract?



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11. What has to be done for an offer for a contract to be complete.
12. Is mere silence “acceptance” of a contract ?
13. When a communication will be complete, when a proposal is made by post?
14. An offer to be capable of acceptance, must contains a definite promise by the offeror that he would be bound, provided the terms specified by him are accepted. Is it correct?
15. Can a proposal be revoked otherwise than by communication? How?

### Answers

1. See Paragraph 1.2.
2. See Paragraph 1.3 – Point No. 6.
3. A contract without any legal effect and which cannot be enforced in a court of law
4. Voidable
5. Because of subsequent illegality
6. Yes
7. Illegal contract
8. Unenforceable contract
9. A general offer is made to the public in general and a specific offer to a definite person
10. No
11. The offer has to be accepted
12. No
13. When the letter reaches the person
14. Yes
15. Yes. By lapse of time fixed for acceptance or by the failure of the acceptor to fulfill a condition precedent to acceptance or by death or insanity of the person



## **UNIT – 2 : CONSIDERATION**

### **Learning objectives**

After studying this unit, you would be able to -

- ◆ Understand the concept of consideration, its importance for a contract and its double aspect.
- ◆ Clearly understand how consideration may move from a third party and how this makes the contract valid.
- ◆ Learn about the peculiar circumstances when a contract is valid even without consideration.
- ◆ Be aware of the rule 'A stranger to a contract cannot sue' and exceptions thereof.

In the previous unit we learnt that one of the important elements of contract is “consideration”. In this unit the concept of consideration and the legal requirements for consideration are discussed.

### **1.10 WHAT IS CONSIDERATION?**

The expression ‘consideration’ has to be understood as a price paid for an obligation. In *Curie Vs Misa* 1875 10 Ex 130 it was held (in U K) that consideration is “some right, interest, profit or benefit accruing to one party or forbearance, detriment, loss, or responsibility given, suffered or under taken by the other”. The judgment thus refers to the position of both the promisor, and the promisee in an agreement.

Section 2 (d) of the 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 promises to do or abstain from doing something, such an act or abstinence or promise is called consideration for the promise*’.

From the above definition it can be inferred that

Consideration is doing or not doing something, which the promisor desires to be done or not done.

- (1) Consideration must be at the desire of the promisor.
- (2) Consideration may move from one person to any other person
- (3) Consideration may be past, present or future and
- (4) Consideration should be real though not adequate



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In most cases the promisor for doing an act or not doing an act derives some benefit by way of consideration. This consideration is identified as *quid pro quo* from its promise of the promisor.

But it is also possible that there may not be any identifiable benefit towards consideration. For example 'A' promises to carry 'B' goods free of charge and B allows 'A' to carry the same. Here 'B' does not offer any consideration to 'A'. Is this a valid contract?

The answer to the question is 'B' has suffered a detriment or disadvantage while allowing 'A' to carry his goods. Here there is sufficient consideration. This illustration is given essentially to prove the point that consideration could be not necessarily a gain or advantage to the promisor but it can even be a loss or detriment to the promisee. That is why 'consideration' is referred to as a concept with 'double aspect'.

Where Y applies for a loan of Rs,10,000/- to X, and if 'X' insists on a guarantee by 'S' and upon 'S' guaranteeing the loan, 'X' gives the loan to "Y". In this case 'S' will be the promisor and 'X' the promisee. The benefit in this transaction conferred on 'Y' by 'X' at the guarantee of 'S', is sufficient consideration for X. In other words 'X' has suffered a detriment which is the consideration for the guarantee of 'S' to repay the loan which 'X' has given to 'Y'. Detriment to one is benefit to another.

It can often be seen that consideration is mutual. For instance if 'A' promises to sell his house to 'B' for Rs.5 lakhs, here "A" is the promisor and "B" is the promisee. In the same transaction where 'B' agrees to buy the house for Rs.5 lakhs, 'B' will be the promisor and 'A' will be the promisee. Here 'A' must part with the house and 'B' must part with Rs.5 lakhs. This proves the point that consideration is mutual and has two sides.

### **Whether gratuitous promise can be enforced?**

The word "gratuitous" means 'free of cost' or 'without expecting any return'. It can therefore be inferred that a gratuitous promise will not result in an agreement in the absence of consideration. For instance a promise to subscribe to a charitable cause cannot be enforced.

### **1.11 LEGAL REQUIREMENTS REGARDING CONSIDERATION**

Now let us consider the other legal requirement of consideration.

#### **(i) Consideration must move at the desire of the promisor**

Consideration must move at the desire of the promisor, either from the promisee or some other third party. But consideration cannot move at the desire of a third party. Where collector had passed an order that any one using the market constructed by the Zamindar, for the purpose of selling his goods should pay commission to the Zamindar, it was held that it was not a proper order as the desire to receive consideration had not emanated from the Zamindar but from a third party namely the collector (Durga Prasad Vs Baldev (1880) 3, All 221)





**(ii) Consideration can flow either from the promisee or any other person**

The consideration for a contract can move either from the promisee or from any other person. This point is made clear even by the definition of the word “consideration”, according to which at the desire of the promisor, the promisee or any other person, doing something is consideration.

That the consideration can legitimately move from a third party is an accepted principle of law in India though not in England. ‘A’ by a deed of gift made over certain property to her daughter with condition that her brother should be paid annuity by A’s daughter. On the same day A’s daughter executed a document agreeing to pay annuity accordingly but declined to pay after sometime. A’s brother sued A’s daughter. It was contended on behalf of A’s daughter, that there was no consideration from A’s brother and hence there was no valid contract. This plea was rejected on the ground that the consideration did flow from A’s mother to ‘A’ and such consideration from third party is sufficient to enforce the promise of A’s daughter to enforce her promise to pay annuity to A’s brother (Chinya Vs Ramaya(1881) a.mad.13.7.

Thus a stranger to a contract can sue upon a contract in India and also in England, where a stranger to a consideration can sue under Indian law though not under English law.

**(iii) Executed and executory consideration**

Where consideration consists of performance, it is called “executed” consideration. Where it consists only of a promise, it is executory. For example where A pays Rs.5000/- to ‘B’ requesting ‘B’ to deliver certain quantity of rice, to which B agrees, then here consideration for B is executed by ‘A’ as he has already paid Rs.5000/- whereas ‘B’s promise is executory as he is yet to deliver the rice.

Insurance contracts are of the same type. When A pays a premium of Rs.5000/- seeking insurance cover for the year, from the insurance company which the company promises in the event of fire, the consideration paid by A to the insurance company is executed but the promise of insurance company is executory or yet to be executed. A forbearance by the promisor should however be considered as an executed consideration provided the forbearance is sufficient at the time of contract.

**(iv) Past consideration**

The next issue is whether past consideration can be treated as consideration at all. This is because consideration is given and accepted along with a promise concurrently. However the Act recognizes past consideration as consideration when it uses the expression in Section 2(d) ‘has done or abstained from doing”. But in the event of services being rendered in the past at the request or desire of the promisor the subsequent promise is regarded as an admission that the past consideration was not gratuitous. The plaintiff rendered services to the defendant at his desire during his minority. He also continued to render the same services



after the dependant attained majority. It was held to be good consideration for a subsequent express promise by the defendant to pay an annuity to the plaintiff but it was admitted that if the services had not been rendered at the desire of the defendant it would be hit by section 25 of the Act. (*Sindia Vs Abraham* (1985)Z. Bom 755)

**(v) Adequacy of Consideration**

Consideration need not necessarily be of the same value as of the promise for which it is exchanged. But it must be some thing which can be inadequate as well. Inadequate consideration would not invalidate an agreement but such inadequate consideration could be taken into account by the court in deciding whether the consent of the promisor was freely given.

In *Chijitumal Vs. Rampal Singh* AIR, 1968, the Supreme Court reiterated that consideration need not be material and may be even absent. In the said case, the father had died leaving his house to two sons. They had agreed to partition the house which did not admit the division in exactly equal parts and one of the sons had agreed not to construct a door at a certain place in his portion of the house. In a dispute, the agreement was challenged on the ground that it was without adequate consideration. The Supreme Court came to the conclusion that the motive for the said agreement at the time when it was made, was to avoid any dispute in future, and held that it was sufficient consideration.

The above view is in tune with explanation 2 to section 25 of the Act, which provides that an agreement to which the consent of the promisor is freely given is not void merely because the consideration is inadequate. Where there is valuable consideration, Court will not interfere and inquire into the adequacy of it but leave the matter to the parties to make their own bargain. But inadequate consideration might raise suspicion about the free will of the promisor. Promisor could be treated as victim of some imposition but this would not render the agreement void.

**(vi) Performance of what one is legally bound to perform:**

The performance of an act by a person who is legally bound to perform the same cannot be consideration for a contract. Hence, a promise to pay money to a witness is void, for it is without consideration. Hence such a contract is void for want of consideration. Similarly, an agreement by a client to pay to his counsel after the latter has been engaged, a certain sum over and above the fee, in the event of success of the case would be void, since it is without consideration.

But where a person promises to do more than he is legally bound to do, such a promise provided it is not opposed to public policy, is a good consideration. For instance during a civil strike, a question arose as to how best to protect a coal mine. The police authorities thought that surveillance by a mobile force would be adequate but the colliery manager desired a stationary police guard. Ultimately it was agreed that the police authorities would provide a



stationary guard and the manager would pay \$2,200 for the service. It was held that the promise to pay the amount was not without consideration. The police, no doubt, were bound to afford protection, but they had discretion as to the form it should take. The undertaking to provide more protection than what they deemed to be necessary was a consideration for the promise of reward. (*Classbrook Brothers vs. Glamorgan Country Council* (19250 A.C.270))

**(vii) Consideration must not be unlawful, immoral, or opposed to public policy.**

### **1.12 SUIT BY A THIRD PARTY TO AN AGREEMENT.**

There is a big difference between a third party to consideration and third party to a contract; while the first can sue, the second cannot sue. Thus a contract by the purchaser of a mortgaged property to pay off the mortgage cannot be enforced by the mortgagee who was not a party to the contract between vendor and vendee.

However there are exceptions to the above principle. These are:

1. In the case of a trust, the beneficiary can sue enforcing his right though he was not a party to the contract between the trustee and the settler. In *Khawja Mohammed Khan Vs Hussain Begum* 371.A. 152, where, the father of the bridegroom promised to pay through a contract with the father of the bride, an allowance to the bride, if she married his son, the bride sued her father-in-law after marriage for the allowance which he did not pay as per the contract. It was held by the Privy Council that though the bride was not a party to the contract between her father and father in law, she could enforce her claim in equity.
2. In the case of family settlement, if the terms of settlement are reduced in writing, members of the family who were not a party to the settlement can (also) enforce their claim. (*Shuppu Vs Subramanian* 33 Mad.238)
3. In the case of certain marriage contracts a female member can enforce a provision for marriage expense based on a petition made by the Hindu undivided family (*Sunder Raja Vs Lakshmi* 38. Mad 788).
4. Where there is an assignment of a contract, the assignee can enforce the contract for various benefits that would accrue to him on account of the assignment. (*Krishanlal Sadhu Vs Primila Bala Dasi* (1928) Cal.1315)
5. In case of part performance of a contractual obligations or where there is acknowledgment of liability on account of estoppel, a third party can sue for benefits. Where for example 'A' gives Rs.25000/- to 'B' to be given to 'C' and 'B' informs 'C' that B is holding it on behalf of C, but subsequently refuses to pay 'C' then 'C' can sue and enforce his claim.
6. Where a piece of land which is sold to buyer with certain covenants where the buyer is kept on notice of the covenants with certain duties the successors to the seller can enforce these covenants.



### 1.13 VALIDITY OF AN AGREEMENT WITHOUT CONSIDERATION

We have all along learnt that an agreement without consideration is void. Not only that, even inadequate consideration would render the enforceability of the contract quite difficult as the free consent of the parties would become suspect. The Act however contains certain exceptions to this important rule. These are:

(i) A written and a registered agreement made between parties out of natural love and affection does not require consideration. Such an agreement is enforceable even without consideration. It is important that parties should be near relation like husband and wife to get this exemption (Rajlukhee Devee Vs Bhootnath).

(ii) **Compensation paid for past voluntary services:** A promise to compensate wholly or in part for past voluntary services rendered by someone to promisor does not require consideration for being enforced. However the past services must have been rendered voluntarily to the promisor. Further the promisor must have been in existence at that time and he must have intended to compensate.

(iii) **Promise to pay debts barred by limitation:** Where there is a promise in writing to pay a debt, which was barred by limitation, is valid without consideration.

(iv) **Creation of Agency:** In term of section 185 of the Act, no consideration is necessary to create an agency

(v) In case of completed gifts, no consideration is necessary. This is clear from the Explanation (1) to section 25 of the Act which provides that “nothing in this Section shall affect the validity as between donor and donee of any gift actually made.

### 1.14 SELF-EXAMINATION QUESTIONS

1. Consideration is the doing or not doing of something which the promisor desires to be done or not to be done – is it correct?
2. Should the consideration be adequate?
3. Whether consideration results in detriment to the promisee or some benefit to the promisor?
4. Study the following example and answer the questions.  
A promises to sell his house to B for Rs.5,00,000/- Here who is the promisor and who is the promisee?
5. B agrees to buy a house from A for Rs.5,00,000/- Here who is the promisor and who is the promisee?
6. Is it true that consideration is mutual and has two sides? Identify the two sides.



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7. Whether a consideration can move at the desire of the third party other than the promisor and promisee?
8. Whether a consideration can move from a third party?
9. A pays Rs.5000/- requesting B to deliver certain quantity of rice to which B agrees. What is the position of consideration as “executed” or “executory” regarding A and B?
10. While a third party to consideration can sue, a third party to a contract cannot sue. In the case of family settlement, if the terms of settlement are reduced in writing, members of the family who were not a party to the settlement can also enforce the claim. Is it correct?
11. An agreement without consideration is void. Even inadequate consideration would render enforceability of the contract difficult. In such a case, whether a written and a registered agreement made between parties out of natural love and affection without consideration is valid?
12. Without consideration a promise was made to compensate for past voluntary services rendered by someone to promisor. Can the promise be enforced?
13. Can a promise in writing to pay a debt which is barred a limitation valid without consideration?
14. Whether consideration is necessary to create an agency?
15. Should consideration be adequate to the value of the promise?

### **Answers**

1. Yes      2. No      3. Yes      4. A, B      5. B, A
6. Yes      7. No      8. Yes
9. For ‘A’ executed, & for ‘B’ executory
10. Yes, It is an exception
11. Yes
12. Yes
13. Yes
14. No
15. No



### UNIT – 3 : OTHER ESSENTIAL ELEMENTS OF A CONTRACT

#### Learning objectives

After studying this unit, you would be able to -

- ◆ Note the various ingredients of incapacity to contract.
- ◆ Be clear about the legal consequence of contracting with a minor.
- ◆ Be familiar with the concept of 'consensus ad idem' i.e. parties agreeing upon the same thing in the same sense.
- ◆ Try to grasp the characteristics of different elements vitiating free consent and particularly to distinguish amongst fraud, misrepresentation and mistake.
- ◆ Understand the circumstances when object and consideration become unlawful.
- ◆ Be aware of the agreements opposed to public policy.

In the previous units we discussed all aspects of offer, acceptance, revocation, and consideration. In this unit we will discuss other elements, which would constitute a contract.

We have earlier seen that in terms of section 10 of the Contract Act, a legally enforceable agreement should be made with the free consent of the parties who are competent to contract for a lawful consideration with a lawful object. Further the agreement should not have been expressly declared as void by law. These elements would be examined hereunder.

#### 1.15 FREE CONSENT

In terms of section 13 of the Act, two or more persons are said to have consented when they agree upon the same thing in the same manner. This is referred to as identity of minds or “consensus-ad-idem”. Absence of identity of minds would arise when there is an error on the part of the parties regarding (a) nature of transaction or (b) person dealt with or (c) subject matter of agreement. In such cases there would be no consent. However cases of fundamental errors have to be distinguished from cases of mutual mistakes.

Where the persons refer to a ship of a name in the contract but each of them had a different ship in mind though of same name, there is no identity of minds and hence there is no consent. That there is no contract in the absence of consent was considered in the case of Cundy Vs Lindsay. In this case one Blenkarn in placing order for goods with Cundy closely imitated the address and signature of another well-known firm known as Blenkiron & Co. Cundy sent the goods to Blenkarn but thinking that the order was from Blenkiron & Co. Blenkarn in turn sold the goods to Lindsay. Cundy discovered his mistake, brought a suit against Lindsay for recovery of goods. It was held by the House of Lords that Cundy was



under mistake as he thought he was dealing with Blenkiron & Co, while he was in fact dealing with Blenkran. Hence there was no contract at all, valid or voidable. The agreement was declared as void in the absence of identity of minds or proper consent. The suit was decreed against Lindsay.

The consent referred above must be “free consent” as well. Consent is free when it is not caused by coercion, undue influence, fraud, misrepresentation or mistake (section 14). When the consent is caused by mistake, the agreement is void, but when caused by other factors it is voidable.

Now let us discuss each of these factors, which should not influence consent.

**(a) Coercion**

“Coercion” is the committing, or threatening to commit any act forbidden by the Indian Penal Code 1860, or the unlawful detaining, or threatening to detain any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement. For example, X says to Y ‘I shall not return the documents of title relating to your wife’s property, unless you agree to sell your house to me for Rs.5000’. ‘Y’ says, “All right, I shall sell my house to you for Rs.5000; do not detain my wife’s documents of title”, X has employed coercion; he cannot therefore enforce the contract. But Y can enforce the contract if he finds the contract to his benefit. An agreement induced by coercion is voidable and not void. That means it can be enforced by the party coerced, but not by the party using coercion.

It is immaterial whether the Indian Penal Code is or is not in force at the place where the coercion is employed.

Where husband obtained a release deed from his wife and son under a threat of committing suicide, the transaction was set aside on the ground of coercion, suicide being forbidden by the Indian Penal Code. (Amiraje Vs. Seshamma (1974) 41 Mad, 33)

A person to whom money has been paid or anything delivered under coercion, must repay or return it.

**(b) Undue influence (Section 16)**

A contract is said to be 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 of the other. A person is deemed to be in a position to dominate the will of the other, when he holds authority, real or apparent over the other, or when he stands in a fiduciary relation to other.

The essential ingredients of undue influence are:

One of the parties dominates the will of the other and

- (i) he has real or apparent authority over the other;



- (ii) he is in a position to dominate the will of the other and
- (iii) the dominating party takes advantage of the relation.

Following are the instances where one person can be treated as in a position to dominate the will of the other.

- (i) A solicitor can dominate the will of the client.
- (ii) A doctor can dominate the will of his patient having protracted illness and
- (iii) A trustee can dominate the will of the beneficiary.

The burden of proof (in situations like the above) that there is no undue influence in an agreement would be on the person who is in a position to dominate the will of the other. For instance the 'father' should prove that he had not unduly influenced his son in the case of any given agreement. The stronger party must act in good faith and see that the weaker party gets independent advice.

The following two decisions would enable us to understand the law.

- (a) Allahabad High Court set aside a gift of the whole of the property by an elderly Hindu to his spiritual advisor.
- (b) Similarly, Privy Council set aside a deed of gift executed by an old illiterate Muslim lady in favour of the manager of her estate.

While deciding on the question of undue influence, the courts will examine

- (i) Whether the transaction is righteous
- (ii) If it is possible that the donor was not master of himself and not in a state of mind to weigh the pros and cons of what he was doing
- (iii) Whether it was a matter requiring independent legal advice to the donor and
- (iv) Whether the intention of making the gift originated with the donor [as per Lord Macnaghten in Mohammed Buksh Vs. Hussein Bibi (1928) 15 Cal.684; Venkat Ramalayer Vs. Krishnammal (1927) 52 Mad.L.J.20]

### **Money lending operations and undue influence**

It is often seen that on account of 'undue influence' borrowers end up paying very high rate of interest to the lenders. This is because lenders are in a position to dominate the will of the borrowers. Such high rate of interest will be treated as unconscionable where parties are not on same footing.

### **1.16 CAPACITY TO CONTRACT**

The next issue for consideration is, who is competent to contract? Every person who (a) has attained the age of majority (b) is of sound mind and (c) is not otherwise disqualified from contracting, is competent to contract. Now let us discuss each one of these requirements.





**(a) Age of majority**

In terms of Indian Majority Act 1875, every domiciled Indian attains majority on the completion of 18 years of age. However where a guardian is appointed by a court to protect the property of a minor and the court takes charge of the property before the person attains 18 years, then he or she would attain majority on completion of 21 years.

Now let us analyze the position with regard to the position of minor's agreement -

(i) **An agreement entered into by a minor is altogether void:** An agreement entered into by a minor is void against the minor and the question of its enforceability does not arise. The Privy Council in *Mohori Bibee vs. Dharmodos Ghose* [1903] LR 30, CI 5395, decided that an agreement where minor is a party is altogether void. In this case a minor executed a mortgage in favour of the husband of Mohori Bibee. The question for consideration is whether the mortgage is valid. Interpreting Sections. 10&11 of the Act, Privy Council held that unless all the parties to an agreement were competent to contract, the agreement would be void. The main reason for such a view is that a minor is incapable of performing his part of the contract imposing a legal obligation.

(ii) **Minor can be a beneficiary:** Though a minor is not competent to contract, nothing in the Contract Act prevents him from making the other party bound to the minor. Thus, a promissory note duly executed in favour of a minor is not void and can be sued upon by him, because he though incompetent to contract, may yet accept a benefit.

A minor cannot become partner in a partnership firm. However, he may with the consent of all the partners, be admitted to the benefits of partnership (Section 30 of the Indian Partnership Act).

(iii) **Minor can always plead minority:** Any money advanced to a minor cannot be recovered as he can plead minority and that the contract is void. Even if there had been false representation at the time of borrowing that he was a major, the amount lent to him cannot be recovered.

This position was upheld by Privy Council in *Mohori Bibee's* case where money was lent to a minor with full knowledge of the borrower's infancy and even request for payment of compensation under sections 38 & 41 of the Specific Relief Act was refused. Privy Council concurred with the views of Calcutta High Court that no discretion could be used even under that Act to grant any kind of relief to the lender of money.

When the mortgage documents had to be cancelled at the instance of minor who mortgaged the property fraudulently, Courts have ordered compensation under Specific Relief Act to the other party to the instrument [*Dattaram vs. Vinayak* (1903) 28 bom.181., *Manmatha Kumar vs. Exchange Loan Co.* 41 C.W.e.N 115]

If a minor had obtained payment fraudulently by concealing his age, he may be compelled to



restore the payment but he cannot be compelled for an identical sum as it would amount to enforcing void contract.

#### **Ratification of agreement not permitted**

A minor on his attaining majority cannot validate any agreement which was entered into when he was minor, as the agreement was void. Similarly a minor cannot sign fresh promissory notes on his attaining majority in lieu of promissory notes executed for a loan transaction when he was minor, or a fresh agreement without consideration.

#### **Liability for necessaries**

A person who supplied necessaries of life to a minor or his family, is entitled to be reimbursed from the properties of a minor, not on the basis of any contract but on the basis of an obligation resembling a contract. Necessaries of life not only include food and clothing but also education and instruction. They also include 'goods' and 'services'.

#### **Contract by guardian are valid**

Though an agreement with minor is void, valid contract can be entered into with the guardian on behalf of the minor. The guardian must be competent to make the contract and the contract should be for the benefit of the minor. For instance a guardian can make an enforceable marriage contract on behalf of the minor. Similarly father of bride can enter the contract with the father of bridegroom for payment of certain allowance to the bride.

But not all contracts by guardian are valid. A guardian cannot bind a minor in a contract to purchase immovable properties – *Mir Sarwarjan vs. Fakharuddin* [1912] 39. Cal. 232. However a court appointed guardian can bind a minor in respect of certain sale of property ordered by the court.

#### **Sound Mind**

The next important requirement by way of capacity to contract is "sound mind". A person will be considered to be of sound mind if he at the time of entering into a contract is capable of understanding it and forming a rational judgment as to its effect upon his interest. A person who is of unsound mind but occasionally of sound mind can enter into a contract when he is in sound mind though for temporary periods. For example a person who is in lunatic asylum during intervals of sound mind can enter into contracts. Similarly a person who is generally of sound mind, but occasionally of unsound mind cannot enter into a contract when he is of unsound mind.

From the above it clear that the period of lucidity would be crucial as much as the periods of lunacy. But the burden of proof of 'unsound mind' is on the person who challenges the validity of the contract.

A lunatic whose estate is managed by a committee or manager is not capable of entering into a contract even during the periods of lucidity in view of special provisions of Lunacy Act.



The basic test for lunacy or lucidity is to see whether the person is able to understand the implications of a contract which he enters into on his interest. Idiots, lunatics and drunken persons are examples of persons of unsound mind.

**Necessaries of life supplied to a person of unsound mind**

In term of section 68 of the Act if a person incapable of entering into a contract is supplied by another person with necessaries of life, the person who has furnished such supplies is entitled to be reimbursed from the property of such a person.

**Contract by disqualified persons.**

Apart from minors and persons of unsound mind, there are others who are not capable of entering into contract either wholly or partially. Contract by such persons are void.

An alien enemy, during war cannot enter into a contract with an Indian subject, unless he is permitted by central government to do so he cannot sue in Indian Courts. This disability to an alien enemy arises on account of public policy. Statutory corporations or Municipal bodies cannot enter into contracts on matters which are beyond their statutory powers or ultra vires the memorandum or articles through which they are created.

An Advocate in India can enter into contracts with his clients for recovery of fees or payment of fees in certain manner unlike his counterpart in U.K where barristers are prohibited to enter into contracts for recovery of fees from their clients [Nichal chand vs. Dilawar Khan 55. All 790]

Before entering into contract with the government, certain procedure and formalities are required to be complied with. On default of it, such contract will be void. [Bikhraj vs. Union of India (1962) 2 S.C.R.880. Karamshi vs. State of Bombay AIR (1964) S.C.1714]

Sovereign states, Ambassadors and Diplomatic Couriers enjoy certain privileges with the result that they cannot be proceeded against in Indian Courts. However, they can, at their will enter into contracts which may be enforceable in India.

**1.17 DIFFERENCE BETWEEN COERCION AND UNDUE INFLUENCE**

Having discussed in detail the concepts of coercion and undue influence, let us understand the difference between the two.

**Nature of action**

Coercion involves physical force and sometimes only threat. Undue influence involves only moral pressure.

**Involvement of criminal action**

Coercion involves committing or threatening to commit any act prohibited or forbidden by law, or detention or threatening to detain a person or property. In undue influence there is no such illegal act involved.



### **Relation ship between parties**

In coercion there need not be any relationship between parties; whereas in undue influence, there must be some kind of relationship between parties, which enables to exercise undue influence over the other.

### **Exercise by whom**

Coercion need not proceed from the promisor. It also need not be directed against the promisee. Undue influence is always exercised by one on the other, both of whom are parties to a contract.

### **Enforceability**

Where there is coercion, the contract is voidable. Where there is undue influence the contract is voidable or court may set it aside or enforce it in a modified form.

### **Position of benefits received**

In case of coercion, where the contract is rescinded by the aggrieved party any benefit received has to be restored back. In the case of undue influence, the court has discretion to pass orders for return of any such benefit or not to give any such directions.

Now let us analyse Fraud & Misrepresentations in the following paragraphs.

### **1.18 FRAUD**

In term of section 17 of the Act, fraud means and includes any of the following act committed by a party to a contract or with his connivance or by his agent with intent to deceive another party thereto or his agent or to induce him to enter into the contract

- (i) the suggestion, as to a fact, of that which is not true by one who does not believe it be true;
- (ii) the active concealment of a fact by one, having knowledge or belief of the fact;
- (iii) a promise made without any intention of performing it;
- (iv) any other act fitted to deceive; and
- (v) any such act or omission as to law specially declared to be fraudulent

It is important to note that 'fraud' that results in a contract alone is covered by section 17 of the Act. If there is a 'fraud' but it does not result in a contract, it would not fall within the purview of the Act.

The following can be taken as illustration of fraud

- ◆ A director of a company issues prospectus containing misstatement knowing fully well about such misstatement. It was held any person who had purchased shares on the faith of such misstatement can repudiate the contract on the ground of fraud.



- ◆ B discovered an ore mine in the Estate of 'A' He conceals the mine and the information about the mine. 'A' in ignorance agrees to sell the estate to 'B' at a price that is grossly undervalued. The contract would be voidable of the option of 'A' on the ground of fraud.
- ◆ Buying goods with the intention of not paying the price is an act of fraud.
- ◆ It will be interesting to know that not only Contract Act but also other Acts have specifically declared certain acts and omission as fraud. A seller of a property should disclose any material defect in the property. Concealing the information would be an act of fraud. Any other act committed to deceive is fraud.

**Mere silence would amount to fraud under certain circumstances.**

Although a mere silence as to facts which is likely to affect the willingness of a person to enter into a contract is no fraud, where there is a duty to speak or where his silence is speech, then such silence amounts to fraud. This would be clearly seen from the explanation to section 17 of the Indian Contract Act. This situation often arises in Insurance contracts.

In the case of fire insurance contract between person standing in fiduciary relationship, non-disclosure of certain information would amount to fraud as there is a duty to make special disclosure. These are also known as *uberrimae fidei* contract.

In the case of marine insurance policy contract, where a charterer is shipping goods of high value but fails to disclose such high value of the goods to the underwriter, there is fraud. Similarly the insurer is not bound by the policy issued by him where he is misinformed about insurance policy previously taken by the insured.

**1.19 MISREPRESENTATION [SECTION 18]**

“Misrepresentation’ does not involve deception but is only an assertion of something by a person which is not true, though he believes it to be true. Misrepresentation could arise because of innocence of the person making it or because he lacks sufficient or reasonable ground to make it. A contract which is hit by misrepresentation can be avoided by the person who has been misled.

For example, A makes the statement on an information derived, not directly from C but from M. B applies for shares on the faith of the statement which turns out to be false. The statement amounts to misrepresentation, because the information received second-hand did not warrant A to make the positive statement to B [Section 18 (1)]

Now let us analyse the difference between fraud and misrepresentation.

**Extent of truth varies**

One of the important difference between fraud and misrepresentation is that in case of fraud the person making the representation knows it fully well that his statement is untrue & false. In



case of misrepresentation, the person making the statement believes it to be true which might later turn out to be untrue. In spite of this difference, the end result is that the other party is misled.

#### **Right of the person concerned who suffers**

Fraud not only enables the party to avoid the contract but is also entitled to bring action. Misrepresentation merely provides a ground for avoiding the contract and not for bringing an action in court.

#### **Action against the person making the statement**

In order to sustain an action for deceit, there must be proof of fraud. As earlier discussed fraud can be proved only by showing that a false statement was made knowing it to be false or without believing it to be true or recklessly without any care for truth. One is for action against deceit and the other is action for rescission of the contract. In the case of misrepresentation the person may be free from blame because of his innocence but still the contract cannot stand.

#### **Defences available to persons**

In case of misrepresentation, the fact that plaintiff had means of discovering the truth by exercising ordinary diligence can be a good defense against the repudiation of the contract, whereas a defense cannot be set up in case of fraud other than fraudulent silence.

The tenuous difference between fraud and misrepresentation was beautifully brought out in the famous case of *Dery vs. Peek*. In the said case the plaintiff brought an action of deceit against the promoters of a tramway company.

According to him, the promoters in the prospectus had not mentioned that they had not obtained the permission of the board of trade which was necessary for using mechanical power [to run a train] and here this was deceit. The plea of the defendant was that it never occurred to them to say anything about the consent —of the Board of trade because they had a right under the Act of parliament for using steam; they had presumed they would also get the consent of Board of trade. The Court verified the position and concluded that there was no deceit and the plea for action for deceit was dismissed.

#### **1.20 GENERAL CONSEQUENCES OF COERCION, FRAUD, MISREPRESENTATION ETC; (SECTION 19)**

What is the effect and what the consequences of a contract hit by coercion, undue influence, fraud or misrepresentations are, are dealt by section 19 of the Act. It is seen that in all these cases though the agreement amounts to a contract, it is voidable. The injured party might insist on being placed in the same position in which he might have been had the vitiating circumstances not been present.



For example 'A' fraudulently informs 'B' that his estate is free from encumbrance, therefore 'B' buys the estate. But the estate is subject to mortgage. 'B' may avoid the contract or insist on the debt being redeemed and mortgage being released.

But where it is possible to discover the truth with ordinary diligence, and though the consent might have been obtained by misrepresentation or silence, then the contract cannot be avoided. For instance where 'A' misrepresents to 'B' that his sugar factory can produce 500 tons of sugar and whereas it actually produced 300 tones of sugar and if 'B' had the opportunity to examine the accounts through which he could have found out the truth and if in spite of that he had entered into a contract, he can not repudiate it.

Where a party to contract perpetrates fraud or misrepresentation, but the other party is not misled by such fraud or misrepresentation, then the contract cannot be avoided by the latter. Where for instance, the seller of specific goods deliberately conceals a fault in order that the buyer may not discover it even if he inspects the goods, but the buyer in fact does not make any inspection at all, the buyer cannot avoid the contract as he is not deceived by the seller.

Where a contract is voidable and the party entitled to avoid it decides to do so by rescinding it, he must restore any benefit which he might have received from the other party. He cannot avoid the contract and at the same time enjoy the benefit under the rescinded/avoided contract.

However where a contract is sought to be rescinded on the ground of 'undue influence' the court may set aside the contract partially or fully. Where the party seeking to rescind the contract had received only benefit, the contract will be set aside by the court upon such terms and conditions deemed fit.

Example: A student was induced by his teacher to sell his brand new car to the latter at less than the purchase price to secure more marks in the examination. Accordingly the car was sold. However, the father of the student persuaded him to sue his teacher. State on what ground the student can sue the teacher?

Yes, the student can sue his teacher on the ground of undue influence under the provision of Indian Contract Act, 1872. A contract brought about as a result of coercion, undue influence, fraud or misrepresentation would be voidable at the option of the person whose consent was so caused.

### **1.21 MISTAKE**

The fifth significant element that vitiates consent is 'Mistake'. Where parties to an agreement are under a mistake as to a matter of fact which is essential to the agreement, then the agreement is void. As we all know a void agreement cannot be enforced at all.

In a particular case, 'A' agrees to sell certain cargo which is supposed to be on its way in a ship from London to Bombay. But in fact, just before the bargain was struck, the ship carrying



the cargo was cast away because of storm and rain and the goods were lost. Neither of the parties was aware of it. The agreement is void. [Couturier vs Hasite 5 H.L.C.673]

Mistake must be a matter of fact and not of law. Where 'A' and 'B' enter into contract believing wrongly that a particular debt is not barred by law of limitation, then the contract is valid because there is no mistake of fact but of law only. However a question on foreign law would become a matter of question of fact. Similarly the existence of a particular private right though depends upon rules of law, is only a matter of fact. For instance where a man promises to buy a property which already belongs to him without him being aware of it, then such a promise is not binding on him. However a family arrangements or a compromise of doubtful rights cannot be avoided on the ground of mistake of law.

Yet another issue to remember in mistake is that it must be of an essential fact. Whether the fact is essential or not would again depend on how a reasonable man would regard it under given circumstances. A mere wrong opinion as to the value is not an essential fact.

While deciding whether a contract is hit by mistake or not it must be remembered that 'Mistake' is not unilateral. Both the parties should be under mistake. A unilateral mistake would not render the contract invalid. For example where 'A' agrees to purchase from 'B' 18 caret gold thinking it to be pure gold but 'B' was not instrumental for creating such an impression then contract between 'A' and 'B' should be treated as valid.

From the foregoing it is clear that

- a. Mistake should be a matter of fact
- b. Mistake should not be a matter of law
- c. Mistake should be a matter of essential fact
- d. Mistake should not be unilateral but of both the parties and
- e. Mistake renders agreement void and neither party can enforce the contract against each other

## **1.22 LAWFUL OBJECT AND CONSIDERATION**

Now let us discuss two other important ingredients of a valid contract namely lawful object and lawful consideration. Speaking generally all persons enjoy freedom for entering into contracts of their choice. But this contractual freedom or their right to enter into agreements is not absolute. There is a limitation on such contractual freedom as they are bound by certain general provisions of law. The above observation can be illustrated with the following example: suppose 'A' agrees to pay Rs.100/- to B on 'B' stealing 'C's' purse, then no Court can compel 'A' to pay 'B' even if he manages to steal 'C's' purse because it would amount to encouraging these things.





While on the subject of 'object' and 'consideration' it must be said that in practice it is difficult to distinguish between 'object' and 'consideration' especially when consideration consists of a promise to do or, not to do something. Sometimes both 'object' and 'consideration' are seen for evaluation. For example, where 'A' agrees to sell goods to 'B' who is insolvent and B assigns the benefit of the contract for Rs.100/- with a view to defrauding creditors, the consideration for the assignment viz Rs.100/- is lawful but the object namely defrauding creditors is unlawful as it is to defeat the provision of insolvency law.

Although 'object' and 'consideration' are sometimes intertwined we have to, where ever it is possible, separate them and identify whether they are lawful.

### **1.23 UNLAWFUL OBJECT**

In terms of section 23 of the Act 'consideration' or object is unlawful if it is forbidden by law; or it would if permitted defeat the provisions of any law or is fraudulent or involves injury to the person or property of another or is immoral or opposed to public policy. Every agreement where the object or consideration is unlawful is void. Thus section 23 has set out the limits to contractual freedom. Following are examples of agreement which are void because the object is unlawful.

- (i) Where A, B & C enter into an agreement to share equally among themselves certain gains acquired by fraud or loss acquired by fraud. The agreement is void because the object being commission of fraud, is unlawful.
- (ii) A promises to return the stolen property of 'B' if 'B' would withdraw the criminal case filed against him, the agreement is void as its object namely withdrawing the case would mean stifling prosecution.

### **1.24 UNLAWFUL CONSIDERATION**

Now let us consider circumstances which would make consideration and the object as well unlawful. There are seven such circumstances namely -

#### **(i) Agreement forbidden by law**

Acts forbidden by law means acts that are punishable under any statute or Rules or Regulations made under any statute.

For instance a plantation company that is commenced, for growing, felling and selling timber cannot enter into any agreement to grow and fell sandalwood trees as felling of sandalwood is prohibited by law viz Forest Act.

A license to cut grass is given to 'X' by Forest Department under the Forest Act. The license provides for imposition of penalty in the events of 'X' choosing to assign his right. However, if 'X' assigns his right, the agreement would still be valid since there is no prohibition for such



assignment as the consideration stipulating penalty is only to regulate the matter as a matter of administrative measure.

**(ii) Consideration defeats the provision of law**

Where an agreement is entered into with the object of defeating any provision of law then it is prohibited. "Law" here should mean any statute, Law, regulation etc, in force. This can be illustrated by the following.

Where a debtor agrees not to plead limitation vis-à-vis his creditor, it is an agreement to defeat Limitation Act.

An agreement between owner of land who has to pay land revenue in arrears and a stranger that the stranger would purchase his estate for revenue's sake and reconveys it to the former on receipt of purchase money is void, as it would defeat the law relating to revenue, which apparently prohibits defaulting owners from purchasing back the same estate already sold due to his default.

An agreement by a Hindu to give his son in adoption in consideration of annual allowance to natural parents would be in violation of Hindu Law and hence is unlawful.

Any agreement by a Muslim with wife before their marriage that the wife shall be at liberty to live with her parents after marriage is void as it would defeat the provisions of Muslim Law.

**(iii) Consideration that would defeat any rule for the time being in force**

This is a situation not very different from point (ii) discussed above. The issue covered by this point can be explained by following two examples:

- (a) A 'will' must be proved in order to be probated by a court. A mere consent of parties by way of agreement to except this requirement of proof of genuineness or proper execution of will is not lawful and therefore cannot be enforced under C.P.C.
- (b) A receiver is a court officer. Therefore his remuneration has to be fixed by the court. Parties to certain litigations cannot add or devocate of the power of the receiver. Similarly they cannot fix salary of a receiver without the leave of the court however unconditional it may be. Such an act would be in contravention of law.

**(iv) Where consideration is a fraud**

Following are illustrations to prove where the object or consideration of an agreement is unlawful on the ground of fraud -

- (a) 'A' is an agent for Zamindar, the principal. He agrees for money to obtain a lease of land for 'B' from his principal the Zamindar. The agreement between 'A' and 'B' is void as the consideration is fraudulent



(b) 'A' & 'B' are partners in a firm. They agree to defraud a Government department by submitting a tender in the individual name and not in the firm name. This agreement is void as it is a fraud on the Government department.

**(v) Where object or consideration is unlawful because it involves causing injury to a person or loss of property**

The term 'injury' means criminal or wrongful harm. Following are the illustrations where the object or consideration is unlawful as it involves injury either to person or property.

(a) 'A' agrees to buy a property from 'B' although A knows 'B' had agreed previously to sell the property to 'C'. The intention of 'A' here is to cause injury to the property of 'C'

(b) 'A' agrees to print a book of 'B' which has clearly been published by "W" This agreement is void as it is not only in violation of Copyright Act but also with the intent to cause injury to the property of another.

(c) A' borrowed money from 'B'. He is unable to pay either the principal or interest. Therefore he agrees to render manual labour for certain period failing which he agrees to pay exorbitant interest. This agreement is void as rendering labour as consideration amounts to agreeing to be a slave. Slavery is opposed to public policy as well. In other words consideration involves 'injury' to 'A'. Hence the agreement is void.

**(vi) Where consideration is immoral**

Following are illustration where the agreement is void because the object or consideration is unlawful being immoral.

(a) Where 'A' agrees to let his house to a prostitute on rent, where with A's knowledge she carries on her vocation. 'A' cannot collect the rent as the agreement is void, the object being void.

(b) Where 'P' had advanced money to 'D' a married woman to enable her to obtain a divorce from her husband. He also promised to marry her after divorce. It was held that 'P' was not entitled to recover the amount from 'D' as the agreement was against good morals.

**(vii) Where consideration is opposed to public policy**

Agreement, either because of their object or consideration being opposed to public policy are void and not enforceable. Therefore the meaning of the expression 'public policy' is very important. It can be interpreted in a narrow sense or in a broad sense. If it is understood in a narrow sense, it would cut into rights of people to enter into even genuine agreements. 'Public policy' as a concept is evolved basically to develop an orderly society and for good of the community. But framing public policy itself is a difficult exercise since a too restrictive approach would stifle the rights of people and a too liberal approach would open the gate for very many illegal transactions. Therefore policy on 'public policy' has to be developed with



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circumspection. Public policy has been described as “an unruly horse, which if not properly bridled, may carry its rider he knows not where”. Time immemorial following activities/agreements have been identified as “opposed to public policy”.

(a) **Trading with enemy:** Any trading or business activity with a person who owes allegiance to a Government of a country with whom India is at war without any license from Government of India is void. This is because such a trade would be against the interest of Government of India and people of India.

Any agreement made during peace time would be suspended automatically and cannot be carried on further until hostilities come to an end.

(b) **Stifling prosecution:** Any agreement to stifle or prevent illegally any prosecution is void as it would amount to perversion or abuse of justice. The principle is that one should not make a trade of felony. It must be understood however that under Criminal Procedure Code many offences are compoundable. Therefore any agreement towards compounding of an offence to avoid prosecution is not void but is very much enforceable. Thus, where ‘A’ agrees to sell certain land to ‘B’ in consideration of ‘B’ abstaining from taking any criminal proceeding against ‘A’ with respect to an offence which is compoundable, the agreement is not opposed to public policy.

(c) **Maintenance and Champerty:** Maintenance is promotion of litigation in which the litigant has no interest. Champerty is bargain whereby one party agrees to assist the other in recovering property with a view to sharing the profit of litigation. These agreements for maintenance and champerty are void in England but not in India. Hence these are not opposed to public policy. But where such advances are made by way of gambling in litigation, the agreement to share the subject of litigation is certainly opposed to public policy and therefore is void.

(d) **Interference with course of law and justice:** Any agreement with the object of inducing a judicial officer or administrative officer of the state to act corruptly or not impartially is void. Similarly an agreement to use influence in a litigation in a underhand manner is void. For instance through an agreement ‘A’ agrees to reward ‘B’ if he abstains from being a witness in a suit against ‘A’ is void. But an agreement to pay for to a holy man for prayers for success of a suit is valid.

(e) **Marriage brokerage contract:** An agreement to negotiate a marriage for reward is void. Such marriage brokerage contracts are opposed to public policy.

(f) **Interest against obligation:** The following are examples of agreement that are void as they tend to create an interest against obligation. The object of such agreements is opposed to public policy.

(1) An agreement by an agent to receive without his principal’s consent compensation from another for the performance of his agency is invalid.



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- (2) A promise by a trustee to do something in violation of his duty is unlawful
- (3) A, who is the manager of a firm, agrees to pass a contract to X if X pay to A Rs.2000 privately; the agreement is void.

(g) **Sale of public offices:** While appointing a person to certain important and high public office, merit alone should be the criteria. Any attempt to influence or any agreement to influence anyone in this regard should be seen as an act 'opposed to public policy'. 'Public policy' also demands that there should be no money consideration and if it is there, it could be opposed to public policy. This is for the reason presence of money consideration would convert the situation as sale of public office.

Following are illustration in this regard.

- (1) An agreement to pay money to public servant in order to induce him to retire from his office so that another person may secure the appointment is void.
- (2) An agreement to procure a public recognition like Padma Vibhushan for reward is void.
- (3) The sale of the office of a mutwali of wakf is opposed to public policy, because the office of mutwali is connected with matters of public interest.

(h) **Agreement for the creation of monopolies:** Agreements having for their object the establishment of monopolies are opposed to public policy and therefore void. It is also hit by the MRTP Act.

(i) **Agreement in restraint of marriage (Section 26):** Every agreement in restraint of marriage of any person other than a minor, is void. So if a person, being a major, agrees for good consideration not to marry, the promise is not binding.

(j) **Agreement in restraint of trade (Section 27):** Any agreement through which a person is restrained from exercising a lawful profession, trade or business of any kind is to that extent void. The object of this law is to protect trade. The restraint, even if it is partial, will make the the agreement void. Thus if X, a shop keeper, in a particular locality agrees to pay 'Y' his rival in business certain compensation, if 'Y' close his business in that locality the agreement is void.

The principle of law however has a number of exceptions which are discussed hereunder.

- (i) where a person sells his business along with the goodwill to another person, agrees not to carry on same line of business in certain reasonable local limits, such an agreement is valid.
- (ii) In terms of section 36 of Indian Partnership Act, an agreement through which an outgoing partner will not carry on the business of the firm for a reasonable time will be valid, though it is in restraint of trade.



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- (iii) Again in terms of section 54 of the Partnership Act partners among themselves may agree that upon dissolution of the firm some of them may not carry on the business of the firm. Such an agreement is valid.
- (iv) Section 55 of the Act provides that where a full firm is sold by partners along with goodwill to a buyer, there can be an agreement that they would not carry on the business of the dissolved firm for certain period and within certain local limits and such an agreement will be valid.
- (v) An agreement of service through which an employee commits not to compete with his employer is not in restraint of trade. 'B' is a Doctor and he employs 'A' a junior Doctor as his assistant. 'A' agrees not to practice as Doctor during the period of his employment with 'B' as a Doctor independently. Such an agreement will be valid.
- (vi) An agreement between manufacturer and a wholesale merchant that the entire production during a period will be sold by the manufacturer to the wholesale merchant is not in restraint of trade.
- (vii) An agreement among sellers not to sell a particular product below a particular price is not an agreement in restraint of trade.

### **(k) Agreement in restraint of legal proceedings (Section.28)**

An agreement in restraint of legal proceedings resulting in restriction of one's right to enforce legal rights is void. Similarly any agreement which abridges the usual period for commencing the legal proceedings is also void. Further these agreement are also void in view of section 23 of the Contract Act as the object of the agreements are to defeat the provision of law.

Nevertheless, a clause in an fire insurance policy stipulating that if the claim is made and rejected and if no suit is instituted within three months after such a rejection, all the benefits under the policy will be forfeited, is valid. However, there are certain exceptions to the above rule:

- (i) A contract by which the parties agree that any dispute between them in respect of any subject shall be referred to arbitration and that only the amount awarded in such arbitration shall be recoverable is a valid contract. For instance, in agreement between the holder of a fire insurance policy and the insurance company that no suit shall be instituted until the question of the amount of damage sustained by the assured has first been ascertained by a reference to an arbitrator is a perfectly valid agreement.
- (ii) Similarly, a contract by which the parties agree to refer to arbitration any question between them which has already arisen or which may arise in future, is valid; but such a contract must be in writing.



### **1.25 AGREEMENT EXPRESSLY DECLARED AS VOID**

We have already seen that certain agreements are void ab initio under the Contract Act, like agreements by incompetent persons [section.11], agreement with unlawful object or consideration [section.23], agreement made under mutual mistake of fact [section.20], agreement without consideration [section.25], agreement in restraint of marriage, trade or legal proceedings etc., as they are opposed to public policy.

In addition to the above, there are also other agreements which are expressly declared as void.

#### **(a) Where consideration is unlawful in part**

By virtue of section 24 of the Indian Contract Act, "If any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object is unlawful, the agreement is void".

This Section is obviously a corollary to section 23 of the Act. Where the consideration is unlawful, the entire agreement is void as the agreement has to be looked as a whole. The general principle of law is where the legal part of an agreement can be separated from the illegal part, then the legal part if it can be given effect by rejecting the bad part and retaining the good part, then the good part is given effect. But where no such separation is possible, the contract is altogether void.

'A' has business interest in Indigo, as a manufacturer. He also has interest in illegal traffic of other goods. Where 'A' employs 'B' for a salary of Rs.2000/- to act as superintendent of A's entire business, the agreement is void as the object of A's promise unlawful in part.

#### **(b) Agreement the meaning of which is uncertain (Section 29)**

Where the meaning of the terms of an agreement is uncertain or if it is not capable of being understood with certainty, then the agreement is void. But where the meaning is capable of being made certain, then the agreement is valid. For example where 'A' enters into an agreement to supply 100 tones of oil, the agreement is not valid as the meaning of it is uncertain since what type of oil that is promised to be supplied is not clear. But on the other hand if 'A' is a dealer of coconut oil only, then the meaning of the agreement would crystallize very easily and then the agreement would be valid.

#### **(c) Wagering agreement**

Let us discuss wagering contract. We shall also distinguish wagering agreements from speculative transactions and mere 'gambling'.

Wagering agreement is one which involves payment of a sum of money upon the determination of an uncertain event. The essence of wagering agreement is where there are two parties, one wins, the other loses upon an uncertain event taking place in which neither of them has legitimate interest.



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For example 'A' agrees to pay Rs.500/- to 'B' if it rains and similarly 'B' agrees to pay 'A' if it does not. This is a classic case of a wagering agreement. But where one of the parties has control over the event, the agreement is valid. An agreement by way of a wager is void. A good definition of wagering agreement would be the one given by Anson: "A promise to give money or money's worth upon determination or ascertainment of an uncertain event".

Now let us see the position with regard to transaction of "purchase of lottery ticket" and "horse racing". Section 30 of the Act provides that an agreement [to buy lottery tickets] is one by way of wager and is void. However any subscription or contribution or agreement towards such subscription or contribution towards any plate or prize or sum of money, of the value of Rs.500 or more to be awarded to a winner of a horse race is not unlawful.

### **Speculative transactions**

While as clearly seen, wagering contracts are void, speculative transactions are valid. It is often difficult to distinguish between the two. There are two bare elements of a speculative transaction. They are (a) mutual intention of parties to acquire or deliver goods or commodities and (b) undertaking of risk arising from movement prices. In wagering contract, only the element of risk is seen.

Now let us take an example:

'A' enters into an agreement with 'B' to buy 100 bales of jute at Rs.150/- per bale for forward delivery after six months. This is a proposed transaction of purchase @ Rs.150/- per bale. What if the price at the time of delivery goes up to Rs.200/- 'A' has the following two options

- (i) to take delivery of 100 bales at the contracted rate of Rs.150/- [and sell it to some other buyer and make a profit of Rs.50/ per bale or
- (ii) to simply collect the difference of Rs.50/- per bale from 'B'

Similarly what if the price at the time of delivery goes down to Rs.125/- per bale. 'A' has the following two options.

- (i) to take delivery of 100 bales at the contracted rate of Rs.150/- [and perhaps sell it to some buyer and incur a loss of Rs.25 per bale] or
- (ii) to pay the difference of Rs.25/- per bale to 'B' & close the contract.

In the above example if the original intention of the parties was only to settle the difference in price, than it would be a wagering contract which would be void. Thus by now it would be clear that wagering postulates only incurring of risk. It is void because it is opposed to public policy.

While gambling and wagering are prohibited by law, speculation is not.

Now let us consider other peculiar situations to see whether they are wagering contracts or speculative contracts or valid contracts.





### **Insurance policy**

An insurance policy is a valid contract. But if an insurance policy is taken by a person who has no insurable interest, then it is void. For instance a person who has no insurable interest in a ship, takes a policy against it being sunk, then the contract is void.

### **Promissory notes on a wagering contract**

While a wagering contract is void ab initio, it is but automatic that a promissory note given out of a wagering contract is not enforceable by way of a suit. A promissory note of this character is one without consideration and hence is null and void.

### **Suit to recover deposit**

A winner of bet cannot recover the amount which he has won even if the amount is kept by way of deposit by the loser with the stakeholder. Such earmarking or identification of funds does not enhance the validity of the contract which is void. In the above example the loser can recover the amount from stakeholders as long as the amount has not been made over by the stakeholder to the winner.

### **Wager and collateral transactions**

The validity of a collateral transaction cannot be challenged because the main contract is a wager and void. For instance in a wagering contract, the broker is entitled to collect his brokerage. Similarly the principal can recover the prize money from his agent received by him on account of a wagering transactions.

The acid test of validity of a collateral transaction is whether the main transaction is illegal or legal but void. If the main transaction is illegal, the collateral transaction cannot be valid. For example security given for regular payment of the rent of a house let out for the purpose of gambling cannot be recovered; the recovery of security being tainted with the illegality of original transaction cannot be enforced.

A promise made by the loser of a wager to pay the amount lost in consideration of the winners forbearance to sue him as defaulter can be enforced as a fresh contract, separate and distinct from original wagering contract though collateral to it.

### **1.26 SELF- EXAMINATION QUESTIONS**

1. What will become to an agreement when it has free consent of parties who are competent to contract for a lawful consideration with a lawful object? Further it is also not expressly declared as void by law.
2. Two persons refer to a ship and refer to it in the contract but each of them had a different ship in mind though of the same name. Whether it will be valid and why?



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3. Can a doctor dominate the will of a patient who has protracted illness? How do you describe such domination?
4. The burden of proof that there is no undue influence in an agreement would be that of the person who is in a position to dominate the will of another – true or false?
5. On account of undue influence borrowers paying very high rate of interest to the lenders. Is it because lenders are in a position to dominate the will of the borrower?
6. Is a person of unsound mind competent to contract?
7. Is it necessary for a person to attain age of majority to enforce a contract?
8. Can money advanced to a minor be recovered?
9. Can a minor on his attaining majority validate any agreement which was entered into when he was minor?
10. Is a contract entered into by a guardian on behalf of minor valid?
11. The burden of proof of unsound mind in a contract is on the person who challenges the validity of contract. Is it correct?
12. Idiots, lunatics and drunken persons are examples of persons having unsound mind- true or false?
13. Can an alien enemy during war enter into a contract with an Indian subject?
14. Whether illegal act is present in coercion or undue influence?
15. In cases of coercion and undue influence the contract is voidable. Is it true?
16. Where there is a duty to speak or where one's silence is speech, then such silence amounts to fraud. Is it true?
17. 'A' charters a ship describing in the charter party claiming that weight of the ship is not more 2000 tonnes but the ship turns out to be a vessel of 3045 tonnes. Can 'A' avoid the contract on the ground of misrepresentation?
18. In terms of Section 19 of the Act, a contract hit by coercion or undue influence or fraud or misrepresentation is voidable – true?
19. 'A' and 'B' enter into a contract believing wrongly that a particular debt is not barred by law of limitation. Whether the contract is valid or not? Whether the mistake, in this case is mistake of fact or mistake of law?
20. 'A' agrees to pay Rs.100 to 'B' on 'B' stealing the purse of 'C'. 'B' manages to steal the purse of 'C' and 'A' does not fulfill his promise. Whether court can compel 'A' to pay 'B' Rs.100?



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21. Where the object or consideration is unlawful, it involves injury either to a person or a property – is it true?
22. An agreement through which a person is restrained from exercising a lawful profession, trade or business of any kind is to that extent void or voidable?
23. An agreement not to sell a particular product below a particular price is not an agreement in restraint of trade. Is it true?
24. What is the nature of agreement which involves payment of a sum of money upon the determination of an uncertain event?
25. Mutual intention of parties to acquire or deliver goods or commodities arising from movement of prices is
  - a. What type of transaction?
  - b. What type of contract?

### **Answers**

1. It will be an enforceable contract.
2. No, No identity of mind
3. Yes, Undue influence
4. True
5. Yes
6. No
7. Yes
8. No
9. No
10. Yes
11. Yes
12. True
13. No, unless permitted by Central Govt.
14. Coercion
15. Yes
16. Yes
17. Yes



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18. True
19. Yes, Mistake of law
20. No, because the contract is illegal
21. True
22. Void u/s.27
23. Yes
24. Wagering
25. Speculative transactions, wagering contract



**UNIT – 4 : PERFORMANCE OF CONTRACT**

**Learning objectives**

After studying this unit, you would be able to -

- ◆ Understand how obligations under a contract must be carried out by the parties.
- ◆ Be familiar with the various modes of performance.
- ◆ Be clear about the consequence of refusal of performance or refusal to accept performance, by either of the parties.
- ◆ Understand rights of joint promisees, liabilities of joint promisors, and rules regarding appropriation of payments.

A contract being an agreement enforceable by law, creates a legal obligation, which subsists until discharged. Performance of the promise or promises remaining to be performed is the principal and most usual mode of discharge. This unit explains; who must perform his obligation; what should be the mode of performance; and what shall be the consequences of non performance.

**Basic tenet of performance**

In a contract where there are two parties, each one has to perform his part and demands the other to perform. This obligation is the primary tenet. The parties would be treated as having been absolved only under the provisions of any law or by the conduct of the other party. Until such time the performance is neither excused nor dispensed with. Not only the promisor has a primary duty to perform, even the representative in the event of death of a promisor, is bound by the promise to perform, unless a contrary intention appears from the contract. [Section.37]

**1.27 BY WHOM A CONTRACT MAY BE PERFORMED**

The promise under a contract can be performed by any one of the following

**(i) Promisor himself**

Invariably the promise has to be performed by the promisor where the contracts are entered into for performance of personal skills, or diligence or personal confidence, it becomes absolutely necessary that the promisor performs it himself.

**(ii) Agent**

Where personal consideration is not the foundation of a contract, the promisor or his representative can employ a competent person to perform it.



**(iii) Representatives**

Generally upon the death of promisor, the legal representatives of the deceased are bound by the promisor unless it is a promise for performance involving personal skill or ability of the promisor. However the liability of the legal representative is limited to the value of property inherited by them from the promisor.

**(iv) Third Person**

The question here is whether a total stranger to a contract who is identified as a third person can perform a promise. Where a promisee accepts performance from a third party he cannot afterwards enforce it against the promisor. Such a performance, where accepted by the promisor has the effect of discharging the promisor though he has neither authorized nor ratified the act of the third party.

**(v) Joint promisors**

Where two or more persons jointly promise, the promise must be performed jointly unless a contrary intention appears from the contract.

Where one of the joint promisors dies, the legal representative of the deceased along with the other joint promisor(s) is bound to perform the contract

Where all the joint promisors die, the legal representatives of all of them are bound to perform the promise.

The law set out above can be illustrated with the following examples:

1. A promises to B to pay Rs.1000/- on delivery of certain goods. A may perform this promise either himself or causing someone else to pay the money to B. If A dies before the time appointed for payment, his representative must pay the money or employ some other person to pay the money. If B dies before the time appointed for the delivery of goods, B's representative shall be bound to deliver the goods to A and A is bound to pay Rs.1000/- to B's representative.
2. A promises to paint a picture for B for a certain price. A is bound to perform the promise himself. He cannot employ some other painter to paint the picture on his behalf. If A dies before painting the picture, the contract cannot be enforced either by A's representative or by B.
3. A delivered certain goods to B who promise to pay Rs.5000/-. Later on B expresses his inability to clear the dues. C, who is known to B, pays Rs.2000/- to A on behalf of B. Before making this payment C did tell B nothing about it. Now A can sue B only for the balance and not for the whole amount.



### **1.28 DISTINCTION BETWEEN SUCCESSION AND ASSIGNMENT**

This discussion arises in the context of the observation that the obligations of a promisor would bind the legal representative also (only) to the extent of value of property inherited by them. This became the law that legal representatives are successors.

When the benefits of a contract are succeeded by a process of law, both the burden and the benefit would some times devolve on the legal heir. For example 'B' is the son of 'A' the father. Upon A's death 'B' will inherit all the assets and liabilities of 'A' [These assets and liabilities are also referred to as debts and estates]

Thus 'B' will be liable to all the debts of 'A', but if the liabilities inherited are more than the value of the estate [assets] inherited it will be possible to pay only to the extent of assets inherited. Not a rupee more, not a rupee less.

Now let us understand the concept of "assignment". Unlike succession, the assignor can assign only the assets to the assignee and not the liabilities. Because when a liability is assigned, a third party gets involved in it. The debtor cannot through assignment relieve himself of his liability to creditor.

However there cannot be any assignment of benefit of a contract coupled with a liability or when a personal consideration has entered into making of the contract then the contract cannot be assigned. In *Zaffer Mehar Ali vs Budge Budge Jute Mills Company Ltd.* 33 Cal., 'A' agreed to sell certain gunny bags to 'B' which were to be delivered in monthly installments for a period of 6 months and the contract contained certain options for the buyer as regards quality and packing. It was held that the clause relating to the buyer's option did not preclude the assignment of the contract.

### **1.29 EFFECTS OF REFUSAL TO ACCEPT OFFER OF PERFORMANCE**

In any promise, the promisor should act first by offering performance also known as 'tender'. In terms of section 38 of the Act, where the promisee has not accepted the offer or tender of performance by the promisor then the promisor is not responsible for non performance. In this case the promisor does not also lose his rights under a contract.

The promisor should however ensure that his tender or offer to perform his part should satisfy following conditions.

- (i) the offer is unconditioned.
- (ii) the offer is made at a proper time and place under such circumstances that the person to whom it is made may have a reasonable opportunity of ascertaining that the person by whom it is made is able and willing to do what he is bound to do, then and there.
- (iii) if the offer is an offer to deliver any thing to the promisee, then the promisee must have a reasonable opportunity of seeing that the thing offered is the thing that the promisor is bound by his promise to deliver.



The above legal principles were settled in the famous English case *Start up vs. Macdonald* 1843 6 Man. & G. 593, 610 thus “The law considers a party who has entered into a contract to deliver goods or pay money to another as having substantially performed it, if he has tendered the goods or money to the party to whom the delivery or payment was to be made, provided only that the tender has been made under such circumstances that the party to whom, it has been made, has had a reasonable opportunity of examining the goods or the money tendered in order to ascertain that the thing tendered is really what that it is purported to be”.

An offer to any one of the several joint promisees has the same legal consequence as an offer to all of them.

### **1.30 EFFECT OF A REFUSAL OF A PARTY TO PERFORM PROMISE**

The next issue for consideration is as to what would be the effect where the promisor refuses to perform his promise. The obvious conclusion is that it would give rise to certain rights to the other party. Let us now analyse the other issues.

Where a party to a contract has refused to perform the promise he has made or had disabled himself from performing his promise in its entirety, the promisee may put an end to the contract, unless his acquiescence in the continuance of the contract has been conveyed either by words or by deeds [conduct] [Section 39]. Thus from the above it could be seen that the following two rights accrue to the aggrieved party. Namely (i) to terminate the contract and (ii) to indicate by words or conduct that he is interested in its continuance.

In case the promisee decides to continue the contract, he would not be entitled to put an end to the contract on this ground immediately. In either case, the promisee would be able to claim damages that he suffers as a result of the breach for it is not incumbent on the promisee to decide immediately in case of an anticipated breach that the contract may be ended. He may, however, choose to do so. In that event, the loss (if any) suffered by him will have to be made good by the promisor. On the other hand, if he indicates that he is interested in the performance of the contract, then he would be entitled to claim damages which accrue on the date the contract is due to be performed. It would, therefore, be clear that the rights that we have just stated above accrue to a promisee when the promisor decides not to perform the promise.

It has been held by the Privy Council in *Muralidhar Chatterjee vs. International Film Company* 47 Cal.W.N.407 that when a promisee puts an end to a contract being rightly entitled to do so, it shall be deemed as if he has rescinded a voidable contract. In view of Section 64 of the Act, the promisee, in the events of his putting an end to the contract, is bound to return all the benefits received under the contract and in turn is entitled for compensation for all damages sustained by him for breach of contract by the promisee.





### **1.31 LIABILITY OF JOINT PROMISOR & PROMISEE**

The next set of issues for consideration is liability of joint promisors and joint promisee. The legal liability of a joint promisor and other connected issues are set out in Sections.42, 43 & 44 of the Act.

In terms of Section 42 of the Act “when two or more persons have made a joint promise then unless a contrary intention appears from the contract, all such person, during their joint lives, and after the death of any one of them, his representative jointly with the survivor or survivors and after the death of last survivor, representatives of all jointly must fulfill the promise”.

Thus joint promisors together during their life time, and where some of the joint promisors die, their representatives along with survivors [ of original joint promisors] and in the event of death of all joint promisors, their legal representatives should fulfill a promise.

The above law can be illustrated with the following example. Where ‘A’, ‘B’ and ‘C’ jointly borrow a sum of money from ‘X’ all of them are jointly liable to repay the amount. Where in the above example, ‘A’ dies, his legal representative, ‘L’ would be liable to repay the loan along with ‘B’ and ‘C’, the remaining joint borrowers.

Now let us consider the position whether the promisee can enforce his right against any one of the joint promisors and if so what are the rights and duties of the other promisors to make contributions.

In terms of Section 43 of the Act,

- (i) when two or more persons make joint promise, the promisor can compel any one of the joint promisors to perform the whole of promise.
- (ii) in the above situation, the performing promisor can enforce contribution from other joint promisors, in the absence of express agreement to the contrary.

Where A,B and C have jointly signed a promissory note for Rs.3000/-, and where ‘A’ is compelled to pay the entire amount of Rs.3000/- , he is entitled recover by way of contribution of Rs.1000/- each from the other two joint promisors namely B and C unless agreed to otherwise mutually.

In the above situation again, if one of the joint promisors namely ‘B’ is unable to contribute Rs.1000/-, ‘A’ is entitled to recover Rs.1500/- from ‘C’ who is the remaining joint promisor instead of Rs.1000.

From the above it clear that the liability of joint promisors is joint and several and in the absence of any special contract to the contrary, the amount due can be recovered from any one of the joint promisors.

For example X,Y and Z jointly borrow from P, Rs.3000/-, Because the liability of the borrower is joint and severed, ‘P’ can recover the amount either from X or from Y or from Z or from all of



them jointly. A joint promisor cannot claim that he be sued along with all other joint promisors only. If, however the promisee sues one of the promisors and obtains a decree against him, he is precluded from bringing a fresh suit against the remaining borrowers.

The above rule of contribution, does not apply as between the principal debtor and his surety even though they are joint promisors in one sense. The principal debtor, if he pays up the full loan, cannot recover anything from surety.

However the concept of “joint and several liability” is not applicable against the legal heirs. In other words where the original debtor dies, the liability devolves on the legal heirs. But among the legal heir, the creditor cannot bring a suit against any one or more legal heirs. He must bring a suit against all the legal heirs collectively.

In the matter of release of one of the joint promisors, by another joint promisor, it must be understood that such a release does not discharge other joint promisors nor does the released joint promisor would stand released to other joint promisor or promisors. [Section 44 of the Act].

### **1.32 RIGHTS OF JOINT PROMISEES**

The rights of two or more promisees who are known as joint promisees is discussed in Section 45 of the Act. In terms of the said Section “When a person has made a promise to two or more persons jointly, then unless a contrary intention appears from the contract, the right to claim performance rests, as between him and them, with them during their joint lives, and after the death of any of them with the representatives of such deceased person jointly with the survivor or survivors, and after the death of the last survivor, with the representatives of all jointly”.

For example, A, in consideration of Rs.5,000 lent to him by B and C, promises B and C jointly to repay the sum with interest on a specified day but B dies. In such a case right to demand payment shall rest with B’s legal representatives, jointly with C during C’s lifetime and after the death of C, with the legal representatives of B and C jointly as ‘B’ and ‘C’ both are joint promisees”.

The above principle of joint promises is applicable for partners, joint mortgagees and members of a Hindu Undivided family. In all these cases there is no single promisee. Therefore in order to enforce a promise all the joint promisees should sue the promisor. If any one of the joint promisees refuses to sue the promisor he would not be a plaintiff but be treated as defendant. *Ashinsa Bibi vs Abdul Kadar* [1902] 25.Mad 26,35 *Mohammed, Isaq vs. Shekh Haq* [1908] 12 C.W.N. 84, 86, 93.

### **1.33 TIME AND PLACE FOR PERFORMANCE OF THE PROMISE**

Sections 46 to 50 of the Act deal with this issue of “Time and place” for performance of a promise. Following are the rules of performance where the promisee has not applied for



performance. Where no time is specified for performance of a promise, it must be performed within a reasonable time. What is reasonable time would depend on the facts and circumstances of each case [section 46]. Where a promise is to be performed on a specified date but no time is mentioned, then it can be performed any time on that day but during business hours only.

A promisee may refuse to accept delivery (of goods), if it is delivered after business hours. For example if the promisor wishes to deliver goods at a time which is beyond business hours, the promisee can refuse.

As regards the place of performance, where no place is fixed for the performance of a promise, it is the duty of the promisor to ask the promisee to fix a reasonable place. No distinction is made between an obligation to pay money and an obligation to deliver goods or discharge any other obligation. But generally the promise must be performed or goods must be delivered at the usual place of business.

Where the promisor has not undertaken to perform the promise without an application by the promisee and the promise is to be performed on a certain day it is the duty of the promisee to apply for performance of a proper place and within usual hours of business.

The above are subject to the position that promisor can perform any promise at any place, in any manner, at any time which the promisee prescribes or sanctions.

### **1.34 PERFORMANCE OF RECIPROCAL PROMISE**

Now let us discuss the law relating to reciprocal promise as set out in Sections 51 to 54 of the Act.

#### **(i) General observations**

A contract may consist of (i) an act and a promise or (ii) two promises one being the consideration for the other.

The second type of contract which involves two promises, one promise from each to the other party is known as "Reciprocal promise". This can be illustrated with the following.

When 'A' sells 500 quintals of rice to 'B' and 'B' promises to pay the price on delivery, the contract would consist of two promises one by 'A' to 'B' and another by 'B' to 'A'. These promises are reciprocal promises. Here the promise of 'A' is the consideration for the promise of 'B' and vice versa.

The above is in contrast to another situation. In the above example if 'B' promises to pay the price after a month, the contract would have two parts one is the act of 'A' and the second is promise of 'B'. This is not a reciprocal promise.

The performance of reciprocal promise can take different forms



- (i) They can be performed simultaneously or
- (ii) They can be performed according to the order decided by parties or
- (iii) They can be performed according to the order fixed by implication.

There is also a probability where one of the parties could be preventing the other from performing his part of the promise.

Now let us examine each of the above situations -

**(i) Simultaneously performance of reciprocal promise [Section.51]**

In this case, promises have to be performed simultaneously not one after another. The conditions and performances are concurrent. If one of the parties does not perform his promise, the other also need not perform his promise. For example where 'A' promises to deliver rice and 'B' promises to pay the price on delivery, both have to be performed simultaneously. Here both 'A' and 'B' must be willing and ready to perform their accepted part.

**(ii) Performance of reciprocal promise where the order is expressly fixed.**

Where the order of performance is expressly fixed, the promise must be performed in that order only. Where 'A' promises to build a house for 'B' and 'B' promises to pay after construction, here 'A' must perform his promise before he can call upon 'B' to fulfill his promise of payment of money. A's performance of the promise is a condition precedent to 'B' performing his part of the promise. Any breach of promise by 'A' would enable 'B' to avoid the contract.

**(iii) Performance of reciprocal promise by implication**

Where the performance of reciprocal promise is not fixed expressly, some times the order is understood by implication. For example where 'A' agrees to make over certain stock in trade to 'B' and 'B' agrees to provide certain security for the value of stock in trade, then 'A' need not make over the stock until 'B' provides the security as by implications 'B' is required to perform his part first; otherwise 'A' in the absence of any security will not make over the stock to 'B'.

**(iv) Effect of one party preventing another from performing promise [Section.53]**

When in a contract consisting of reciprocal promises one party prevents the other from performing his promise, the contract becomes voidable at the option of the party so prevented. The person so prevented is entitled to get compensation for any loss he may have sustained for the non-performance.

The above can be illustrated with the following illustrations by way of two case laws.

- (a) Where there is a contract for sale of standing timber and as per the terms seller is expected to cut and cord the standing timber before the buyer takes delivery but seller



ords only a part of it , but neglects to cord the rest of it, then the buyer has a right to avoid the contract and claim compensation for any loss sustained.

- (b) In the well known case of O 'Nell vs. Armstrong, an Englishman was engaged by the Captain of a Japanese ship to act as fireman on a voyage from England to Japan. During the course of the voyage Japan declared War against China. The Englishman had to leave service because had he continued in service he would have incurred penalties under Foreign Enlistment Act. In effect because of the war, the Englishman was prevented from discharging his part of the contract. The suit filed by him was decreed in his favour in spite of being opposed by the Japanese shipping company. It should be appreciated that the Captain of Japanese ship could not have brought a case against the Englishman for non-performance as the Japanese themselves were responsible for preventing the Englishman from performing his part of the contract.

Sometimes the parties would be prevented from discharging a part of the contract but not the entire contract. In such a case, the party so prevented need not avoid the full contract but perform the rest of it.

**(v) Effects of default as to promise to be performed first**

Section 54 of the Act provides that promises may be such that

- (i) one of them cannot be performed or
- (ii) its performance cannot be demanded till the other has been performed.

Where 'B' a ship owner agrees to convey A's cargo from Calcutta to Mauritius for a freight. Here the beginning part of the transaction is on 'A' as he has to provide the cargo to 'B' to enable 'B' to perform his promise. Thus until cargo is handed over by 'A'. A cannot expect 'B' to perform his promise nor would 'B' be in a position to perform his promise. This peculiar position arises because of default on the part of one of the parties. Here 'B' is entitled to put an end to the contract and claim compensation for any loss he may have suffered.

**Position of legal and illegal parts of Reciprocal promises**

*Reciprocal promise to do certain things that are legal and certain others that are not legal –*

Section 57 of the Act provides that if reciprocal promises have two parts, the first part being legal and the second part being illegal, the legal part is a valid contract and the illegal part is void.

Where 'A' agrees to sell his house to 'B' for Rs.50000/- and further 'A' insists and it is agreed that if the house is used as a gambling house, then 'B' would pay another Rs.75000/-. In this case the first part is valid as it is legal, the second part is void as it is illegal.



### **Alternative promise one branch being illegal**

“In the case of the alternative promise, one branch of which is legal and the other illegal, the legal branch alone can be enforced”.

For example, in the nearest reversionary heir of B, agreed to transfer his inheritance to C, if he succeeded to B; and he did not transfer his own estate to C. It was held that first promise was not enforceable, as it amounted to an agreement to transfer an estate on the mere chance of succession prohibited by Section 6 of the Transfer of Property Act, but the second promise was enforceable under Section 58 as an alternative promise. *Mahadeo Prasad Singh vs. Mathura* 132 L.C. 321 A,

### **1.35 EFFECTS OF FAILURE TO PERFORM AT A TIME FIXED IN A CONTRACT IN WHICH TIME IS ESSENTIAL**

Section 55 of the Act regulates the position of performance of contract where time is of essence. In terms of this Section, where it is understood between parties that time is an essential element, and where one party is unable to perform his part of the promise either in full or in part within the time specified, then the contract is voidable at the option of the party either in full or in part to the extent of non performance of the contract within the time. In these cases the contract is not voidable if time is not of essence of the contract, but the promisee is entitled for compensation for loss if any suffered on account of such failure.

In a contract where time is of essence and promisor is unable to perform his part within the time, as already stated the contract becomes voidable at the option of the other party. However the other party agrees that the promisor would perform his part subsequently after the time fixed, the promisee cannot claim any compensation for loss or damage or injury unless he gives any notice to the promisor of his intention to do so.

### **The next question for consideration is how to determine whether time is essence of a contract?**

Ordinarily from a plain examination of a contract it would be difficult to ascertain from the terms of the contract whether time is essence of the contract. A promisee may have failed to perform his contract within the specified time. Yet time may not be treated as essence of the contract in that case. Whether time is essence of a contract has to be decided from the terms of the contract.

In mercantile contracts, as business world is ruled by ‘time’ and ‘money’ any stipulation as to ‘time’ and ‘money’ is an essential condition.

The general principles that are followed can be enunciated as under.

- (i) In transaction on sale of gold, silver, blue chip shares, time of delivery is of essence. Here time will be treated as essence of contract.



- (ii) In transaction involving sale of land, redemption of mortgages, though certain time frame is fixed, any delay is not valued seriously provided justice can be done to parties. Of course even in sale of land, time can be made as on essence of contract by express words.

**Contract cannot be avoided where time is not of essence**

When there is delay in performing promise on executing a contract where the time is not of essence, parties concerned cannot avoid the contract. However in such cases promises must be performed within a reasonable time otherwise it becomes voidable at the option of the promisee.

**Effect of acceptance of performance out of time**

Even where time is of essence, the party who is entitled to avoid the contract can waive the condition relating to "performance within time"; but in such cases he cannot claim any compensation for loss if any suffered unless he has put the other party on notice.

**1.36 IMPOSSIBILITY OF PERFORMANCE**

Agreements become void when it becomes impossible to perform them due to a variety of reasons. This is known as "impossibility of performance" and dealt with by section 56 of the Act

In terms of Section 56 of the Act "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 event which the promisor could not prevent,) 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 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".

**(1) Impossibility existing at the time of contract**

Even at the time of entering into the agreement, it may be impossible to perform certain contracts at the beginning or inception itself. The impossibility of performance may be known or may not be known to the parties

(i) *If the impossibility is known to the parties* : Where 'A' agrees to pay 'B' Rs.5000/- to 'B' if he would swim from Bombay in Indian ocean to 'Aden' in 7 days time, this is an agreement where both the parties known that it is impossible to swim the distance between 'Bombay' to 'Aden' in 7 days time and hence is void.

(ii) *If unknown to parties*: Even where both the promisor and the promisee are ignorant of the impossibility the contract is void.



(iii) *If known only to the promisor:* Where the promisor alone knows it is impossible to perform or even if he does not know but he should have known about the impossibility with reasonable diligence, the promisee is entitled to claim compensation for the loss suffered because of failure of the promisor to perform.

## (2) Supervening impossibility

When performance of a promise becomes impossible on account of subsequent developments of events or change in circumstances, which are beyond the contemplation of parties, the contract becomes void. Supervening impossibility can arise due to a variety of circumstances as stated below.

(i) *Accidental destruction of the subject matter of the contract :* 'A' had agreed with 'B' to hire for rent his music hall for holiday concerts on certain specified dates. The music hall was destroyed before the specified dates and hence it became impossible to stage concerts. It was held that as the music hall ceased to exist; it is a case of supervening impossibility and both the parties were excused from the performance of the contract [Taylor vs. Caldwell 3B&S826].

(a) *Non-existence or non occurrence of a particular state of things:* It was agreed to by the defendant through a contract to have from the plaintiff a flat for specified days for witnessing the coronation procession of King Edward VII. The said procession was cancelled and it did not take place. Therefore the defendant refused to pay the balance rent. It was held that the foundation of the contract had totally failed and here the balance of rent amount cannot be recovered from the defendant. [Krell vs. Henry 2 KB. 740]

(b) *Incapacity to perform a contract of personal services :* In case of contract of personal service, disability or incapacity to perform, caused by an act of God e.g. illness, constitutes lawful excuse for non-performance of the contract (Robinson vs. Davison L.R.6Ex.269)

(c) *Change in law:* Performance of a contract may also become impossible due to change in law subsequently. The law passed subsequently may prohibit the act which may form part as basis of contract. Here the parties are discharged from their obligations. For example 'A' and 'B' may agree to start a business for sale of lottery and contribute capital for the business. If the business of sale of lottery ticket is banned by a subsequent law, parties need not keep up their legal obligations.

(d) *Outbreak of war:* Out break of war may be affect the enforceability of contracts in many ways like

- (i) emergency legislations controlling prices
- (ii) relaxation of trade restrictions and
- (iii) prohibiting or restraining transaction with alien enemy.





### **Doctrine of Frustration**

The idea of “supervening impossibility” is referred to as ‘doctrine of frustration’ in U.K. In order to decide whether a contract has been frustrated, it is necessary to consider the “intention of parties as are implied from the terms of contract”.

However in India the ‘doctrine of frustration’ is not applicable. Impossibility of performance must be considered only in term of section 56 of the Act. Section 56 covers only ‘supervening impossibility and not implied terms’. This view was upheld by Supreme Court in ‘Satyabrata Ghose vs Mugneeram Bangur A.I.R.(1954) S. C. 44 and Alopi Prasad vs Union of India A.R. 1960 S.C.588.

### **What would not constitute ground of impossibility**

Now let us consider various decisions which have identified certain situations as not constituting grounds of impossibility. In other words this is a negative list of what are not ‘grounds’ of impossibility -

- (a) ‘A’ promised to ‘B’ that he would arrange for ‘B’s marriage with his daughter. ‘A’ could not persuade his daughter to marry ‘B’. ‘B’ sued ‘A’ who pleaded on the ground of impossibility that he is not liable for any damages. But it was held that there was no ground of impossibility. It was held that ‘A’ should not have promised what he could not have accomplished. Further ‘A’ had chosen to answer for voluntary act of his daughter and hence he was liable.
- (b) The defendant agreed to supply specified quantity of ‘cotton’ manufactured by a mill with in a specified time to plaintiff. The defendant could not supply the material as the mill failed to make any production at that time. The defendant pleaded on the ground of impossibility which was not approved by The Privy Council and held that contract was not performed by the defendant and he was responsible for the failure. [Hamandrai vs Pragdas 501A]
- (c) The defendant agreed to procure cotton goods manufactured by Victoria Mills to plaintiff as soon as they were supplied to him by the mills. It was held by Supreme Court that the contract between defendant and plaintiff was not frustrated because of failure on the part of Victoria Mills to supply goods [Ganga Saran vs Finn Rama Charan,A.I.R 1952 S.C.9]
- (d) A dock strike would not necessarily relieve a labourer from his obligation of unloading the ship within specified time.
- (e) In Satyabrat Ghosh vs Mugneeram Bangur & Co. A.I.R 1954 S.C.44, Calculate High court held in a context of impossibility of performance that “having regard to the actual existence of war condition, the extent of the work involved and total absence of any definite period of time agreed to the parties, the contract could not be treated as falling under impossibility of performance. In the given case the plaintiff had agreed to



purchase immediately after outbreak of war a plot of land. This plot of land was part of a scheme undertaken by the defendant who had agreed to sell after completing construction of drains, roads etc. However the said plot of land was requisitioned for war purpose. The defendant thereupon wrote to plaintiff asking him to take back the earnest money deposit, thinking that the contract cannot be performed as it has become impossible of being performed. The plaintiff brought a suit against the defendant that he was entitled for conveyance of the plot of land under condition specified in the contract. It was held that the requisition order did not make the performance impossible.

While judging the impossibility of performance issue the Courts would be very cautious since contracting parties often bind themselves to perform at any cost of events without regard to price prevailing and market conditions.

### 1.37 APPROPRIATION OF PAYMENTS

Where a person [Debtor] owes a number of debts to another person [creditor], and when he releases certain payments, then the question arises as to how to adjust the receipt against so many dues. This issue is considered and answered in Sections 59, 60 and 61 of the Act under the heading 'Appropriation of payments',

#### (i) Application of payment where debt to be discharged is indicated

In term of section 59 of the Act "Where a debtor, owing several distinct debts to one person, makes a payment to him either with express intimation or under circumstances implying that the payment is to be applied to the discharge of some particular debt, the payment, if accepted, must be applied accordingly".

Where a debtor owes a number of debts and he pays an amount with express or implied instructions towards appropriation, the debtor is at will to appropriate to any debt and the creditor is bound by it. This is set out in the Latin Maxim of "*quicquid sovitur, sovit sectionundum modum solventis*" meaning that what ever is paid, is paid according to intention or manner of party paying. The right of debtor to decide the appropriation is also known as decision in Clayton's case.

What is the position if the debtor does not expressly state the method of appropriation? Then we have to go by the circumstances of the case. For example a debtor who owes among other debts Rs.2000/- to a creditor and pays Rs.2000/- on a given day when the debt of Rs.2000/- falls due, then the amount must be accordingly applied and the debt be discharged accordingly.

#### (ii) Application of payment where debt to be discharged is not indicated

"Where the debtor has omitted to intimate and there are no other circumstances indicating to which debt the payment is to be applied, the creditor may apply it at his discretion to any lawful debt actually due and payable to him from the debtor whether its recovery is or is not barred by the law in force for the time being as to the limitation of suits".



From the above it can be seen that the creditor enjoys the right to appropriate even to a debt which is barred by limitation.

It was held by Lord Macnaughten in *Cory Bros. & Co. vs. Owner of the Mecca* (1817) A.C.286.293 that if the debtor does not make any appropriation, at the time of payment, the right devolves on the creditor. Creditors have a right to decide till the very last moment. The above decision was followed in a number of important cases including in the famous case of *Vinkatadri Appa Rao vs Parthasarathi Appa Rao* [(1921) L.R. 48. I.A. 150; 44 Mad 570 573]. In the said case it was held that creditor can decide at his discretion on the appropriation of payment towards any lawful debt even if barred by limitation. If there is any debt carrying interest and if there are no express or implied instructions the amount paid should be appropriated towards payment of interest and then to capital.

**(iii) Application of payment when neither party appropriates**

In terms of section 61 of the Act, where neither party appropriates

- (a) the payment shall be applied in discharge of debts in order of time and
- (b) if the debts are of equal standing the payment shall be applied in discharge of each proportionately.

The above appropriation takes place whether or not the debt is barred by limitation.

For example where there are two debts of Rs.500 and another Rs.700 falling due on the same day, and if the debtor pays Rs.600/- the appropriation shall be prorata of Rs.250/- and Rs.350/- for the two debts.

**1.38 CONTRACT, WHICH NEED NOT BE PERFORMED**

A contract would not require performance under circumstances spelt out in Sections 62 to 67 of the Act. These circumstances are (i) novation, (ii) rescission, (iii) alteration and (iv) remission.

Section 62 of the Act provides that “if the parties to a contract agree to substitute a new contract for it or to rescind or alter it, the original contract need not be performed”.

**(a) Effect of novation**

Novation means substitution. Where a given contract is substituted by a new contract it is novation. The old contract, on novation ceases. It need not be performed. Novation can take place with mutual consent. However novation can take place by substitution of new contract between the same parties or between different parties. Novation results in discharge of old contract. This can be illustrated as follows -

- (i) A owes money to B under a contract. It is agreed between A, B and C that B shall thenceforth accept C as his debtor, instead of A. The old debt of A to B is at an end, and a new debt from C to B has been contracted.



**(b) Effect of rescission**

In case of rescission, the old contract is cancelled and no new contract comes in its place. A contract is also discharged by rescission. Some times parties may enter into an agreement to rescind the previous contract. Sometimes, the contract is rescinded by implication or by non-performance for a long time without each other complaining about it.

**Difference between novation and rescission**

While novation involves rescission, there is no novation in rescission. Both in novation and rescission the contract is discharged by mutual agreement. In both cases parties enter into a new contract to come out of the old contract. The new agreement is the consideration for rescission.

**(c) Effect of alteration**

Where the contract is altered, the original contract is rescinded. Hence the old one need not be performed whereas the new one has to be performed. Alteration involves both rescission and novation. The line of difference between alteration and novation is very thin. While there can be very minor alterations, there can not be unilateral material alteration to a contract. If it is done it will be void.

**Novation and alteration**

Both in novation and in alteration the old contract need not be performed.

The main difference between the two are

- (a) novation involves changes in the terms of contract. It also sometimes means change in the parties to contract. It in effect operates as a substitution of the old contract
- (b) in alteration there are only changes in the term of contract, by mutual consent. The parties to contract remain the same
- (c) in alteration there is no substitution of old terms; only some terms and conditions change.
- (d) Remission of performance

Remission means waiver. Section 63 of the Act deals with remission. It provides that “every promisee may dispense with or remit wholly or in part, the performance of the promise made to him or may extend the time for such performance or may accept instead of it any satisfaction which it thinks fit”. Thus the promisee can waive either in full or in part the obligation of the promisor or extend the time for performance. For example where ‘A’ owes ‘B’ a sum of Rs.1 lakh, ‘B’ may accept a part of it in full and final settlement of the due or waive his entire claim.

While granting the time to the promisor, the promisee cannot do so for his benefit but can do so only for the benefit of the promisor. For example where ‘A’ promises ‘B’ that he would



deliver certain goods by a certain date, 'B' can extend the time but he cannot take advantage to charge interest on the extended time.

Similarly a promisee can accept any other performance to his satisfaction instead of the specified stipulated performance.

For example where A promises to sell his horse for a consideration of Rs.5000/- to 'B', 'A' may instead of cash consideration of Rs.5000/- may accept jewellery worth Rs 5,000/- in full satisfaction of the consideration. In a situation like this the essential element of 'satisfaction' is that the promisee must accept the consideration unequivocally. If a promisor tenders some thing in full satisfaction but the promisee does not accept it or accepts in part performance, such satisfaction will fall outside the ambit of section 63 of the Act. [ Shyamnagar tin Factory vs Snow White Food Products, A.I.R (1965) Cal 54]

It should be noted that novation, rescission or alteration cannot take place without consideration but in case of part or complete rescission no consideration is required. The promisee can dispense with performance without consideration and without a new agreement.

### **1.39 RESTORATION OF BENEFIT UNDER A VOIDABLE CONTRACT**

It has already been seen that certain contracts referred to in Sections 19, 19A, 39, 51, 54 & 55 are voidable. The question for consideration is what is the effect of recession of contract by that person at whose option the contract is voidable. The following are the effects of such an action

- (i) The other party need not perform the promise
- (ii) Any benefit received by the person rescinding it must restore it to the person from whom it was received.

A voidable contract which is voidable either at its inception or subsequently comes to an end when it is avoided by the party at whose option it is avoided. In such a case, not only the contract need not be performed there is also restoration of benefit.

- (a) the injured party on account of non performance of the contract is entitled to recover compensation for damages suffered and
- (b) benefits received must be restored.

In Murlidhar vs. International Film Co. A.I.R 1943 P.C. 34, the plaintiff having wrongfully repudiated the contract, the defendants rescinded it u/s 39 of the Act. The plaintiff brought a suit to recover Rs.4000/- paid to the defendant. Held defendant was bound to restore the amount after setting off such damages.

When an insurance company has rescinded the policy because the policy holder could not disclose material information, it should refund the premium after making necessary adjustments for expenses already incurred.



It should be noted that any benefit received out of ancillary transaction to the contract need not be restored. For example earnest money paid in connection with sale of land by the seller, may be retained by him although he has validly rescinded the contract.

**1.40 OBLIGATIONS OF PERSON WHO HAS RECEIVED ADVANTAGE UNDER VOID AGREEMENT OR ONE BECOMING VOID.**

In terms of section 65 of the Act, where

- (a) an agreement is discovered to be void or
- (b) a contract becomes void

any person who received an advantage must

- (a) restore it or
- (b) pay compensation for damages in order to put the position prior to contract.

In *Dhuramsey vs. Ahgmedhai* (1893) 23 Bom 15, the plaintiff hired a godown from the defendant for 12 months and paid the advance in full. After about seven months the godown was destroyed by fire, without any fault on the part of plaintiff. When the plaintiff claimed refund of the advance, it was upheld that he was entitled to recover the rent for the unexpired term.

The next issue is the benefit which has to be returned must have been received under the contract. Any benefit received which is ancillary to main contract need not be returned. For example, the deposit paid for a transaction of sale of house between parties, need not be returned just because the sale transaction could not take place. This was on the ground that the deposit is only a security and not part of main contract.

**Communication of rescission**

Just as a proposal has to be communicated, a rescission should also be communicated. A rescission may be revoked in the same manner a proposal is revoked.

**Effects of neglect of promise**

Where any promisee neglects or refuses to afford the promisor usual facilities to enable the promisor to fulfill the promise, the promisor is not liable for non-performance. Where 'A' promises to repair 'B's house for a consideration but 'B' never showed 'A' his house, 'A' is discharged from fulfilling the obligation.

**1.41 DISCHARGE OF A CONTRACT**

A contract may be discharged in eight ways as discuss hereunder.



**(a) Discharge by performance**

Discharge by performance will take place when there is (i) Actual performance or (ii) Attempted performance

Actual performance / discharge takes place when parties to the contract fulfill their obligations within time and in the manner prescribed. Here each party has done what he has to do under the contract. In attempted performance the promisor offers to perform his part but the promisee refuses to accept his part. This is also known as tender.

**(b) Discharge by mutual agreement**

Discharge also takes place where there is substitution [novation] rescission, alteration and remission. In all these cases old contract need not be performed.

**(c) Discharge by impossibility of performance**

A situation of impossibility may have existed at the time of entering into the contract or it may have transpired subsequently (also known as supervening impossibility)

Impossibility can arise when

- (i) there is an unforeseen change in law.
- (ii) destruction of subject matter.
- (iii) non-existence or non occurrence of a state of thing to facilitate happening of the agreement.
- (iv) personal incapacity of the promisor.
- (v) declaration of war.

**(d) Discharge by lapse of time**

Performance of contract has to be done within certain prescribed time. In other words it should be performed before it is barred by law of limitation. In such a case there was no remedy for the promisee. For example where ,then the debt is barred by law of limitation.

**(e) Discharge by operation of law**

Where the promisor dies or goes insolvent there is a discharge by operation of law.

**(f) Discharge by breach of contract**

Where there is a default by one party from performing his part of contract on due date then there is breach of contract. Breach of contract can be actual breach or anticipatory breach. Where a person repudiates a contract before the stipulated due date, it is anticipatory breach. In both the events, the party who has suffered injury is entitled for damages. Further he is discharged from performing his part of the contract.



- (g) A promisee may remit the performance of the promise by the promisor. Here there is a discharge. Similarly the promisee may accept some other satisfaction. Then again there is a discharge on the ground of accord and satisfaction
- (h) When a promisee neglects or refuses to afford the promisor reasonable facilities or opportunities for performance, promisor is excused by such neglect or refusal.

#### 1.42 SELF-EXAMINATION QUESTIONS

1. In a contract where there are two parties each one has to perform his part before he demands the other to perform – what is the name of this obligation?
2. In the absence of personal consideration of the promisor, can his representative perform the promise?
3. Can the promisee accept the performance from a third party instead of the promisor?
4. In case of joint promise, where all the joint promisors die, whether the legal representatives of all of them are bound to perform the promise?
5. 'B' the son of 'A' has inherited assets & liabilities from his father after his death. But the liabilities were more than the assets. Whether 'B' will be responsible to pay only to the extent of the assets he has inherited?
6. What is the other name of the first act of offering performance in any promise?
7. When a party to a contract has refused to perform the promise he has made, can the other aggrieved party terminate the contract or indicate by words or conduct that he is interested in its continuance?
8. A,B and 'C' jointly borrowed a sum of money from 'X'. 'A' dies, whether his legal representative 'L' would be liable to repay the loan along with 'B' and 'C'?\*\*\*\*\*
9. When two or more persons make a joint promise, the promisor can compel any one of the joint promisees to perform the whole of promise - Is it true?
10. X,Y & Z jointly borrow from 'P' Rs.3000/- the liability of borrower is joint & several.
  - (i) Whether 'P' can recover the amount either from 'X' or from 'Y' or from 'Z' or from all of them jointly?
  - (ii) Similarly whether the creditor can bring a suit against any one or more of legal heirs of a debtor on his death?
11. In case of partners, or of members of Hindu Undivided Family whether all the joint promisees should sue the promisor to enforce a promise?
12. When no time is specified for performance of a promise, how it must be performed?
13. Where the place is not fixed for the performance of a promise, what is the duty of the promisor to ask the promisee?





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14. A sells 500 qtls of rice to 'B' and 'B' promises to pay the price on delivery. What is the name of promise in this case?
  - (ii) In the above case, whether simultaneous performance is possible?
15. In performance of reciprocal promise where one order is expressly fixed and in the other the order is understood by implication. Is this possible?
16. What if a Section of the reciprocal promise is valid?
17. In reciprocal promise the first part being legal, the second part being illegal, what will happen to the legal and illegal part of contract?
18. In a contract, promise must be performed within a reasonable time, otherwise what will happen to it?
19. (i) When both the promisor and promisee are ignorant of the impossibility of the promise what will happen to the contract?
  - (ii) Where in the above case the promisor only knows about the impossibility of the promise what is the remedy available to the promisee?
20. Can a creditor enjoy the rights to appropriate debts which is barred by limitation?
21. Where there are two debts one Rs.500/- another Rs.700/- falling due on the same day and if the debtor pays Rs.600/-. Whether the appropriation can be made pro rata for the two debts?
22. What is the name given to a contract which is substituted by a new contract?
23. In case of rescission what happens to the old contract?
24. What is called remission?
25. Under voidable contract, earnest money paid in connection with sale of land to the seller can be retained by him – is it correct?
26. What are the two types of discharges of performance?
27. What is the discharge of contract when a promisor dies or goes insolvent?

### **Answers**

1. Primary tenet
2. Yes
3. Yes
4. Yes
5. Yes
6. Tender



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7. Yes
8. Yes
9. Yes
10. Yes, No
11. Yes
12. Within a reasonable time
13. To fix a reasonable place
14. Reciprocal promise, Yes
15. Yes
16. Section 57
17. Legal – valid  
Illegal – void
18. Will become voidable
19. Void, He can claim compensation
20. Yes
21. Yes
22. Novation
23. Cancelled
24. Waiver
25. Yes
26. Actual performance, attempted performance
27. Discharge by operation of law



**UNIT – 5 : BREACH OF CONTRACT**

**Learning objectives**

After studying this unit, you would be able to -

- ◆ Understand the concept of breach of contract and various modes thereof.
- ◆ Understand the rule laid down in 'Hadley vs. Baxendale' for award of compensation.
- ◆ Be clear about how the damages are to be measured.
- ◆ Note the circumstances when vindictive damages are awarded.

Let us now examine breach of contract and the methodology for estimation of compensation for such breach of contract.

**1.43 ANTICIPATORY BREACH OF CONTRACT**

Where the promisor refuses to perform his obligation even before the specified time for performance and signifies his unwillingness, then there is an anticipatory breach.

Leading case on this point is *Huckster vs. Deal Tour*. In this case defendant had engaged the services of plaintiff as his attendant for a tour of the continent from June 1<sup>st</sup> on a fee of £10 per month for three months. However defendant changed his mind before June 1<sup>st</sup> and informed the plaintiff that his services are not required. This is thus a case of anticipatory breach of contract. It was held in this case that plaintiff could put an end to the contract even before the due date viz 1<sup>st</sup> June and he need not wait for the date meant for performance of the promise.

The principle of anticipatory breach was well summed up in *Frost vs. Knight*. In the above case it was held that promisee could wait till the due date of performance also before he puts an end to the contract. In such a case the amount of damages will vary depending on the circumstances. This can be explained with the following illustration. 'X' agrees to sell 'Y' certain quantity of wheat at a certain price. viz @ Rs.100/- per quintal by 3<sup>rd</sup> March. However on 2<sup>nd</sup> February X gives notice of his unwillingness to sell the given goods. Price of wheat on that date is Rs.110/- per quintal. 'Y' has a right to repudiate the contract on the same day instead of waiting for the date of performance. On that day 2<sup>nd</sup> February, he is entitled to recover damages of Rs.10/- per quintal this being the difference between market price and contracted price. If on the other hand, he chooses to wait till 3<sup>rd</sup> March and the price on that date is Rs.125/-, he can recover damages @ Rs.25/- per quintal. The third possibility is that if between 2<sup>nd</sup> February and 3<sup>rd</sup> March, Government prohibits sale of wheat, then the contract becomes void and Y will not be able to recover any damage whatsoever. Hence from this illustration it would be clear that when the promisee postpones his right to repudiate the promise, it would operate to the advantage of the promisor also depending on circumstances.



#### 1.44 ACTUAL BREACH OF CONTRACT

Where one of the parties breaches the contract by refusing to perform the promise on due date, it is known as actual breach of contract. In such a case the other party to contract obtains a right of action against the one who breached the contract.

#### 1.45 MEASUREMENT OF DAMAGES

In cases where there is a breach of contract, the promisor who breaches is liable to pay compensation for damages suffered by the promisee. The compensation can be classified as

- (i) those for damages that usually arise in the event of breach of contract and
- (ii) those for damages which parties know and anticipated at the time of entering into the contract called special damages. This kind of special damages can be claimed only on previous notice.

However no compensation is payable for any remote or any indirect loss. While assessing the damage the inconvenience caused to the aggrieved party on account of non-performance should be assessed carefully, as the party entitled for compensation, he has a duty to take steps to minimise the loss.

The rules relating to compensation were enunciated in detail in *Hadley vs. Baxendale* (1854) 9 Ex. 341. In this case, the mill of the plaintiff had to be stopped because of a broken crank shaft. The plaintiff sent the crank shaft as a pattern for manufacturing a new one. Till the arrival of the new crank shaft, the mill could not be resumed. Hence mill incurred losses. However this position was not properly conveyed to the defendant, the carrier. There were some delay on the part of the defendant in delivering the crank shaft to the manufacturer which in turn delayed the reopening of the mill. As a result of this, there were losses to the mill. The defendant claimed compensation for loss in profit of the mill. However this was not accepted by court on the ground the plaintiff did not explain to defendant that delay in delivering the crank shaft would delay resumption of the mill and this would result in losses to the plaintiff.

Madras High Court in *Madras Railway Company vs. Govind Ram*, Mad. 176 upheld the same principle as above. In that case a tailor had given his sewing machine to railways to be delivered at a station as a consignment. He did not mention that any delay in delivering the sewing machine would result in damages for the business of the tailor as he had planned to do good business at the place proposed where a festival was to be held. The sewing machine was delivered after the festival was over. Held Railways were not responsible for the damages as the Railway authorities were not informed of the specific purpose of delivery of the sewing machine namely business during a festival.



### **1.46 LIABILITY FOR DAMAGES**

The liability to pay damages is of four kinds. They are:

- (i) liability for special damages
- (ii) liability for exemplary damages
- (iv) liability to pay nominal damages and
- (v) liability to pay damages for deterioration caused by delay.

Now let us discuss each one of them

#### **(i) Liability for special damages**

Where it is understood between parties that in the event of breach of contract, there would be special damages also in addition to normal damages, then special damages would be payable. In our given example above if the tailor had informed about the special circumstances, special damages would have become payable.

#### **(ii) Liability for exemplary damages**

These situations may arise mainly in two cases namely (i) breach of promise to marry and (ii) wrongful dishonour of cheques of customer by bank.

In case of breach of promise to marry the damages are awarded taking into account the injury or humiliation which the aggrieved person would have suffered

In case of wrongful dishonour of cheques the damages would depend upon the loss of credit and reputation suffered by the customer. The damages could be very heavy if loss had been suffered by a businessman, when compared to a non-businessman customer. For example Mrs. G, a non-trader paid a cheque for £90 and 16 shillings drawn on Westminster Bank to her landlord for rent. The cheque was dishonoured by the bank. But she was awarded damages of only 40 shilling as nominal damages. [Gibbons vs. Westminster Bank (1939) 2 K.B. 882]

Similarly where the value of cheque is small the damages could be very heavy in comparison to a situation where the value of cheque is heavy. This is on the theory that dishonour of a small value of cheque would cause more damages to the honour of the customer.

#### **(iii) Liability to pay nominal damages**

Nominal damages are awarded in those cases of breach of contract where no damage has been suffered. Such damages are awarded only to establish the right to decree for breach of contract. Such damages are for nominal amounts like ten rupees or even ten paise.

#### **(iv) Damages for deterioration caused by delay**

Compensation can be recovered even without notice for damages or 'deterioration' caused to goods on account of delay by carriers amounting to breach of contract. Here the word



“deterioration” means not only physical damages but also loss of opportunity. In *Wilson vs. Lancashire and Yorkshire Railway Company* 50 LJCP 232, the plaintiff bought velvet with a view to making it into caps for sale during spring. But due to delay in transit, he was unable to use the velvet for making caps for sale during season.

It was held that the fall in value of sale of cloth in consequence of the same having arrived after the season amounted to deterioration. It was here held that the plaintiff is entitled for compensation without notice.

#### **1.47 HOW TO CALCULATE THE DAMAGE**

In case of a contract for sale of goods, where the buyer breaks the contract, the damages would be the difference between contract price and market price as on the date of breach. Similarly where the seller breaks the contract, the buyer can recover the difference between market price and contract price as on date of breach. [students may please appreciate the subtle difference between the two]

If the seller retains the goods after the contract has been broken by the buyer he cannot recover from the buyer any further loss even if the market falls. Again he is not liable to have the damages reduced if the market rises.

In *Jamal vs. Mulla Dawood* (1961) 43.I.A. 6, the defendant agreed to purchase from the plaintiff, certain shares on December 30, but wrongfully rejected them when tendered on date. The difference between the contract price and market price amounted to Rs.1,09,218; the plaintiff recovered a part of the loss by selling those shares in a rising market and the actual loss amounted to Rs.79,882. The plaintiff, however, sued the defendant claiming Rs.1,09,218 as damages and the Privy Council allowed the claim in full.

#### **Duty to mitigate loss.**

The person who suffers losses on account of breach of contract by the other party must take all reasonable steps to mitigate the loss.

#### **1.48 COMPENSATION FOR BREACH OF CONTRACT WHERE THE PENALTY IS STIPULATED FOR**

The compensation for breach of contract falls into two broad categories namely liquidated damage and penalty.

Liquidated damage is a genuine pre estimate of compensation for damages for certain anticipated breach of contract. This estimate is agreed to between parties to avoid at a later date detailed calculations and the necessity to convince outside parties.

Penalty on the other hand is an extravagant amount stipulated and is clearly unconscionable and has no comparison to the loss suffered by the parties.



The distinction between liquidated damages and penalty is very much part of English law, whereas Section 74 of the Indian Contract Act 1872 does not make any such distinction.

In terms of Section 74 of the Act “where a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach, can claim whether or not actual damages or loss is proved to have been caused thereby, from the other party, a reasonable compensation not exceeding the amount so named, or as the case may be the penalty stipulated for.

Any stipulation for payment of increased interest is a stipulation for payment of penalty which has to be paid.

There are however exceptions to the general rule laid down in Section 74.

These are:

- (a) In contract of bail bond recognizance and other similar instrument or under laws of any state govt. or a contract where public is interested, any one who makes a breach of such contract shall be liable to pay whole sum mentioned
- (b) Person who enters into a contract with govt. does not necessarily thereby undertake any public duty or to do an act in which public is interested.

In terms of Section 74, courts are empowered to reduce the sum payable on breach whether it is ‘penalty’ or “liquidated damages” provided the sum appears to be unreasonably high.

Supreme Court in Sri Chunni Lal vs. Mehta & Sons Ltd. A.I.R.1962 S.C. 1314 laid down the ratio that the aggrieved party should not be allowed to claim a sum greater than what is specific in the written agreement. But even there the court has powers to reduce the amount if it considers it reasonable to reduce.

The brief facts of the case leading to the above ratio is as follows:

Where the parties to a contract specify liquidated damages then the right to claim an uncertain some of money is excluded. It however does not mean that the party who had suffered by the breach has given up his right to claim an amount whether or not ascertainable or on the date of the breach.

Apart from claiming damages for breach of contract, the following other remedies are also available.

### **Liquidated damages and penalty**

Following are the important differences between liquidated damages and penalty.

- (i) Liquidated damages are imposed by way of compensation, but penalty is imposed by way of punishment.



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- (ii) Liquidated damages are assessed amounts of loss based on actual or probable calculation. Penalty is not based on actuals or probables. It is imposed to prevent parties from committing the breach.
- (iii) Though the English Law recognizes the difference between the two, Section 74 of the act does not recognize any difference between the two.

### (i) Rescission of contract

Where one party breaches the contract, the other party can treat it as rescinded. In this case the other party is absolved of his obligation and is entitled to compensation for damages which he suffered.

### (ii) Suit upon quantum meruit

The phrase 'quantum meruit' literally means "as much as is earned" or "according to the quantity of work done". A person who has begun a civil contract work and has to later stop the work because the other party has made the performance impossible, is entitled to receive compensation on the principle of 'Quantum Meruit'

Following are instances where 'quantum meruit' may arise:

- (a) Where the work has been done and accepted under a contract which is subsequently discovered to be void. In such a case, the person who has performed his part of the contract is entitled to recover the amount for the work done and the party, who receives and accepts the benefit under such contract, must make compensation to the other party.
- (b) Where a person does some act or delivers something to another person with the intention of receiving payment, the other person is bound to make payment if he accepts such services or goods or enjoys the benefits.
- (c) Where the contract is divisible and where a party performs a part of the contract and refuses to perform the remaining part, the party in default may sue the other party who enjoyed the benefit of the part performance.

### (iii) Suit for specific performance

Where damages are not an adequate remedy in the case of breach of contract, the court may in its discretion on a suit for specific performance direct the party in breach, to carry out his promise according to the terms of the contract.

## 1.49 SELF-EXAMINATION QUESTIONS

1. Can remedy by way of compensation for damages suffered be available both in anticipatory breach and actual breach of contract?
2. In case of breach of promise to marry the damages are awarded under what type of measurement of damage and what will be taken into account to give damage?





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3. Under dishonour of cheque when the value of cheque is small the damage will be heavy and vice versa – is it true?
4. When the buyer breaks the contract, the damage would be the difference between \_\_\_\_ price and \_\_\_\_ price.  
When the seller breaches the contract, the buyer can recover the difference between \_\_\_\_ price and \_\_\_\_ price as on the date of breach.
5. What is meant by “Quantum Merit”?
6. How liquidated damages and penalty are imposed?

### **Answers**

1. Yes
2. Exemplary damages, would take into account the injury suffered by the person
3. True
4. Contract, Market  
Market, Contract
5. (a) “as much as is earned”  
(b) “according to the quantity of work done”
6. (i) By compensation (ii) By punishment



## UNIT – 6: CONTINGENT AND SPECIAL CONTRACTS

### Learning objectives

After studying this unit, you would be able to -

- ◆ Have clarity about the basic characteristics of 'Contingent contract' and 'quasi-contract' so that you are able to distinguish between a contract of any of these types and a simple contract.
- ◆ Be familiar with the rules relating to enforcement of these in order to gain an understanding of rights and obligations of the parties to the contract.

In this unit we shall briefly examine

- (a) 'Contingent contracts' and the rules regarding their enforceability and
- (b) Quasi contracts

### 1.50 CONTINGENT CONTRACT

In terms of section 31 of the Act contingent contract is a contract to do or not to do something, if some event collateral to such contract does or does not happen. Contracts of indemnity and contracts of insurance fall under this category.

For instance if 'A' contracts to pay 'B' Rs.100000/- if B's house is destroyed by fire then it is a contingent contract.

#### Essentials of a contingent contract

- (a) The performance of a contingent contract would depend upon the happening or non-happening of some event or condition. The condition may be precedent or subsequent
- (b) The event referred to is collateral to the contract. The event is not part of the contract. The event should be neither performance promised nor a consideration for a promise.

Where 'A' agrees to deliver 100 bags of wheat and 'B' agrees to pay after delivery, this is a conditional contract and not a contingent contract. Similarly where 'A' promises to pay 'B' Rs.10000/- if he marries 'C' is not a contingent contract but a conditional contract.

- (c) The contingent event should not be a mere 'will' of the promisor. The event should be contingent in addition to being the will of the promisor.

For example if 'A' promises to pay 'B' Rs.10000/- if 'A' left for Delhi from Mumbai on a particular day, it is a contingent contract because though 'A's leaving for Delhi is his own will, it cannot happen only at his will.



### **1.51 RULES RELATING TO ENFORCEMENT**

The rules relating to enforcement of a contingent contract are laid down in sections 32,33,34 and 36 of the Act. Let us now examine these rules.

#### **(a) Contingency is the “happening of an event”**

Where a contract identifies happening of a future contingent event, the contract cannot be enforced until and unless the event ‘happens’. If the happening of the event becomes impossible, then the contingent contract is void. For instance ‘X’ enters into a contract to buy ‘Y’s car provided ‘Y’ survives ‘A’. Here ‘Y’ surviving ‘A’ or ‘A’ dying before ‘Y’ is the event on which the contract is contingent and they cannot be enforced until ‘A’ dies.

#### **(b) Contingency is the non-happening of an event**

Where a contingent contract is made contingent on a non-happening of an event, it can be enforced only when its happening becomes impossible. For example where ‘P’ agrees to pay ‘Q’ a sum of money if a particular ship does not return, the contract becomes enforceable only if the ship sinks so that it cannot return.

#### **(c) Contingent on the future conduct of a living person**

A contract would cease to be enforceable if it is contingent upon the conduct of a living person when that living person does some thing to make the ‘event’ or ‘conduct’ as impossible of happening. For example where ‘A’ agrees to pay ‘B’ a sum of money if ‘A’ marries ‘C’. ‘C’ marries ‘D’. This act of ‘C’ has rendered the event of ‘A’ marrying ‘C’ as impossible; it is though possible if there is divorce between ‘C’ and ‘D’.

#### **Contingent on an impossible event**

A contingent agreement to do a thing or not to do a thing if an impossible event happens is void and hence is not obviously enforceable. The situation would not change even if the parties to the agreement are not aware of such impossibility. ‘A’ agrees to pay ‘B’ Rs. One lakh if Sun rises in the west next morning. This is an impossible event and hence void.

#### **Difference between a contingent contract and a wagering contract**

1. A wagering agreement is a promise to give money or money’s worth with reference to an uncertain event happening or not happening.  
A contingent contract is a contract to do or not to do something with reference to a collateral event happening or not happening.
2. A wagering agreement consists of reciprocal promises whereas a contingent contract may not contain reciprocal promises.
3. In a wagering contract the uncertain event is the core factor whereas in a contingent contract the event is collateral.



4. A wagering agreement is essentially contingent in nature whereas a contingent contract may not be wagering in nature.
5. In a wagering agreement, the contracting parties have no interest in the subject matter whereas it is not so in a contingent contract.
6. A wagering contract is a game, losing and gaining alone matters whereas it is not so in a contingent contract.
7. A wagering agreement is void where as a contingent contract is valid.

### **1.52 QUASI – CONTRACTS**

Even in the absence of a contract, certain social relationships give rise to certain specific obligations to be performed by certain persons. These are known as quasi contracts as they create same obligations as in the case of regular contract.

In the words of Anson “Circumstances must occur under any system of law in which it becomes necessary to hold a person to be accountable to another without any agreement on the part of the former to be so accountable on the ground that otherwise he would be retaining money or some other benefit which has come into his hands to which the law regards the other person as better entitled, or on the ground that contracts exist to provide remedies in circumstances of the kind”.

Quasi contracts are based on principles of equity, justice and good conscience.

#### **Salient features of quasi contracts are:**

- (a) In the first place, such a right is always a right to money and generally, though not always, to a liquidated sum of money.
- (b) Secondly, it does not arise from any agreement of the parties concerned, but it imposed by the law; and
- (c) Thirdly, it is a right which is available not against all the world, but against a particular person or persons only, so that in this respect it resembles a contractual right.

### **1.53 TYPES OF QUASI CONTRACT**

There are five circumstances which are identified by the Act as quasi contracts. These five circumstances do not result in regular contracts.

#### **(a) Claim for necessaries supplied to persons incapable of contracting.**

Any person supplying necessaries of life to persons who are incapable of contracting is entitled to claim the price from the other person’s property. Similarly where money is paid to such persons for purchase of necessaries, reimbursement can be claimed.



For example if 'A' supplies necessities of life to 'B' a lunatic or to his wife or child whom 'B' is liable to protect and maintain, then 'A' can claim the price from the property of 'B'. For such claim to be valid 'A' should prove the supplies were to the actual requirements of 'B' and his dependents. No claim for supplies of luxury articles can be made. If 'B' has no property 'A' obviously cannot make his claim.

**(b) Right to recover money paid for another person.**

A person who has paid a sum of money which another is obliged to pay, is entitled to be reimbursed by that other person provided the payment has been made by him to protect his own interest.

Here the person who makes the payment must honestly believe that his own interest demands payment. [Muni Bibi vs. Trilokinath]. Presence of reasonable ground even if unfounded is enough.

In a case the plaintiff agreed to purchase certain mills and to save it from being sold to outsiders paid certain arrears of municipal dues. Here the payment made by the plaintiff was held to be recoverable as he had interest in the property as prospective buyer.

**(c) Obligation of person enjoying benefits of non-gratuitous act .**

In term of section 70 of the Act "where a person lawfully does anything for another person, or delivers anything to him not intending to do so gratuitously and such other person enjoys the benefit thereof, the latter is bound to pay compensation to the former in respect of, or to restore, the thing so done or delivered.

In the above situation there are three limbs namely

- (i) plaintiff must have acted lawfully & paid.
- (ii) the payment was not intended to be gratuitous and
- (iii) the other person enjoyed the benefit.

The above can be illustrated by a case law where 'K' a government servant was compulsorily retired by the government. He filed a writ petition and obtained an injunction against the order. He was reinstated and was paid salary but was given no work and in the mean time government went on appeal. The appeal was decided in favour of the government and 'K' was directed to return the salary paid to him during the period of reinstatement. [Shyam Lal vs. State of U.P. A.I.R (1968) 130]

**(d) Responsibility of finder of goods.**

In terms of section 71 'A person who finds goods belonging to another and takes them into his custody is subject to same responsibility as if he were a bailee'.

Thus a finder of lost goods has



- (i) to take proper care of the property as men of ordinary prudence would take
- (ii) no right to appropriate the goods and
- (iii) to restore the goods if the owner is found.

Where 'P' a customer in 'D's shop puts down a brooch worn on her coat and forgets to pick it up and one of 'D's assistants finds it and puts it in a drawer over the week end. On Monday, it was discovered to be missing. 'D' was held to be liable in the absence of ordinary care which a prudent man would have taken.

**(e) Liability for money paid or thing delivered by mistake or by coercion.**

In terms of section 72 of the Act, "a person to whom money has been paid or any thing delivered by mistake or under coercion, must repay or return it. Every kind of payment of money or delivery of goods for every type of 'mistake' is recoverable. It is not necessary to distinguish between a mistake of fact and mistake of law [Shivprasad vs Sirish Chandra A.I.R. 1949 P.C. 297]

A payment of municipal tax made under mistaken belief or because of mis- understanding of the terms of lease can be recovered from municipal authorities. The above law was affirmed by Supreme Court in cases of Sales tax officer vs. Kanhaiyalal A.I.R.1959 S.C.835

Similarly any money paid by coercion is also recoverable. The word coercion is not necessarily governed by S.15 of the Act. The word is interpreted to mean and include oppression, extortion, or such other means [Seth Khanjelek vs National Bank of India].

In a case where 'T' was traveling without ticket in a tram car and on checking he was asked to pay Rs.5/- as penalty to compound transaction. T filed a suit against the corporation for recovery on the ground that it was extorted from him. The suit was decreed in his favour. [Trikamdas vs. Bombay Municipal Corporation A.I.R.1954]

In all the above cases the contractual liability arose without any agreement between the parties.

**1.54 SELF-EXAMINATION QUESTIONS**

1. Give examples for contingent contract?
2. What are the rules relating to enforcement of a contingent contract?
3. Where a contract identifies happening of future contingent event, whether the contract can be enforced until and unless the event happens?
4. 'A' agrees to pay 'B' Rs. One lakh if sun rises in the west next morning. Is the contract valid?



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5. A promises to give money or money's worth if an uncertain event happens or does not happen is.....agreement. A contract to do or not to do something with reference to a collateral event happening or not happening is.....contract. Fill in the blanks.
6. Quasi contract does not arise from any agreement of the parties concerned, but it is imposed by law. Is this correct. How?
7. If necessaries are supplied to persons incapable of contracting whether the supplier is entitled to claim their price from the property of such a person?
8. Can a finder of goods appropriate those goods to his own use?
9. What is the liability u/s.72 of the Contract Act of a person to whom money has been paid or anything delivered?

### **Answers**

1. Contract of Insurance
2. Refer Section.32, 33, 34 and 36
3. No
4. No – Contract is void
5. Wagering, Contingent
6. Yes
7. Yes
8. No
9. The person must repay or return it.



**UNIT – 7 : CONTRACT OF INDEMNITY AND GUARANTEE**

**Learning objectives**

After studying this unit, you would be able to -

- ◆ Be conversant with the two special type of contracts i.e. Indemnity contracts and Guarantee contracts and also the nature of obligations and rights of each of the parties to the contracts.
- ◆ Be clear about distinction between these contracts.

In this unit let us discuss and learn the law relating to indemnity and guarantee.

**1.55 CONTRACT OF INDEMNITY**

In terms of Section 124 of the Act, ‘a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or the conduct of any person is called a “contract of indemnity”. This is also a typical contingent contract.

For example, A may contract to indemnify B against the consequences of any proceedings which C may take against B in respect of a sum of Rs.5000/- advanced by C to B. In consequence, when B who is called upon to pay the sum of money to C fails to do so, C would be able to recover the amount from A as provided in Section 124.

Rights of Indemnity –Holder when sued

In a contract of indemnity, the promisee acting within the scope of his authority is entitled to recover from the promisor

- (a) all damages which he may be compelled to pay
- (b) all costs which he may have been compelled to pay in any suit and
- (c) all sums which he may have paid under the terms of any suit

It may be understood that the rights contemplated u/s 125 are not exhaustive. The indemnity holder has other rights besides those mentioned above. If he has incurred a liability and that liability is absolute, he is entitled to call upon his indemnifier to save him from the liability and to pay it off.

**1.56 CONTRACT OF GUARANTEE**

A contract of guarantee is a contract to perform the promise made or discharge liability incurred by a third person in case of his default. For example, where ‘A’ obtains housing loan from LIC Housing and if ‘B’ promises to pay LIC Housing in the event of ‘A’ failing to repay, it is a contract of guarantee.





The principle of implied promise to indemnify surety (one who gives guarantee) is contained in Section 145 of the Act which provides that 'in every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety and the surety is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee but no sum which he has wrongfully paid.

The right of surety is not affected by the fact that the creditor has refused to sue the principal debtor or that he has not demanded the sum due from him.

What constitutes consideration in a case of guarantee is an important issue and is laid down in section 127 of the Act. As per section 127 of the Act "anything done or any promise made for the benefit of the principal debtor may be sufficient consideration to the surety for giving the guarantee.

For example 'A' had advanced money to 'B' on a bond hypothecating B's property stating that C is the surety for any balance that might remain due after realization of B's property. C was not a party to the bond. He, however signed a separate surety bond two days subsequent to the advance of the money. It was held that the subsequent surety bond was void for want of consideration: (Nanak Ram vs. Mehinlal 1877, 1 Allahabad 487).

#### **1.57 NATURE OF SURETY'S LIABILITY**

As per Section 128 of the Act, the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. Thus it can be seen:

- (i) the liability of surety is the same as that of principal debtor
- (ii) where a debtor cannot be held liable on account of any defect in the document, the liability of the surety also ceases
- (iii) surety's liability continues even if the principal debtor has not been sued or is omitted from being sued. This is for the reason that the liability of the surety is separate on the guarantee.

#### **1.58 CONTINUING GUARANTEE**

A guarantee which extends to a series of transactions is called a 'continuing guarantee'. Where 'A' promises 'B' to be responsible, so long 'B' employs only 'C' to collect his rentals from tenants for an amount of Rs.5000/-, there is a continuing guarantee by A to B so long 'C' is employed as rent collector. In other words A stands a guarantor to 'B' for rent collected by 'C'.

There are two important aspects regarding continuing guarantee which should be borne in mind.

The first aspect is "the continuing guarantee may at any time be revoked by the surety as to future transactions by notice to creditors". However no revocation is possible where a



continuing relationship is established. For instance where 'A' becomes surety of 'C' for B's conduct as manager in C's bank and 'B' is appointed on the faith of this guarantee, 'A' is precluded from annulling the guarantee so long as B acts as manager in C's bank.

The second aspect is upon the death of surety, the continuing guarantee is revoked for all future transactions in the absence of any contract to the contrary.

### **1.59 DISCHARGE OF A SURETY**

Sections 133 to 139 of the Act lay down the law as to when a surety would be discharged.

These are as follows:

- (i) where there is any variance in the terms of contract between the principal debtor and creditor without surety's consent it would discharge the surety in respect of all transactions taking place subsequent to such variance.

Where 'A' stands to 'C' as surety for 'B' for rent payable by 'B' to 'C' for 'C's house and if B & C agree on a higher rent without A's consent, 'A' would stand discharged for the entire rent amount accruing after the date of variance.

- (ii) the surety is discharged if the principal debtor is discharged
  - (a) by a contract or
  - (b) any act or
  - (c) any omission the result of which is the discharge of principal debtor

For instance where 'A' contracts with 'B' to build a house for him and if 'C' stands as surety for 'B', 'C' as surety will stand discharged if 'A' discharges 'B' of his obligation to build house. Yet another example could be where 'A' agrees to build a house for 'B' if 'B' supplies the necessary timber and if 'C' stands as surety for A's performance. If 'B' fails to supply the timber, both 'A' and 'C' stand discharged.

There are certain exceptions to the above rule. These are given hereunder: -

- (a) A mere forbearance on the part of a creditor to sue the debtor or to enforce any other remedy would not discharge the surety in the absence of any specific provision.
- (b) Even where the claim is barred by limitation, surety is still responsible. In *Krishto Kishore vs. Radha Romun* I.L.R. 12 Cal.330, the plaintiff sued the principal debtor and the surety for arrears of rent. The plaintiff also made the legal representatives of the principal debtor a party after knowing about the death of the principal debtor to avoid the debt being barred by limitation. It was held that even if debt is barred by limitation on account of death of principal debtor, the surety is still liable. The same view was confirmed by Privy Council in *Mahant Singh vs U Bai* A.I.R 1939 P.C 110 where it was held that omission of the creditor to sue within the period of limitation does not discharge the surety.



- (iii) Where the principal debtor compounds [settles] with the creditor regarding the amount or promises not to sue, the surety will be discharged. But a contract for giving time to a debtor is entered into with a third party, the surety will not be discharged. Where there are co-sureties release of one co-surety would not automatically discharge the other co-sureties. Further in between other co-sureties, the released co-surety is not absolved of his liability vis a vis other co-sureties.
- (iv) the surety would be discharged if the creditor does anything or acts in a manner which
  - (a) is inconsistent with the rights of surety and
  - (b) impairs the eventual remedy of the surety.

For example, 'A' puts 'M' as the cashier under B and agrees to stand as surety provided 'B' checks the cash every month. 'M' embezzles cash. 'A' was not held to be responsible as B failed to verify the cash every month.

#### **1.60 RIGHTS OF SURETY AGAINST THE PRINCIPAL DEBTOR AND CREDITOR**

The rights of surety are contained in sections 140 and 141 of the Act. These are

##### **(1) Against the principal debtor**

- (a) where a guaranteed debt has become due or default of the principal debtor to perform a guaranteed duty has taken place, the surety upon payment or performance of all that he is liable for, is vested with all the rights which the creditor had against the principal debtor. The right of the surety is known as the right of subrogation namely the right to stand in the shoes of the creditor.
- (b) the surety is entitled to the benefit of all securities made available to the creditor by the principal debtor whether the surety was aware of its existence or not.
- (c) the surety is entitled to recover from the principal debtor what ever sums he has rightfully paid. In this connection the following principles were laid down in Reed vs. Norris
  - (i) the claim of the surety is restricted to that smaller amount which he may have paid under the principle of "accord and satisfaction". Surety is not entitled for higher amount than what he has paid.
  - (ii) surety can also claim indemnity for any special damages which he has suffered while discharging his duties
  - (iii) surety can claim even if he has paid a time barred debt as it is a rightful payment though there are contrary views on this issue.

In all the above instances surety can claim reimbursements only if actual payments have been made and not where he has merely executed promissory notes. [Panth Narayana Murthy vs. Marimuthu (1902) 26 Mad. 322,328]



Where surety becomes surety without the knowledge of principal debtor, he is entitled for all the rights against the principal debtor but not the right to claim an indemnity against the principal debtor.

## **(2) Sureties right against the creditor**

Following are the rights of sureties against the creditor:

- (i) the surety gets the right of subrogation for all payments and performances he is liable. This right would accrue only when the surety has paid the amount of liability in full. For example where a creditor had the right to stop the goods or sellers lien, surety would enjoy the same right after he has paid the amount per *Imperial Bank vs. SL Kathereine Docks* 1877 5 Ch.D.
- (ii) surety is entitled for all securities which the debtor has provided to creditor whether surety is aware of it or not. Where a creditor loses any of the security by default or negligence the liability of the surety abates proportionately. If a creditor does not hand over the securities to surety he can be compelled to do so. Classic examples of surety's right are: he is entitled for all mortgage rights which the secured creditor has. But the surety is not entitled for any security provided subsequent to the contract of guarantee
- (iii) surety has a right to require the creditor to sue for and recover the guaranteed debt. This right of surety is known as right to file a 'Quia timet action" against the debtor. There is of course an inherent risk of having to indemnify the creditor for delay and expense
- (iv) surety has a right to call upon the creditor to dismiss the person from service if the person whose fidelity is guaranteed by surety is persistently dishonest
- (v) surety has a right of set off against the principal debtor exactly as a creditor would have.
- (vi) surety also can compel the creditor where he has claim on two funds, to resort to that fund first on which surety has no claim.
- (vii) surety can claim that he is not liable on the guarantee to the creditor, if it can be proved that principal debtor was incapable of entering into a contract, say because he was a minor.

This is on the principle that the liability of the surety is co-extensive with that of the principal debtor.

## **Guarantee when valid**

Following are the circumstances when a guarantee can be treated as invalid.

- (i) when the guarantee has been obtained by means of mis-representation made directly by the creditor or made with his knowledge and the mis-representation relates to a material part of the transaction.



- (ii) when the creditor has obtained any guarantee by means of keeping silence as to material circumstances.

The expression “keeping silence” implies intentional concealment of a material fact, as distinct from a mere non-disclosure thereof. There must exist some element of fraud. [Balakrishna vs. Bank of Bengal (1891) 15 Bom. 585]. Thus, A engages B as clerk to collect money for him and B fails to account for some of his receipts. Thereupon, A calls upon B to furnish security for his duly accounting the receipts. C gives the required guarantee. A does not apprise C of the fact of a previous defalcation by B and thereafter B again makes a default. The guarantee would be invalid.

- (iii) when a contract of guarantee is entered into on the condition that the creditor shall not act upon it until another person has joined in it as co-surety and that other party fails to join as such.

#### **1.61 CONTRIBUTION AS BETWEEN CO-SURETIES**

As per section 146 of the Act “when two or more persons are co-sureties for the same debt, or duty, either jointly, or severally and whether under the same or different contracts and whether with or without the knowledge of each other, the co-sureties in the absence of any contract to the contrary, are liable, as between themselves, to pay each an equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor”.

A co surety gets a right to recover from other sureties only when he has paid more than his share of debt to the creditor.

#### **Liability of two sureties is not affected by mutual arrangements.**

As per section 132 of the Act “where two persons contract with a third person to undertake a certain liability and also contract with each other that one of them shall be liable only on the default of the other, third person not being a party to such contract, the liability of each of such two persons to the third person under the first contract is not affected by the existence of the second contract, although such third person may have been aware of its existence”.

The foregoing is the position of law applicable when the liability is undertaken jointly by two parties in respect of the same debt. But it is not so when it is in respect of different debts. For example, a party who accepts a bill of Exchange for the accommodation of another would plead that he was the accommodating party. This is because the liability undertaken by the acceptor and drawer of the bill is in no sense a joint liability. Though they contract to pay the same sum of money, they contract severally in different ways and subject to different conditions. [Pages vs. Bank of Bengal (1877) 3 Cal. 174].



### **1.62 DISTINCTION BETWEEN A CONTRACT OF INDEMNITY AND A CONTRACT OF GUARANTEE**

We have in previous para learnt in detail about the contract of indemnity and a contract of guarantee. Now let us analyse the differences between the two.

#### **(i) Number of parties**

In a contract of indemnity there are only two parties namely the indemnifier [promisor] and the indemnified [promisee]. In a contract of guarantee there are three parties creditor, principal debtor and surety.

#### **(ii) Extent of liability**

The liability of the indemnifier is primary and independent. The liability of the surety is secondary as the primary liability is that of the principal debtor.

#### **(iii) Time of liability**

The liability of the indemnifier arises only on the happening of a contingency. In the case of guarantee, liability is already in existence but specifically crystallises when principal debtor fails.

#### **(iv) Time to Act**

The indemnifier need not necessarily act at the request of indemnified. In case of guarantee surety must act by extending guarantee at the request of debtor.

#### **(v) Number of contracts**

In case of indemnity there is only one contract between the indemnified & the indemnifier. In case of guarantee there are three contracts namely (i) between principal debtor and creditor (ii) between the creditor and surety and (iii) between the surety and the principal debtor.

#### **(vi) Right to sue third party**

In case of contract of indemnity, indemnifier cannot sue a third party for loss in his own name as there is no privity of contract. Such a right would arise only if there is an assignment in his favour. On the other hand in the case of contract of guarantee surety can proceed against principal debtor in his own right because he gets all the right of a creditor after discharging the debts.

### **1.63 SELF-EXAMINATION QUESTIONS**

1. A contract of indemnity is a type of contingent contract. Is it true or false?
2. In a contract of indemnity, the promisee is acting within the scope of his authority. Whether he is entitled to recover from the promisor all damages, all cost and all sums which he may have paid?



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3. A obtains housing loan from LIC Housing and if B promises to repay what is the nature of contract?
4. What is called a guarantee which extends to a series of transaction?
5. If A becomes a surety to C for payment of rent by B under a lease and B and C contract, without the consent of 'A' that 'B' will pay higher rent, then what would be the liability of 'A' as a surety?
6. 'A' puts 'M' as the cashier under 'B' and agrees to stand as surety provided, 'B' checks the cash every month. B does not check the cash every month. 'M' embezzles the cash. What is the liability of 'A' in this case?
7. Whether a surety can claim reimbursement only of actual payments that have been made along with merely executed promissory notes?
8. Surety as the debtor is entitled for securities provided to creditor – is it true?
9. Whereas there is only one contract in case of contract of indemnity, how many contracts are there in the contract of guarantee?
10. On discharging the debt due by the principal debtor to the creditor what is the remedy available to the surety?

### **Answers**

1. True
2. Yes
3. Contract of guarantee
4. Continuing guarantee
5. He will be discharged from his liability
6. A was not held to be responsible
7. He can not claim on executed promissory notes
8. Yes
9. Three
10. "He can proceed against the principal debtor"



**UNIT – 8 : BAILMENT AND PLEDGE**

**Learning objectives**

After studying this unit, you would be able to -

- ◆ Understand the general principles underlying contracts of bailment and pledge.
- ◆ Grasp the duties and rights of the parties to the contracts.

**1.64 WHAT IS BAILMENT?**

Bailment etymologically means 'handing over' or 'change of possession'. As per Section 148 of the Act, bailment is an act whereby goods are delivered by one person to another for some purpose, on a contract, that the goods shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person who delivers the goods is the bailor and the person to whom the goods are delivered is the bailee.

For example where 'X' delivers his car for repair to 'Y', 'X' is the bailor and 'Y' is the bailee.

The essential characteristics of bailment are

- (a) Bailment is based upon a contract. Sometimes it could be implied by law as it happens in the case of finder of lost goods.
- (b) Bailment is only for moveable goods and never for immovable goods or money.
- (c) In bailment possession of goods changes. Change of possession can happen by physical delivery or by any action which has the effect of placing the goods in the possession of bailee.
- (d) In bailment bailor continues to be the owner of goods as there is no change of ownership.
- (e) Bailee is obliged to return the goods physically to the bailor. The bailee cannot deliver some other goods, even not those of higher value.

**General issues**

In bailment both custody and possession must change but not the ownership. But where a person is in custody without possession he does not become a bailee. For example servants of a master who are in custody of goods of the master do not become bailees.

Possession and custody do not however mean physical delivery of goods. Constructive delivery could also create a bailor and bailee relationship. This arises in situations where the bailee is already in possession of goods but agrees to be a bailee through a contract.

Deposit of money in a bank is not bailment since the money returned by the bank would not be identical currency notes.





Similarly depositing ornaments in a bank locker is not bailment, because ornaments are kept in a locker whose key are still with the owner and not with the bank. The ornaments are in possession of the owner though kept in a locker at the bank.

### **Different forms of Bailment**

Following are the popular forms of bailment

- (1) Delivery of goods by one person to another to be held for the bailor's use.
- (2) Goods given to a friend for his own use without any charge
- (3) Hiring of goods.
- (4) Delivering goods to a creditor to serve as security for a loan.
- (5) Delivering goods for repair with or without remuneration.
- (6) Delivering goods for carriage.

### **1.65 BAILOR'S DUTIES AND RIGHTS**

The duties of bailor are spelt out in a number of Sections. These are enumerated hereunder:

- (i) the bailor must disclose all defects/faults in the goods bailed. If the bailor does not disclose, he would be responsible for any loss or damage suffered by the bailee while keeping the goods in his custody. The bailor is particularly responsible for defects in goods hired to bailee whether bailor was aware of such defects or not.
- (ii) where the bailment is gratuitous, the bailor must reimburse the bailee for any expenditure incurred in keeping the goods.
- (iii) the bailor should reimburse any expense which the bailee may incur by way of loss in the process of returning the goods or complying with other directions for returning the goods.
- (iv) the bailor must compensate the bailee for the loss or damage suffered by the bailee that is in excess of the benefit received, where he had lent the goods gratuitously and decides to terminate the bailment before the expiry of the period of bailment.
- (v) the bailor is bound to accept the goods after the purpose is accomplished. If bailor fails, he is responsible for any loss or damage to the goods and has to reimburse for expenses incurred by the bailee for keeping the goods safely.

### **Rights of Bailor**

The following are the rights of bailor:

- (1) Bailor has a right to enforce the duties of the bailee such as -
  - (a) right to claim damages for loss caused to the goods by the negligence of bailee;



- (b) right to claim compensation for loss caused by an unauthorized use of the goods bailed;
  - (c) right to claim damages arising out of mixing the goods of the bailor with his own goods.
- (2) Bailor has a right to terminate the contract if the bailee does anything which is inconsistent with the conditions of bailment. For example 'A' lets on hire his horse to 'B' for his own riding but 'B' uses the horse for driving his carriage. 'A' has a right to terminate the contract of bailment.
- (3) Bailor in the case of gratuitous bailment has a right to demand the goods back even before the expiry of the period of bailment. If in the process, loss is caused to the bailee, bailor is bound to compensate.
- (4) Bailor has a right to claim the increase or profit from the goods bailed which may have occurred from the goods value. For example where 'A' bails his cow to 'B' and if the cow gives birth to a calf, 'B' is bound to return the cow and the calf to 'A'.

#### **1.66 CARE TO BE TAKEN BY BAILEE**

The bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence with regard to quantity, bulk and value would take.

In such a case he will not be responsible, in the absence of special contract, for any special loss or destruction or deterioration of the goods bailed, since he has taken as much care as a man of ordinary prudence.

For example if X bails his ornaments to 'Y' and 'Y' keeps these ornaments in his own locker at his house along with his own ornaments and if all the ornaments are lost/stolen in a riot 'Y' will not be responsible for the loss to 'X'. If on the other hand 'X' specifically instructs 'Y' to keep them in a bank, but 'Y' keeps them at his residence, then 'Y' would be responsible for the loss [caused on account of riot].

#### **Special liabilities of bailees**

Under English Law bailees like common carriers and inn-keepers have certain special liabilities as they are responsible for every injury caused except on account of act of God or the Queen's enemies.

In India before the enactment of the Carriers Act 1865, a common carrier suffered same liabilities but after the enactment, their liability is restricted though not to the extent of absolving them for negligence. Similarly Railways in India as common carriers and as bailees are governed by the provisions of the Contract Act. Inn-keepers in India have no special liabilities attached to them except under the Contract Act.



### **Bailee has right to terminate**

The bailee has the right to terminate a contract of bailment if the bailor does any thing inconsistent with bailment conditions.

### **1.67 DUTIES AND RIGHTS OF A BAILEE.**

In addition to the two important duties of having to take care of the goods bailed and being responsible for loss/injury/damage to goods, bailee has other following duties under the Act.

- (i) Bailee has no right to make unauthorized use of goods bailed
- (ii) Bailee has no right to mix the goods bailed with his own goods without the consent of the bailor.
- (iii) Bailee has to return the goods on expiration of period of bailment
- (iv) Bailee has a duty to return any extra profit accruing from goods bailed. Where A bails his cow to 'B' and if the cow gives birth to a calf, 'B' must return both the cow and the calf to 'A'
- (v) Bailee has duty not to do anything inconsistent with the condition of bailment.

### **Rights of bailee**

The bailee has the following rights [These rights are also the duties of the bailor]

- (i) to claim compensation for any loss arising from non-disclosure of known defects in the goods
- (ii) to claim indemnification for any loss or damage as a result of defective title.
- (iii) to deliver back the goods to joint bailors according to the agreement or directions
- (iv) to deliver the goods back to the bailor whether or not the bailor has the right to the -- goods
- (v) to exercise his 'right of lien'. This right of lien is a right to retain the goods and is exercisable where charges due in respect of goods retained have not been paid. The right of lien is a particular lien for the reason that the bailee can retain only these goods for which the bailee has to receive his fees/remuneration.
- (vi) to take action against third parties if that party wrongfully denies the bailee of his right to use the goods

### **1.68 RIGHTS AND DUTIES OF FINDER OF GOODS**

We have already seen in an earlier study unit, that the duties of 'finder of lost goods' are that of the bailee. Such a 'finder of lost goods' is as good as a bailee and he enjoys all the rights and carries all the responsibilities of a bailee.



Apart from the above, the 'finder of lost goods' can ask for reimbursement for expenditure incurred for preserving the goods but also for searching the true owner. If the real owner refuses to pay compensation, the 'finder' cannot sue but retain the goods so found.

Further where the real owner has announced any reward, the finder is entitled to receive the reward. The right to collect the reward is a primary and a superior right even more than the right to seek reimbursement of expenditure.

Lastly the finder though has no right to sell the goods found in the normal course, he may sell the goods if the real owner cannot be found with reasonable efforts or if the owner refuses to pay the lawful charges subject to the following conditions.

- a) when the article is in danger of perishing and losing the greater part of the value or
- b) when the lawful charges of the finder amounts to two-third or more of the value of the article found.

### **1.69 GENERAL LIEN AND PARTICULAR LIEN**

A general lien is the right to retain the property of another for a general balance of account. In contract the particular lien is the right to retain the particular goods bailed for non-payment of charges/remuneration.

Bankers, factors, wharfingers, policy brokers and attorneys of law have a general lien in respect of goods which come into their possession during the course of their profession.

For instance a banker enjoys the right of a general lien on cash, cheques, bills of exchange and securities deposited with him for any amounts due to him. For instance 'A' borrows Rs.500/- from the bank without security and subsequently again borrows another Rs.1000/- but with security of say certain jewellery. In this illustration, even where 'A' has returned Rs.1000/- being the second loan, the banker can retain the jewellery given as security to the second loan towards the first loan which is yet to be repaid.

Under the right of general lien the goods cannot be sold but can only be retained for dues. The right of lien can be waived through a contract.

Interestingly, Chartered Accountants have a general lien against the books of their clients which come into their possession against professional fees not paid to them by those clients.

#### **Particular lien**

In accordance with the purpose of bailment if the bailee by his skill or labour improves the goods bailed, he is entitled for remuneration for such services. Towards such remuneration, the bailee can retain the goods bailed if the bailor refuses to pay the remuneration. Such a right to retain the goods bailed is the right of particular lien. He however does not have the right to sue.



Where the bailee delivers the goods without receiving his remuneration, he has a right to sue the bailor. In such a case the particular lien may be waived. The particular lien is also lost if the bailee does not complete the work within the time agreed.

**Difference between general lien and particular lien.**

The difference between the two can be summarised as follows:

- (a) particular lien is exercisable only on such goods in respect of which charges are due. General lien is a right to detain/retain any goods of the bailor for general balance of account outstanding
- (b) particular lien is automatic. A general lien is not automatic but is recognized through on agreement. It is exercised by the bailee only by name
- (c) particular lien comes into play only when some labour or skill is involved. A general lien can be exercised against goods even without involvement of labour or skill.

**1.70 PLEDGE**

Pledge is a variety or specie of bailment. It is bailment of goods as security for payment of debt or performance of a promise. The person who pledges[or bails] is known as pledgor or also as pawnor, the bailee is known as pledgee or also as pawnee. In pledge, there is no change in ownership of the property. Under exceptional circumstances, the pledgee has a right to sell the property pledged.

Let us now examine the rights of pawnee and pawnor.

**Pawnee's rights**

**(a) Right of retainer**

Pawnee has right to retain the goods pledged not only for payment of debt or performance of a promise but also for recovery of debts and all expenses incurred for preservation of goods pledged. Where 'M' pledges stock of goods for certain loan from a bank, the bank has a right to retain the stock not only for adjustment of the loan but also for payment of interest.

**(b) Right to retention to subsequent debts**

Pawnee has a right to retain the goods pledged towards subsequent advances as well, however subject to such right being specifically contemplated in the contract.

**(c) Right to seek reimbursement of extraordinary expenses**

Pawnee has a right to seek reimbursement of extraordinary expenses incurred. However his right to retain the goods shall not extend to such extraordinary expenses but is restricted to ordinary expenses.



**(d) Right to sue**

In the event of pawnor failing to redeem the debt or perform the promise, the pawnee has a right to sue the goods which he has retained. He can in the alternative, under certain circumstances, sell the goods after giving a reasonable notice, to the pledgor. The two rights namely the right to sue and the right to sell are alternative rights and not cumulative rights.

**Rights of a pawnor**

**(a) Right to redeem:** Pawnor has a basic right to redeem the goods pledged by performing his promise.

**(b) Right to sue:** Pawnor has a right to sue, but within a period of 3 years in view of provision of Limitation Act only in the event of pawnee refusing to return the goods even after payment of debt etc.

**Suit by bailor & bailee against wrong doers**

Both bailor and bailee have right to sue a third party who has deprived the bailee to the use or possession of goods bailed. Any relief obtained against such deprivation or injury can be shared between the bailor and bailee according to their respective interest.

**1.71 PLEDGE BY MERCANTILE AGENTS**

Though generally only a owner of goods can pledge, the Act recognizes the right of certain mercantile agents to pledge provided it is done with the consent of the owner of the goods. Such a pledge done in the ordinary course of business is valid. Pledge in this case can be effected through pledge of documents like a bill of lading or a railway receipt etc.

**1.72 DISTINCTION BETWEEN BAILMENT AND PLEDGE**

There are three distinctions between bailment and pledge. These are

**(a) As to purpose**

Pledge is a variety of bailment. Under pledge goods are bailed as a security for a loan or a performance of a promise. In regular bailment the goods are bailed for other purpose than the two referred above. The bailee takes them for repairs, safe custody etc.

**(b) As to right of sale**

The pledgee enjoys the right to sell only on default by the pledgor to repay the debt or perform his promise, that too only after giving due notice. In bailment the bailee, generally, cannot sell the goods. He can either retain or sue for non-payment of dues.

**(c) As to right of using goods**

Pledgee has a right to use goods. A bailee can, if the terms so provide, use the goods.



**1.73 SELF-EXAMINATION QUESTIONS**

1. 'X' delivers his car to 'Y' for repair, in this case who is bailor & who is bailee?
2. Can bailment be applied for immovable goods or money?
3. It is true that in bailment the ownership of the goods also changes along with custody & possession?
4. Is depositing of money in a bank bailment? And why or why not?
5. Is depositing of ornaments in a bank locker bailment?
6. 'A' lets on hire his horse to 'B' for his own riding but 'B' uses horse for driving his carriage. Can 'A' terminate the contract of bailment?
7. 'X' bails his ornament to 'Y' and 'Y' keeps this ornament in his own locker at his house along with his own ornaments and if all the ornament are lost, whether 'Y' is responsible for the loss to 'X'?
8. Whether a banker can enjoy the right of general lien for any amount due to him?
9. 'A' borrows Rs.500/- from the bank without surety and borrows another loan for Rs.1000/- by pledge of jewellery. 'A' returns Rs.1000/- being the second loan The bank retains the jewellery towards the first loan which is still due to him. Is it correct under general lien?
10. When particular lien comes into play?
11. Under pledge the person who pledges is known as..... and the bailee is known as.....
12. In bailment the bailee cannot sell the goods, he can either retain the goods or sue for non payment of dues. What is the position in the case of pledge?

**Answers**

1. 'X' bailor. 'Y' bailee
2. No- only for movable goods
3. No
4. No-the money cannot be identified
5. No- the ornaments are in possession of owner
6. Yes
7. No- he has exercised with ordinary prudence
8. Yes
9. Yes
10. Where labour or skill is involved
11. Pledgor, Pledgee.
12. He enjoys the right to sell after giving the notice



## UNIT – 9 : AGENCY

### Learning objectives

After studying this unit, you would be able to –

- ◆ Understand the relationship between agent and principal and the intention behind adoption of such course of agency.
- ◆ Note that consideration is not at all necessary for validity of agency contracts.
- ◆ Learn various modes of creation, especially agency by ratification.
- ◆ Understand rights and obligations of an agent as well as the circumstances when the agent is personally liable for the acts done by him on behalf of the principal and the legal position of the agent, the principal and the third parties involved.
- ◆ Be familiar with the terms ‘sub-agent’ and ‘substituted agent’ and to distinguish between the two.

### 1.74 WHAT IS AGENCY?

The Indian Contract Act does not define the word ‘Agency’. However the word ‘Agent’ is defined “as a person employed to do any act for another or to represent another in dealings with third persons. The third person for whom the act is done or is so represented is called “Principal”.

Thus ‘Agency’ is a comprehensive word used to describe the relationship between one person and another, where the first mentioned person brings the second mentioned person into legal relation with others.

### Salient features of agency

Following are the four salient features of agency

(i) *Basis*

The basic essence of ‘agency’ is that the principal is bound by the acts of the agent and is answerable to third parties.

(ii) *Consideration not necessary*

Unlike other regular contracts, a contract of agency does not need consideration. In other words, the relationship between the ‘principal’ and ‘agent’ need not be supported by consideration.

(iii) *Capacity to employ an agent*

A person who is competent to contract alone can employ an agent. In other words, a person in order to act as principal must be a major and of sound mind.





(iv) *Capacity to be an agent*

A person in order to be an agent must also be competent to contract. In other words, he must also be a person who has attained majority and is of sound mind.

**1.75 MODES OF CREATION OF AGENCY**

There are five general methods of creating agency. These are (i) agency by actual authority (ii) agency by ratification (iii) agency of ostensible authority (iv) agency by necessity and (v) agency by actual authority and apparent authority.

Let us briefly discuss these five modes of creation of agency.

**(a) Agency by actual authority**

A contract of agency can be express or implied. Whether it is express or implied, it can be by words spoken or written. While the express contract is often expressed in clear terms, implied contracts are created by circumstances.

For example, 'A' owns a shop and 'B' manages that shop. Though 'A' being the owner orders purchases for that shop and pays through his bank account, 'B' by virtue of his position can also purchase as an agent, express or implied.

**(b) Agency by ratification**

Agency is also created by subsequent ratification or approach. The subsequent ratification becomes necessary because the agent acts without the knowledge or the approval of the principal. Following are the rules of ratification.

- (i) Ratification can be made only by a person who was in existence at the time of act.
- (ii) Ratification must be by a person for whom the act was done, professing him to be a principal. This implies competency on the part of the person ratifying the act.
- (iii) Ratification would date back to the date of the act, and validate it
- (iv) Ratification may either be express or even implied by the conduct of the person on whose behalf the act was done.

Ratification must be of the whole act and not just for a part of the act.

- (vi) Ratification [by the purported principal] of the acts of an agent can not be such as to create any liability to third parties or cause any injury or damage to third parties
- (vii) Ratification cannot be done if the person ratifying is in knowledge of facts which are materially defective.
- (viii) Illegal acts cannot be ratified.
- (ix) Acts which are void ab initio cannot be ratified



Ratification would be restricted to certain limitations to which original acts are limited and ratification can be to that portion of exceeded authority by the agent.

**(c) Agency by ostensible authority**

Where the authority of the principal is inferred by the conduct of the principal, there the agency through ostensible authority is born. Here the agent's authority is ostensible and the principal is bound by the act of the agent. Ostensible authority happens on account of estoppel and holding out. Let us analyse these two types with examples.

**(i) Agency by estoppel**

If a person permits or represents another to act on his behalf, so that a reasonable person would infer that the relationship of principal and agent had been created then he will be stopped from denying his agent's authority and getting himself relieved from his obligations to a third party by proving that no such relationship in fact existed

For instance where 'A' informs 'B' in the presence and within hearing of 'P' that 'P' is his agent. Later 'B' enters into contract with 'P' thinking that 'P' is the agent of 'A'. In a situation like this neither 'P' nor 'A' can refuse the obligations under the contract. 'P' had become the agent of 'A' by estoppel. 'P' will be treated as agent of 'A' even if he was not an agent at all.

Where a master permits his servant to pledge his credit, there is an agency on account of estoppel. Even if the servant had on occasion pledged without the authority of master, the master is still bound because of estoppel. Similarly where a married woman co-habits with her husband, there is a presumption that she has the authority to pledge his credit for necessities.

A principal cannot privately revoke or restrict the authority of his agent, which he has allowed in public.

**(ii) Agency by Holding out**

Under the principle of holding out, any one who holds himself out as an agent of another, then a relationship of agent and principal gets in place. The process of holding out happens through willful conduct done to create a deliberate impression. In such a case person concerned is estopped from denying that he is the agent of a principal. The doctrine of holding out is also applicable in case of partnerships. The law of partnership also adopts the principle of agency to a large extent. However under "holding out" principle following conditions are required to be present:

- (a) statement or conduct of misrepresentation
- (b) a genuine not necessarily a fraudulent misrepresentation and
- (c) the third person should prove that he entered into the transaction believing the statement so made.



**(d) Agency by necessity**

Sometimes circumstances would compel and a relation of agency would fall in place. This is often out of necessity. For example a captain of a ship can borrow money at other ports where there are no agent to act on behalf of the owner, to carryout repairs. The captain becomes an agent by necessity. To constitute an agency by necessity following conditions must be fulfilled.

- (i) agent should be in a position of not being able to communicate in time with the principal
- (ii) there must have been an actual and definite commercial necessity
- (iii) the agent must have acted bonafide and for the benefit of principal
- (iv) the agent must have adopted most reasonable and practicable course of action.

**(e) Actual authority and apparent authority**

Actual authority to act as agent stems from a consent. The consent to act may be oral or in writing. Some time the authority can also be 'implied authority'. The implied authority is incidental or usual or customary. It would depend on the circumstance of the case.

The authority of the agent is 'apparent' where the principal represents or is regarded by law as having represented that another has, authority. Under the doctrine of 'apparent authority', the 'principal' is bound to third parties by the acts of that person though he had not given such authority or had limited the authority by instructions not made known to third party. The notion of apparent authority is essentially confined to relationship between the principal and third party.

**1.76 EXTENT OF AGENT'S AUTHORITY**

The agent's authority is governed by two principles namely (a) in normal circumstances and (b) in emergency.

Let us examine these two situations -

**(i) Agent's authority in normal circumstances**

An agent has the power and authority to do all acts lawful and necessary in the normal circumstances in discharge of his functions. For instance, where 'A' who lives in Andamans employs 'B' as his agent to collect his debts in Kanyakumari, 'B' has all the authority including the authority to pursue legal proceedings. Similarly 'B' can also give valid discharge. Again for example, where 'A' executes a power of attorney in favour of 'B' in running a silk factory, but the power of attorney did not authorize 'B' to borrow and if 'B' borrowed, it was stated to be an act in excess of his authority [Ferguson vs. Uma Chand Bold (1905) 33 Cal. 343]



**(ii) Agent's authority in emergency**

An agent has the authority in an emergency to do all such acts as a man of ordinary prudence would, for protecting his principal from losses under similar circumstances.

A typical case is where the 'agent' who handles perishable goods like 'mangoes' can decide the time, date and place of sale, not necessarily as per instructions of the principal but with the intention of protecting the principal from losses. Here the agent acts in an emergency and acts as a man of ordinary prudence.

**Notice to an agent:** Any notice given to an agent or information obtained by him will be deemed to be given to the principal. Thus where the agent of an insurance company negotiates with a customer who had lost an eye in an accident, the insurance company is deemed to have knowledge of the fact.

**1.77 DUTIES AND OBLIGATIONS OF AN AGENT**

Following are the duties of an agent:

(i) *Duty in conducting principal's business:* The agent should conduct the business of the principal as per directions of the principal or in the absence of any directions as per the custom prevalent in the business

(ii) The agent is liable to the principal for any loss if he deviates from the above duty/obligation where he did not act according to instruction of the principal. It was held by the Supreme Court in a case that the agent had to compensate the principal where the agent did not act according to the instructions of the principal. In the given case the agent was under instruction to insure the goods of the principal but he did not. There was an explosion in the Bombay dock and as a result all the goods of the principal, along with others, was destroyed. The Government passed an ordinance that where ever there was a fire insurance policy, full amount would be paid to the owners and where there was no insurance cover, half the amount would be repaid. The principal was paid half the losses and he sued the agent for the balance loss and the agent was ordered by court to pay the balance amount to compensate him for loss.

(iii) *Requirements as to skill and diligence :* Agent must act always as a person with diligence and skill normally exercised in the trade. He would otherwise be responsible to compensate the principal for any loss suffered by the principal for want of his skill.

Where 'A' acts as an agent for 'B' and sells rice to 'C' in the usual course of business without verifying about C's solvency and if 'C' goes insolvent, then 'A' is responsible for losses arising to 'B'.

(iv) *Agents duty to account:* The agent has to maintain and render proper accounts to principal whenever demanded. He is bound to pay the principal all sums received. He is bound to maintain accounts even if the contract is illegal or void.



(v) *Duty to communicate*: The agent must in order to obtain instruction, communicate and contact the principal as a man of ordinary diligence.

### **1.78 RIGHTS OF AN AGENT**

Following are the rights of an agent

#### **(i) Right of lien on principal's property**

An agent is entitled to retain the goods, properties and books for any remuneration, commission etc due to him. The possession of such property should be however lawful.

#### **(ii) Right of indemnification for lawful acts**

The principal is bound to indemnify the agent against all consequences of lawful acts done in exercise of his authority. For example 'A' of Delhi appoints 'B' of Mumbai as agent to sell his merchandise. As a result 'B' contracts to deliver the merchandise to various parties. But 'A' fails to send the merchandise to 'B' and 'B' faces litigations for non-performance. Here 'A' is bound to protect 'B' against the litigations and all costs, expenses arising out of that.

#### **(iii) Right of indemnification against acts done in good faith**

Where the agent acts in good faith on the instruction of principal, agent is entitled for indemnification of any loss or damage from the principal. Where 'P' appoints 'A' as his agent and directs him to sell certain goods which in fact turned out to be not those belonging to 'P' and if third parties sue 'A' for this act, 'A' is entitled for reimbursement and indemnification for such act done in good faith.

However the agent cannot claim any reimbursement or indemnification for any loss etc arising out of acts done by him in violation of any penal laws of the country.

#### **(iv) Right of retention**

The agent can retain, out of the sums received from the principal, such amounts towards reimbursement of expenditure, remuneration and advances paid by him on account towards the business and render accounts only for the balance.

#### **(v) Right of remuneration**

The agent in the normal course is entitled for remuneration as per the contract. In the absence of any agreed amount of remuneration, he is entitled for usual remuneration which is customary in the business. However he is not entitled for any remuneration for acts done through misconduct/negligence.



### 1.79 PERSONAL LIABILITY OF THE AGENT

We have already seen that basic principle of agency is that agent acts on behalf his principal and therefore cannot personally enforce the contract. Similarly he is also not personally bound for any act.

However under certain circumstances like, where the agent exceeds his authority, or has no authority or the principal does not ratify the act of the agent, the agent is personally liable . This is known as doctrine of implied warranty of authority. The rules with regard to personal liability of an agent are set out hereunder.

- (i) where the contract expressly provides for personal liability of the agent
- (ii) where the agent signs the negotiable instrument without indicating that he is signing it for the principal
- (iii) where the agent works for a foreign principal
- (iv) where the agent acts for a principal who cannot be sued viz Ambassador of a country etc.
- (v) where a Govt. servant enters into a contract on behalf of Union of India in disregard of Article 299(1)
- (vi) where according to usage in trade in certain kinds of business agents are personally liable.
- (vii) where the agency is coupled with interest. An agency will be treated as such where the agent himself has interest in the subject matter. The 'interest' of the agent to come under this category should not be an ordinary 'interest' like towards remuneration etc., but should be a special interest.

### 1.80 UNDISCLOSED PRINCIPAL

An 'undisclosed principal' comes into play where an agent having the authority to contract, does not disclose the fact, concealing not only the name of the principal but also the fact that there is a principal; here the agent gives an impression that he acts on his own.

In 'undisclosed principal', the mutual rights, of principal , agent and third party are as follows:

- a) the liability of the agent is his own since he has not disclosed that there is a principal
- b) where the third party comes to know about the existence of the principal he can sue the agent or the principal.
- c) the third party's interest would stand protected evenly, and would not suffer even if the principal surfaces and intervenes at a later date.



- d) third party has a right to refuse, if the principal discloses himself, on the ground that had he known about the principal he would not have entered into the contract.

### **1.81 PRINCIPAL'S LIABILITY FOR AGENT'S ACT TO THIRD PARTIES**

The liability of the principal to third parties would fall under following categories -

**(a) When agent acts within the scope of his authority**

The principal is liable for the acts of the agent done within the scope of his actual or apparent authority. Where there are specific restrictions on the authority of the agent, then the principal is not bound by it.

**(b) Principal is bound by notice given to agent**

The principal is bound by the notice given to the agent. Knowledge of the agent is knowledge of the principal. Knowledge of a bank manager is knowledge of the bank. Therefore the principal is bound except where the agent does acts that are fraudulent.

**(c) Liability by estoppel**

Where the agency is by the doctrine of estoppel, the principal is bound by the same doctrine.

**(d) Liability for misrepresentation**

The principal is liable for any fraud or misrepresentation done by the agent within his authority regardless of the fact that the act has resulted in benefit to the agent or the principal.

No liability where agent exceeds the authority

The principal is not liable for acts of agent done in excess of authority. Some times the acts can be separated as 'within the authority' and 'beyond the authority'. Principal is bound for those acts which are within the authority. But where acts are not separable, the principal may repudiate the entire transactions.

**(e) Unnamed principal**

Where the existence of the principal is known but his name is not known, the principal is liable for the acts of the agent. Third parties can sue the principal for the acts of the agent, unless agent refuses to disclose the identity of the principal.

### **1.82 TERMINATION OF AGENT'S AUTHORITY.**

The termination of the agency arises and is based on the doctrine of revocation.

In terms of section 201 of the Act, following are the circumstances when the authority conferred on the agent gets terminated:

- (a) Revocation of authority by the principal



- (b) Renunciation of agency by the agent
- (c) Completion of business of agency
- (d) Death or insanity of principal or agent and
- (e) Insolvency of the principal

The rights of the principal to revoke the authority of the agent and the right of the agent to renounce are each exercised at their will and pleasure.

Following are the general principles in this regard:

- (a) Even where the agent gets interested in the subject matter, that would not be a ground for the principal to terminate the agency. The agency becomes an agency coupled with interest.
- (b) The principal cannot revoke the authority after the authority has been exercised.
- (c) The agent's authority cannot be revoked if the agent has partially exercised the authority.
- (d) Where there is an implied or express contract, agency may continue for a period of time. The agency can not be terminated without compensation.
- (e) Reasonable notice must be given for termination, otherwise the agent is entitled for compensation.
- (f) Revocation and Renunciation must be express or implied.

### 1.83 IRREVOCABLE AGENCY

Where the agency cannot be terminated, it is called irrevocable agency.

- (a) Where agency is coupled with interest then it is a case where the agent has interest in the subject matter of agency. In this case, agency cannot be terminated except where there is an express provision, to cause prejudice to the interest of the agent. For the agency coupled with interest does not come to an end on the death, insanity, or the insolvency of the principal.
- (b) Where the agent has incurred personal liability, principal cannot revoke the agency leaving the agent to face the liability. For instance where 'A' appoints 'B' as his agent and 'B' purchases as per orders of 'A' some rice in his personal name, A cannot revoke the authority
- (c) Where the agent has partly exercised the authority, the authority cannot be revoked, where 'A' appoints 'B' as his agent to procure 10 bags of rice and 'B' procures in the name of 'A' then 'A' cannot revoke his authority.





#### **1.84 SUB- AGENT**

Sub agency refers to case where an agent appoints another agent. The appointment of sub agent is not lawful, because the agent is a delegatee and a delegatee cannot further delegate. This is based on the Latin principle “**delegatus non potest delegare**”.

The appointment of a sub agent would be valid if the terms of appointment originally contemplated it. Sometimes customs of the trade may provide for appointment of sub agents. In both these cases the sub agent would be treated as the agent of the principal.

Position of sub agent vis a vis third parties where the sub agent is properly appointed

##### **(a) Where the sub-agent is properly appointed**

Where a sub agent is properly appointed, the principal is bound by his acts and is therefore responsible to third parties as if he were an agent originally appointed by the principal.

##### **(b) In the case of appointment without authority**

In case where the appointment of sub agent takes place without authority, the principal is not bound by the acts of sub agent and sub agent is not bound to the principal. It is the agent who is the principal of sub agent. Where the sub-agent purportedly acts in the name of first principal, that first principal may ratify the act of sub agent. However if the sub agent acts in his own name or in the name of the agent who has without authority delegated to the sub agent the business which is in fact of the principal, the principal cannot ratify such acts of sub agent.

#### **1.85 SUBSTITUTED AGENT**

Substituted agents are not sub agents. They are agents of the principal. Where the principal appoints an agent and if that agent identifies another person to carry out the acts ordered by principal, than the second person is not to be treated as a sub agent but only as an agent of the original principal.

For example, ‘A’ directs ‘B’ his solicitor to sell his property by auction and ‘B’ appoints ‘C’ an auctioneer. In this regard, ‘C’ is an agent of ‘A’ and not a sub agent.

While selecting a “substituted agent” the agent is bound to exercise same amount of diligence as a man of ordinary prudence and if he does so he will not be responsible for acts or negligence of the substituted agent.

For example ‘X’ consigns goods to ‘Y’ a merchant for sale. ‘Y’ in due course employs an auctioneer in goods to sell goods of ‘X’ and also allows him to receive the proceeds of sale. The auctioneer becomes insolvent afterwards without handing over the proceeds. Here ‘Y’ will not be responsible to ‘X’ as he has discharged his duties as a man of ordinary prudence and diligence.



### 1.86 SELF-EXAMINATION QUESTIONS

1. Under agency who is called principal?
2. What is the capacity of the principal to employ an agent?
3. 'A' owns a shop. 'B' manages the shop. 'A' as owner orders purchases. 'B' also as the agent orders purchases. Can he do so?
4. What are the different types of authorities which can be given to an agent?
5. Whether the agent has the right of retention and of remuneration?
6. What is the principal's liability for agent's act to third parties?
7. In the absence of reasonable notice for termination, what is the remedy available for the agent?
8. What is the name given when the agency cannot be terminated?
9. Whether appointment of sub agent is lawful. Why so?
10. Substituted agents are appointed by whom?

### Answers

1. Third person for whom the act is done or is so represented.
2. Principal must be a major and of sound mind.
3. Yes.
4. Actual & Ostensible authority.
5. Yes.
6. Principal is liable for the act of agent done with his authority.
7. Agent is entitled for compensation.
8. Irrevocable agency.
9. No- because a delegate cannot further delegate.
10. The Principal.

### EXTRA QUESTIONS FOR PRACTICE

#### Choose the correct alternative

1. An agreement which is enforceable by law at the option of one or more of the parties thereon but not at the option of the other or others is a
  - (a) valid contract.
  - (b) void contract.



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- (c) voidable contract.
  - (d) illegal contract.
2. Which of the following statement is true?
- (a) Consideration must result in a benefit to both parties.
  - (b) Past consideration is no consideration in India.
  - (c) Consideration must be adequate.
  - (d) Consideration must be something, which a promisor is not already bound to do.
3. Which of the following statement is false?
- (a) Generally a stranger to a contract cannot sue.
  - (b) A verbal promise to pay a time barred debt is valid.
  - (c) Completed gifts need no consideration.
  - (d) No consideration is necessary to create an agency.
4. Which of the following is not an exception to the rule – no consideration, no contract
- (a) Compensation for involuntary services.
  - (b) Love & affection.
  - (c) Contract of agency.
  - (d) Gift.
5. Which of the following statements is not true about minor's position in a firm?
- (a) He cannot become a partner in an existing firm.
  - (b) He can become a partner in an existing firm.
  - (c) He can be admitted only to the benefits of any existing firm.
  - (d) He can become partner on becoming a major.
6. A wrong representation when made without any intention to deceive the other party amounts to
- (a) coercion.
  - (b) undue influence.
  - (c) misrepresentation.
  - (d) fraud.



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7. An agreement is void if it is opposed to public policy. Which of the following is not covered by heads of public policy?
- (a) Trading with an enemy.
  - (b) Trafficking in public offices.
  - (c) Marriage brokerage contracts.
  - (d) Contracts to do impossible acts.
8. A, B and C jointly promised to pay Rs. 60,000 to D. Before performance of the contract, C dies. Here, the contract
- (a) becomes void on C's death.
  - (b) should be performed by A and B along with C's legal representatives.
  - (c) should be performed by A and B alone.
  - (d) should be renewed between A, B and D.
9. Generally, which of the following damages are not recoverable?
- (a) ordinary damages.
  - (b) special damages.
  - (c) remote damages.
  - (d) nominal damages.
10. A contract in which one person promises to compensate the other for the loss suffered by him due to conduct of the promisor or of any other person, is known as a
- (a) contract of indemnity.
  - (b) contract of guarantee.
  - (c) quasi contract.
  - (d) illegal contract.
11. In a contract of guarantee, a person who promises to discharge another's liability, is known as
- (a) principal debtor.
  - (b) creditor.
  - (c) indemnified.
  - (d) surety.



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12. The delivery of goods by one person to another for some specific purpose, is known as
  - (a) bailment
  - (b) pledge
  - (c) hypothecation
  - (d) mortgage.
13. The delivery of goods by one person to another as security for the repayment of a debt, is known as
  - (a) bailment
  - (b) pledge
  - (c) hypothecation
  - (d) mortgage.
14. A person appointed by the original agent to act in the business of agency, but under the control of original agent, is known as
  - (a) agent
  - (b) sub-agent
  - (c) substituted agent
  - (d) del credere agent
15. Which of the following agency is irrevocable?
  - (a) agency for fixed period.
  - (b) agency for single transaction.
  - (c) agency coupled with interest.
  - (d) continuing agency.
16. All agreements in restraint of trade are void and there are no exception to this,
  - (a) true, the Indian Contract Act provides so.
  - (b) false, the Indian Contract Act and Partnership Act contain exception.
17. A, B and C jointly promised to pay Rs. 30,000 to D. For recovery of this amount, D filed a suit against A only. Is he justified ?
  - (a) yes, as the liability of joint promisors is joint and several



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**The Indian Contract Act, 1872**

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- (b) no, as the liability of joint promisors is joint only.
18. An anticipatory breach does not give any right to claim compensation
- (a) true
- (b) false
19. When the consent of a party is not free, the contract is void.
- (a) true.
- (b) false.
20. Consideration must be adequate.
- (a) true.
- (b) false.

**State Yes or No**

21. X owes Rs. 500 to his friend Y. Y assures X that he will not file a suit against him. Does this assurance of Y constitute "proposal" in the legal sense of the term ?
22. Does a proposal become a promise ?
23. A invited B and his family to dine with him on a particular night. The latter accepted the former's invitation. On the scheduled date, B drove with his family from Karol Bagh to the residence of A in Kalkaji (at a distance of 12 miles) and found the latter's house locked. They waited up to 9 o' clock but the hosts did not return. They left the place and had their meals in Wengers. The cost of the meals and car-drive stood approximately at Rs. 200/-. Could B claim this amount from A ?
24. X offered through an advertisement in "The Statesman" to sell certain "antique" piece on a particular day at a particular place in Delhi. In response to the advertisement a person travelled all the way from Bombay to Delhi and found to his immeasurable annoyance that the place was locked and there was no such projected sale. He wanted to sue X on this account. Would it be advisable for him to take this course of action ?
25. The law requires that proposal, the acceptance thereof and revocation of proposal and acceptance respectively must be communicated. State when this communication will be complete in the following cases.
- (a) Through a letter addressed to Y, X proposes to sell a TV set for Rs. 2,000.
- (b) Y accepts the proposal of X by posting a letter to the effect.



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- (c) X revokes the aforesaid proposal by a telegram.
- (d) Y revokes his acceptance by a telegram.
26. A makes an offer by a letter to B on a particular day. Two days after, A revokes his offer by a telegram. The telegram reaches B after the letter. Will the offer be deemed to have been revoked ?
27. B (mentioned in the preceding illustration) has posted his letter of acceptance on a particular day and two days thereafter sends a telegram revoking his acceptance. But the telegram reaches A after the letter. Will the acceptance be deemed to have been revoked ?
28. Death or insanity of the proposer.
- (a) operates as revocation of the proposal irrespective of whether the acceptor has the knowledge of the same prior to his acceptance.
- (b) operates as revocation only if the acceptor knows about it before acceptance.
- Which of the above statements is correct?
29. If the proposer does not fix any time for acceptance when can the proposal be deemed to have been revoked ?
30. X makes an offer to Y in these terms : "I will sell my horse for Rs. 5000 if you give me your mule". Y agrees in writing to buy the horse but refuses to make over the mule to X. Does any binding agreement come into existence ?
31. A writes to B, "I am willing to sell my car as it is today for Rs. 40,000. B replies, "I can buy it for Rs. 35,000". A keeps quiet. Subsequently, B writes. "I will buy the car at Rs. 40,000". Is it binding promise ?
32. X's brother runs away from the house. Y who is an employee of X offers to search for the brother and goes out for the purpose. In the absence of Y, X offers a reward of Rs. 100 to any one who can either find out the brother or give clues enabling X to find him out. Y gets the brother back to X in ignorance of the offer for reward. Can Y now claim the reward ?
33. Is a promisor normally bound by his promise unless some consideration is offered by the promisee ?
34. Can consideration be offered by a person other than the promisee ?
35. Where the consideration has moved from the promisee but not at the request of the promisor, can the promisor enforce the promise ?



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36. P pays Rs. 4,000 to Q and Q promises to deliver him 45 bags of cement within a fortnight. What is the nature of consideration in this transaction ?
37. Is past consideration valid in India?
38. Can a stranger to a contract normally sue thereon ?
39. R's son was missing. N who was a distant relation of R made a search for the missing son, found him and brought him back. R then promised N that he would compensate him for the services rendered. Later R refuses to keep his promise. Could N enforce it in a court ?
40. A promised to pay a subscription of Rs. 5,000 to the Gandhi Memorial Fund. He later changed his mind. Could the amount be recovered from A ?
41. A agreed to give his house to school for its library on the condition that the library would be named after him. The management accepted the condition. Subsequently, A changed his mind. Could the management enforce the contract ?
42. A's father had died leaving a house to two sons. They agreed to partition the house which did not admit the division in exactly equal parts and one of the sons had agreed not to construct a door at a certain place in his portion of the house. In a dispute, the agreement was challenged on the ground that it was without adequate consideration. Could the challenge be upheld ?
43. Can a contract which is made by a deed (i.e., a contract under seal) be valid even if it is made without consideration ?
44. Can a promise to pay money to a witness served with a notice be enforced ?
45. A gives to B Rs. 300 to be given to C. B informs C that he is holding the money for him. But afterwards B refuses to pay the money. C sues B for the money. B contends that C cannot sue as he was not a party to the contract. Will the contention of B be upheld ?
46. Can a minor, though incompetent to contract, receive a benefit arising thereunder ?
47. The guardian of a minor (a) can, (b) cannot, bind the minor by a contract entered into on his behalf for the purchase of immovable property. Which statement is correct ?
48. A minor, lent Rs. 100 to B at the market rate of interest on the basis of a promissory note. A year thereafter, when he had attained majority, he filed a suit against B for the recovery of the amount thereon. B contended that since A was a minor at the time the loan was advanced, the contract was void. Would B succeed ?





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49. A buys from B bales of branch cotton for December, 1991 delivery, at Rs. 1,250 per bale. On the date of delivery, the price is Rs. 1,000 per bale. A wants to avoid contract. Can he do so with impunity ?
50. X sells horse to Y knowing well that the horse is vicious. X does not disclose the nature of the horse to Y. Can X be made liable to Y for the transaction ?
51. A grocer supplied monthly rations for five months to B who was aged 17 years and 5 months. B having failed to pay the bills for the supplies, the grocer decided to sue him for the realisation of his dues. Could he succeed if he does so ?
52. A advanced money to his son B, during his minority. Upon B's coming of age, A obtains by use of his parental influence, a bond from B, for a greater amount than the sum due in respect of the advance. Can A enforce the loan ?
53. A, enfeebled by disease or age, is induced by B, his attendant, to agree to pay B an unreasonable sum for his professional services. Can B enforce the agreement ?
54. A being indebted to B, the money-lender of his village, contracts, a fresh loan on terms which appear to be unconscionable. Will it be presumed that the contract was induced by undue influence ?
55. A applies to banker for a loan at a time when there is stringency in the money market. The banker declines to make the loan except at an unusually high rate of interest. A accepts the loan on these terms. Is the contract induced by undue influence ?
56. A and B, being traders enter upon a contract. A has private information of a change in prices which would affect B's willingness to proceed with the contract. Is A bound to inform B ?
57. A falsely represents to B that 500 tonnes of nails are made annually at A's factory and thereby induces B to buy the factory. Is the contract voidable at the option of B ?
58. A by misrepresentation, leads B erroneously to believe that 500 maunds of indigo are made annually at A's factory. B examines the accounts of the factory, which shows that only 100 maunds of indigo have been made. After this B buys the factory. Can the contract be avoided on the ground of misrepresentation ?
59. A's son had forged B's name to a promissory note. B under threat of prosecuting A's son, obtains a bond from A for the amount of the forged note. B sues on bond. Will he succeed ?
60. A and B make contract grounded on the erroneous belief that a particular debt is barred by the Indian law of limitation. Is the contract voidable ?



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**The Indian Contract Act, 1872**

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61. A agrees to marry C's daughter in consideration of dowry to be paid by C. Can A enforce the promise in a court ?
62. Which of the following statements are correct ?
- (a) In the case of fraud, the person making the representation believes it to be true.
  - (b) In the case of misrepresentation, the maker does not believe it to be true.
  - (c) Fraud does not afford a ground for bringing an action in tort for damages; whereas misrepresentation does.
  - (d) In the case of misrepresentation, the fact the plaintiff had means of discovering the truth by exercising ordinary diligence can be good defence against the repudiation of the contract but such a defence cannot be set up in the case of fraud other than fraudulent silence.
63. Are the following agreements valid ?
- (a) A sells the goodwill of his business to B and agrees with him to refrain from carrying on a similar business within specified local limits.
  - (b) A, a shopkeeper in Kalkaji Market, agrees to pay B who is his rival in the business a sum of money as compensation, if B closes his business there.
  - (c) R, an optical surgeon, employs S as the assistant for a term of three years and S agrees not to practice as a surgeon during this period.
  - (d) A promise made by the loser of wager to pay the amount lost in consideration of the winner's forbearance to post him as a defaulter.
  - (e) A agrees to sell B "my white horse for Rs. 5000 or Rs. 10,000".
  - (f) A promises to superintend, on behalf of B, a legal manufacturer of liquor and an illegal traffic in the other narcotic drugs. B promises to pay a salary of Rs. 2,000 per month.
64. A promises to deliver goods to B on a certain day, on payment of Rs. 1,000. A dies before that day. Discuss the liability of A's representative to B.
65. A promises to paint a picture for B by a certain day, at a certain price. A dies before that day. Can the contract be enforced either by A's representatives or by B ?
66. A, a singer, enters into a contract with B, the manager of a theatre, to sing at his theatre two nights in every week during the next two months and B engages to pay her 100 rupees for each night's performance. On the sixth night, A wilfully absents herself from the theatre. Is B at liberty to put an end to the contract ?



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67. A, a singer, enters into a contract with B, the manager of a theatre, to sing at the theatre two nights in every week during the next two months and B agrees to pay her at the rate of 100 rupees for each night's performance. On the sixth night, A wilfully absents herself from theatre. With the consent of B, A sings the seventh night. Discuss B's rights.
68. A, B and C jointly promise to pay D Rs. 3,000. Can D compel either A or B or C to pay him Rs. 3,000 ?
69. A, B and C jointly promise to pay D a sum of Rs. 3,000. C is compelled to pay the whole. A is insolvent but his assets are sufficient to pay one half of his debts. Discuss C's rights.
70. A, B and C are under a joint promise to pay D a sum of Rs. 3,000. C is unable to pay anything and A is compelled to pay the whole. Is A entitled to receive Rs. 1,500 from B ?
71. A promises to deliver goods to B's warehouse, on the 1st January. On that day A brings the goods to B's warehouse, but after the usual hour for closing the warehouse and they are not received. Has A performed his promise ?
72. B owes A Rs. 2,000. A desires B to pay the amount to A's account with C, his banker. B who also banks with C, orders the amount to be transferred from the account to A's credit and this is done by C. Afterwards, and before A knows of the transfer, C fails. Has there been a good payment by B ?
73. A owes B Rs. 2,000. B accepts some of A's goods in deduction of the debt. Does the delivery of the goods operate as a part payment ?
74. A and B contract that B shall execute certain work for A for Rs. 1,000. B is ready and willing to execute the work accordingly. But A prevents him from doing so. (a) is the contract voidable ? (b) is compensation claimable for any loss that results from such non-performance ?
75. A hires B's ship to take in and convey from Kolkata to Mauritius a cargo to be provided by A, B receiving a certain freight for its conveyance. A does not provide any cargo for the ship.
- (a) can A claim the performance of B's promise ?
- (b) can A be compelled to recompensate B for any loss arising out of non-performance?
76. A contracts with B to execute certain builder's work for a fixed price with B supplying the scaffolding or timber necessary for the work. B refuses to furnish any scaffolding or timber and the work cannot be executed. Should A execute the work ?
77. A party to a contract promises to do a certain thing at or before a specified time, but he fails to do so. Can the promisee, in the circumstances, avoid the contract ?



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78. Examine the following and decide whether time is of essence of the contract :
- (a) the time of delivery of goods has been fixed by the parties to the contract. But the delivery thereof has not been made at the scheduled date.
  - (b) in a mortgage bond, a time has been fixed for the repayment of the mortgage money.
  - (c) in a contract of sale of land, there is a clause which stipulates a time for the completion of the sale.
79. Suppose the time fixed for performance of the contract has expired but the time is not essential. What is the remedy of the promisee in the circumstances ?
80. Suppose, time is of the essence of the contract but the promisor does not perform the promise within the stipulated time. But five days after the expiry of the stipulated time, the promisor offers to perform his promise. Can the promisee accept such performance and at the same time claim compensation from the promisor for the delay ?
81. A agrees with B to discover treasure by magic. Is the agreement valid ?
82. X and Y contract to marry each other on a particular date. But prior to the scheduled time X turns lunatic. Does the contract become void ?
83. A, an Indian, contracts to marry B. A is already married—a fact of which B was unaware. A breaks his promise in course of time. Thereupon B brings a suit against A for a breach of contract. A pleads that his promise is impossible of being performed as the law of the country does not permit polygamy. Can A get away with the plea ?
84. A and B agree : (i) that A shall sell a house for Rs. 50,000; but (ii) that if B uses it as gambling den, he shall pay A Rs.11 lakhs for it. Which set of these reciprocal promises is a contract ?
85. 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. Does the old debt of A to B come to an end in this manner ?
86. A owes B Rs. 1,000 under a contract, B owes C Rs. 1,000. B orders A to credit C with Rs. 1,000 in his books, but C does not assent to the arrangement. Does B still owe C Rs. 1,000 ?
87. A agrees to sell land to B for Rs. 40,000. B pays to A Rs. 4,000 as a deposit at the time of the contract, the amount to be forfeited to A if B does not complete the sale within a specified period. B fails to complete the sale within the specified period, nor is he ready



and willing to complete the sale within a reasonable time after the expiry of that period. Can A rescind the contract and at the same time retain the deposit?

**Short/ Essay Type Questions**

88. X invites Y (a well-known film actor) to his daughter's engagement and dinner party. Y accepts the invitation and promised to attend. X made special arrangements for Y at the party but he did not turn up. X enraged with Y's behaviour, wanted to sue for the loss incurred in making special arrangements. X is seeking your advice. What will your advice be?
89. Explain the rules under the Indian Contract Act, 1872 as regards to time and place for the performance of the promise?
90. Define an offer. Explain the rules of an offer. How an offer is different from an invitation to offer.
91. Ram, Rahim and Robert are partners of a software business and jointly promise to pay Rs. 30, 000 to Raheja. Over a period of time Rahim became insolvent, but his assets are sufficient to pay one-fourth of his debts. Robert is compelled to pay the whole. Decide whether Robert is required to pay whole amount himself to Raheja in discharging joint promise.
92. Briefly explain how the principal is liable for the acts of an agent and state under what circumstances an agent is personally liable.
93. A, who owes B Rs. 10,000, appoints B as his agent to sell his landed property at Delhi and after paying himself (B) what is due to him, to hand over the balance to A. Can A revoke his authority delegated to B?
94. M advances to N Rs. 5,000 on the guarantee of P. The loan carries interest at ten percent per annum. Subsequently, N becomes financially embarrassed. On N's request, M reduces the interest to six per cent per annum and does not sue N for one year after the loan becomes due. N becomes insolvent. Can M sue P?
95. Briefly explain the contract of indemnity and state the rights of an indemnity-holder.
96. Explain the characteristics of a contract of bailment. Is placing of one's valuables in a locker taken on hire from a bank a contract of bailment?
97. State and explain the different remedies available under the Indian Contract Act, 1872 to an aggrieved party for breach of contract.
98. No consideration, no contract. State the exceptions to the rule.



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## The Indian Contract Act, 1872

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99. Explain the meaning of 'quasi-contract'. Name any four examples of such contract .
100. "The liability of the surety is co-extensive with that of principal debtor". Comment.
101. When is communication of a proposal, acceptance and its revocation said to be complete?
102. What is the effect of failure to perform a contract at a time where time is essential?
103. Explain the position of minor under the Indian Contract Act, 1872.
104. What is the effect of refusal to accept offer of performance and refusal of party to perform the promise?
105. Miss. Chitra, a singer, enters into a contract with the manager of Bangalore gate club, to sing in the club for two concerts every week during the next two months and the club agrees to pay her at the rate of Rs. 2000 for each concert. On the seventh concert Miss. Chitra wilfully absents herself. With the assent of the manager of the club, Miss. Chitra sings for the eighth concert. But on the following day, the club, puts an end to the contract. Can Miss. Chitra claim damages for breach of contract? Advise.
106. Mr. X, is employed as a cashier on a monthly salary of Rs. 2,000 by ABC bank for a period of three years. Y gave surety for X's good conduct. After nine months, the financial position of the bank deteriorates. Then X agrees to accept a lower salary of Rs. 1,500/- per month from bank. Two months later, it was found that X has misappropriated cash since the time of his appointment. What is the liability of Y?
107. Under what circumstances the doctrine of supervening impossibility is not applicable?
108. X agrees to sell his house to Y. X further fraudulently tells Y that the house is free from all mortgages. On X's coming to know from his friend Z that the house is already mortgaged, Y still decides to buy the house but wants X to redeem the mortgage debt. X refuses to redeem the mortgage debt. Considering the provisions of the Indian Contract Act, 1872, decide giving reasons whether Y will succeed.
109. Define acceptance. What are its rules?
110. What are the differences between void and illegal agreements.
111. Under what circumstances the consideration and an object of the contract becomes illegal? Illustrate.

### Answers

1. (c); 2. (d); 3. (b); 4. (a); 5. (b); 6. (c); 7. (d); 8. (b); 9. (c); 10. (a); 11. (d); 12. (a);  
13. (b); 14. (b); 15. (c); 16. (b); 17. (a); 18. (b); 19. (b); 20. (b)



**Yes or No type questions**

21. Yes; 22. Yes, on acceptance thereof; 23. No; 24. No; 25. (a) When Y receives the letter; 25. (b) Against X, when Y has posted the letter. Against Y when the letter reaches to X; 25. (c) Against X when he sent the telegram. Against Y when Y receives the telegram; 25. (d) Against Y when he sent the telegram. Against X when X receives it; 26. Yes, provided the letter of acceptance has not been posted; 27. No; 28. (b); 29. After the expiry of a reasonable time; 30. No; 31. No; 32. No; 33. No; 34. Yes; 35. No; 36. P's payment executed and Q's promise executory; 37. Yes; 38. No; 39. Yes; 40. No; 41. Yes; 42. No; 43. No; 44. No; 45. No; 46. Yes; 47. (b); 48. No; 49. No; 50. Yes; 51. Yes; 52. No; 53. No; 54. Yes; 55. No; 56. Yes; 57. Yes; 58. No; 59. No; 60. No; 61. No; 62. (d); 63. (a) Yes. So long as b or his successor in interest carries on like business therein; 63. (b) No; 63. (c) Yes; 63. (d) Yes; 63. (e) No; 63. (f) No; 64. Delivery of goods to be compulsory and payment by b to a's representative compulsory; 65. No; 66. Yes; 67. Cannot repudiate the contract: claim arises for damages; 68. Yes; 69. Can get Rs. 500 from A's estate and Rs. 1250 from B; 70. Yes; 71. No; 72. Yes; 73. Yes; 74. (a) Yes; 74. (b) Yes; 75. (a) No; 75. (b) Yes; 76. No; 77. Yes, but only if both the promisor and the promisee intended that time should be essence of the contract; 78. (a) Yes; (b) No; (c) No; 79. To claim compensation from the promisor for loss caused the delay; 80. Yes, but for claiming compensation, the promisee must notify the promisor of his intention to claim compensation at the time of accepting the performance; 81. No; 82. Yes; 83. Yes, but not without making compensation to b for the loss occasioned by the non-performance of the promise; 84. To sell the house and to pay thereof Rs. 50,000; 85. Yes; 86. Yes; 87. Yes;

# CHAPTER 2

## THE NEGOTIABLE INSTRUMENTS ACT, 1881

### Learning Objectives

In this Chapter, the students will understand the

- ◆ Meanings of various negotiable instruments and their differences
- ◆ Negotiation and assignability of instruments
- ◆ Presentment and dishonour of instruments

### 2.1 INTRODUCTION

The law relating to negotiable instruments is the law of the commercial world which was enacted to facilitate the activities in trade and commerce making provision of giving sanctity to the instruments of credit which could be deemed to be convertible into money and easily passable from one person to another. In the absence of such instruments, the trade and commerce activities were likely to be adversely affected as it was not practicable for the trading community to carry on with it the bulk of the currency in force. The introduction of negotiable instruments owes its origin to the bartering system prevalent in the primitive society. The negotiable instruments are, in fact, the instruments of credit being convertible on account of the legality of being negotiated and thus easily passable from one hand to another. The source of Indian law relating to such instruments is admittedly the English Common Law. The main objective of the Act is to legalise the system by which instruments contemplated by it could pass from hand to hand by negotiation like any other goods. The purpose of the Act was to present an orderly and authoritative statement of the leading rules of law relating to the negotiable instruments.

The Law in India relating to negotiable instruments is contained in the Negotiable Instruments Act, 1881. It deals with Promissory Notes, Bills of Exchange and cheques, the three kinds of negotiable instruments in most common use. The Act applies to the whole of India and to all persons resident in India, whether foreigners or Indians. The provisions of this Act is not applicable to Hundis and other native instruments. Special customs and local usages govern such instruments. Where no such custom is established, this Act will equally apply to Hundis.

**Students may kindly note that the Act, 1881 was amended by the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002{55 of 2002}.**





## **2.2 MEANING OF NEGOTIABLE INSTRUMENTS**

It is an instrument which is transferable (by customs of trade) by delivery, like cash, and is also capable of being sued upon by the person holding for the time being. The property in such an instrument passes to a *bona fide* transferee for value. The attribute of negotiability is acquired by certain documents by custom.

Section 13 of the Negotiable Instruments Act, 1881 does not define a negotiable instrument although it mentions only three kinds of negotiable instruments namely, bills, notes and cheques. But it does not necessarily follow that there can be no other negotiable instruments than those enumerated in the Act. It is now fairly well settled in England that any instrument containing a contract to pay money or any other security representing money which is in a form that renders it capable of being sued on by the holders of pro tempore in his own name, and which is transferable by custom of trade by delivery like cash, is a negotiable instrument. Section 17 of the Transfer of Property Act speaks of “instruments which are for the time being, by law of custom, negotiable”, implying thereby that the Courts in India may follow the practice of the English Courts in extending the character of Negotiable Instruments Act. Thus in India, Government promissory notes, Shah Jog Hundis, delivery orders and railway receipts for goods have been held to be negotiable by usage of custom.

## **2.3 CHARACTERISTICS OF NEGOTIABLE INSTRUMENTS**

The important characteristics are as follows :

- (i) It is presumed by law that every negotiable instrument is made or drawn for a consideration. Consequently, there is no necessity to state such a position. But it is not an irrebuttable presumption. It must be rebutted by proof that the instrument had been obtained from its lawful owner by means of fraud, undue influence or for an unlawful consideration. The onus of proof is on the person who challenges the existence of consideration (i.e., the defendant). If the defendant is able to make out a good case by proving the want of consideration then the responsibility to prove that there was consideration would shift on to the plaintiff.
- (ii) A negotiable instrument may be transferred by endorsement and delivery if it is an instrument payable to order, and by mere delivery, if it is a bearer instrument.
- (iii) The transferee, who takes the instrument bona fide and for valuable consideration, obtains a good title despite any defects in the title of the transferor. To this extent, it constitutes an exception to the general rule that no one can give a better title than he himself has.

## **2.4 DEFINITIONS**

**(a) Promissory Note :** A promissory note is an instrument (not being a bank note or a currency-note) in writing containing an unconditional undertaking, signed by the maker to pay



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## The Negotiable Instruments Act, 1881

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a certain sum of money only to or to the order of, a certain person or to the bearer of the instrument (Section 4). In other words, the requirements of a promissory note are as follows :

(i) *It must be in writing* : This means that the engagement cannot be oral. There is no prescribed form or language for this; even the word 'promise' need not be used. What is necessary is that whatever language is used, it must clearly show that the maker is unconditionally bound to pay the sum.

(ii) *The promise to pay must be unconditional*: If a condition is attached to the 'promise to pay' then the instrument will not be construed as a promissory note. Suppose, A signs an instrument made out as follows, "I promise to pay to B Rs. 500 on D's death, provided D leaves me enough to pay the sum". The instrument will not be a promissory note. Similarly, if A signs thus, "I promise to pay to B Rs. 500 deducting any money which B may owe me;" such an instrument also will not be a promissory note. Let us now take a converse case. An instrument runs thus : "I acknowledge myself to be indebted to B of Rs. 500 to be paid on demand, for value received". This instrument would be a promissory note.

It may be noted that a promise to pay will not be conditional under Section 4, where it depends upon an event which is certain to happen but the time of its occurrence may be uncertain. For example, where a promissory note is in this form : "I promise to pay to A Rs. 2,000, 15 days after the death of B", it is not conditional as it is certain that B will die though the exact time of his death is uncertain (Section 4).

(iii) *The amount promised must be a certain and a definite sum of money* : Certainty is one of the essential characteristics of a promissory note. Certainty must be as to the amount and also as to the person by whose order and to whom payment is to be made. Uncertainty in such matters has a tendency to restrict credit and to hamper commerce. Hence the necessity of certainty. For example, where an instrument contains: "I promise to pay Rs. 350 and all other sums which shall be due", it is not a valid promissory note as the sum is not certain within the meaning of Section 4.

You should also note that payment with interest or at a specified rate of exchange is certain within the meaning of Section 4. You should also remember that in the event of figures and words indicating the sum payable being contradictory, the sum in words must be taken into account.

(iv) *The instrument must be signed by the maker* : It is incomplete till it is so signed. Since the signature is intended to authenticate the instrument it can be on any part of the instrument.

(v) *The person to whom the promise is made must be a definite person* :- The payee must be a certain person. Where the name of the payee is not mentioned as a party, the instrument becomes invalid. Remember that a promissory note cannot be made payable to the maker himself. Thus, a note which runs "I promise to pay myself" is not a promissory note and hence invalid. However, it would become valid when it is endorsed by the maker. This is because it



then becomes payable to bearer, if endorsed in blank, or it becomes payable to the endorsee or his order, if endorsed specially.

In connection with the promissory note, you should also remember that : (a) consideration need not be mentioned; (b) place and date of making it need not be mentioned; (c) an undated instrument will be treated as having been made on the date of its delivery; and (d) an ante-dated or post dated instrument is not invalid.

*N.B. The words "or to the bearer of the instrument" still appear in Section 4 to the Act, since these have not yet been deleted therefrom by the Parliament : Nevertheless, in view of the provision contained in Sub-section (2) of Section 31 of the Reserve Bank of India Act, the aforesaid words have become inoperative or ineffective. Therefore, the present position is that no person in India other than the Reserve Bank of India or the Central Government can make or issue a promissory note payable to the bearer of the instrument.*

**(b) Bill of Exchange :** Before going into the definition, you must know how a bill of exchange ordinarily comes into existence. It comes into being, when a trader decides to sell goods on credit. Suppose, A sells goods worth Rs. 800 to B, and allows him three months' time to pay the price. A will then draw a bill on B in the following terms "Three months after date pay to my order the sum of Rs. 800 for value received". After signing the bill, A will present it to B for acceptance. If B writes across the bill 'accepted', it will indicate that B undertakes the liability to pay a sum of Rs. 800 within the time stipulated therein. Here A is the drawer, B is the drawee and after acceptance B will be the acceptor. A bill of exchange is an instrument in writing containing an unconditional order signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of certain person to the bearer of the instrument (Section 4).

You should now try to understand the application of the points emerging from the said definition :

- (i) The bill of exchange must be in writing. This point, we take it for granted, needs no further annotation.
- (ii) There must be an order to pay. It is of the essence of the bill that its drawer orders the drawee to pay money to the payee. It must be imperative - mere precatory words do not suffice. Although terms of politeness may be admissible, excessive politeness may nonetheless prompt one to disregard it as an order.
- (iii) This order must be *unconditional*, as the bill is payable at all events. Thus it is absolutely necessary for the drawer's order to the drawee to be *unconditional*. The order must not make the payment of the bill *dependent on a contingent* event. A conditional bill of exchange is invalid.



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Where a bill contains an order to pay the amount specified therein out of a particular fund it will be conditional and therefore invalid. The reason for this invalidity is that it is uncertain whether the fund will be in existence or prove sufficient on the bill becoming payable. However, an unqualified order to pay together with an indication of a particular fund out of which the drawee is to reimburse himself, is not conditional. Hence such an indication does not vitiate the instrument.

- (iv) The drawee must sign the instrument. The instrument without the proper signature will be inchoate and hence ineffective. It is permissible to add the signature at any time after the issue of the bill. But if it is not so added, the instrument remains *ineffectual*.
- (v) The drawer, the drawee (acceptor) and the payee-the necessary parties to a bill-are to be specified in the instrument with reasonable certainty. You should remember that all these three parties may not necessarily be three different persons. One can play the role of two. But there must be two distinct persons in any case.
- (vi) The sum must be certain [what we have discussed on this point in relation to promissory note vide requirement (iii) on page 3 will equally hold good here].
- (vii) The medium of payment must be money and money only. The distinctive order to pay anything in kind will vitiate the bill.

**(c) Distinction between a promissory note and a bill of exchange :** The distinctive features of these two types of negotiable instruments are tabulated below :

Promissory Note	Bill of Exchange
1. It contains a promise to pay	It contains an order to pay.
2. The liability of the maker of a note is <i>primary and absolute</i> (Section 32).	The liability of the drawer of a bill is <i>secondary and conditional</i> . He would be liable if the drawee, after accepting the bill fails to pay the money due upon it provided notice of dishonour is given to the drawer within the prescribed time (Section 30)
3. It is presented for payment without any previous acceptance by maker.	If a bill is payable some time after sight, it is the required to be accepted either by the drawee himself or by some one else on his behalf, before it can be presented for payment.
4. The maker of a promissory note stands in immediate relationship with the	The maker or drawer of an accepted bill stands in immediate relationship with the



the payee (Explanation to Section 44) and is primarily liable to the payee or the holder.	acceptor and the payee (Explanation to Section 44).
5. It cannot be made payable to the maker himself, that is the maker and the payee cannot be the same person.	In the case of bill, the drawer and payee or the drawee and the payee may be the same person.
6. In the case of a promissory note there are only two parties, viz., the maker (debtor) and the payee(creditor).	In the case of a bill of exchange there are three parties, viz., drawer, drawee and payee, and any two of these three capacities can be filled by one and the same person.
7. A promissory note cannot be drawn in sets.	The bills can be drawn in sets.
8. A promissory note can never be conditional.	A bill of exchange too cannot be drawn conditionally, but it can be accepted conditionally with the consent of the holder. It should be noted that neither a promissory note nor a bill of exchange can be made payable to bearer on demand.

**(d) Definition of Cheque :** A “cheque” is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form.

Explanation I :For the purposes of this section, the expressions-

- (a) “a cheque in the electronic form” means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed in a secure system ensuring the minimum safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system;
- (b) “a truncated cheque” means a cheque which is truncated during the course of a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.

*Explanation II :* For the purposes of this section, the expression “clearing house” means the clearing house managed by the Reserve Bank of India or a clearing house recognised as such by the Reserve Bank of India.’ (Section 6, Negotiable Instruments Act). That is to say, it is a bill drawn on a banker, which is payable on demand.



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A cheque being a specie of bill of exchange, it must, under Section 5, be signed by the drawer and must contain an unconditional order on a specified banker to pay a certain sum of money to or the order of the specified person or to the bearer of the instrument. A cheque, however, is a peculiar type of negotiable instrument in the sense that it does not require acceptance; also it is not meant to be payable to bearer on demand. A cheque is an exception to the general rule that a bill of exchange cannot be drawn "payable to bearer on demand" Section 31, (The Reserve Bank of India Act). A cheque may be drawn up in three forms, viz., (i) bearer cheque (*i.e.*, one which is either expressed to be so payable or on which the last or only endorsement is an endorsement in blank); (ii) order cheque *i.e.*, one which is expressed to be so payable or which is expressed to be payable to a particular person without containing any prohibitory words against its transfer or indicating an intention that it shall not be transferable (Section 18); and (iii) crossed cheque is a cheque which can be only collected through a banker.

### (e) Difference between Cheque and Bill of Exchange :

- (1) In the case of a cheque the drawee- *i.e.*, the person on whom the bill is drawn-must always be banker whereas in the case of a bill of exchange the drawee may be any person.
- (2) No days of grace are allowed in the case of a cheque, and a cheque is as a rule, payable on demand, whereas three days' grace is allowed in the case of a bill.
- (3) In the case of a dishonour of a cheque, notice of dishonour is not necessary whereas notice of dishonour is usually required in the case of a bill.
- (4) A cheque can be drawn to bearer and made payable on demand, whereas a bill cannot be bearer if it is made payable on demand.
- (5) In the case of a cheque, it is not necessary to present it for acceptance. It needs only be presented for payment. Bills sometimes, require presentment for acceptance and it is advisable to present them for acceptance even when it is not essential to do so.
- (6) Cheques do not require to be stamped in India, whereas bills must be stamped according to the law. In England and several other countries, cheques also are required to be stamped.
- (7) A cheque may be crossed, whereas a bill cannot be crossed.

Generally, it must be remembered that cheques are negotiable instruments and the most of the rules in relation to bills of exchange also apply to cheques.

**(f) Bank Draft :** A bank draft is, by definition, an order drawn by an office of a bank upon another office of the same bank. In other words, it is, in a sense, an order drawn by one person upon himself, whereas in the case of bills, they are drawn by one person upon another person (Section 85A).



Section 131A of the Act makes all rules as regards crossed cheques, laid down in Sections 123 to 131, applicable to drafts defined by Section 85A. Thus a banker who collects a draft on behalf of a customer will not be protected by Section 131.

A draft is drawn either against cash deposited at the time of its purchase or against debit to the buyer's current account with the banker. The buyer of the draft generally furnishes particulars of the person to whom the amount thereof should be paid. The banker charges for his services a small commission. The draft like a cheque, can be made payable to drawer on demand without any legal objection thereto, since the Reserve Bank of India Act, under Section 31, specially allows such a draft be issued.

Moreover, where a draft purports to have been endorsed by or on behalf of the payee the paying bank is discharged from liability by its payment in due course even though the endorsement of the payee has been forged. This affords great protection to the paying banker in so far as it is always possible for the paying banker to identify the signature of the payee.

**(g) Marked cheques :** A cheque need not be presented for acceptance. Therefore the drawee of the cheque *i.e.*, the banker, is under liability, to the person in whose favour the cheque is drawn. The banker, however, will be liable to his customer (drawer), if he wrongly refuses to honour the cheque. In such a case, action can be taken by the customer against the banker for the loss of his reputation. In certain cases, however, a cheque is marked or certified by the banker on whom it is drawn as "good for payment". Such a certification or marking is strictly not equivalent to an acceptance but is very similar to it and protects the person to whom the cheque is issued against the cheque being refused for payment subsequently by Banking in India, as a rule, do not mark or certify cheques in this manner. Bankers in India, are not liable even if a bank has marked a cheque as "good for payment" (*Bank of Baroda vs. Punjab National Bank Ltd.*).

**(h) Crossed cheque:** (a) *The usage of crossing cheques :* Cheques are usually crossed as a measure of safety. Crossing is made by drawing two parallel transverse lines across the face of the cheque with or without the addition of certain words. The usage of crossing distinguishes cheques from other bills of exchange. The object of general crossing is to direct the drawee banker to pay the amount of the cheque only to a banker, to prevent the payment of the cheque being made to wrong person (Section 123);

(b) *Special crossing :* Where a cheque bears across its face an entry of the name of a banker either with or without the words "not negotiable", the cheque is considered to have been crossed specially to that banker. In the case of special crossing the addition of two parallel transverse lines is not essential though generally the name of the bank to which the cheque is crossed specially is written between two parallel transverse lines (Section 124).

(c) *Crossing after issue :* (i) If cheque has not been crossed, the holder thereof may cross it either generally, or specially. (ii) If it is crossed generally, the holder may cross it, specially.



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(iii) If it is crossed, either generally or specially the holder may add the words "not negotiable".  
(iv) If a cheque is crossed specially, the banker to whom it is crossed, may again cross it specially to another banker, his agent, for collection. This is the only case where the Act allows a second special crossing by a banker and for the purpose of collection [*Akro Kervi Mines vs. Economic Bank (1904) 2 K.B. 465 (Section 125)*]. It may be noted that the crossing of a cheque is an instance of an alteration which is authorised by the Act.

(d) *Payment of cheque, crossed generally or specially (Sections 126 & 127)* : If a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker. Again, where a cheque is crossed specially, the banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed or his agent for collection.

Where a cheque is crossed specially to more than one banker except when it is crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereof. This is because, in such a case, the instruction by the drawer would not be clear (Section 127).

(e) *Payment in due course of crossed cheque* : Where the banker on whom a crossed cheque is drawn, pays it in due course, it is to be presumed that he has made payment to the true owner of cheque, though in fact, the amount of the cheque may not reach the true owner. In other words, banker making payment in due course is protected, whether the money is or is not, in fact, received by the true owner of the cheque (Section 128).

(f) *Payment out of due course* : Any banker paying a crossed cheque otherwise than in accordance with the provisions of Section 126 shall be liable to the true owner of the cheque for any loss he may have sustained. Thus, if the money does not reach the true owner, he can claim payment over again from the banker (Section 129).

(g) *Cheque marked "not negotiable"* : A person taking a cheque crossed generally or specially bearing in either case the words 'not negotiable' shall not have or shall not be able to give a better title to the cheque than the title the person from whom he took had. In consequence if the title of the transferor is defective, the title of the transferee would be vitiated by the defect. But, in the case of a bill negotiated in the ordinary way, the title of the holder in due course would not be affected by the defect in the title of the transferor (Section 130).

For example, X, by means of fraud, obtained from Y a cheque crossed 'not negotiable' and got it cashed at a bank other than the drawee bank. Y sued the bank for conversion. Is the bank liable for conversion? The effect of Section 130 of the Act, broadly, is that if the holder has a good title, he can still transfer it with a good title; but if the transferor has a defective title, the transferee is affected by such defects, and he cannot claim the right of a holder in due course by proving that he purchased the instrument in good faith and for value. As X in the case in question had obtained the cheque by fraud, he had no title to it and could not give to the bank





any title to the cheque or the money: and the bank would be liable for the amount of the cheque for conversion. A similar decision was taken in *Great Western Railway Co. vs. London and Country Banking Co. (1901) A.C. 414* the facts whereof are exactly the same as the example cited above.

The addition of the words “not negotiable” in a crossed cheque has a special significance. The use of the words does not render the cheque non-negotiable but only affects one of the main features of negotiability. The general rule about the negotiability is that the holder in due course of a bill or promissory note or cheque takes the instrument free from any defect which might be existing in the title of the transferor. If the holder takes the instrument in good faith, before maturity and for valuable consideration, his claim is not defeated or affected by the defective title of the transferor. In case of any dispute, it is the transferor with the defective title who is liable. But the addition on the words “not negotiable” to the crossing of a cheque, makes the position different. When such a crossing is placed on a cheque, the holder in due course does not get any better title than what the transferor had. If the transferor had defective title, the title of the holder in due course also becomes defective. Therefore, he will have to refund the amount of the bill to the true owner. In other words, the principle of the ‘nemo dat quod non habet’ - (that is, nobody can pass on a title better than what he himself has) will be applicable to a cheque with a “not negotiable” crossing.

Thus, cheques with “not negotiable” crossing are negotiable so long as their title is good. Once the title of the transferor or endorser become defective the title of the transferee is also affected by such defect and the transferee cannot claim the right of a holder in due course.

As per the latest instructions issued by the Reserve Bank of India (9-9-1992) it would be safer for the drawer to cross a cheque “not negotiable” with the words “account payee” added to it. The courts of law have held that “an account payee” crossing is a direction to the collecting banker as to how the proceeds are to be applied after receipt. The banker can disregard the direction only at his own risk and responsibility. In other words, an ‘account payee’ cheque can be collected only for the account of the payee named in the cheque and not for anyone else. A banker collecting an ‘account payee’ cheque for a person other than the payee named in the cheque may be held liable for conversion.

In other words, if the bank collects an account payee cheque for a person other than the payee it does so at its own risk. It is imperative on the part of collecting bank, therefore to take utmost care to enquire into the title of its customer and satisfy itself that there is no defect in the title of the customer presenting such cheque for collection.

(h) *Cheque marked “Account Payee”* : It is a form of restrictive crossing, represented by the words “Account Payee” entered on the face of the cheque. Such a crossing acts as a warning to the collecting bankers that the proceeds are to be credited only to the account of the payee. If the collecting banker allows the proceeds of the cheque so crossed to be credited to pay



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any other account, he may be held guilty of a negligence in the event of an action for wrongful conversion of funds being brought against him. These words are not an addition to the crossing but are mere direction to the receiving or collecting bankers. These do not affect the paying banker who is under no duty to ascertain that the cheque in fact has been collected for the account of the person named as the payee.

In the case of a cheque bearing "Account Payee" crossing which is not specially crossed to another banker, the paying banker needs only to see that the cheque bears no other endorsement but that of the payee, and that it is otherwise in order. But where the cheque is also crossed specially, the paying banker must make payment only to the bank named in the crossing. It has been held that crossing cheque with the words "Account Payee" and mentioning a bank is not a restrictive endorsement so as to invalidate further negotiation of the cheque by the endorsee.

(i) *Protection in respect of uncrossed cheque* : When a cheque payable to order purports to be endorsed by or on behalf of the payee and the banker on whom it is drawn pays the cheque in due course, he is authorised to debit the account of his customer with the amount so paid, even though the endorsement of the payee subsequently turns out to be a forgery, or though the endorsement may have been made by payee's agent without his authority. In other words, the banker is exonerated for the failure to direct either the genuineness of the validity of the endorsement on the cheque purporting to be that of the payee or his authorised agent.

For example, a cheque is drawn payable to B on order and it is stolen. Thereafter, the thief or someone else forges B's endorsement and presents the cheque to the bank for encashment. On paying the cheque, the banker would be able to debit the drawer's account with the amount of the cheque. Likewise, if the cheque, in the above case, was not stolen but instead presented for payment by B's agent on endorsing the same "Per pro" for B and the cheque is cashed the banker could debit the account of the drawer. He would not be held guilty of the ground that he has cashed the cheque endorsed by the agent of B who has misappropriated the amount thereof.

Example: X drew a cheque payable to 'Y or on order'. Unfortunately it was lost and Y's endorsement was forged. Subsequently, the banker pays for the cheque. Is the banker discharged from liability? What will be the consequences if the drawer's signature were forged?

The paying banker is discharged from liability, despite the forged endorsement in favour of the payee, because of special protection granted by section 85(1) of the Negotiable Instruments Act, 1881.

In another instance, where the drawer's signature is forged, a banker remains liable to the drawer even by a payment in due course and cannot debit the drawer's account.



Such a protection is also available in respect of drafts drawn by one branch of a bank of another payable to order (Section 85A).

(j) *Protection in respect of crossed cheques* : When a banker pays a cheque (drawn by his customer), if crossed generally then to any banker, and if crossed specially then to banker, to whom it is crossed or his agent for collection (also being a banker), he can debit the drawer's account so paid, even though the amount of the cheque does not reach true owner.

The protection in either of the two cases aforementioned can be availed of, if the payment has been made in due course: *i.e.*, according to the apparent tenor of the instrument, in good faith and without negligence, to any person in possession thereof in the circumstances which do not excite any suspicion that he is not entitled to receive payment of the cheque.

The condition of good faith and without negligence would be judged on the criteria as are applied for judging the conduct of a collecting banker. In brief, the payment should be made in ordinary course in circumstances in which a man of ordinary prudence would not suspect that the person claiming payment was not the true owner.

Even though the banker is protected for having made payment of the cheque to a wrong person, the true owner of the cheque is entitled to recover the amount of the cheque from the person who had no title to the cheque.

(k) *Drawer, Drawee, Acceptor, Maker, Payee, etc.* : (i) The party who draws a bill of exchange or a cheque or any other instrument is called drawer.

(ii) The party on whom such bill of exchange of cheque is drawn is called the drawee. In other words the person who is thereby directed to pay is called the drawee.

(iii) The drawee of a bill of exchange who has signified his assent to the order of the drawer is called the acceptor. The acceptor becomes liable to the holder after he has signified his assent but not before.

Now a question would naturally arise as to who can be acceptors? Under Section 33 of the Act, no person except the drawee of a bill of exchange, or all or some of several drawees or a person named therein as drawee in case of need, can bind himself by an acceptance. Under Section 34, where they are several drawees of a bill of exchange who are not partners, each of them can accept it for himself; but none of them can accept it for another without his authority.

It follows from the aforesaid provisions that the following persons can be acceptors:

- (a) Drawee, *i.e.*, the person directed to pay.
- (b) All or some of the several drawees when the bill is addressed to more drawees than one.
- (c) A drawee in case of need.



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- (d) An acceptor for honour.
- (e) Agent of any of the persons mentioned above.
- (f) When no drawee has been named in a bill but a person accepts it, then he may be stopped from denying his liability as an acceptor.
- (iv) Acceptance is ordinarily made by the drawee by the signing of his names across the face of the bill and by delivery. Acceptance, therefore, means the signification of assent to the order of the drawer by delivery or notification thereof.

Under Section 27 of the Act, every person capable of legally entering into a contract, may make, draw, accept endorse, deliver and negotiate a promissory note, bill of exchange or cheque, himself or through a duly authorised agent. The agent may sign in two ways, viz., (a) he may sign the principal's name, for it is immaterial what hand actually signs the name of the principal, when in fact there exists an authority for the agent to put it there; (b) he may sign by procuracy stating on the face of the instrument that he signs as agent. It is thus essential that the agent, while putting his signature to the instrument, must have either express or implied authority to enter, for his principal who must be *sui juris*, into the particular contract. The authority of an agent to make, draw, accept or endorse notes and bills depends on the general law of agency and is a question of fact. From a perusal of Sections 27 and 28 it is, however, evident that a general authority to transact business and to discharge debits does not confer upon an agent the power to endorse bills of exchange so as to bind his principal; nor can an agent escape personal liability unless he indicates that he signs as an agent and does not intend to incur personal liability (*Parmode Kumar Pate vs. Damodar Sahu I.L.R. [1953] Cuttack 221*).

*The essentials of a valid acceptance are as follows:*

- (a) *Acceptance must be written:* The drawee may use any appropriate word to convey his assent. It may be sufficient acceptance even if just a bare signature is put without additional words. But it should be remembered that an oral acceptance is not valid in law. However, oral acceptance may be sufficient only in the case of hundies and that too only if a special custom is proved to exist.
- (b) *Acceptance must be signed:* A mere signature would be sufficient for the purpose. Alternatively, the words 'accepted' may be written across the face of the bill with a signature underneath; if it is not so signed, it would not be an acceptance.
- (c) *Acceptance must be on the bill:* That the acceptance should be on the face of the bill is not necessary; an acceptance written on the back of a bill has been held to be sufficient in law. What is essential is that it must be written on the bill; else it creates no liability as acceptor on the part of the person who signs it. Now what will happen if acceptance is signed upon a copy of the bill and the copy is not one of the part of it or if acceptance is



made on a paper attached to the bill; in either of the cases, acceptance would not be sufficient.

- (d) Acceptance must be completed by delivery: It would not complete and the drawee would not be bound until the drawee has either actually delivered the accepted bill to the holder or tendered notice of such acceptance to the holder of the bill or some person on his behalf.

Where a bill is drawn in sets, the acceptance should be put on one part only. Where the drawee signs his acceptance on two or more parts, he may become liable on each of them separately.

Acceptance may be either general or qualified. By a general acceptance, the acceptor assents without qualification to the order of the drawer. The acceptance of a bill is said to be qualified, when the drawee does not accept it according to the apparent tenor of the bill but attaches some conditions or qualification which have the effect of either reducing his (acceptor's) liability or acceptance of the liability subject to certain conditions. The holder of a bill is entitled to require an absolute and unconditional acceptance as well as to treat it as dishonoured, if it is not so accepted. However he may agree to qualified acceptance, but he does so at his own peril, since thereby he discharges all parties prior to himself, unless he has obtained their consent.

According to the Explanation to Section 86 of the Act, an acceptance to be treated as qualified.

- (1) Where it is conditional, declaring the payment to be dependent on the happening of an event therein stated, e.g., "accepted payable when in funds" (*Juisan vs. Shobrooke* (1753, 2 Wills, 9) "accepted payable on giving up bills of lading for cover per S.S. Amazon" (*Smith vs. Virtue*) "accepted payable when a cargo consigned to me is sold" (*Smith vs. Abbot*);
- (2) When it undertakes the payment of part only of the sum ordered to be paid, e.g., a bill drawn for Rs. 5,000 but "accepted for Rs. 4,000 only".
- (3) When, no place of payment being specified on the order, it undertakes to pay only at a specified place and not elsewhere or to pay at a place different from that specified in the bill and not elsewhere.

An acceptance to pay at a particular place is only a general acceptance unless it expressly states that the bill is to be paid there only and not elsewhere in which case it becomes qualified, for example, "accepted payable at the Diwala Bank". This is general acceptance, whereas "acceptance payable at the Diwala Bank and not elsewhere" is an instance of qualified acceptance.



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- (4) Where it undertakes the payment at a time other than that at which under the order it would be legally due e.g., a bill drawn “payable three months after date” is accepted as “accepted, payable six months after date.”

The aforementioned list of examples is only illustrative of the different respects in which the bill may be qualified, for it is possible to qualify the acceptance of a bill in other ways as well.

- (v) *Drawee in case of need*: When in the bill or any endorsement thereon the name of any person is entered, in addition to the drawee, to be restored to in case of need, such a person is called a drawee in case of need. In case of need means in the event of the bill being dishonoured by the drawee by non-acceptance or non-payment. The holder of the bill is at liberty to choose whether he will resort to the drawee in case of need or not.
- (vi) *Payee*: The party to whom or to whose order the amount of a bill of exchange, cheque or promissory note is payable is the payee.
- (vii) *Delivery* means transfer of possession from one person to another.
- (viii) *Issue of negotiable instrument* means its first delivery, complete in form, to a person who takes it as a holder.
- (l) *Holder, holder for value and holder in due course*: (Sections 8 & 9) : (i) “Holder” of a negotiable instrument means any person entitled in his own name to the possession of it and to receive or recover the amount due thereon from the parties thereto. In other words, holder means the payee or endorsee of a bill of exchange, cheque, or promissory note, who is in possession of it. The finder of a lost instrument payable to bearer, or a person in wrongful possession of such instrument, is not a holder.
- (ii) “Holder for value” means, as regards all parties prior to himself, a holder of an instrument for which value has at any time been given.
- (iii) “Holder in due course”, in the case of an instrument payable to bearer means any person who, for consideration became its possessor before the amount mentioned in it became payable. In the case of an instrument payable to order, “holder in due course” means any person who became the payee or endorsee of the instrument before the amount mentioned in it became payable. In both the case, he must receive the instrument without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title. In other words, holder in due course means a holder who takes the instrument *bona fide* for value before it is overdue, and without any notice of defects in the title of the person, who transferred it to him. Thus a person who claims to be ‘holder in due course’ is required to prove that: (1) on paying a valuable consideration, he became either the possessor of the instrument if payable to bearer, or endorsee thereof, if payable to order; (2) he had come into the possession of the instrument before the



amount due thereunder became actually payable; and (3) he had come to possess the instrument without having sufficient cause to believe that any defect existed in the title of transferor from whom he derived his title.

*(m) Privileges of a “holder in due course”:*

- (i)* A person signing and delivering to another a stamped but otherwise inchoate instrument is debarred from asserting, as against a holder in due course, that the instrument has not been filled in accordance with the authority given by him, the stamp being sufficient to cover the amount (Section 20).
- (ii)* In case a bill of exchange is drawn payable to the drawer’s order in a fictitious name and is endorsed by the same hand as the drawer’s signature, it is not permissible for acceptor to allege as against the holder in due course that such name is fictitious (Section 42).
- (iii)* In case a bill or note is negotiated to a holder in due course, the other parties to the bill or note cannot avoid liability on the ground that the delivery of the instrument was conditional or for a special purpose only (Sections 42 and 47).
- (iv)* The person liable in a negotiable instrument cannot set up against the holder in due course the defences that the instrument had been lost or obtained from the former by means of an offence or fraud or for an unlawful consideration (Section 58).
- (v)* No maker of a promissory note, and no drawer of a bill or cheque and no acceptor of a bill for the honour of the drawer shall, in a suit thereon by a holder in due course be permitted to deny the validity of the instrument as originally made or drawn (Section 120).
- (vi)* No maker of a promissory note and no acceptor of a bill payable to order shall, in a suit thereon by a holder in due course, be permitted to deny the payee’s capacity, at the rate of the note or bill, to endorse the same (Section 121). In short, a holder in due course gets a good title to the bill.

*(n) Distinction between a holder and a holder in due course :*

- (i)* A holder may become the possessor or payee of an instrument even without consideration, whereas a holder in due course is one who acquires possession for consideration.
- (ii)* A holder in due course as against a holder, must become the possessor payee of the instrument before the amount thereon become payable.
- (iii)* A holder in due course as against a holder, must have become the payee of the instrument in good faith *i.e.*, without having sufficient cause to believe that any defect existed in the transferor’s title.



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## The Negotiable Instruments Act, 1881

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*Negotiation, endorsement, etc. (Sections 14 & 15)* (i) Negotiation means the transfer of an instrument for value to a person who, thereupon, become entitled to hold in and sue thereon in his own name.

- (ii) Endorsement denotes appropriate writing on the back of an instrument so as to transfer the right, title and interest therein to some other person. For the purpose, no particular form is necessary. For example, X, who is the holder of a negotiable instrument writes on the back thereof: "pay to Y or order" and signs the instrument. In such a case, X is deemed to have endorsed the instrument to Y. If X delivers the instrument to Y, X ceases to be the holder and Y becomes the holder.
- (iii) Bearer means the person in possession of an instrument which is payable to bearer.
- (iv) Instrument, being choses, in action, are assignable without endorsement but the assignee only acquires the rights of the assignor.
- (o) *Payment in due course (Section 10)*

Under Section 10 of the Negotiable Instrument Act, "payment in due course" means payment in accordance with the apparent tenor of the instruments in good faith and without negligence to any person in possession thereof under circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment of the amount therein mentioned. In order that such payment may operate as a discharge of a negotiable instrument, it must fulfil the following conditions.

- (i) That the payment should be in accordance with the apparent tenor of the instrument. The connotation of the expression 'apparent tenors' is "in accordance with what appears on the face of the instrument to be the intention of the parties. Consequently, it is imperative that the payment should be made at or after maturity. A payment before maturity is not a payment in accordance with the apparent tenor of the instrument; and as such it is not a payment in due course. Further, for the purpose of Section 10, such payment should be made in money only, because the instrument expressed to be payable in money. A different form of payment may however be adopted but only with the consent of the holder of the instrument.
- (ii) That the person to whom payment is made should be in possession of the instrument. Therefore, payment must be made to the "holder" or a person authorised to receive payment on his behalf. Suppose, the instrument is payable to a particular person or order and is not endorsed by him. Payment to any person in actual possession of the instrument in such case, will not amount to payment in due course. However, in the event of the instrument being payable to bearer or endorsed in blank the payment to a person who possesses the instrument is, in the absence of suspicious circumstances, payment in due course. Any party to a bill, but not any stranger, may pay it; and on payment,





acquire the rights of the holder against all parties prior to him. But a stranger may pay supra protest and for honour of some party to the bill or note.

- (iii) That the payment should be made in good faith, without negligence, and under circumstances which do not afford a reasonable ground for believing that the person to whom it is made is not entitled to receive the amount. If suspicious circumstances are there, then person making the payment is to at once put on an enquiry. If he does not make the enquiry, the payment would not be in due course.

## **2.5 CLASSIFICATION OF INSTRUMENTS**

- (a) *Bearer and Order instruments*: An instrument may be made payable: (1) to bearer; (2) to a specified person or to his order.

An instrument is payable to bearer which is expressed to be so payable on which is expressed thus "Pay to R or bearer". It is also payable to bearer when the only or last endorsement on it is an endorsement in blank.

An instrument is payable to order, (1) when it is payable to the order of a specified person or (2) when it is payable to a specified person or his order or, (3) when it is payable to a specified person without the addition of the words "or his order" and does not contain words prohibiting transfer or indicating an intention that it should not be transferable. When an instrument, either originally or by endorsement, is made payable to the order of a specified person and not to him or his order, it is payable to him or his order, at his option.

When an instrument is not payable to bearer, the payee must be indicated with reasonable certainty.

*Significance of bearer instruments*: The expression "bearer instrument" signifies an instrument, be it a promissory note, bill of exchange or a cheque, which is expressed to be so payable or on which the last endorsement is in blank (Explanation 2 to Section 13 of the Negotiable Instrument Act).

Under Section 46, where an instrument is made payable to bearer it is transferable merely by delivery, *i.e.*, without any further endorsement thereon. This character of the instrument, however, can be altered subsequently. For Section 49 provides that a holder of negotiable instrument endorsed in blank (*i.e.*, bearer) may, without signing his own name, by writing above the endorser's signatures, direct that the payment of the instrument be made to another person. An endorsee thus, can convert an endorsement in blank into an endorsement in full. In such a case, the holder of the instrument would not be able to negotiate the instrument by mere delivery. He will be required to endorse the instrument before delivering it.

In the case of a cheque, however the law is a little different from the one stated above. According to the provisions of Section 85(2) where a cheque is originally expressed to be payable to bearer, the drawee is discharged by payment in due course to the bearer thereof,



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despite any endorsement whether in blank or full appearing thereon notwithstanding that any such instrument purported to restrict or exclude further negotiation. In other words, the original character of the cheque is not altered so far as the paying bank is concerned, provided the payment is made in due course. Hence the proposition that “once a bearer instrument always a bearer instrument”.

(b) *Inland and foreign instrument (Sections 11 & 12)*: A promissory note, bill of exchange or cheque drawn or made in India and made payable in or drawn upon any person resident in India shall be deemed to be an inland instrument. Any such instrument, not so drawn, made or payable shall be deemed to be a foreign instrument.

Thus, the foreign bills are:

- (i) bills drawn outside India and made payable in or drawn upon any person resident in any country outside India;
- (ii) bills drawn outside India and made payable in India, or drawn upon any person resident in India;
- (iii) bills drawn in India upon persons resident outside India and made payable outside India.

In the absence of a contract to the contrary, the liability of the maker or drawer of a foreign promissory note or bill of exchange is regulated in all essential matters by the law of the place where he made the instrument, and the respective liability of the acceptor and endorser by the law of the place where the instrument is made payable (Section 134). For example, a bill of exchange is drawn by A in California where the rate of interest is 25% and accepted by B payable in Washington where the rate of interest is 6%. The bill is endorsed in the State and is dishonoured. An action on the bill is brought against B in the States. He is liable to pay interest at the rate of 6% only. But if A is charged as drawer, he is liable to pay interest at 25%.

The distinction between inland and foreign bills is of importance in connection with Sections 104 and 134 of the Act. Inland bills need not be protested for dishonour; protest in this case is optional. But foreign bills must be protested when law of the place of making or drawing them requires such protest. The question by what law are the contracts on negotiable instruments governed is also important. *Lex loci contractus* governs the liabilities of the drawer or maker and the form of the instrument.

N.B. Foreign bills must be protested for dishonour if the law of the place where these are drawn prescribes for such a protest. In the case of inland bills, protest is optional (Section 104).

(c) *Ambiguous and inchoate bills*: An ambiguous bill means an instrument which can be construed either as a promissory note or as bill of exchange (Section 17), e.g., a bill drawn by a person on himself in favour of a third person or where the drawee is a fictitious person. The



law on the point is that the holder of such a bill is at liberty to treat the instrument as bill or a promissory note. The nature of the instrument will be as determined by the holder.

An incomplete instrument called an inchoate instrument. Section 20 of the Negotiable Instruments Act provides that when one person signs and delivers to another a paper stamped in accordance with the law relating to negotiable instruments then in force in India and either wholly blank or having written thereon an incomplete negotiable instrument, he thereby give *prima facie* authority to the holder thereof to make or complete, as the case may be, upon it a negotiable instrument for an amount specified therein and not exceeding the amount covered by the stamp. The person so signing shall be liable upon such instrument in the capacity in which he signed the same, to any holder in due course for such amount. Provided that no person other than a holder in due course shall recover from the person delivering the instrument anything in excess of the amount intended to be paid by them there under. The principle of this rule (namely that a person who gives another possession to his signature on a blank stamped paper, *prima facie* authorises the latter as his agent to fill it up and give to the world the instrument as accepted by him) is one of estoppel. By such signature he binds himself as drawer, maker, acceptor or endorser. His signature on the blank paper purports to be an authority to the holder to fill up the blank, and complete the paper as a negotiable instrument. Till this filling in and completion, the instrument is not a valid negotiable instrument, and no action is maintainable on it. Further, as a condition of liability, the signer as a maker, drawer, endorser or acceptor must deliver the instrument to another. In the absence of delivery, the signer is not liable. Furthermore, the paper so signed and delivered must be stamped in accordance with the law prevalent at the time of signing and on delivering otherwise the signer is not estopped from showing that the instrument was filled without his authority.

## **2.6 SIGHT AND TIME BILLS ETC (SECTIONS 21 TO 25)**

(i) *Instruments payable on demand*: Bills and notes are payable either on demand or at a fixed future time. Cheque are always payable on demand. A promissory note or bill of exchange in which no time for payment is mentioned is payable on demand. A bill or promissory note is also payable on demand when it is expressed to be payable on demand, or "at sight" or "presentment". It should be noted that the expression "on demand" does not imply that any actual demand is to be made; it is only a technical expression meaning "immediately payable". Such a bill or note may be presented for payment at any time at the option of holder, but it must be presented within a reasonable time after its issue in order to tender the drawer liable, and within a reasonable time after its endorsement to render the endorser liable.

An instrument payable on demand would be overdue when it remains in circulation for an unreasonable length of time.



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(ii) *Time Bills*: The expression “after sight” means, a promissory note after presentment for sight, and in a bill of exchange, after acceptance, noting for non-acceptance or protest for non-acceptance. It is useful to make a bill or not payable at so many months or days after sight.

The term ‘after sight’ is differently used in a note and a bill. In the former case, it denotes that payment is not to be demanded till it has been exhibited to the maker, for a note is incapable of being accepted; while in the latter case, it denotes that sight must appear in legal way, *i.e.*, after acceptance, if the bill has been accepted, or after noting for non-acceptance or protest for non-acceptance (*Homes vs. Kerisson*).

(iii) *Maturity*: Where bill or note is payable at fixed period after sight, the question of maturity becomes important. The maturity of a note or bill is the date on which it falls due. A note or bill, not payable on demand, at sight or on presentment; is at maturity on the third day after the day on which it is expressed to be payable. Three days are allowed as days of grace. No days of grace are allowed in the case of a note or bill payable on demand, at sight, on presentment.

(iv) *Calculation of maturity* : Where a bill is payable at a fixed period after sight, the time is to be calculated from the date of acceptance if the bill is accepted and from the date of noting or protest if the bill is noted or protested for non-acceptance (For the explanation of noting and protesting, read Sections 99 and 100 of the Negotiable Instruments Act).

In the case of a note, the expression “after sight” means after exhibition thereof to maker for the purpose of founding a claim for payment.

In the case of a bill payable after a stipulated number of months after sight which has been accepted for honour, the date of its maturity is calculated from the date of acceptance for honour. (For the explanation of the phrase ‘acceptance for honour’, read Section 108 of the Negotiable Instruments Act).

In calculating the date at which a note or bill made payable a certain number of days after date or after sight or after a certain event is at maturity on the day or the date, or the day of presentment for acceptance or sight or the day of protest for non-acceptance, or the day on which the event happens shall be excluded (Section 24). When a note or bill is made payable, a stated number of months after date, the period stated terminates on the day of the month which corresponds with the day on which the instrument is dated. When it is made payable after a stated number of months after sight the period terminates on the day on the month which corresponds with the day on which it is presented for acceptance or sight or noted for non-acceptance or protested for non-acceptance. When it is payable a stated number of months after a certain event, the period terminates on the day of the month which corresponds with the day on which the event happens (Section 23).



If the month in which the period would terminate has no corresponding day, the period terminates on the last day of such month (Section 23). Three days of grace are allowed to these instruments after the day on which they are expressed to be payable (Section 22).

When the last day of grace falls on a day which is public holiday, the instrument is due and payable on the preceding business day (Section 25).

## **2.7 NEGOTIATION, NEGOTIABILITY, ASSIGNABILITY**

*Negotiation* : When a negotiable instrument is transferred to any person with a view to constituting that person the holder thereof, the instrument is deemed to have been negotiated (Section 14). A negotiable instrument may be transferred in either of the two ways, viz., (1) by negotiation under the Negotiable Instruments Act (Sections 14, 48, 47, 46); and (ii) by assignment of the instrument as an ordinary chose in action under the Transfer of Property Act (Chapter VII, Section 130). Transfer by negotiation, however, is the only mode of transfer recognised by the Act.

Under the Act, negotiable instruments may be negotiated either by delivery when these are payable to bearer or by endorsement and delivery when these are payable to order.

(i) *Importance of delivery (Section 46)* : Delivery is an incident of the utmost importance in the case of an instrument. It is essential to the issue of an 'instrument' for "issue" means the delivery of the instrument, complete in form, to a person who takes it as a holder. It is equally essential to the negotiation of an instrument, for a bearer instrument, must be transferred by delivery and in the case of any other instrument, endorsement is incomplete without delivery. In fact, a negotiable instrument is nothing but a contract which is incomplete and revocable until the delivery of the instrument is made. For instance, in the case of a promissory note so long as the note, remains with the maker, the payee cannot claim payment; it is the delivery of the note to the payee that entitles him to claim payment; Section 46 of the Act provides as follows :

"The making, acceptance or endorsement of promissory note, bill of exchange or cheque is completed by delivery, actual or constructive"

(ii) *How to deliver* : As between parties standing in immediate relation, delivery to be effectual, must be made by the party making, accepting or endorsing the instrument, or by a person authorised by him in this behalf. Thus a promissory note must be handed over to the payee by the maker himself or by some one authorised by the maker. Similarly, a bill of exchange must be delivered to the transferee by the maker, acceptor or endorser, as a case may be.

(iii) *Conditional and unconditional delivery* : An instrument may be delivered conditionally or only for a special purpose, and not for the purpose of transferring absolutely the property in the instrument. A bill delivered conditionally is called an 'escrow'. Although a conditional



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delivery is valid, the condition attaches exclusively to the delivery and not to the making or drawing of an instrument. A bill must be drawn and a note made unconditionally. When an instrument is delivered conditional or for special purpose, the property in the instrument does not pass on to the transferee until the condition is fulfilled and the transferee holds such instrument in law as trustee or agent of the transferor.

If, however, an instrument delivered conditionally to X is transferred by him for value to Y without notice of the condition, Y can claim payment even if the condition is not complied with. The reason is obvious - Y is *bona fide* transferee for value without notice of the condition and, as such, he should not suffer for suppression of fact by X.

(iv) *Negotiation by delivery (Section 47)* : An instrument payable to bearer is negotiable by delivery thereof. But when such instrument is delivered on condition that it is not to take effect except in certain event, it is not negotiable (except in the hands of a holder for value without notice of the condition) unless such event happens.

The distinction between 'delivery' and 'negotiation' should be noticed. An instrument is said to be negotiated, when it is transferred from one person to another in such a manner as to constitute the transferee the holder thereof.

(v) *Negotiation by endorsement* : In order to negotiate, that is to transfer title to an instrument payable to order, it is at first to be endorsed and then delivered by the holder.

The Indorsement consists of the signature of the holder made on the back of the negotiable instrument with the object of transferring the instrument. If there is no space on the instrument, the Indorsement may be made on a slip of paper attached to it. This attachment is known as "Allonge".

According to Section 15 of the Negotiable Instruments Act, 1881 " when the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face therefore or on slip of paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as negotiable instrument, he is said to indorse the same, and is called the indorser."

(vi) *Different types of endorsements (a) Blank (or general)* : No endorsee is specified in an endorsement in blank; it contains only the bare signature of the endorser. A bill so endorsed becomes payable to bearer.

*SPECIMEN*

*Motilal Poddar*

(b) *Special (or in full)* : In such an endorsement, in addition to the signature of the endorser the person to whom or to whose order the instrument is payable is specified.



**SPECIMEN**

Pay to B, Batliwala or order.

*S. Shroff*

- (c) *Restrictive* : Such an endorsement has the effect of restricting further negotiation and transfer.

*SPECIMEN* :           (1)       Pay to A only    *S. Mukerjee*  
                              (2)       For the account of A only *N. Aiyar*

- (d) *Conditional* : Such an endorsement combines an order to pay with condition.

*SPECIMEN*: Pay to A on safe receipt of goods.

*V. Chopra*

- (e) *Sans Recourse* : By adding these words after the endorsement, the endorser declines to accept and liability on the instrument of any subsequent party.

- (f) *Sans Frais* : These words when added at the end of the endorsement, indicate that no expenses should be incurred on account of the bill.

- (g) *Facultative* : When it is desired to waive certain right, the appropriate words are added to indicate the fact, e.g., “notice of dishonour dispensed with”.

Every endorser of a negotiable instrument is liable, under Section 35, to every subsequent party to it provided due notice of dishonour is given to or received by him e.g., if a bill is drawn by A upon B and is payable to C or order, and C endorses the bill to D, who in turn endorses it to E, then, in case B, dishonours the bill, the holder, *i.e.*, E has the right of action against all the parties *i.e.*, D.C. and A. Similarly, D has right against C and A. To this rule that every prior party of a bill is liable to every subsequent party, there are a few exceptions which are enumerated below:

- (1) Any endorser can exclude personal liability by endorsing “sans recourse” *i.e.* without recourse.
- (2) If the holder of a negotiable instrument, without the consent of the endorser destroys the instrument or in any way prejudices the holder (*Section 40 ibid*).
- (3) The rule is not applicable also in the case of “circuity of action” - e.g., a bill is drawn by A upon B payable to C or order, who endorses it to D who endorses it to E, who endorses it to F, who endorses it to G and who again, endorses it back to D. In that case, it will be observed that a circle is complete between the first and second holdings of D; and the parties in between (*i.e.*, E,F and G) are absolved from liability to D because D is, as against them, both a subsequent party and a prior party. If, however, D’s first endorsement was “sans recourse”, the intermediate parties, *i.e.*, E, F and G would not be absolved from liability to him.



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Example: M drew a cheque amounting to Rs. 2 lakh payable to N and subsequently delivered to him. After receipt of cheque N indorsed the same to C but kept it in his safe locker. After sometime, N died,

and P found the cheque in N's safe locker. Does this amount to Indorsement under the Negotiable Instruments Act, 1881?

No, P does not become the holder of the cheque as the negotiation was not completed by delivery of the cheque to him. (Section 48, the Negotiable Instruments Act, 1881)

(vii) *Conversion of endorsement in blank into endorsement in full (Section 49)* : The holder of a negotiable instrument endorsed in blank may, without signing his own name by writing above the endorsers, signature a direction to pay to any other person as endorsee, convert the endorsement in blank into an endorsement in full; and the holder does not thereby incur the responsibility of an endorser, for his name appears nowhere in the instrument. The advantage of such course is that the holder, though he transfers the instrument, does not incur the responsibility of an endorser (*Hirschfeld vs. Smith* (1886) L.R.I. C.P. 340).

(viii) *Effect of endorsement (Section 50)* :

- (a) The endorsement of an instrument, followed by delivery, transfers to the endorsee the property in the instrument with right of further negotiation. That is, the endorsee may endorse it to some other person.
  - (b) The endorsement may also contain express terms making it restrictive. The effect of restrictive endorsement is (1) to prohibit or exclude the right of further negotiation, or (2) to constitute the endorsee an agent to endorse the instrument; or (3) to entitle the endorsee to receive the contents of the instrument for the endorser or for some other specified person.
  - (c) *A restrictive endorsement gives the endorsee* : (1) the right to receive payment of the instrument; (2) the same rights of action against any other party to the instrument as the endorser had; (3) power, only in accordance with the express terms of his authority, to transfer the instruments and his right thereon to another.
- (ix) *Who may negotiate (Section 51)* : The following persons may negotiate an instrument: (1) sole maker, (2) drawer, (3) payee, (4) endorsee.

A maker or drawer only when the instrument is drawn to his own order. When the endorsee is the holder under a restrictive endorsement, he must exercise his power of negotiation strictly in accordance with the express terms of his authority. Thus, if negotiability is excluded by the respective endorsement, the endorsee, as holder, cannot negotiate.





The explanation to Section 51 provides that though a maker or a drawer may endorse or negotiate an instrument, he cannot do so, unless the instrument fall into his possession in a lawful manner or unless he is the holder thereof. Further, insofar as the payee or an endorsee is concerned, he must before he can negotiate the instrument, be a holder thereof. Consequently, a person who steals or endorses or finds a lost instrument, cannot endorse or negotiate, as he is not a holder within the meanings of the Act.

- (x) *Exclusion of liability of endorser (Section 52)* : The endorser of an instrument may, by express words in the endorsement, exclude his own liability on the instrument. Suppose that the endorser signs his name, adding the words “without recourse”, he incurs no liability. The holder cannot claim compensation from him in case of dishonoured by the drawee, acceptor or maker. But for the words “without recourse”, he would have been liable.

The endorser, instead of excluding his liability altogether, may restrict his liability by endorsement. Thus, he may either (1) make his liability depend upon the happening of a specified uncertain event, (2) make the right of the endorsee to receive the amount mentioned in the instrument depend upon a specified uncertain event.

But when such endorser afterwards becomes the holder, all intermediate endorsers are liable to him. For example, A the payee and holder of an instrument endorses it to B with the words “without recourse” and B endorses it to C who in his turn endorses it to A, B and C are liable to A as intermediate endorsers.

- (xi) *Holder deriving title from holder in due course (Section 53)* : A holder of an instrument deriving title from a holder in due course has rights thereon of the holder in due course. Therefore, a holder deriving title from a holder in due course can claim the amount of a bill drawn and accepted without consideration. It has been held that a title, which has been cleansed of defects by passing through the hands of a holder in due course remains immune from those defects inspite of the fact that a subsequent holder may have noticed that the defects once existed provided he was not a party to them [*Guidford Trust vs. Goss* [1926] 43 LR 167; *Credit Bank vs. Schenkers* [1927] WN 39]. For example, X obtains Y’s acceptance to a bill by fraud. X endorses it to Z who takes it as a holder in due course. Z endorses the bill to F who knows of the fraud. Since F derives the title from Z who is a holder in due course and F is not party to fraud, F gets a good title to the bill.
- (xii) *Effect of endorsement in full after a blank one (Sections 54 and 55)* : An instrument endorsed in blank is payable to the bearer, although originally it was payable to order. If an instrument after having been endorsed in blank is endorsed in full, the endorsee in full does not incur the liability of an endorser, so the amount of it cannot be claimed from him. In other words, if an endorsement in blank is followed by an endorsement in full, the



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instrument still remains payable to bearer and negotiable by delivery as against all parties prior to the endorse in full, though the endorser in full is only liable to a holder who made title directly through his endorsement and the persons deriving title through such holder. For example, X is the payee holder of a bill of exchange. X endorsee it in blank and delivers it to Y who endorses it in full to Z or order Z, without endorsement, transfers the bill to F. In view of Section 55, F as the bearer of the instrument can receive payment or sue the drawer, acceptor or X but not Y or Z who is a subsequent but not a prior party. But there is an exception to this rule. The person to whom it has been endorsed in full, or any one who derives title through him, can claim the amount from the endorser in full.

- (xiii) *Effect of endorsement for part of sum due (Section 56)* : An endorsement purporting to transfer only a part of the amount of instrument is invalid, and the endorsee, therefore cannot negotiate it. But when the amount due has been paid in part, a note to that effect may be endorsed on instrument and the instrument may then be negotiated for the balance.

### 2.8 NEGOTIABILITY VS. ASSIGNABILITY

- (i) The essential distinction between transfer by negotiation and transfer by assignment is that in the latter case, the assignee does not acquire the right of a holder in due course but has only the right, title and interest of his assignor; on the other hand in the former case he acquires all the rights of a holder in due course *i.e.*, rights from equities (*Mohammad Khunerali vs. Ranga Rao*, 24 M. 654).
- (ii) In the case of negotiable instrument, notice of transfer is not necessary while in the case of an assignment of chose in action, notice of assignment must be served by the assignee on his debtor.
- (iii) Again, in the case of transfer of negotiable instrument, consideration is presumed, but in the case of transfer by assignment, consideration must be proved as in the case of any other contract.
- (iv) Negotiation requires either delivery only in the case of “bearer” instrument, or endorsement and delivery only in the case of “order instrument”. But in the case of an assignment, Section 130 of the Transfer of Property Act requires a document to be reduced into writing and signed by the transferor.
- (v) Indorsement do not require payment of stamp duty whereas negotiation requires payment of stamp duty.

### 2.9 DIFFERENT PROVISIONS RELATING TO NEGOTIATION

**(a) Negotiation Back:** An instrument is said to have been negotiated back to him and he is said to have taken up or taken back the negotiable instrument when a person who has been a



party to the negotiable instrument takes it again. For example, suppose that the endorsements on a negotiable instrument are as under:

P  
A  
B  
X  
Y  
A

Here A is person who is a prior party to the instrument. He negotiated it to B, B to X, X to Y and Y again to this very A. On account of this last endorsement, A should have right to claim money from X, Y and B. The rule is that every prior party is liable to every subsequent party. Thus, conversely, every subsequent party may sue every prior party. As a result of the prior party (*i.e.*, A) having taken back the instrument subsequently, he (*i.e.*, A) becomes a 'subsequent' party. Therefore A, by reason of the last endorsement mentioned above, come to have the rights to claim money Y, X or B. A is permitted by law to sue Y, X or B then Y, X or B in his turn can sue A because of A's prior endorsement. This will lead to a circuitry of action. To prevent this, Section 52 of the Negotiable Instruments Act enacts an exception to the general rule to provide that the holder in due course of a negotiable instrument may sue all prior parties thereto. Thus A, in the above case cannot sue Y, X or B. But A can sue P since the latter is prior to A's original endorsement. If however A, in original endorsement, had signed "sans recourse" there could be no circuitry of action and A could sue Y, X or B.

**(b) Capacity to incur liability under instrument Section 26** : Every person competent to contract has capacity to incur liability by making 'drawing' accepting, endorsing, delivering and negotiating an instrument.

A party having such capacity may himself put his signature or authorise some other person to do so.

A minor cannot make himself liable as drawer, acceptor or endorser, but where the instrument is drawn or endorsed by him, the holder can receive payment from any other party thereto.

*Authority to sign (Sections 27 & 28)* : Every person, capable of incurring liability, may bind himself or be bound by a duly authorised agent acting in the name.

A general authority to transact business given to an agent does not empower him to accept or endorse bills of exchange so as to bind the principal.

An agent may have authority to draw bills of exchange, but not endorse them. An authority to draw does not, necessarily, imply an authority to endorse.



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An agent who signs his name on an instrument without indicating that he signs as agent, is personally liable, but this rule does not apply where any one induces him to sign upon the belief that principal only would be held liable.

The mere signature of an agent in his own name, with the word “agent” added, does not exempt him from personal liability.

### (c) Liabilities of parties

(a) *Liability of legal representatives (Section 29)* : A ‘legal representative’ of a deceased person, who signs his own name on an instrument, is personally liable for the entire amount; but he may expressly limit his liability to the extent of the assets received by him as legal representative. The term “legal representative” includes heirs, executors and administrators.

(b) *Liability of drawer (Section 30)* : The drawer of a bill of exchange or cheque is bound, in the case of dishonour by the drawer or acceptor thereof to compensate the holder, provided due notice of dishonour has been given to, or received by him provided in Sections 93 to 98 of the Act.

The drawer’s liability is conditional, *i.e.*, it arises only in the event of a dishonour by the drawee or acceptor. Once there has been dishonour and the notice of dishonour has been served on the drawer, he is bound to compensate the holder whatever be the state of the account between himself and the drawee or acceptor (*Seth Ka-Haridas vs. Bhai 3, Bom. 182*). The holder will have to be compensated, for the principal sum together with interest calculated according to the rules mentioned in Sections 79 & 80 and for the expenses properly incurred by him in presenting noting and protesting the instrument. On dishonour of a bill of exchange by non-acceptance followed by a notice of dishonour to the drawer, the drawer becomes liable immediately for the full amount of the bill. The drawer cannot ask the holder to wait till the date of maturity to see whether it will be dishonoured by non-payment [*Whitehead vs. Walker* [1842] 9 M and W 506]. If however, the holder chooses to wait till its maturity before he sues the drawer he does not acquire a fresh cause of action by reason of its non-payment of the due date.

The only pre-condition of the liability of the drawer is that notice of dishonours should have been received by him, unless the case is one covered by Section 98 of the Act and notice of dishonour is dispensed with.

The drawer of a bill or cheque is a “prior party” to the instrument and as such is liable for every holder in due course, under Section 36 of the Act, till the instrument is discharged. Until acceptance, he is liable on the instrument as a principal debtor and thereafter as a surety (Section 37).



Usually, the liability of the drawer of a bill or cheque is secondary and conditional (the liability of the acceptor of the bill and drawee of the cheque being primary and unconditional). However, in the case of an accommodation bill drawn for the accommodation of the drawer, in addition to his liability to the payee or holder, the drawer is bound to indemnify the acceptor if he suffers any damage on account of his acceptance.

It should, however, be noted that the liability of a drawer is subject to a contract to the contrary. He may, by an express stipulation in the instrument, limit or exclude his liability.

(c) *Liability of drawee of cheque (Section 31)* : The drawee of the cheque is always a banker. It is the duty of the banker to pay the cheque, provided he has in his hands sufficient fund of the drawer and the funds are properly applicable to such payment. Trust money is not properly applicable to the payment of a cheque drawn in breach of trust. If the banker refuses payment without sufficient cause being shown, he must compensate the drawer for any loss caused by such improper refusal. The bank is required to compensate, not the holder, but the drawer. The amount of compensation, that the drawee would have to pay to the drawer is to be measured by the loss or damage say loss of credit, suffered by the drawer). The principle is: "The lesser the value of the cheque dishonoured, the greater the damage to the credit of the drawer". If there is any agreement between the drawer and the banker that the former shall not draw more than one cheque every week, the banker is not bound to pay the second cheque. The banker must pay the cheque, only when he is duly required to do so. If any trustee opens an account the banker is entitled to refuse to pay cheques drawn for purposes other than those of the trust.

In addition to such a general right, a banker will be justified or bound to dishonour a cheque in the following cases, viz. ;

- (i) If a cheque is undated [*Griffith vs. Delton* [1940] 2 K.B. 264].
- (ii) If it is stale, that is if it has not been presented within reasonable period, which may vary three months to a year after its issue dependent on the circumstances of the case (*Paget's Law of Banking*).
- (iii) If the instrument is inchoate or not free from reasonable doubt [as per view of Lord Haldan in *London Joint Stock Bank vs. Macmillan and Arthur* [1981] A.C. 777 (814)].
- (iv) If the cheque is post-dated and presented for payment before its ostensible date [*Morley vs. Culverwell* 7 M. & W. 174, 178].
- (v) If the customer's funds in the banker's hands are not 'properly applicable' to the payment of cheque drawn by the former. Thus, should the funds in the banker's hand's be subject to a lien or should the banker be entitled to a set-off in respect of them, the funds cannot be said to be "properly applicable" to the payment of the customer's cheque, and the banker would be justified in refusing payment.



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- (vi) If the customer has credit with one branch of a bank and he draws a cheque upon another branch of the same bank in which either he has account or his account is overdrawn [*Woodload & Fear* (1808) A.C. 998].
- (vii) If the bankers receive notice of customer's insolvency or lunacy [*Mathew vs. Sherwell* (1810), 2 Taunt 439, *Screw vs. Nunn* (879) 4 Q.B.D. 661].
- (viii) If the customer countermands the payment of cheque for the banker's duty and authority to pay on a cheque ceases [*Mowji Shamji vs. The National bank of India* 22 Bom. 499].
- (ix) If a garnishee or other legal order from the Court attaching or otherwise dealing with the money in the hand of the banker, is served on the banker [*Rogers vs. Whitely* (1889), 22 Q.B.D. 236, affirmed 1892 A.C. 118].
- (x) If the authority of the banker to honour a cheque of his customer is undermined by the notice of the latter's death. However, any payment made prior to the receipt of the notice of death is valid [*Tata vs. Hbert* 9 Ves, 111; in re *Beaumont*, 1 Ch. 889].
- (xi) If notice in respect of closure of the account is served by either party on the other [*Bukingham & Co. vs. London & Midland Bank* (1895) 12 T.L.R. 70].
- (xii) If it contains material alterations, irregular signature or irregular endorsement.
- (d) *Liability of maker of note and acceptor of bill (Section 32)* : The maker of a promissory note is bound to pay the amount at maturity, according to the tenor of the note. In default of such payment, the maker is bound to compensate any party to the note for any loss sustained by reason of such default.

Under Section 32, the liability of the drawee only arises when he accepts the bills. In the absence of a contract to the contrary, the acceptor (drawee) of a bill before maturity is bound to pay the amount thereof only at maturity, in accordance with the apparent tenor of the acceptance. In the event of the bill being accepted after maturity, he is bound for the amount to the holder on demand. In default of such payment as aforesaid, he is bound to compensate any party to the bill for any loss or damage caused to him by such a default. There is no provision in the Act that the drawee as such is liable on the instrument, the only exception being under Section 31 in the case of a drawee of cheque (discussed hereinafter) having sufficient funds of the customer in his hands, and even then the liability is towards the drawer and not the payee (*Seth Jagjivan vs. Ranchhoddas A.I.R. 1954 S.C. 551*).

The following persons incur liability by acceptance; (1) drawee (2) person named as drawee in case of need, and (3) acceptor for honour. Where there are several drawees, each can accept only for himself, unless they are partners.

- (e) *Liability of endorser (Section 35)* : The endorser of an instrument by endorsing and delivering the instrument, before maturity, undertakes in effect the responsibility that on the



due presentment it shall be accepted, (if a bill), and paid and that if it is dishonoured by the drawee, acceptor or maker, he will indemnify the holder or subsequent endorser who is compelled to pay, provided due notice of dishonour is received by him. But he may insert, in the endorsement, stipulations excluding, or making his liability conditional. In this respect, his position is better than that of a drawer or an acceptor, neither of whom can exclude his liability. An acceptor, however can make his acceptance conditional.

(f) *Liability of parties to holder in due course (Section 36)* : Every prior party (*i.e.*, maker or drawer, acceptor and all intervening endorsers to an instrument is liable to a holder in due course until the instrument is satisfied. Thus the maker and endorsers of a note are jointly and severally liable for the payment and may be sued jointly.

(g) *Liability of maker, drawer and acceptor as principals (Sections 37 & 38)* : The maker of a promissory note is liable as the principal debtor. If the payee endorses it to A, the maker will be liable to A as the principal debtor and the payee will be liable as a surety. Similarly, the drawer of a cheque, the drawer of a bill until acceptance and the acceptor are respectively liable as sureties. As between the parties so liable as sureties, each prior party is also liable as a principal debtor in respect of each subsequent party. For instance, A draws a bill payable to his own order on B who accepts it. Afterwards A endorses the bill to C, C to D to E. As between E (holder and B, B is the principal debtor, and A, C and D are his sureties. As between E and C, C is the principal debtor and D his surety.

(h) *Nature of suretyship (Section 39)* : The holder of an accepted bill may waive his claim against the acceptor, but at the same time, he may expressly reserve his right to charge the other parties. Under Section 134 of the Contract Act, the release of the principal debtor has the effect of discharging the surety, but in the case of a bill it is not so. But if the holder does not reserve his right expressly against the other parties, they too will be discharged if he releases the acceptor.

(i) *Discharge of endorser's liability (Section 40)* : Any party liable on the instrument may be discharged by the intentional cancellation of his signature by the holder. Suppose that A is the holder of a bill of exchange of which B is the payee and it contains the following endorsement in blank:

First endorsement, "B"

Second endorsement, "C"

Third endorsement, "D"

Fourth endorsement, "E"

A, the holder, may intentionally strike out the endorsement by D and C; in that case the liability of D and C upon the bill will come to an end. But if the endorsements of D and C are struck out without the consent of E, A will not be entitled to recover anything from E the reason being that as between D and E, D is the principal debtor and E is surety. If D is released by the holder under Section 39 of the Act, E, being surety, will be discharged. The rule may be stated



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thus: when the holder without the consent of the endorser impairs the endorser's remedy against a prior party, the endorser is discharged from liability to the holder.

(j) *Effect of forged endorsement on acceptor's liability (Section 41)* : A bill may be accepted before or after endorsement by the payee. The acceptor is not precluded by his acceptance from showing that the subsequent endorsement is forged, since acceptance does not amount to an admission that the endorsement is genuine. And the holder under a forged endorsement cannot demand payment from the acceptor. But an acceptor of a bill already endorsed is not relieved from liability by reason of the fact that such endorsement is forged, if he was aware at the time of acceptance that the endorsement was forged; for by such acceptance he is stopped from setting up forgery in denial of his liability.

(k) *Liability of acceptor of a bill drawn in a fictitious name (Section 42)* : The acceptor is not relieved from liability by proving that the drawer is fictitious. Suppose X uses a fictitious name in drawing a bill upon Z and that the bill is made payable to the order of the drawer X then endorses the bill in the same fictitious name to Y, who presents the Bill to Z, for acceptance. If Z accepts the bill, in spite of the fact that the name of the drawer is fictitious; he cannot escape liability to pay by showing that the name of the drawer is fictitious; rather he will not be allowed to lead evidence that the name is fictitious.

(l) *Liability on an instrument made drawn etc. without consideration (Section 43)* : An instrument made, drawn, accepted, endorsed, or transferred without consideration creates no obligation of payment between the parties to the instrument. For example, if a promissory note is delivered by the maker to the payee as a gift, it cannot be endorsed against the maker by the payee.

Similarly, if the consideration fails, there is no obligation on the parties to pay. For example, X makes a note in favour of Y in anticipation of Y's supplying a bale of cotton. Y fails to deliver the cotton cannot claim payment from X.

Again, a bill that is drawn or accepted without consideration does not impose any liability either on the drawer or on the acceptor to pay the holder. Similarly, if an instrument is endorsed without consideration, nothing can be claimed from the endorser.

But if any party to an instrument made, accepted, endorsed or transferred without any consideration, or for a consideration which fails, has transferred the instrument to a holder for a consideration such holder and every subsequent holder deriving title from him, may recover the amount due on such instrument from the transfer for consideration or from any party prior thereto. For Example, X and Z are respectively the drawer, the payee and the acceptor of a bill of exchange drawn without consideration; Y transfers the bill to P for consideration. P can claim payment from Y and also from Z and X.

(d) **Dishonoured cheque to be treated as an offence** : From 1st April 1989, a person issuing a Cheque will be committing an offence if the cheque is dishonoured for insufficiency





of funds. The offence will be punishable with imprisonment for a term up to two years [as prescribed by the Negotiable Instruments (Amendment and Miscellaneous Provisions Act, 2002] or with a fine twice the amount of the cheque or both. The cheque in question should be issued in discharge of a liability and therefore a cheque given as gift will not fall in this category. The cheque should be presented within six months or its specific validity period whichever is earlier. The payee or holder in due course should give notice demanding payment within 15 days of his receiving information of dishonour which should be for no reason other than insufficiency of funds. The drawer can make payment within 15 days of the receipt of the notice and only if he fails to do so, prosecution can take place. The complaint can be made only by the payee/holder in due course, within one month.

A banker who in good faith but without negligence receives payment for a customer of a cheque crossed generally or specially to himself, does not, in the event of the title of the customer to the cheque proving to be defective, incur any liability to the true owner of the cheque for having received payment therefor (Section 131). It is special protection given to the collecting banker which is available to him only if he acts in good faith but without negligence. Given below are a few illustrations of circumstances in which a banker has been deemed to have complied with these conditions :

(i) That the collecting banker has acted in good faith and without negligence. In *Lloyds Savoury Co. (1933) A.C. 201*, the court held that if the banker receives payment of a cheque to which the customer has no title, the onus is on him to disprove negligence. What amounts to negligence is, however a question of fact in each case. "Negligence" means want of "reasonable care" with reference to the interest of the true owner. The test of "negligence" is whether the transaction of paying in any given cheque coupled with the circumstances antecedent and present was so flagrantly out of the ordinary course that it ought to have aroused suspicion in the mind of the banker and caused him to make enquiry (*Bopulal Prem Chand vs. The Nath Bank Ltd. 48 Bom. L.R. 393*).

(ii) That the collecting banker has received payment of the crossed cheque for a customer. To make a person a customer of a bank it is essential that there must be some sort of account, either a deposit or a current account or some similar relation [*Lucave Co. vs. Credit Lyonnais (1897) 1 Q.B. 148*].

(iii) That the collecting banker acts only to receive payment of the crossed cheque for customer. The section will be restricted to a case where the banker is acting as an agent for collection but not to a case where the banker is himself the holder. For example, if a customer had overdrawn his account with the bank, and cheque was paid to extinguish that overdrawn account, it was held that the bank was a holder of the cheque for value and not a mere agent for collection. [*McLean vs. Clydesdale Banking Co. (1833) 9 A.C. 95, 115; A.L. Underwood Ltd. vs. Barclays Bank (1914) I.K.B. 799*].



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(iv) That the payment has been received only for a crossed cheque, and that crossing had been made before the cheque fell into the hands of the collecting bankers.

If the aforementioned conditions do not co-exist, this protection would be denied to the collecting banker. The protection can be claimed by the collecting banker even when he credited his customer's account with the amount of the cheque before receiving payment thereof. The protection is also available in respect of any draft as defined in Section 85A (Section 131A).

**(e) Problems :**

(1) A drawer of a cheque after having issued the cheque, informs the drawee not to present the cheque as well as informs the bank to stop the payment. Does it constitute an offence under the Act ?

The Supreme Court in *Modi Cements Ltd. vs. Kuchil Kumar Nandi* [1998] 2 CLJ 8 held that once a cheque is issued by the drawer, a presumption under Section 139 follows and merely because the drawer issues a notice thereafter to the drawee or to the bank for stoppage of payment, it will not preclude an action under Section 138. The object of Sections 138 to 142 of the Act is to promote the efficacy of the banking operations and to ensure credibility in transacting business through cheques. Section 138 is a penal provision in the sense that once a cheque is drawn on an account maintained by the drawer with his banker for payment of any amount of money to another person from out of that account for the discharge in whole or in part of any debt or other liability, is informed by the bank unpaid either because of insufficiency of amount to honour the cheques or the amount exceeding the arrangement made with the bank, such a person shall be deemed to have committed an offence.

(2) Whether the payee or the holder of a cheque can initiate prosecution for an offence under the N.I. Act, for its dishonour for the second time if he had not initiated now prosecution on the first occasion ?

**Supreme Court in *Sadanandan Bhadran v. Madhavan Sunil Kumar*** [1998] 4 CLJ 228 held that on a careful analysis of Section 138, it is seen that the main part creates an offence when a cheque is returned by the bank unpaid for any of the reasons mentioned therein. The said proviso lays down three conditions precedent to the applicability of the above section and the conditions are :

- (1) the cheque should have been presented to the bank within six months of its issue or within the period of its validity whichever is earlier;
- (2) the payee should have made a demand for payment by registered notice after the cheque is returned unpaid and;
- (3) the drawer should have failed to pay the amount within 30 days [as per Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002] of the receipt of



notice. It is only when all the above three conditions are satisfied that a prosecution can be launched for the offence under Section 138.

So far as the first condition is concerned, clause (a) of the proviso to section 138 does not put any embargo upon the payee to successively present a dishonoured cheque during the period of validity. It is not uncommon for a cheque being presented again and again within its validity period in the expectation that it would be encashed. The question whether dishonour of the cheque on each occasion of its presentation gives rise to a fresh cause of action, the following facts are required to be proved to successfully prosecute the drawer for an offence under Section 138 :-

- (1) that the cheque was drawn for payment of an amount of money for discharge of a debt/liability and the cheque was dishonoured;
- (2) that the cheque was presented within the prescribed period;
- (3) that the payee made demand for payment of the money by giving a notice in writing to the drawer within the stipulated period;
- (4) that the drawer failed to make the payment within 30 days (as per Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002) of the receipt of the notice.

If one has to proceed on the basis of the generic meaning of the terms “cause of action”, certainly each of the above facts would constitute a part of the cause of action, but it is significant to note that clause (b) of Section 142 gives a restrictive meaning in that it refers to only one fact which will give rise to the cause of action and that is failure to make the payment within 30 days from the date of receipt of the notice.

Besides the language of Sections 138 and 142 which clearly postulates only one cause of action, there are other formidable impediments which negates the concept of successive causes of action. The combined reading of Sections 138 and 142 leave no room for doubt that cause of action within the meaning of Section 142(c) arises and can arise only once.

The final question as how apparently conflicting provisions of the Act, one enabling the payee to repeatedly present the cheque and the other giving him only one opportunity to file a complaint for its dishonour and that too within one month from the date of cause of action arises can be reconciled, the Court held that the two provisions can be harmonised with the interpretation that on each presentation of the cheque and its dishonour, a fresh right and not cause of action accrues in his favour.

Therefore, the holder/payee of a cheque cannot initiate prosecution for an offence under Section 138 for its dishonour for the second time, if he had not initiated such prosecution on the earlier cause of action.



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(3) What is the extent of liability of the company and the person(s) in charge of the company in respect of an offence for dishonour of cheques?

From a perusal of Section 141, it is apparent that in case where a company committed an offence under Section 138, then not only the company, but also every person who at the time when the offence was committed, was in charge of and was responsible to the company shall be deemed to be guilty of the offence and liable to be proceeded against under those provisions, only if that person was in charge of and was responsible to the company for the conduct of its business. [*K.P.G. Nair vs. Jindal Menthol Indian Ltd. (2001) 2CLJ 258 SC*]

(4) For cognizance of offence for the dishonour of cheque, should the cheque necessarily be presented to the drawee's (payee's) bank or can it be presented before any bank within the stipulated period?

The Act intends to legalise the system under which claims upon mercantile instruments could be equated with ordinary goods passing from hand to hand. To achieve the objective of the Act, the legislature in its wisdom thought it proper to make provision in the Act for conferring such privileges to the mercantile instruments contemplated under it and provide special procedure in case the obligation under the instrument was not discharged. It has, always to be kept in mind that Section 138 of the Act creates an offence and it has further to be noticed that to make an offence under Section 138 of the Act, it is mandatory that the cheque is presented to the bank within a period of six months, from the date on which it is drawn or within the period of its validity, whichever is earlier. It is the cheque drawn which has to be presented to the bank within the period specified therein. The post-dated cheque becomes a cheque under the Act on the date which is written on the said cheque and the six months period has to be reckoned, for the purposes of Section 138 of the Act, from the said date.

Section 138 provides that where any cheque drawn by a person on an account maintained by him with a 'banker' for payment of any amount of money to another person from out of that account for the discharge, in whole or in part, of any debt or other liability, is returned by 'the bank' unpaid, either because of the amount of money standing to the credit of that account is insufficient to honour the cheque or that it exceeds the amount arranged to be paid from that account by an agreement made with the bank, such person shall be deemed to have committed an offence punishable with imprisonment as prescribed therein subject to the conditions mentioned in clauses (a), (b) and (c) of the proviso. Section 3 of the Act defines the 'banker' to include any person acting as a banker and any post office savings bank. Section 72 of the Act provides that a cheque must, in order to charge the drawer, be presented at the bank upon which it is drawn before the relations between the drawer and his banker have been altered to the prejudice of the drawer.

The use of the words 'a bank' and 'the bank' in the section is an indicator of the intention of the legislature. The former is an indirect article and the latter is pre-fixed by a direct article. If the



legislature intended to have the same meanings for 'a bank' and 'the bank', there was no cause or occasion for mentioning it distinctly and differently by using two different articles. It is worth noticing that the word 'banker' in Section 3 of the Act is prefixed by the indefinite article 'a' and the word 'bank' where the cheque is intended to be presented under Section 138 is prefixed by the definite article 'the'. The same section permits a person to issue a cheque on an account maintained by him with 'a bank' and makes him liable for criminal prosecution if it is returned by 'the bank' unpaid. The payment of the cheque is contemplated by 'the bank' meaning before nouns, with a specifying of particularising effect opposed to the indefinite or generalising force of 'a' or 'an'. It determines what particular thing is meant that is, what particular thing we are to assume to be meant. 'The' is always mentioned to denote particular thing or a person. 'The' would, therefore, refer implicitly to a specified bank and not any bank. "The bank" referred to in clause (a) to the proviso to Section 138 of the Act would mean the drawee-bank on which the cheque is drawn and not all banks where the cheque is presented for collection including the bank of the payee, in whose favour the cheque is issued.

It, however, does not mean that the cheque is always to be presented to the drawer's bank on which the cheque is issued. The payee of the cheque has the option to present, the cheque in any bank including the collecting bank where he has his account, but to attract the criminal liability of the drawer of the cheque, such collecting bank is obliged to present the cheque in the drawee or payee bank on which the cheque drawn within the period of six months from the date on which it is shown to have been issued. In other words, a cheque issued by (A) in favour of (B) drawn in a bank named (C) where the drawer has an account can be presented by the payee to the bank upon which it is drawn i.e. (C) bank within a period of six months, or present it to any other bank for collection of the cheque amount provided such other bank including the collecting-bank presents the cheque for collection to the (C) bank. The non-presentation of the cheque to the drawee-bank within the period specified in the Section would absolve the person issuing the cheque, of his criminal liability under Section 138 of the Act, who shall otherwise may be liable to pay the cheque amount to the payee in a civil action initiated under the law.

[A combined reading of Sections 2, 72 and 138 of the Act would leave no doubt that the law mandates the cheque to be presented at the bank on which it is drawn, if the drawer is to be held criminally liable. Such presentation is necessarily to be made within six months at the bank on which the cheque is drawn whether presented personally, or through another bank, namely, the collecting bank of the payee.] *Shri Ishar Alloy Steels Ltd. (v) Jayaswals Neco. Ltd. (2001) LCLJ 18 (SC)*

(5) Whether 'giving of notice of dishonour itself constitute 'receipt of notice for constituting offence under Section 138 of the Negotiable Instruments Act, 1881?



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The above matter was considered by the Supreme Court in *Oalmia Cement (Bharat) Ltd v. Galaxy Traders and Agencies Ltd.*, (2001) 5 CLJ 26 SC. The Court observed that, the payee has to make a demand by 'giving' notice in writing and it is a failure on the part of the drawer to pay the amount within 15 days [30 days as per Negotiable Instrument (Amendment and Miscellaneous Provisions) Act, 2002] of the 'receipt' in writing of the said notice in writing giving is a process of which receipt is the accomplishment. It is therefore clear that 'giving' notice is not the same as 'receipt' of notice. It is for the payee to perform the former process by sending the notice to the drawer at the correct address. The context envisaged in Section 138 of the Act invites a liberal interpretation for the person who has the statutory obligation to give notice because he is presumed to be the loser in the transaction and it is for his interest, that the very provision is made by the legislature. The words in clause (b) of the proviso to Section 138 of the Act shown that the payee has the statutory obligation to make a demand by giving notice. The thrust in the clause is on the need to make a demand. It is only the mode for making such demand, which the legislature has prescribed. A payee can send the notice for doing his part for giving the notice. Once it is dispatched, his part is over and the next depends on what the sender does.

The next question arises - What is the starting point for fifteen (now 30 days) days notice?

Section 138(b), inter alia, provides that the payee has to make a demand for the payment of money by giving a notice to the drawer of the cheque within 15 days (now 30 days) of the receipt of information by him from the bank regarding the return of the cheque as unpaid. Therefore, the fifteen days (now 30 days) are to be counted from the receipt of information regarding the return of the cheque as unpaid. For example, where the cheque was returned on 13th January by the bank with stop endorsement, but the information regarding the return was received by the appellant only on 17th January, since 14th to 16th January happened to be bank holidays and the complainant issued notice on 29<sup>th</sup> January, it cannot be said that the notice issued on 29th January fell outside the prescribed period of 15 days (now 30 days). *Munoth Investments Ltd. v. Puttukola Properties Ltd.* IT 2001 (6) SC 403

### **Whether demand draft is a cheque?**

Section 131 of the Negotiable Instruments Act, 1881 is intended to widen the scope of a crossed draft as to contain all incidences of a crossed cheque. This is for the purpose of foreclosing a possibility of holding the view that a draft cannot be crossed. Even if it is possible to construe the draft either as a promissory note or as a Bill of Exchange, the law has given the option to the holder to treat it as he chooses. This can be discerned from the Section 137 which says that where an instrument may be construed either as a promissory note or bill of exchange, the holder may, at his discretion, treat it as either and the instrument shall thence forward be treated accordingly. This means, once the holder has elected to treat the instrument as a cheque, it cannot but be treated as a cheque thereafter. This is an irretrievable corollary of exercising such an election by the holder himself. A pay order was



accordingly held to be a cheque entitling the bank holding the instrument to lodge a complaint under Section 138. *Punjab & Sind Bank v Vinkar Sahakari Bank Ltd.*, (2001) 4 CLJ 188 (SC)

(6) Where an owner of company, who is neither a director nor a person-in-charge, sent a cheque from the companies account to discharge its legal liability. Subsequently the cheque was dishonoured and the complaint was lodged against him. Does he liable for an offence under section 138?

*H.N.D.Mulla Feroze Vs. C.Y.Somayajulu, J [2004] 55 SCL (AP)*

The owner of a company (i.e., petitioner) borrowed a loan of 25 lakhs on behalf of his company from the respondent. Later, at the request of respondent, the petitioner sent a cheque from the companies account. However, the cheque was dishonoured.

The respondent filed a complaint under section 138 with reference to Dishonour of cheque for insufficiency, etc, of funds in the account, against the petitioner and another in connection with the bouncing of a cheque issued on behalf of the company.

This complaint was challenged on the ground that, the petitioner is neither a director nor a person-in-charge of the company and is not connected with the day to day affairs of the company and had neither opened nor is operating the bank account of the company and had not issued the cheque which was dishonoured and further contended that in any event notice of dishonour of the cheque was not served.

The Andhra Pradesh High court held that, although the petitioner has a legal liability to refund amount to the appellant, petitioner is not the drawer of the cheque, which was dishonoured, and the cheque was also not drawn on an account maintained by him but was drawn on an account maintained by the company. Hence, it was held that the petitioner couldn't be said to have committed the offence under section 138 of the Act.

## **2.10 RIGHTS AND OBLIGATIONS OF PARTIES TO AN INSTRUMENT OBTAINED ILLEGALLY (SECTIONS 45A, 58, 59 AND 60).**

(a) *Rights and obligations of the finder of a lost instrument* : When a negotiable instrument has been lost, the finder or the endorsee from the finder is not entitled to receive the amount of it from maker, acceptor or holder, or from any party prior to such holder. He is bound to return the instrument to the real owner. But if the instrument lost by one and if it passes by delivery, e.g., a bill payable to bearer or endorsed in blank, the third acquiring it *bona fide* and for valuable consideration and before maturity, is entitled both to retain the instrument against the real owner and to compel payment from the prior parties thereon. In other words if the possessor of a lost instrument is a holder of it in due course, he is entitled to receive the amount due thereon from the acceptor or holder or from any party prior to such holder. The possessor or endorsee is also entitled to receive amount when the person through whom he claims was a holder of the lost instrument in due course.



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Under Section 45A, the loser of the instrument has the right to apply to the drawer for a duplicate of the lost bill. If the drawer does not grant the application the loser may compel him to provide him with a duplicate.

(b) *Rights and obligations of a person who had obtained an instrument by unlawful means* : If an instrument is obtained from any maker, acceptor or holder by means of an offence or fraud, the possessor is not, ordinarily, entitled to receive the amount under it from such maker, acceptor or holder, or from any party prior to such holder. Thus, if X steals a bill from the acceptor, X does not acquire any title to the instrument, and the proceeds of the bill, if collected, could be recovered from X by acceptor. If X transfers it to Y who is a gratuitous transferee, Y too would not acquire any title to the bill. Similarly, if X obtains a bill from the acceptor by fraud, he cannot receive the amount of it, but if he endorses it to Y who receives the bill for value without notice of the fraud, he could collect the amount of the bill from X but from no other party.

(c) *Rights and obligations of a person who has obtained an instrument for unlawful consideration* : When an instrument has been obtained from any maker, acceptor or holder for an unlawful consideration no possessor is, ordinarily, entitled to receive the amount due thereon from such maker, acceptor or holder or from any party prior to such holder. The consideration may be unlawful either because it is immoral and contrary to public policy or because it is specially interdicted or prohibited by the statute. If the possessor endorses it to say, P, even P would not be entitled to claim payment, unless he is holder in due course. P would be regarded as a holder in the course, if it is endorsed to him for valuable consideration without any notice having been received by him as to the consideration being unlawful.

*Effect of forgery* : Where a signature on a negotiable instrument has been forged, it becomes a nullity: the property in the instrument remains vested in the person who is the holder at the time when the forged signature was put on it. The holder of a forged instrument can neither enforce payment thereon nor give a valid discharge therefor. In the event of the holder being able to obtain payment in spite of forgery, he cannot retain the money. The true owner may sue in tort the person who had received. This principle is universal in character, by reason whereof even a holder in due course is not exempt from it. Forgery is not capable of being ratified.

But what would be the effect of a forged endorsement? The answer to this question is wholly dependent upon whether the instrument had been endorsed in full or in blank. In the former case, the person claiming under the forged endorsement even if he is a purchaser for value and in good faith, cannot acquire the rights of a purchaser for value and in good faith cannot acquire the rights of a holder in due course. He acquires no title to the bill or note. (*Mercantile Bank vs. D' Silva*, 30 Bom. L.R. 1225).





*Instrument acquired after dishonour (Section 59)* : It has already been pointed out that the holder in due course is not affected by the defect in the title of his transferor; but it is not so in the case of a holder who acquires the instrument after dishonour, or after maturity.

The holder of instrument, who has acquired it after dishonour, has as against the other parties, only the rights thereon of his transferor. For example, receive the amount of it from the other parties because the endorsee too could not do so.

*Instrument acquired after maturity (Section 59)* : The holder of an overdue instrument too is affected by the defect in title of his transferor. For example, Q accepts a bill drawn by P and deposits with P certain goods as collateral security for the payment of bill. The bill, not having been paid at maturity, P sells the goods and retains the proceeds, but in breach of faith endorses the bill to R. R, having only the right of P, cannot realise the amount of the bill from Q. But if R were bona fide endorsee before maturity, he could realise the amount from Q.

*Liabilities on an accommodation note or bill (Proviso to Section 59)* : In the case of accommodation bills or notes, a defect in the title of the transferor does not affect the title of the holder acquiring after maturity. An accommodation may be explained as follows: X draws a bill payable to himself on Y, who accepts the bill without consideration just to accommodate X, that is, to enable X to raise money by negotiating the bill in the market. Though Y accepts the bill, X is primarily liable on the bill, and he cannot demand the amount from Y, for in an accommodation bill, the acceptor is only surety for the party accommodated. However, if the accommodation bill, in the above illustration, is transferred by X to Z for good consideration after maturity and Z becomes the holder in good faith, Z will be able to realise the amount of the bill from Y, the acceptor though Z's transferor X could not, at the date of transfer, recover anything from Y.

*Duration of negotiation (Section 60)* : An instrument may be negotiated until payment thereof by the maker, drawee or acceptor at or after maturity, but not after such payment. But the maker, drawee or acceptor cannot negotiate the instrument after maturity, even if it remains unpaid. An instrument may be satisfied even without payment, and such satisfaction is equivalent to payment.

*Discharge from liability on Notes, bills and cheques* : (a) Distinction between discharge of a party and discharge of instrument: An instrument is said to be discharged only when the party who is ultimately liable thereon is discharged from liability. Therefore, discharge of a party to an instrument does not discharge the instrument itself. Consequently, the holder in due course may proceed against the other parties liable for the instrument. For example, the endorser of a bill may be discharged from his liability, but even then acceptor may be proceeded against. On the other hand, when a bill has been discharged by payment, all rights thereunder are extinguished, even a holder in due course cannot claim any amount under the bill.



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(b) *Different modes of discharge from liability* : Parties to negotiable instrument are discharged from liabilities when the right of action on the instrument is extinguished. The right of action on a negotiable instrument is extinguished by the following methods:

- (i) *By payment in due course* : The maker, acceptor or endorser respectively of a negotiable instrument is discharged from liability thereon to all parties thereto if the instrument is payable to bearer, or has been endorsed in blank and such maker, acceptor or endorser makes payment in due course of the amount due thereon i.e., when the payment has been made to the holder of the instrument at or after maturity in good faith and without notice of any defect in the title to the instrument (Section 82).
- (ii) *By cancellations of acceptor's or endorser's name* : The maker, acceptor and endorser respectively of a negotiable instrument is discharged from liability thereon to a holder thereof who has cancelled such acceptor's or endorser's name with the intent to discharge him and to all parties claiming under such holder. In other words, if the holder (payee) of a bill cancels the signature of acceptor (drawee) with an intention to discharge him, both maker (drawer) and the acceptor of such negotiable instrument are discharged from the liability to the holder and to all parties claiming under such a holder [Clause (a) Section 82.]
- (iii) *By release* : The maker, acceptor or endorser respectively of a negotiable instrument is discharged from liability thereon to a holder thereof who has renounced his right in respect of the instrument. The waiver of the right may be express or implied [Clause (b) of Section 82].
- (iv) *By default of the holder* : If the holder of a bill of exchange allows the drawee more than forty-eight hours, exclusive of public holiday, to decide whether he will accept the bill, all prior parties not consenting to such an allowance are discharged from liability to such holder. It is because if the drawee fails to signify his acceptance within forty-eight hours, the holder must treat the instrument as dishonoured and he must at once give notice to the drawer and to all prior, parties, and must not allow time unless they give their consent that more time should be allowed (Section 83).
- (v) *Dissenting parties discharged by qualified or a limited acceptance* : If the holder of a bill who is entitled to an absolute and unqualified acceptance elects to take a qualified acceptance, he does so at his own peril and discharges all parties prior to himself unless he obtains their consent to such an acceptance. Thus, the previous parties are discharged in the following cases namely (i) when acceptance is qualified, (ii) when acceptance is for a part of the sum, (iii) when acceptance substitutes a different place or time of payment, (iv) when acceptance is not signed by the drawees not being partners.

They are discharged, if such acceptance is acquiesced in by the holder without obtaining their previous consent. They are discharged as against the holder and those claiming



under him. But, if they subsequently approve of such acceptance by the holder, they will not be discharged.

An acceptance is qualified in the following cases, namely : (a) where it is conditional, declaring the payment to be dependent on the happening of an event stated therein, (b) when it undertakes the payment of part only of the sum ordered to be paid, (c) where no place of payment being specified on the order, it undertakes the payment at a specified place, and not otherwise or elsewhere or where a place of payment being specified in the order it undertakes the payment at some other place and otherwise or elsewhere, (d) where it undertakes the payment at a time other than that at which under the order it would be legally due (Section 86).

- (vi) *By material alteration of the instrument without assent of all parties liable* : Any material alteration of a negotiable instrument renders the same void as against any one who is party thereto at the time of making such alteration and does not consent thereto, unless it was made in order to carry out the common intention of the original parties and any such alteration, if made by an endorsee, discharges his endorser from all liability to him in respect of the consideration thereof (Section 87). The alteration must be so material that it alters the character of the instrument to a great extent. Alteration of the date, alteration of the amount payable, or alteration of the time and the alteration on the place of payment of the instrument are regarded as material alterations of the instrument. *In Hongkong and Shanghai Bank vs. Lee Shi* (1928) A.C. 181, it has been held that an accidental alteration will not, however, render the instrument void. It is necessary to show that the alteration has been improperly and intentionally.
- (vii) *By payment, alteration not being apparent* : If, however, a person pays an altered note, bill or cheque, provided the alteration is not apparent and payment is made in due course by person or a banker who is liable to pay the amount he is protected (Section 89): For example, if A draws a cheque for Rs. 8 in favour of B who fraudulently converts eight into eighty, and the alteration is not apparent, the banker, paying Rs. 80 to B will not be liable to make good to the drawer the amount paid in excess.
- (viii) *By acceptor becoming holder of a bill at or after maturity in his own right* : If a bill of exchange which has been negotiated is, at or after maturity held by the acceptor in his own right all rights to action thereon are extinguished (Section 90).
- (ix) *By default in presenting the cheque within a reasonable time* : In the case of a cheque, if it is not presented for payment within a reasonable time of its issue and the drawer or person on whose account, it is drawn had the right at the time when presentment ought to have been made as between himself and the banker, to have the cheque paid and suffers actual damage through the delay he is discharged to the extent of such damage,



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that is to say, to the extent to which such drawer or person is creditor of the banker to a larger amount that he would have been if such cheque had been paid (Section 84).

For example, if X draws 10 cheques of Rs. 100 each, but when the cheque ought to be presented, has only Rs. 600 at the bank and subsequently the bank fails before the cheques are presented, X will be released from liability to the extent of Rs. 600 but will remain liable for the balance. If he had the full amount of Rs. 1,000 at the bank, he will be discharged in full.

*Note : In the above case liability of the drawer will be transferred to the banker. For determining what is reasonable time for presentation, the following matters would be considered: (i) nature of instrument: (ii) usage of the trade and bankers and (iii) facts of the case.*

- (x) *By operation of law* : It should be noted that a negotiable instrument is also discharged by operation of law which may occur in any one of the following circumstances. (a) By lapse of time i.e., when the claim under the instrument becomes barred by the Limitation Act on the expiry of the period prescribed for the recovery of the amount due on the instrument; (b) By merger, i.e., when the debt, under the instrument is merged in the judgement debt obtained against the acceptor maker or endorser; Under the law of insolvency, i.e., when the acceptor, maker, or endorser, who has been adjudicated an insolvent, is discharged by an order of the Court made in the insolvency proceedings.
- (xi) *By payment by the drawee of a cheque payable to order or to bearer* : Where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee who always is a banker is discharged by payment in due course. A cheque is said to have been paid in due course, when it has been paid in good faith, after taking proper care to ascertain the genuineness of the endorsement. Payment in due course discharges the bank from liability even if the payment is made to a wrong person. Even if the endorsement of the payee is forged the banker is discharged from the payment in good faith and without negligence. But if the drawer's signature is forged, the banker can, under no circumstances, claim discharge on payment, for the banker is presumed to know the signature of his customer (i.e. the drawer).

The bank is discharged by payment in due course to the bearer notwithstanding any endorsement thereon, whether in full or in part and whether or not such endorsement purports to restrict or exclude further negotiation. The endorsee under an endorsement in full cannot recover the amount from the banker who has paid it to the bearer (Section 85).

The rule of the discharge applicable to a cheque payable to order also applies, to a draft drawn by one of the bank upon another payable to order or demand (Section 85A).



### **2.11 NOTICE OF DISHONOUR**

(a) **Dishonour by non-acceptance (Section 91)** : A bill may be dishonoured either by non-acceptance or by non-payment. A dishonour by non-acceptance may take place in any one of the following circumstances: (i) when the drawee either does not accept the bill within forty-eight hours of presentment or refuse to accept it; (ii) when one of several drawees, not being partners, makes default in acceptance; (iii) when the drawee gives a qualified acceptance; (iv) when presentment for acceptance is excused and the bill remains unaccepted; and (v) when the drawee is incompetent to contract.

Note that presentment is not necessary where the drawee after diligent search cannot be discovered, or where the drawee is incompetent to contract or here the drawee is a fictitious person.

When a bill has been dishonoured by non-acceptance, it gives the holder an immediate right to have recourse against the drawer or the endorser. Since a dishonour by non-acceptance constitutes a material ground entitling the holder to take action against the drawer, he need not wait till the maturity of the bill for it to be dishonoured on presentment for payment (*Ram Ravji Jambekar vs. Prulhaddas 20 Bom.133*).

(b) **Dishonour by non-payment (Section 92)** : An instrument is dishonoured by non-payment when the party primarily liable e.g., the acceptor of a bill, the maker of a note or the drawee of a cheque, make default in payment. An instrument is also dishonoured for non-payment when presentment for payment excused and the instrument, when overdue, remains unpaid, under Section 76 of the Act.

(c) **Distinction between dishonour by non-acceptance and by non-payment** : If a bill is dishonoured by non-acceptance, there is no right of action against the drawee as he is not a party to the bill: the holder of the bill can proceed only against the drawer or endorser, if any. On dishonour by non-payment the drawee can be sued.

(d) **Notice of dishonour (Sections 93 and 94)** : (i) By whom notice to be given: When an instrument is dishonoured either by non-acceptance or by non-payment, the holder thereof or some party thereto who remains liable thereon must give notice of dishonour.

(ii) *To whom notice is to be given* : Notice must be given to such parties whom the holder proposes to charge with liability severally or jointly, e.g., the drawer and the endorsers. Notice may be given either to the party himself or to his agent, or to his legal representative on his death, or to the official assignee on his involvency. It is not necessary to give notice to the maker of a note or the drawee or acceptor of a bill or cheque.

(iii) *Effect of non-service of notice* : If a notice is not sent to any prior party who is entitled to such notice within a reasonable time, he is discharged from liability. It is a condition precedent to the continuation of the liability of the drawer under Section 30 and of the endorsee under



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Section 35 of the Act that they should be notified of the dishonour.

(iv) *Requirements of valid notice* : The holder must inform the party to whom the notice has been given that the instrument has been dishonoured, and that he will be held liable thereon. It must give an exact description of the instrument dishonoured, for misdescription which misleads the addressee, vitiates the notice.

(v) *Mode of service of notice* : The notice, if written, may be given by post at the place of business or at the residence of party for whom it is intended, and even if it is miscarried, the notice is not rendered invalid by such miscarriage. When the holder of the instrument and the party to whom notice is given, carry on business or live in different place, the notice of dishonour must be posted by the next post if the parties carry on business or live in the same place, it is sufficient if the notice is so despatched that it reaches its destination on the day next after the day of dishonour.

(e) **Transmission of notice of dishonour by party receiving it (Section 95)** : Any party receiving notice of dishonour should communicate the same within a reasonable time to any prior party whom he intends to hold liable in respect of the instrument; but if the prior party receives otherwise, no such communication is necessary.

To illustrate the necessity of transmission of notices, let us consider the following case :

- A) draws a bill in favour of B on X;
- B) endorses it to C;
- C) endorses it to D;
- D) endorses it to E;
- E) endorses it to F.

Suppose X refuses to accept the bill and F, the holder, gives notice of dishonour only to E and A, but E does not transmit the notice to D, C and B. In that case F shall have the right of action against E or A. E in his turn could claim the amount from A, but not from D, C and B. In order that E also has right of action against D, C and B, E must transmit the notice to them as well.

(f) **When notice of dishonour is unnecessary (Section 98)** : In a suit against the drawer or endorser on an instrument being dishonoured, notice of dishonour is a material part of the cause of action. However, in the following cases the notice of dishonour is not necessary: (i) When the necessity of the notice has been dispensed with by an express waiver by the party entitled to it. For example, when the drawer of a bill informs the holder that the bill will be dishonoured on presentment, the notice of dishonour is said to have been dispensed with [*Bertt vs. Levett* (1811) 13 East 213]. (ii) When the drawer has countermanded payment, he, having put an impediment in the way of the holder obtaining payment is not entitled to the



notice of dishonour. (iii) When the party charged would not suffer damage for want of a notice. In such a case neither presentment nor notice of dishonour is necessary, provided it is shown that at the time of drawing the instrument there were no funds belonging to the drawer in the hands of the drawee [*Subrao vs. Sitaram 2 Bom. L.R. 891*]. (iv) When the party entitled to notice after due search, cannot be found. (v) Where there has been accidental omission to give the notice, provided the omission has been caused by an unavoidable circumstances, e.g., death or dangerous malady of the holder or his agent, or other inevitable accident, or overwhelming catastrophe not attributable to the default, misconduct or negligence of the party tendering notice. (vi) When one of the drawers is acceptor. From this, it is also possible to deduce a further rule that notice of dishonour is not necessary for charging the drawer where the drawer and the acceptor are the same person. However, the mere fact that the drawer and drawee of a bill are partners does not give rise to the presumption that they are partners in respect of the drawing of the bill, or that the bill was drawn by one of them on behalf of both. [*Jambu Ramaswamy vs. Sundraraja Chetti 29 Mad. 239*]. Such a case does not fall under purview of the rule mentioned above, so as to dispense with notice. (vii) In the case of promissory note which is not negotiable, (viii) When the party entitled to notice, knowing the facts, promises unconditionally to pay the amount due on the instrument.

## **2.12 NOTING AND PROTESTING**

(a) *Noting*: Noting is a convenient mode of authenticating the fact that a bill or note has been dishonoured. When a note or a bill has been dishonoured by non-acceptance or non-payment, the holder causes such dishonour to be noted by a Notary Public. Noting is a minute recorded by a notary public on the dishonoured instrument. When an instrument, say a bill of exchange, is to be noted for dishonour, it is taken to Notary Public who presents it once again for acceptance or payment, as the case may be; and if the drawee or acceptor still refuses to accept or pay the bill, it is noted, i.e., a minute is prepared containing the date of dishonour, reason for such dishonour, etc.; which is attached to the instrument; and the facts are noted on the instrument.

(b) *Protest*:- When an instrument is dishonoured, the holder may cause the fact not only to be noted, but also to be certified by a Notary Public that the bill has been dishonoured. Such a certificate is referred to as a protest.

If the credit or an acceptor of a bill is shaken by insolvency or otherwise before the date of maturity of the bill, the holder may cause such a fact also to be noted and certified. Such a certificate is called a protest for better security. The contents of a protest are given in Section 101 of the Act.

Neither noting nor protesting is compulsory in the case of inland bills. But under Section 104 every foreign bill of exchange must be protested for dishonour when such a protest is required by the law of the country where the bill was drawn. The advantage of both noting and



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protesting is that this constitutes *prima facie* good evidence in the Court of the fact that instrument has been dishonoured. It is necessary to note that under Section 119, the Court is bound to recognise a protest. But it may or may not recognise noting. To make good this lacuna, Section 104A has been introduced. It clarifies the position that any bill or document which has been noted can be protested any time thereafter for taking legal action against the parties. Thus, where a document has been noted within the time required by law, legal proceeding cannot be vitiated on account of protest not having been made.

(c) *Notary Public* : A Notary public is appointed by the Central or State Government. His functions are to attest deeds, contracts and other instruments that are to be used abroad and to give a certificate of due execution of such documents. He enjoys the confidence of the business world, and any certificate given by him is presumed to be true by a court of law. The profession of notaries is regulated by the Notaries Act, 1952.

(d) *Notice of Protest* : When a promissory note or a bill of exchange is required by law to be protested, notice of such protest in lieu of notice of dishonour must be given in the same manner as notice of dishonour (Section 102).

### 2.13 ACCEPTANCE AND PAYMENT FOR HONOUR AND REFERENCE IN CASE OF NEED

*Acceptance for honour*:- If a bill has been dishonoured by non-acceptance and has been duly noted or protested for such dishonour, any person, before it is overdue, who is not a party already liable under the bill may, with the consent of the holder of the bill, by writing on the bill, accept the bill for the honour of any of the parties liable on it. The object of such an acceptance for honour is to protect the credit of the party liable on the bill, and to prevent legal proceedings being taken against him.

*Conditions for valid acceptance for honour* : These are : (i) that the bill has been noted or protested for non-acceptance or better security; (ii) that such an acceptance has been made with the consent of the holder, (iii) that the acceptor for honour is not already liable on the bill, (iv) that the acceptance is for the honour of any party already liable on the bill; and (v) that the acceptance is by writing on the bill.

*Rights and Liabilities of such acceptor* : Section 111 of the Act states that an acceptor for honour binds himself to all parties subsequent to the party for whose honour he accepts to pay the amount of the bill if the drawee does not. But an acceptor for honour is not liable to the holder of the bill unless it is presented or (in case the address given by such acceptor on the bill is a place other than the place where the bill is made payable) forwarded for presentment not later than the day next after the day of its maturity. Moreover, an acceptor for honour cannot be charged unless the bill has been presented at its maturity to the drawee for payment and has been dishonoured by him and noted or protested for such dishonour (Section 112).





Section 111 further provides that the party for whose honour the acceptor accepts to pay and all prior parties become liable in their respective capacities to compensate the acceptor for honour for all loss or damage sustained by him in consequence of such acceptance.

*Payment for honour* : It is a payment which is made by any person for the honour of any party liable on the bill after it has been protested for non-payment. The condition essential for such payment are, (i) that the bill must have been noted or protested for non-payment (ii) that the person paying or his agent declares before Notary Public the party for whose honour he pays; (iii) that such declaration has been recorded by such Notary Public; (iv) that the payment must be made for the honour of any party liable to pay the bill and (v) that the payment may be made by any person whether he is already liable on the bill or not.

The effects of such a payment are :

All parties subsequent to the party for whose honour it is paid are discharged.

- (1) The payer for honour acquires for the rights of a holder whom he pays and becomes entitled to all the remedies of the holder on the instrument,
- (2) The payer can recover all sums paid by him together with the interest and expenses properly incurred in making such payment (Section 114).

According to Section 115 where a “drawee in case of need” is mentioned in a bill or any endorsement thereon, it is obligatory for the holder to present the instrument to him *i.e.*, the drawee in case of need, and it will not be considered to have been dishonoured, unless it has been dishonoured by such drawee. The failure to present the bill to the drawee in case of need absolves the drawer from liability (*Bahadur Chand v. Gulab Rai AIR Lah 557*). Again according to the Bombay High Court if a bill of exchange has been duly accepted but dishonoured when presented to drawee in the first instance for payment, it cannot be validly presented for payment to the drawee in case of need if it was not first presented to him for acceptance [*Dore vs. Kanchiwalla & Co. 40 Bom. LR 473*].

#### **2.14 PRESENTMENT OF INSTRUMENTS**

(a) *Presentment of bills for acceptance (Section 61)*: A bill of exchange is not necessarily required to be presented for acceptance, before its being presented for payment. For example, a bill payable on demand, payable certain number of days after date, payable on a certain day, etc., need not be presented for acceptance. Although it is a matter of common practice to obtain acceptance of the bill by the drawee at the earliest opportunity after it is drawn, such an acceptance is not absolutely essential to the bill being a negotiable instrument. For example, a person to whom a bill has been negotiated before acceptance may sue thereon as a holder in due course. [*National Park Bank of New York vs. Berggren & Co. (1914) 110 L.T. 907*].

It should, however, be noted that in two cases presentment for acceptance would be necessary, namely :



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- (i) where a bill is payable after sight - presentment for acceptance is with a view to fixing the maturity of the instrument;
- (ii) where a bill expressly stipulates that it shall be presented for acceptance.

But when a bill is not payable after sight, presentment is unnecessary to render any prior party liable. It is, however, prudent for the holder of such bill to present it for acceptance, for if it is accepted, he obtains the security of the acceptor's signature and if it is not accepted he is relieved of the necessary presentment for payment.

*How, when and by whom bill is to be presented* : A bill payable after sight is to be presented to the drawee by a person entitled to demand acceptance, and it is generally the holder of the bill who is entitled to demand acceptance. The bill must be presented by the holder within a reasonable time after it is drawn, and in business hours on a business day either at the residence or at the place of business of the drawee. But if the bill itself indicates a place of presentment, it must be presented at the place. If the drawee cannot, after reasonable search, be found, the bill is to be regarded as dishonoured for non-acceptance. When authorised by agreement of usage, a presentment through the post office by a registered letter is sufficient.

*Drawee's time for deliberation* : Under Section 63, the drawee is entitled to a respite of forty eight hours (exclusive of public holidays) to consider whether he should accept a bill presented to him for acceptance.

When presentment is excused : Presentment for acceptance is excused if the drawee is a fictitious person (Section 91) or if he cannot, after reasonable search, be found (Section 61). Again even if presentment is made irregularly, such an irregularity is excused if the bill has been dishonoured by non-acceptance on some other ground.

(b) *Presentment of promissory note for sight (Section 64)* : When and why a note is to be presented for sight ? Like a bill of exchange payable after sight, a promissory note payable at a certain period after sight must be presented to the maker for sight. The presentment is to be made by a person entitled to demand payment who is usually the holder. Again, the note must be presented within a reasonable time after it is made and in business hours on a business day. In default of such presentment, the maker is not liable to pay anything to the holder. The necessity for presentment, in the case of such a note, viz., a note payable at a certain period after sight, is obvious; without such presentment the maturity of the note cannot be fixed.

(c) *Presentment of instrument for payment* : Presentment of a bill of exchange means its exhibition to drawee or acceptor by holder with a request for payment in accordance with its apparent tenor (Section 64). Presentment may be made through post by means of a registered letter if such a mode of presentment is authorised by agreement or usage. If the bill is paid, the holder would have to hand it over to the payer. In default of presentment, the drawer and the endorser would be discharged from their liability to the holder.



- (i) *By whom and to whom presentment is to be made* : Presentment is to be made either by the holder or by somebody on behalf of the holder. Promissory notes are to be presented to the maker; bills of exchange are to be presented to the acceptor; and cheque are to be presented to the drawee.
- (ii) *Time of presentment for payment* : (a) Presentment should be made during the usual business hours (Section 65)(b). If the bill is made payable a specified period after date or sight, it must be presented for payment at its maturity (Section 66) (c). If the bill is payable on demand, it must be presented for payment within a reasonable time after its receipt by the holder (Section 74).
- (iii) *Place of presentment for payment* : (a) If the bill is drawn or accepted payable at a specified place and not elsewhere, it must be presented for payment at such a place in order to charge any party to the bill (Section 68)(b). If, however the bill is accepted payable at a special place (the word “and not elsewhere” being omitted) then to charge the drawer (but not the acceptor), presentment should be made at the place specified (Section 69)(c). If no place of payment is specified then the bill should be presented for payment at the place of business (if any) or the residence of the drawee or acceptor or (if he has no fixed place of business or residence) to him in person wherever he can be found (Sections 70 and 71).
- (iv) *Presentment of promissory note payable by instalment (Section 67)* : A promissory note payable by instalments must be presented for payment on the third day after the date fixed for payment of each instalment.
- (v) *Presentment of cheque to drawer (Section 72)* : It is the duty of the holder of cheque to present it at the bank upon which it is drawn. If payment is refused by the bank, the holder may sue the drawer. If the holder sues the drawer without first presenting the cheque at the bank, the suit will be dismissed.

If the holder does not present the cheque at the bank in time, the position of the bank may become unsound and it may not be possible for the banker to honour the cheque; in this case, the drawer is not liable if the bank refuses payment on presentment. The rule is that the cheque must be presented before the relation between the drawer and his banker has been altered to the prejudice of the drawer.

- (vi) *Distinction between drawer of bills and drawer of cheques* : If a bill is not presented in time, the drawer is absolutely discharged; but the drawer of a cheque, in case of delay in presentment, is discharged only if he has suffered some loss or injury and that too, to the extent of such loss only. Therefore, if the bank remains solvent, the drawer will remain bound after presentment and refusal, although months (short of the period of limitation) have elapsed since the drawing.



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- (vii) *Presentment of cheque to charge any other person (Section 73)* : It may be recalled that in order to charge the drawer, the cheque must be presented before the relation between the drawer and his banker has been altered to the prejudice of the drawer, but in order to charge any person other than the drawer the cheque must be presented within a reasonable time. For example, A draws a cheque in favour of B, who endorses it to C. C must present it at the bank within a reasonable time, otherwise B will be discharged from liability.
- (viii) *Presentment of instrument to agents, etc. (Section 75)* : Presentment for acceptance or payment may be made not only to the drawer maker or acceptor but also to his duly authorised agent or where he is dead to his legal representative, or where he has been declared an insolvent, to his assignee.

*When presentment is unnecessary (Section 76)* :

- (a) No presentment for payment is necessary in any of the following cases; (1) if the maker, of acceptor intentionally prevents the presentment of the instrument; (2) if the instrument being payable at his place of business, he (*i.e.*, maker, drawer or acceptor) closes such place on a business, day during the usual business hours; (3) if the instrument being payable at some other specified place, neither he nor any person authorised to pay it attends at such place during the usual business hours; (4) if the instrument not being payable at any specified place, he (*i.e.*, maker, etc.) cannot after due search be found.
- (b) No presentment for payment is necessary as against any party sought to be charged with payment, if he has engaged to pay notwithstanding non-presentment.
- (c) No presentment for payment is necessary as against any party if, after maturity and with the knowledge that instrument has not been presented:
- (d) (1) He makes a part-payment on account of the amount due on the instrument; or (2) he promises to pay the amount due thereon in whole or in part; or (3) he otherwise waives his right to take advantage of any default in presentment for payment.

When we say that no presentment for payment is necessary, we mean thereby the instrument is taken as dishonoured at the due date for presentment even though it has not been presented. The result is that the holder may sue the party liable without presentment and the plea that the instrument was not presented for payment is no defence to the claim of the holder.

### 2.15 PAYMENT AND INTEREST

- (a) *To whom payment should be made (Section 78)* : Payment of the amount due on promissory note, bill of exchange or cheque must, in order to discharge the maker or



acceptor, be made to the holder. If payment is made to any person other than the holder, the holder can claim payment over again from the maker or acceptor.

- (b) *Payment of interest when rate is specified (Section 49)* : Where interest at a specified rate is expressly made payable on a promissory note or a bill of exchange, interest shall be calculated at the rate specified, on the amount of the principal money due thereon; (i) from the date of the instrument until tender or realisation of such amount or (ii) from the date of the instrument until such date after the institution of a suit to recover the principal amount as the Court directs.
- (c) *Payment of interest when no rate is specified (Section 80)* : When no rate of interest is specified in the instrument, interest on the amount due shall be calculated at the rate of 18% per annum from the date at which the instrument ought to have been paid until tender or realisation of the amount, or until such date as the Court directs.

### **2.16 INTERNATIONAL LAW REGARDING NEGOTIABLE INSTRUMENT**

In the absence of a contract to the contrary (*i.e.*, unless the parties otherwise agree), the liability of the maker or drawer of a foreign promissory note, bill of exchange or cheque is governed in all essential matters by the law of the place where he made instrument. The respective liability of the acceptor and endorser, in such cases, will be governed by the law of the place where the instrument is made payable (Section 134). For example, if a bill of exchange was drawn by A in California where the rate of interest was 25% it was accepted by B, payable in Washington, where the rate of interest was 6% and the bill was endorsed in India and was dishonoured. On an action on the bill being brought against B in India, B would be liable to pay interest @ 6% only; but if A was charged as drawer, A would be liable to pay interest @ 25%.

When the foreign instrument made is payable in a place different from that at which it is made or endorsed, the law of the place where the instrument is made payable would determine what constitutes dishonour and what notice of dishonour is sufficient (Section 135).

If the instrument is made, drawn, accepted or endorsed abroad, but it is in accordance with the law of India, any subsequent acceptance or endorsement thereon India will not be regarded as invalid, because the agreement as evidenced by such an instrument is invalid according to the law of such foreign country (Section 136).

#### **Special rules of evidence**

(a) **Presumption as to negotiable instrument (Section 118)** : For deciding cases in respect of rights of parties on the basis of a bill of exchange, the Court is entitled to make certain presumptions. These are briefly stated as follow:

- (a) That the negotiable instrument was made or drawn for consideration and every party who made itself bound in respect thereof did so for consideration;



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- (b) That the negotiable instrument was drawn on the date shown on the face of it;
- (c) That the bill of exchange was accepted before its maturity, *i.e.*, before it became overdue;
- (d) That the negotiable instrument was transferred before its maturity;
- (e) That the endorsements appearing upon a negotiable instrument were made in the order in which they appear.
- (f) That an instrument which has been lost was properly stamped;
- (g) That the holder of a negotiable instrument is the holder in due course, except when the instrument has been obtained from its lawful owner or its lawful custodian. Likewise, if it has been obtained from a maker or and acceptor by means of an offence or fraud, it is for the holder to prove that he is the holder in due course.

**(b) Certain rules of estoppel applicable to instruments** : When one person causes another person to believe a thing to be true and to act upon such belief he is not allowed in a suit between him and such person, to deny the truth of that thing. That is, he is not allowed to give evidence in support of his denial. This rule is called the rule of estoppel, by which evidence is excluded. There are certain rules of estoppel applicable to negotiable instruments. These are contained in Sections 120 to 122 of the Act.

The objective of these provisions are : (i) that the original parties to the instrument may not deny the validity of the instrument; (ii) that the maker of a promissory note or an acceptor of a bill may not deny the right of the payee to receive the payment therefore; and (iii) that an endorser of a negotiable instrument may not disown the signature or capacity to contract of any prior party to the instrument.

**Hundis** : Bills of exchange drawn up in the vernacular are generally known as Hundis. The Negotiable Instruments Act ordinarily is not applicable to Hundis but, the parties to the Hundis may agree to be governed by the Negotiable Instrument Act.

### 2.17 DIFFERENT TYPES OF HUNDIS

The most common types of hundis are the following :

(i) *Shah Jog Hundi*:- In this case, apart from a drawer and a drawee, there is another party to the instrument known as Shah (a financial of repute). It is only payable to Shah. The function of the Shah is that he presents the hundi, when it eventually comes to him for payment to the drawee on behalf of the holder. In so far this Shah acts like a banker to whom a cheque has been endorsed specially.

(ii) *Jokhmi Hundi* : It is documentary bill which is drawn by a consignor or the consignee in respect of goods shipped by the consignor. The name of the vessel by which the goods have been shipped is also mentioned in the hundi. The consignee is not required to pay the hundi



unless the goods reach their destination. In consequence, the consignor or the person with whom he has negotiated the hundi, has to suffer the loss in case the ship is sunk.

(iii) *Nam Jog Hundi* : It is a hundi payable to the party named therein or to his order. The party, however, has a right to endorse it in favour of any other person as can be done in case of any other bill of exchange.

(iv) *Jawabee Hundi* : It is an instrument for remitting money and takes the form of ordinary letter advising the party that he may collect money from a banker. The remitter hands over the hundi to his banker who in turn endorses it to a correspondent residing in the town in which the payee is resident. The correspondent on receiving the letter forwards it to the payee. The payee on presenting the letter collects the amount from the correspondent.

**Dhani Jog Hundi** : This is a Hundi payable to Dhani or owner *i.e.* a person who purchase it.

**Firman Jog Hundi** : This is a Hundi payable to order.

#### **Certain terms explained**

(i) *Zikri Chit* : It is a letter of protection addressed to a merchant in the town where a hundi is payable and issue to the holder of the hundi by some prior party liable thereon. The letter, it is intended, would be used by the holder if the hundi is dishonoured by non-acceptance. The letter contains a request to the merchant that he may accept the hundi in case of dishonour.

(ii) *Peth and Perpeth* : Peth is the duplicate copy of hundi, issued on the loss of the original hundi, and perpeth is the triplicate copy of the hundi given on the loss of the peth.

(iii) *Khoka* : After a hundi has been paid and cancelled it is called a Khoka.

**Classification of hundis according to time of payment** : Hundis payable at sight are known as darshani hundis and those payable after a time are known as miadi hundis. A darshani hundi is transferable by endorsement. In drawing a miadi hundi, the interest for the period of hundi is charged. A miadi hundi is known in Bengali as the muddati hundi.

#### **2.18 RULES OF COMPENSATION**

Under Section 17 of the Act, the compensation payable in case of dishonour of a promissory note, bill of exchange, or cheque, by any party liable to the holder or any endorse, shall be determined by the following rules :

(a) The holder is entitled to the amount due upon the instrument, together with the expenses incurred in presenting, noting and protesting it.

The holder is entitled to receive: (1) the amount of the instrument; (2) interest on the principal sum as calculated in accordance with the rules mentioned in Sections 79 and 80; and (3) expenses properly incurred in presenting, noting and protesting the instrument.



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- (b) When the person charged resides at a place different from that at which the instrument was payable, the holder is entitled to receive such sum at the current rate of exchange between the two places.
- (c) When the person charged and such endorser reside at different places, the endorser is entitled to receive such sum at the current rate of exchange between the two places.

Clauses (b) and (c) relate to 're-exchange'. Re-exchange is the measure of damages occasioned by the dishonour of a bill in a country different from that in which it was drawn or endorsed. When a person sought to be charged resides at a place different from that at which the instrument was payable, the holder is entitled to receive such sum at the current rate of exchange between the two countries. If an ordinary bill of exchange is drawn in one country upon a person, in another and distant country, the holder who has contracted for the transfer of funds from the one country to the other, almost necessarily sustains damages by the dishonour of the bill. He must take other means to put himself in funds in the country where the bill was payable. Hence, the right to re-exchange which is the measure of those damages. Re-exchange, in its usual application, means the loss resulting from the dishonour of a bill in a country different from that in which it was drawn. [*Williams vs. Ayres* (1877) 3 A.C. 133, 146]. As the holder of the instrument sustains loss to the extent of the amount mentioned in the instrument on the day of dishonour, the rate of exchange should be taken for calculation as of the rate prevailing on the date of dishonour. [*In re British American Continental Bank Ltd.* (1972), 2 Ch. 575, 589; *S.S. Celia vs. volturna* (1921) A.C. vs. 544 *Muller Maclean & Co. vs. Atanlla & Co.*, 51 Cal. 320].

- (d) An endorser, who has paid the amount due under the instrument, is entitled to the amount so paid with interest at 6% per annum from the date of payment until tender or realisation together with all expenses caused by the dishonour and non-payment. But an endorser who has paid a bill or note is entitled to the amount so paid only if at the time of payment he was liable on the instrument. The endorser is only entitled to charge interest at the rate of 6% per annum on the amount paid by him, even though interest at a higher rate is mentioned in the instrument.
- (e) The party entitled to compensation may draw a bill upon the party liable to compensate him, payable at sight or on demand, for the amount due to him, together with all expenses properly incurred by him. Such bill must be accompanied by the instrument dishonoured and the protest thereof (if any). If such bill is dishonoured, the party dishonouring the same is liable to make compensation thereof in the same manner as in the case of the original bill.

The bill mentioned is called a redraft. The party entitled to compensation is enabled to draw a bill payable at sight or on demand on party liable to compensate him for the amount due to





him together with all expenses properly incurred by him. The re-draft must be accompanied by the dishonoured instrument and the protest thereof if there be any. In case the draft is dishonoured the party on whom it is drawn is liable to make compensation in accordance with the rules laid down in this section in the case of the original bill.

### **2.19 SELF-EXAMINATION QUESTIONS**

*These questions are intended to enable the student to test his knowledge before proceeding to answer the test paper. The answer to these questions are not required to be written out or submitted for evaluation. (The Answers are given at the end).*

#### **Choose the correct alternative**

1. Which of the following is a valid promissory note?
  - (a) "A, I owe you some amount".
  - (b) "A, I owe you Rs. 1000".
  - (c) "I promise to pay A or order Rs. 1000".
  - (d) "I promise to pay the bearer Rs. 1000".
2. A person who is ordered to pay the amount of bill of exchange is known as
  - (a) Drawer
  - (b) Drawee
  - (c) Payee
  - (d) Creditor.
3. Acceptance is required only in case of;
  - (a) Bill of exchange.
  - (b) Cheque.
  - (c) Promissory note
  - (d) All of these.
4. A bill drawn in favour of a minor is;
  - (a) Void
  - (b) Valid but not negotiable
  - (c) Valid
  - (d) None of these.
5. The presentment for sight is required only in case of a;
  - (a) Bill of exchange.



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- (b) Promissory note.
  - (c) Cheque
  - (d) Both (a) and (b)
6. The presentment for payment is required in case of a
- (a) Bill of exchange.
  - (b) Promissory note.
  - (c) Cheque
  - (d) All of these.
7. Which one of the following is not the characteristic of a negotiable instrument?
- (a) It must be in writing.
  - (b) It must be freely transferable.
  - (c) It must be registered.
  - (d) It must contain definite amount of money.
8. In legal terms, a person who receives a negotiable instrument in good faith and for valuable consideration is known as
- (a) Holder.
  - (b) Holder in due course.
  - (c) Holder for value.
  - (d) Holder in rights.
9. A negotiable instrument payable to order can be transferred by
- (a) simple delivery.
  - (b) indorsement.
  - (c) indorsement and delivery.
  - (d) registered post.
10. An indorsement made by an indorser by signing his name and also by writing the name of the indorsee, is known as
- (a) general indorsement.
  - (b) special indorsement.
  - (c) restrictive indorsement.
  - (d) none of these.



**Short/ Essay type questions**

11. X signs a negotiable instrument in the following terms:
- (a) "I promise to pay X or order Rs. 400".
  - (b) "I acknowledge myself to be indebted to X in the sums of Rs. 400 to be paid on demand for value received".
  - (c) "Mr. X, I.O.U. Rs. 800".
  - (d) "I promise to pay X Rs. 400 and all other sums which shall be due to him".
  - (e) "I promise to pay X Rs. 400 first deducting thereout any money which he may owe me".
  - (f) "I promise to pay X Rs. 400 seven days after my marriage with Z".
  - (g) "I promise to pay, X Rs. 400 on P's death provided P leaves me enough to pay that sum.
  - (h) "I promise to pay Rs. 400 and deliver to him my black horse on 1st July next." Which of the aforesaid instruments are not promissory notes?
12. State whether the following bills are "inland" bills:
- (a) Bills drawn outside India and made payable in or drawn upon any person resident in any country outside India.
  - (b) A bill drawn in Calcutta on a merchant in Bombay but endorsed in Paris.
  - (c) Bills drawn outside India made payable in India, or drawn upon any person resident therein.
  - (d) Bills drawn in India and made payable outside India, or drawn upon a person resident outside India, but not made payable in India.
  - (e) A bill is drawn in Madras upon a merchant in Brussels and accepted payable in Bombay.
13. When a note is drawn in this form; "I promise to pay Rs. 500 to B only". Can it be called a negotiable instrument?
14. A bill is made payable to "Saroj Sehgal". Saroj Sehgal endorses it in blank and negotiates it. Is the bill payable to bearer?
15. A bill is drawn by an agent acting with the scope of his authority upon his principal. Can the holder thereof treat it at his option as a note or bill.?
16. A draws a bill on B and negotiates it away. B is fictitious drawee. Can the holder of the bill treat it as note made by A ?



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17. A bill is drawn "Pay to X or order the sum of one thousand rupees. In the margin the amount stated is Rs. 100. What is the amount of the bill for ?
18. When is a negotiable instrument, dated 30th August (in a year) and made payable three months after date, deemed to be at maturity ?
19. A bill of exchange is addressed to Swapn Ganguli. Anil Banerjee writes an acceptance on it. Can Anil Banerjee bind himself by such acceptance?
20. Where there are several drawees of a bill, who are not partners, can any one of such drawees accept it for another without that other's authority ?
21. A who is the holder of a bill transfers it to B without consideration. B transfers it to C without consideration. C transfers it to D for value. D transfers it without consideration to E. (a) Can E recover the amount of the bill from A? (b) Has E any right against D ? Say Yes or No.
22. A owes to B Rs. 500. B draws a bill on A for Rs. 1,000. A to accommodate B and at his request, accept it. B sues A on the bill. Can he recover Rs. 1,000 ?
23. A agrees to supply a quantity of paper to B. B accept a bill for Rs. 1,000 drawn by A, being the price of the paper. The paper is delivered to B but it turns out to be of a quality different from the stipulated one, and worth Rs. 500 only. B retains the paper. A sues B on the bill. Is B bound to pay Rs. 1,000 to A ?
24. X accepts a bill for Rs. 1,500. This is the agreed price of two bales of cotton to be supplied by Y to X, Y delivers only one bale to X, Y sues X on the bill. Can Y recover Rs. 1,500 from X ?
25. X owes to Y Rs. 2,000 and makes a promissory note for the amount payable to Y. X dies and the note is subsequently found amongst his papers. Can Y sue on the note even if it was later on delivered to him ?
26. A, the holder of a negotiable instrument payable to bearer, which is in the hands of A's banker who is at the time the banker of B, directs the banker to transfer the instrument to B's credit in the banker's account with B. The banker does so and according now possesses the instrument as B's agent. Can the instrument be deemed to have been negotiated ?
27. A is the holder of a bill payable to "A or order". A by simple delivery transfers the bill without endorsing it to B. Can 'B' deemed to be a holder in due course?
28. A is holder of a bill endorsed by B in bank. A writes over B's signature the words "pay to C or order". (a) Is the writing of A operates as an endorsement in full from B to C ? (b) Is A liable an endorser?
29. B signs the following endorsement on different negotiable instruments payable to bearer. Do these endorsements exclude the right of further negotiation by C ? Say Yes or no:



- (a) "Pay the contents to C only".
  - (b) "Pay C for my use".
  - (c) "Pay C or order for the account of B."
  - (d) "The within must be credited to C".
  - (e) "Pay C".
  - (f) "Pay C value in account with the State Bank".
  - (g) "Pay the contents to C, being part of the consideration in a certain deed of assignment executed by the endorser and other".
30. A bill is drawn payable to A or order. A endorses it to B but the endorsement does not contain the words "or order" or any equivalent words. Can B negotiate the instrument ?
31. A (the holder of a bill) endorses it to B who endorses it to C who endorses it to D. D in the turn endorses it to A. Can A sue B, C and D ?
32. A bill, originally obtained by fraud from the drawer gets into the hands of A who is holder in due course. A endorses the bill to B by way of gift. Can B sue the acceptor?
33. A is holder of a bill for Rs. 1,000. A endorses it thus; "Pay B or order Rs. 500", Is this instrument valid for purpose of negotiation ?
34. A, the holder of bill, specially endorses it to B but dies before delivering it. Subsequently A's executor hands over the bill to B. Can B sue on this bill?
35. A bill is payable to due drawer's order. It is accepted by B for an illegal consideration. Before its maturity, the drawer endorses it to C who takes it for value and *bona fide*. C endorses the bill, when overdue, to D. Can C sue all parties to the bill?
36. A executed a promissory note in favour of B and the amount thereof was payable to B's order, the payment was made to C who was the adopted son of B. The son was not in possession of the note. Would A be discharged by this payment from his liability ?
37. A draws a cheque for Rs. 2,000. When the cheque ought to have been presented A has funds at the bank to meet it. The bank goes into liquidation prior to cheque being presented to it, (a) Is A discharged from his liability (b) Can the holder of the cheque prove against the bank for the amount of the cheque ?
38. A cheque is drawn "payable to B or order", and delivered to B in payment of a debt, B's agent without having any authority to endorse, endorses the cheque "per pro" for B and obtains payment of the money and misappropriates it. Is the banker discharged?
39. Do the following alterations of a negotiable instrument render the instrument void?
- (a) The holder of a bill alters the date of the instrument to accelerate or postpone the time of payment.



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- (b) The drawer of a negotiable instrument draws a bill but forgets to write the words "or order". Subsequently, the holder of the instrument inserts these words.
  - (c) A bill payable three months after date is altered into a bill payable three months after sight.
  - (d) A bill was dated 1972 instead of 1973 and subsequently the agent of the drawer corrected the mistake.
  - (e) A bill is accepted payable at the Union Bank, and the holder, without the consent of the acceptor, scores out the name of the Union Bank and inserts that of the Syndicate Bank.
40. A cheque payable to bearer is crossed generally and is marked "not negotiable". The cheque is lost or stolen and comes into possession of B who takes it in good faith and gives value for it. B deposits the cheque into his own bank and his banker presents it and obtains payment for his customer from the bank and upon which the cheque is drawn. (a) Can both the bankers paying the cheque and the banker collecting it plead exoneration from their liability ? (b) Can B be compelled to refund the money to the true owner of the cheque ?
41. Define "cheque", under the Negotiable Instrument Act, 1881. What are the differences between a cheque and a bill of exchange?
42. A Bill of Exchange is dishonoured by the acceptor. Explain the provisions of "Noting" and "Protest" under the Negotiable Instruments Act, 1881.
43. State by and to whom, a notice of dishonour of a negotiable instrument should be given and also state the mode to be followed for giving such notice under the provisions of the Negotiable Instruments Act, 1881.
44. What is meant by "Payment in due course" in respect of a negotiable instrument? When does such payment operate as a discharge of a negotiable instrument?
45. What do you understand by the term 'Inchoate Instrument'? Examine the validity of such instruments under the provisions of the Negotiable Instruments Act, 1881.
46. Explain the provisions of the Negotiable Instruments Act, 1881, relating to the liabilities of parties to negotiable instruments drawn, accepted, or endorsed without consideration?
47. M a broker draws a cheque in favour of N, a minor. N indorses the cheque in favour of O, who in turn indorses it in favour of P. Subsequently, the bank dishonoured the cheque. State the rights of O and P and whether N, can be made liable?
48. Who is holder in due course? How he is differing from a Holder?
49. What do you mean by an Indorsement. Briefly explain the types of an Indorsement.
50. Distinguish between a Promissory Note and a Bill of Exchange.



**Practical Problems**

51. Mr. Clever obtains fraudulently from J a cheque crossed 'Not Negotiable'. He later transfers the cheque to D, who gets the cheque encashed from ABC Bank, which is not the Drawee Bank. J, when comes to know about the fraudulent act of Clever, sues ABC Bank for the recovery of money. Examine with reference to the relevant provisions of the Negotiable Instruments Act, 1881, whether J will be successful in his claim. Would your answer be still the same in case Clever does not transfer the cheque and gets the cheque encashed from ABC Bank himself?

52. X by inducing Y obtains a Bill of Exchange from him fraudulently in his (X) favour. Later, he enters into a commercial deal and endorses the bill to Z towards consideration to him (Z) for the deal. Z takes the bill as a Holder-in-due-course. Z subsequently endorses the bill to X for value, as consideration to X for some other deal. On maturity the bill is dishonoured. X sues Y for the recovery of the money.

With reference to the provisions of the Negotiable Instruments Act, decide whether X will succeed in the case?

53. A issues a cheque for Rs. 25,000/- in favour of B. A has sufficient amount in his account with the Bank. The cheque was not presented within reasonable time to the Bank for payment and the Bank, in the meantime, became bankrupt. Decide under the provisions of the Negotiable Instruments Act, 1881, whether B can recover the money from A?

54. A draws a bill on B. B accepts the bill without any consideration. The bill is transferred to C without consideration. C transferred it to D for value. Decide-

- (i) Whether D can sue the prior parties of the bill, and
- (ii) Whether the prior parties other than D have any right of action intense?

Give your answer in reference to the Provisions of Negotiable Instruments Act. 1881

**Answers**

1. (c); 2. (b); 3. (a); 4. (c); 5. (b); 6. (d); 7. (c); 8. (b); 9. (c); 10. (b); 11. (c), (d), (e), (f), (g), (h); 12(a). Foreign; 12(b). Inland; 12(c). Foreign; 12(d). Foreign; 12(e). Inland, 13. No; 14. Yes; 15. Yes; 16. Yes; 17. Rs. 1,000; 18. 3rd December; 19. No. 20. No; 21(a). No; 21(b). No; 22. No; 23. Yes; 24. No; 25. No; 26. Yes; 27. No; 28(a). Yes; 28(b). No; 29(a) Yes; 29(b) Yes; 29(c). Yes; 29(d). Yes; 29(e). No; 29(f). No; 29(g). No; 30. Yes; 31. No; 32. No; 33 Yes; 34. No; 35. No; 36. No, 37(a). Yes; 37(b) yes; 38. Yes; 39(a). Yes; 39(b). No; 39(c). Yes; 39(d). No; 39(e). Yes; 40(a). Yes; 40(b). Yes.

# CHAPTER 3

## THE PAYMENT OF BONUS ACT, 1965

### Learning Objectives

In this Chapter, the students will understand the-

- ◆ Applicability and non-applicability of the Act to certain classes of establishments and employees
- ◆ Computation of profits for the purpose of calculation of allocable and available surplus for the purpose of determination of bonus
- ◆ Set on and Set Off of allocable surplus
- ◆ Percentage limits for minimum and maximum bonus
- ◆ Other miscellaneous provisions

### 3.1 INTRODUCTION

This is an Act intended to provide for the payment of bonus to persons employed in certain establishments and for matters connected therewith. It came into force from September 25, 1965. It extends to the whole of India. Unless it is provided otherwise in the Act, it shall apply to : (a) every factory and (b) every other establishment in which 20 or more persons are employed on any day during an accounting year. But the appropriate Government may apply the provisions of the Act with effect from such accounting year as may be notified in the Gazette to any establishment or class of establishments [including an establishment as defined by Section 2(m) (ii) of the Factories Act], employing persons between 10 and 19 in number [Proviso to Section 1(3)].

An establishment in which 20 or more persons are employed on any day during an accounting year, must continue to be governed by this Act, in spite of the fact that the number of persons employed therein falls below 20.

### 3.2 ACT NOT TO APPLY TO CERTAIN CLASSES OF EMPLOYEES (SECTION 32)

The following are the categories of employees who are excluded from the operation of the Act:

- (i) Employees employed by the Life Insurance Corporation of India.





- (ii) Seamen as defined under Section 3(42) of the Merchant Shipping Act, 1958.
- (iii) Employees registered or listed under any scheme made under the Dock Workers (Regulation of Employment) Act, 1948 and employed by the registered or listed employers.
- (iv) Employees employed by an establishment engaged in any industry carried on by or under the authority of any department of the Central Government or a State Government or a local authority.
- (v) Employees employed by : (a) the Indian Red Cross Society or any other institution of a like nature (including its branches); (b) Universities and other educational Institutions : (c) Institutions (including hospitals, chambers of commerce and social welfare institutions) established not for purposes of profit.
- (vi) Employees employed through contractors on building operations.
- (vii) Employees employed by the Reserve Bank of India.
- (viii) Employees employed by; (a) the Industrial Finance Corporation of India; (b) any financial Corporation established under Section 3 or any joint financial corporation established under Section 3A of the State Financial Corporations Act, 1951; (c) the Deposits Insurance Corporation; (d) the Agricultural Refinance Corporation; (e) the Unit Trust of India; (f) the Industrial Development Bank of India; (g) any other Financial Institution (other than a banking company) being an establishment in public sector, which the Central Government may, by notification in the Official Gazette; specify; while so specifying the Central Government shall have regard to its capital structure, its objectives and the nature and extent of financial assistance or any concessions given to it by the Government and any other relevant factor.
- (ix) Employees employed by inland water transport establishment operating on routes passing through any other country.

Besides the above, if the appropriate Government is of the opinion that it will be in the public interest, having regard to the financial position and other relevant circumstances of any establishment or class of establishment, it may, by notification in the Official Gazette, exempt for such periods as may be specified therein and subject to such conditions as it may think fit to impose, such establishment or class of establishments from all or any of the provisions of this Act.

### **3.3 DEFINITIONS**

*Accounting year [Section 2(1)]* : It means, (i) in relation to a corporation, the year ending on the day on which the books of accounts of the corporation are to be closed and balanced.



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(ii) in relation to a company, this term means a period in respect of which any profit or loss account of the company laid before it in an annual general meeting is made up whether that period is a year or not.

(iii) in any other case (a) the year commencing on the first day of April, or (b) if the accounts of an establishment maintained by the company thereof are closed and balanced on any day other than the 31st day of March then at the option of the employer, the year ending on the day on which its accounts are so closed and balanced.

If, however, the said option is once exercised by the employer, it cannot be exercised once again, except with the permission in writing of the prescribed authority and upon such conditions as that authority may think fit. In other words, the exercise of the said option can only take place on obtaining the previous written permission of the prescribed authority, and the prescribed authority may impose such conditions as it may think fit.

*Allocable surplus [Section 2(4)]* : This expression means 67% of the available surplus in an accounting year, in relation to an employer, being a company, other than a banking company, which has not made the arrangements prescribed under the Income-tax Act, for the declaration and payment within India of the dividends payable out of its profits in accordance with the provisions of Section 194 of that Act. In any other case, the allocable surplus means 60% of such available surplus.

*Appropriate Government* : In relation to an establishment in respect of which the appropriate Government under the Industrial Disputes Act, 1947 is the Central Government the appropriate Government means the Central Government. But in relation to any other establishment, the expression means the Government of the State in which the other establishment is situated.

*Award [Section 2(7)]* : It means an interim or final determination of any industrial dispute or of any question relating thereto by any Labour Court, Industrial Tribunal or National Tribunal constituted under the Industrial Disputes Act, 1947, or by any other authority constituted under any corresponding law, relating to investigation and settlement of industrial dispute in force in state and includes an arbitration award made under Section 10A of that Act or under that law.

*Employee [Section 2(13)]* : It means any person other than an apprentice employed on a salary or wage not exceeding Rs. 10,000 per mensem in any industry to do any skilled or unskilled, manual, supervisory, managerial, administrative, technical or electrical work for hire or reward, whether the terms of employment be express or implied.

*Employer [Section 2(14)]* : In relation to establishment which is a factory, this term includes the owner or occupier of the factory including the agent of such owner or such occupier, the legal representative of a deceased owner or occupier and where a person has been named as a manager of that factory under Section 7(1)(f) of the Factories Act, 1948, the person so named. But in relation to any other establishment which is not a factory, the term includes the



person who or the authority which has the ultimate control over the affairs of the establishment and if the said affairs are entrusted to a managing director, then such manager or managing director.

*Establishment in private sector [Section 2(15)]* : This expression means any establishment other than an establishment in public Sector.

*Establishment in public Sector [Section 2(16)]* : It means an establishment owned, controlled or managed by (a) a Government company as defined in Section 617 of the Companies Act, 1956; (b) a corporation in which not less than 40% of its capital is held whether singly or taken together by : (i) the Government; or (ii) the Reserve Bank of India; or (iii) a corporation owned by the Government or the Reserve Bank of India.

*Salary or wage [Section 2(21)]* : It means all remuneration other than remuneration in respect of overtime work, capable of being expressed in terms of money, which would, if the terms of employment, express or implied, were fulfilled, be payable to an employee in respect his employment or of work done in such employment. It includes dearness allowance, *i.e.*, all cash payments by whatever name called, paid to an employee on account of a rise in the cost of living. But the term excludes :

- (i) any other allowance which the employee is for the time being entitled to;
- (ii) the value of any house accommodation or of supply of light, water, medical attendance or other amenities or of any service or of any concessional supply of food grains or other articles;
- (iii) any travelling concession;
- (iv) any contribution paid or payable by the employer to any pension fund or for benefit of the employee under any law for the time being in force;
- (v) any retrenchment compensation or any gratuity or other retirement benefit payable to the employee or any ex-gratia payment made to him; and
- (vi) any commission payable to the employee.

It may be noted that where an employee is given, in lieu of the whole or part of the salary or wage payable to him, free food allowance or free food by his employer, such food allowance or the value of such food shall be deemed to form part of the salary or wage for such employee.

It is also worthy of note that the words and expression used but not defined in Payment of Bonus Act but defined in the Industrial Disputes Act shall have the same meanings respectively assigned to them in the Act.



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### 3.4 WHO IS ENTITLED TO BONUS ?

Every employee of an establishment covered under the Act is entitled to bonus from his employer in an accounting year provided he has worked in that establishment for not less than thirty working days in the year on a salary less than Rs. 10,000 per month. [Section 2(13) read with Section 8].

If an employee is prevented from working and subsequently reinstated in service, employee's statutory liability for bonus cannot be said to have been lost. Nor can the employer refuse for such bonus. [*ONGC vs. Sham Kumar Sahegal* [1995] 1 LLJ].

There are, however, certain *disqualifications* of an employee to claim bonus in an accounting year. An employee who has been dismissed from service for (a) fraud; or (b) riotous or violent behaviour while on the premises of the establishment; or (c) theft, misappropriation or sabotage of any property of the establishment is not entitled for bonus. [Section 9]

An employee in the following cases is entitled to bonus :

- (i) A temporary workman is entitled to bonus on the basis of total number of days worked by him.
- (ii) An employee of a seasonal factory is entitled to proportionate bonus and not the minimum bonus as prescribed under Section 10 of the Act.
- (iii) A part time employee as a sweeper engaged on a regular basis is entitled to bonus. [*Automobile Karmchari Sangh vs. Industrial Tribunal* [1970] 38 FJR 268].
- (iv) A retrenched employee is eligible to get bonus provided he has worked for minimum qualifying period. [*East Asiatic Co. (P.) Ltd. vs. Industrial Tribunal* [1961] 1 LLJ 720].
- (v) A probationer is an employee and as such is entitled to bonus. [*Bank of Madura Ltd. vs. Employee's Union, 1970, (2) LLJ (21)*].
- (vi) A dismissed employee reinstated with back wages is entitled to bonus. [*Gannon India Ltd. vs. Niranjan Das* [1984] 2 LLJ 223].
- (vii) A piece-rated worker is entitled to bonus. [*Mathuradas Kani vs. L.A. Tribunal AIR, [1958], SC 899*].

An employee in the following cases is not entitled to bonus :

1. An apprentice is not entitled to bonus. [*Wheel & RIM Co. vs. Government of T.N.* [1971] 2 LLJ 299 40 FJR 18].
2. An employee employed through contractors on building operation is not entitled to bonus. (Section 32).
3. An employee who is dismissed from service on the ground of misconduct as mentioned in Section 9, is disqualified for any bonus and not merely for bonus of the accounting year in



which he is dismissed (Pandian Roadways Corporation Ltd. vs. Presiding Officer [1996] 2 CLR 1175 (Mad.).

### **3.5 ESTABLISHMENT TO INCLUDE DEPARTMENTS, UNDERTAKINGS AND BRANCHES (SECTION 3)**

Where an establishment consists of departments or undertakings, or has branches irrespective of whether they are situated in the same place or in different place, all such departments or undertakings or branches are to be treated as part of the same establishment for the purpose of computation of bonus under this Act.

It has been provided that if, for any accounting year, a separate balance sheet and profit and loss account are prepared and maintained in respect of any such departments etc. then such department, undertaking or branch shall be treated as separate establishments for the purpose of calculation of bonus for that year, unless such department, etc., were, immediately prior to the commencement of that accounting year, treated as part of the establishment for the purpose of computation of bonus.

*Computation of gross profit under Section 4 as amended by the Payment of Bonus (Second Amendment Act, 1980) - (a) : The gross profit derived by an employer is required to be calculated in the manner specified in the first Schedule, in the case of a banking company; (b) in any other case, these gross profits are to be calculated in the manner specified in the Second Schedule.*

For your reference, the above mentioned schedules are given below :

### **3.6 The First Schedule**

**[See Section 4(a)]**

#### **Computation of Gross Profits**

Accounting Year ending.

<i>Item No.</i>	<i>Particulars</i>	<i>Amount of sub-items</i>	<i>Amount of main items</i>	<i>Remarks</i>
		<i>Rs.</i>	<i>Rs.</i>	

\*1. Net profit as shown in the Profit and Loss Account after making usual and necessary provisions.

2. Add back provision for :

(a) Bonus to employees

(b) Depreciation.

See foot



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### The Payment of Bonus Act, 1965

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(c) Development Rebate Reserve.		note (1)
(d) Any other reserves.		
Total of Item No. 2	Rs.	
3. Add back also :		
(a) Bonus paid to employees in respect of previous accounting year.		See foot note (1)
(b) The amount debited in respect of gratuity paid or payable to employees in excess of the aggregate of :		
(i) the amount, if any, paid or provided for payment, to an approved gratuity fund; and		
(ii) the amount actually paid to employees on their retirement or on termination of their employment for any reason.		
(c) Donation in excess of the amount Admissible for income tax.		
(d) Capital expenditure (other than capital expenditure on scientific research which is allowed as <i>deduction</i> under any law for the time being in force relating to direct taxes) and capital losses (other than losses on sale of capital assets on which depreciation has been allowed for income-tax).		
(e) Any amount certified by the Reserve bank in terms of Section 34A(2) of the Banking Regulation Act, 1949.		See foot-note - (1)
(f) Losses of, or expenditure relating to, any business situated outside India.		
Total of Item No. 3	Rs.	





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(f) Refund of any excess direct tax paid for previous accounting years and excess provision, if any of previous accounting year, relating to bonus, depreciation or development rebate, it written back.	See foot-note (2)
(g) Cash subsidy, if any, given by the Govt., or by any body corporate established by any law for the time being in force or any other agency through budgetary grants, whether given directly or through any agency for specified purposes and the proceeds of which are reserved for such purposes.	See foot-note (2)
Total of Item No. 6	Rs.
7. Gross profits for purpose of bonus (Item No. 5 minus item No. 6).	Rs.

Explanation: In sub-item (b) of item 3, "approved gratuity fund" has the same meaning as assigned to it in clause (5) of Section 2 of the Income-tax Act.

### Footnotes:

- (1) If, and to the extent, charged to Profit and Loss Account.
- (2) If, and to extent, credited to Profit and Loss Account.
- (3) In the proportion of Indian gross Profit (Item No. 7) to Total World Gross Profit (as per consolidated Profit and Loss Account (adjusted as in Item No. 2 above only).

### 3.7 THE SECOND SCHEDULE

[See Section 4(b)]

#### COMPUTATION OF GROSS PROFITS

Accounting Year ending.





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Item No.	Particulars	Amount of sub-items Rs.	Amount of main items Rs.	Remarks
1.	Net Profit as per Profit and Loss Account			
2.	Add back provision for:			
	(a) Bonus to employees.			
	(b) Depreciation.			
	(c) Direct Taxes, including the provision (if any) for previous accounting years.			
	(d) Development rebate/investment allowance / Development allowance reserve.			See footnote (1)
	(e) Any other reserve.			See footnote (1)
	Total of Item No. 2	Rs.		
3.	Add back also :			
	(a) Bonus paid to employees in respect of previous accounting year.			See footnote (1)
	(aa) Amount debited in respect of gratuity paid or payable to employees in excess of the aggregate of: (i) the amount, if any, paid to, or provided for payment, an approved gratuity fund; and (ii) the amount actually paid to employees on their retirement or on termination of their employment for any reason.			
	(b) Donation in excess of the amount admissible for income tax.			
	(c) Any annuity due, or commuted value of any annuity paid under the provisions of Section 280-D of the Income Tax Act during the accounting year.			
	(d) Capital expenditure (other) than capital expenditure on scientific			See footnote (1)



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research which is allowed as a deduction under any law for the time being in force relating to direct (taxes) and capital losses (other than losses on sale of capital assets on which depreciation has been allowed for income-tax or agricultural Income-tax.)

(e) Losses of, or expenditure relating to, any business situated outside India.		
Total of Item No. 3	Rs.	
4. Add also Income, Profits or gains (if any) credited directly to reserves, other than :		
(i) capital receipts and capital profits on the sale of capital assets on which depreciation has not been allowed or income-tax).		
(ii) profits of, and receipts relating to, any business situated outside India;		
(iii) income of foreign concerns from in- vestment outside India.		
Total of Item No. 4	Rs.	
5. Total of Item Nos. 1, 2, 3, & 4	Rs.	
6. Deduct :		
(a) Capital receipts and capital profits (other than profits on the sale of assets on which depreciation has been allowed for income-tax on agricultural income tax)		See foot- note (2)
(b) Profits of, and receipts relating to any business situated outside India		See Foot- note (2)
(c) Income of foreign concerns from investments outside India.		See foot note (2)
(d) Expenditure or losses, (if any), debited directly to reserves, other than :		
(i) capital expenditure and capital		



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losses (other than losses on sale of capital assets on which depreciation has not been allowed for income-tax or agricultural income tax);

(ii) loss of any business situated out-side India.

(e) In the case of foreign concerns proportionate administrative (over-head) expenses of Head Office allocable to Indian business. See foot-note (3)

(f) Refund of any excess direct tax paid for previous accounting years and excess provision, if any, of previous accounting years relating to bonus, depreciation, taxation or development allowance, if written back. See foot-note (2)

(g) Cash subsidy, if any, given by grants, whether given directly or through any agency for specified the Govt. or by any body corporate established by any law for the time being in force or any other agency through budgetary purposes and the proceeds of which are reserved for such purposes.

Total of Item No. 6

Rs.

7. Gross profit for purpose of bonus (item No. 5 minus item No. 6).

*Explanation:* In sub-item (aa) of item 3, "approved gratuity fund" has the same meaning as assigned to in clause (5) of Section 2 of the Income-tax Act.

### Footnotes :

- (1) If, and to the extent charged to Profit and Loss Account.
- (2) If, and to the extent, credited to Profit and Loss Account.
- (3) In the proportion of Indian Gross Profit (Item No. 7) to Total World Gross Profit (as per consolidated Profit and Loss Account (adjusted as in Item No. 2 above only).

**(a) A Prior deduction from gross profits (Section 6)**



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Having calculated the gross profits in terms of Section 4, the following sums must be deducted from gross profit as prior charges :

- (a) Any amount by way of depreciation admissible under Section 32(1) of the Income Tax Act or under the provisions of the agriculture income tax law. If however, any employer has been paying bonus to his employees under a settlement or an award or agreement made before the promulgation of the Bonus Ordinance, *i.e.*, before 29 May, 1965, and subsisting on that date, after deducting from the "gross profit" notional normal depreciation, then the amount of depreciation to be deducted as prior charge may continue to be such notional normal depreciation. This, however, is at the option of the employer who may choose either the normal depreciation or the depreciation admissible under the Bonus Act. This option has to be exercised only once and within one year from May 29, 1965.
- (b) Any amount by way of development rebate, investment allowance or development nce which the employer is entitled to deduct from his income under the Income-tax Act.
- (c) Subject to the provision of Section 7, any direct tax which the employer is liable to pay for the accounting year in respect of his income, profits and gains during that year.
- (d) Such further sums as are specified in respect of the employer in the Third Schedule.

### 3.8 THE THIRD SCHEDULE

[See Section 6(d)]

<i>Item No.</i>	<i>Category of employer</i>	<i>Further Sums to be deducted</i>
(1)(2)	(3)	
1. Company other than a banking company	(i)	The dividends payable on its preference share capital for the accounting year calculated at the actual rate at which such dividends are payable;
	(ii)	8.5 per cent of its paid up equity share capital as at the commencement of the accounting year;
	(iii)	6 per cent of its reserves shown in its balance sheet as at the commencement of the accounting year, including any profits carried forward from the previous accounting year;

Provided that where the employer is a foreign company within the meaning of Section 591 of the Companies Act, 1956 (1 of 1956) the total amount to be deducted under this item shall be 8.5 per cent on the aggregate of the value of the net fixed assets and the current assets of the



company in India after deducting the amount of its current liabilities (other than any amount shown as payable by the company to its Head Office or otherwise or any interest paid by the company to its Head Office) in India.

**2. Banking company**

- (i) The dividends payable on its reference share capital for the accounting year calculated at the rate at which such dividends are payable;
- (ii) 7.5 per cent of its paid up equity share capital as at the commencement of the accounting year;
- (iii) 5 per cent of its reserves shown in its balance sheet at the commencement of the accounting year, including any profits carried forward from the previous accounting year;
- (iv) any sum which, in respect of the accounting year, is transferred by it.
  - (a) to a reserve fund under Sub-section (1) of Section 17 of the Banking Regulation Act, 1949 (10 of 1949); or
  - (b) to any reserve in India in pursuance or any direction or advice given by the Reserve Bank of India, whichever is higher;

Provided that where the banking company is a foreign company within the meaning of Section 591 of the Companies Act, 1956 (1 of 1956), the amount to be deducted under this item shall be the aggregate of—

- (i) the dividends payable to its preference shareholders for the accounting year at the rate at which such dividends are payable on such amount as bears the same proportion to its preference share capital as its total working funds in India bear to its total world working funds;
- (ii) 7.5 per cent of such amount as bears the same proportion to its total paid up equity share capital as its total working funds in India bear to its total world working funds;
- (iii) 5 per cent of such amount as bears the same proportion to its total disclosed reserves as its total working funds in India bear to its total world working funds;
- (iv) any sum which in respect of the accounting year, is deposited by it with the Reserve Bank of India under sub-clause (ii) of clause (b) of Sub-section (2) of Section 11 of the Banking Regulation Act, 1949, not exceeding the amount required under the aforesaid provision to be so deposited.

**3. Corporation**

- (i) 8.5 per cent of its paid up capital as at the commencement of the accounting year;
- (ii) 6 per cent of its reserves if any, shown in its balance sheet as at the commencement of the accounting year, including any profits carried forward from the previous accounting year.



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### 4. Co-operative society

- (i) 8.5 per cent of the capital invested by such society in its establishment as evidenced from its books of accounts at the commencement of the accounting year;
- (ii) such sum as has been carried forward in respect of the accounting year to a reserve fund under any law relating to co-operative societies for the time being in force.

5. Any other employer not falling under any of the aforesaid his establishment as evidenced from his categories. books of accounts at the commencement of the accounting year; Provided that where such employer is a person to whom Chapter **XXII A** of the Income-tax Act applies, the annuity deposit payable by him under the provisions of that Chapter during the accounting year shall also be deducted: Provided further that where such employer is a firm, an amount equal to 25 per cent, of the gross profits **derived by it from the establishment in respect of the accounting year** after deducting depreciation in accordance with the provisions of clause (a) of Section 6 by way of remuneration to all the partners taking part in the conduct of business of the establishment shall also be deducted, but where the partnership agreement whether oral or written, provides for the payment of remuneration to any such partner, and

- (i) the total remuneration payable to all such partners is less than the said 25 per cent, the amount payable, subject to a maximum of forty-eight thousand rupees to each such partner; or
- (ii) the total remuneration payable to all such partners, is higher than the said 25 per cent, such percentage, or a sum calculated at the rate of forty-eight thousand rupees to each such partner, whichever is less, shall be deducted under this proviso: Provided also that where such employer is an individual or a Hindu undivided family :
  - (i) an amount equal to 25 per cent of the gross profits derived by such employer from the establishment in respect of the accounting year after deducting depreciation in accordance with the provisions of clause (a) of Section 6;
  - (ii) or forty-eight thousand rupees, whichever is less by way of remuneration to such employer, shall also be deducted.

6. Any employer falling under Item No. 1 or Item No. 3, or Item No. 4 or Item No 5 and being a licensee within the meaning of the Electricity (Supply) Act, 1948 (54 of 1948).

In addition to the sums deductible under any of the aforesaid items, such sums as are required to be appropriated by the licensee in respect of the accounting year to a reserve under the Sixth Schedule to that Act shall also be deducted.

*Explanation:* The expression "reserves" occurring in column (3) against Item Nos. 1(iii), 2(iii) and 3(ii) Shall not include any amount set apart for the purpose of :



- (i) payment of any direct tax which according to the balance sheet, would be payable;
- (ii) meeting any depreciation admissible in accordance with the provisions of clause (a) of Section 6;
- (iii) payment of dividends which have been declared, but shall include:
  - (a) any amount, over and above the amount referred to in clause (i) of this Explanation, set apart as specific reserve for the purpose of payment of any direct tax; and
  - (b) any amount set apart for meeting any depreciation in excess of amount admissible in accordance with the provisions of clause (a) of Section 6.

**(b) Available surplus (Section 5):** According to Section 2(6), it means the available surplus Computed under Section 5. Accordingly, the available surplus comprises of the gross profits for accounting year after deducting certain prior charges (already discussed above). Further an amount equal to the tax saved on the account of bonus in respect of the immediately preceding accounting year, should be added. It is obvious that an employer can claim the amount of bonus payable as deductible expense for the purpose of his tax assessments. Such saving must also be added to the amount of gross profits for the purpose of calculation of available surplus.

**(c) Calculation of direct tax payable by the employer (Section 7):** Any direct tax payable by the employer for any accounting year shall, subject to the following provisions, be calculated at the rates applicable to the income of the employer for the year.

In calculating the above mentioned tax, no account shall be taken on the following matters, namely :

- (i) any loss incurred by the employer in respect of any previous accounting year and carried forward under any law for the time being in force relating to direct tax;
- (ii) any arrears of depreciation which the employer is entitled to add to the amount of the allowance for depreciation for any following accounting year or years under Section 32(2) of the Income-tax Act;
- (iii) any exemption conferred on the employer under Section 84 of the Income Tax Act or of any deduction to which he is entitled under Section 101(1) of the Income-tax Act, as in force immediately before the commencement of the Finance Act.

Where the employer is religious or charitable institution to which Section 32 does not apply and the whole or part of its income is exempt from tax under the Income Tax Act, then with respect to the income so exempted, such institution shall be treated as if it were a company in which the public are substantially interested within the meaning of that Act.

If the employer is an Individual or a H.U.F. then the tax payable by such employer under the Income Tax Act shall be calculated on the basis that the income derived by him from the establishment is his only income.



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If the income of the employee includes any profits and gain derived from the export of any goods or merchandise and any rebate on such income is allowed under any law for the time being in force relating to direct taxes, then no account shall be taken of such rebate.

No account shall be taken of any rebate (other than the development rebate or investment allowance or development allowance) or credit or relief or deduction (not herein before mentioned) in the payment of any direct tax allowed under any law for the time being in force relating to direct taxes or under the relevant annual Finance Act for the development of any industry.

### **3.9 PAYMENT OF MINIMUM BONUS (SECTION 10)**

Subject to the other provisions of this Act, every employer shall be bound to pay to every employee in respect of every accounting year, minimum bonus which shall be 8.33% of the salary or wage earned by the employee during the accounting year or Rs. 100, whichever is higher, whether or not the employer has any allocable surplus in the accounting year. But if the employee has not completed 15 years of age at the beginning of the accounting year he will be entitled to a minimum bonus which shall be 8.33% of the salary or wage during the accounting year Rs. 60, whichever is higher.

Even if the employer suffers losses during the accounting year he is bound to pay minimum bonus as prescribed by Section 10 [*State vs. Sardar Dalip Singh Majilhia*, 1979, Lab. I.C. (913) (All)].

### **3.10 PAYMENT OF MAXIMUM BONUS (SECTION 11)**

Where, in respect of any accounting year referred to in Section 10, the allocable surplus exceeds the amount of minimum bonus payable to the employees under that section, the employer shall, in lieu of such minimum bonus, be bound to pay to every employee in respect of that accounting year bonus which shall be an amount in proportion to the salary or wage earned by the employee during the accounting year subject to a maximum 20% of such salary or wage.

In computing the allocable surplus under the above-mentioned provision, the amount set on or the amount set off under the provisions of Section 15 shall be taken into account in accordance with the provision of that section.

### **3.11 CALCULATION OF BONUS WITH RESPECT TO CERTAIN EMPLOYEES (SECTION 12)**

Where the salary or wage of an employee exceeds Rs. 2,500 p.m., the bonus payable to such





employee under Section 10 or, as the case may be, under Section 11, shall be calculated as if his salary or wages were Rs. 2,500 p.m.

### **3.12 PROCEDURE FOR CALCULATION OF WORKING DAYS AND PROPORTIONATE REDUCTION IN BONUS**

Section 14 of the Act provides how to compute the number of working days for purposes of Section 13. Section 13 in turn prescribes a scale whereby bonus can be proportionately reduced in certain cases. Under Section 14, following days shall be deemed to be the working days of an employee and shall be counted while calculating the total working days on which he has been on work for the purpose of bonus :

- (i) day when he has been laid off under an agreement or by a standing order under Industrial Employment (standing orders) Act, 1946 or Industrial Disputes Act, 1947 or any other law.
- (ii) he has been on leave with salary or wage.
- (iii) he has been absent due to temporary disablement caused by accident arising out of and in the course of his employment and
- (iv) the employee has been on maternity leave with salary or wages during the accounting year.

As per Section 13, where an employee has not worked for all the working days in an accounting year, the minimum bonus of Rs. 100 or, as the case may be of Rs. 60, if such bonus is higher than 8.33% of his salary or wage for the days he has worked in that accounting year, shall be proportionately reduced.

Both Sections 13 and 14 do not cover a case where an employee was prevented from working by reason of an illegal order of termination. If an employee by himself and on his violation has not worked on all the working days in an accounting year, then the formula prescribed in Section 13 read with section 14 has to be applied. But where an employee was ready and willing to work, but for reasons beyond his control was unable to work gets the eligibility for bonus under Section 8 of the Act, it cannot be said that Section 14 is a bar for such a claim.

### **3.13 SET ON AND SET OFF OF ALLOCABLE SURPLUS (SECTION 15)**

Where for any accounting year the allocable surplus exceeds the amount of maximum bonus payable to the employees in the establishment under Section 11, then the excess shall, subject to a limit of 20% of the total salary or wage of the employees employed in the establishment in that accounting year, be carried forward for being set on in the succeeding accounting year and so on up to and inclusive of the 4th accounting year. This excess is to be utilised for the purpose of payment of bonus, in the manner illustrated in Fourth Schedule.



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There may be a case where there is no allocable surplus or where the allocable surplus falls short of the amount of minimum bonus payable to the employee under Section 10 and there is no amount or sufficient amount carried forward and set on under the aforesaid provisions which could be utilised for paying minimum bonus. In such a situation minimum amount or the deficiency as the case may be, shall be carried forward for being set off in the succeeding accounting year and so on up to and inclusive of the 4th accounting year in the manner illustrated in Fourth Schedule.

The principle of set on and set off as illustrated in the Fourth Schedule shall apply to all other cases not covered by Sub-section (1) or (2) for the purpose of payment of bonus under this Act [Section 15(3)].

Where in any accounting year any amount has been carried forward and set on or set off under this Section, then, in calculating bonus for the succeeding accounting year, the amount of set on or set off carried forward from the earliest accounting year shall first be taken into account [Section 15(4)].

### 3.14 THE FOURTH SCHEDULE

(See Sections 15 and 16)

In this Schedule, total amount of bonus equal to 8.33 per cent, or the annual salary or wage payable to all the employees is assumed to be Rs. 1,04,167. Accordingly, the maximum bonus to which all the employees are entitled to be paid (twenty per cent of the annual salary or wage of all the employees) would be Rs. 2,50,000.

<i>Year</i>	<i>Amount equal to</i>	<i>Amount</i>	<i>Set on or</i>	<i>Total set on or</i>
	<i>sixty per cent or</i>	<i>payable as</i>	<i>set off of</i>	<i>set off carried</i>
	<i>sixty-seven per cent,</i>	<i>bonus</i>	<i>the year</i>	<i>forward</i>
	<i>as the case may be,</i>		<i>carried</i>	
	<i>of available surplus</i>		<i>forward</i>	
	<i>allocable as bonus</i>			
(1)	(2)	(3)	(4)	(5)
	Rs.	Rs.	Rs.	Rs.
1.	1,04,167	1,04,167***	Nil	Nil
2.	6,35,000	2,50,000*	Set on	Set on
			2,50,000*	2,50,000(2)
3.	2,20,000	2,50,000*	Nil	Set on



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		(inclusive of (30,000 from year-2)		2,20,000(2)
4.	3,75,000	2,50,000*	Set on 1,25,000	Set on 2,20,000(2) 1,25,000(4)
5.	1,40,000	2,50,000* (inclusive of 1,10,000 from year-2)	Nil	Set on 1,10,000(2) 1,25,000(4)
6.	3,10,000	2,50,000*	Set on 60,000	Set on Nil**(2) 1,25,000(4) 60,000(6)
7.	1,10,000	2,50,000*(inclusive of 1,25,000 from year-4 and 25,000 from year-6)	Nil	Set on 35,000(6)
8.	Nil (due to loss)	1,04,167*** (inclusive of 35,000 from year-6)	Set off 69,167	Set off 69,167(8)
9.	10,000	1,04,167***	Set off 94,167	Set off 69,167(8) 94,167(9)
10.	2,15,000	1,04,167***(after setting off 69,167 from year-8 and 41,666 from year-9)	Nil	Set off 52,501(9)

**3.15 SPECIAL PROVISION WITH RESPECT TO CERTAIN ESTABLISHMENTS (SECTION 16)**

Where an establishment is newly set up, the employees of such an establishment shall be



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entitled to be paid bonus in accordance with the provisions of Sub-sections (IA), (IB) and (IC) discussed below [Sub-section (1)]. It may be noted that an establishment shall not be deemed to be newly set up merely by reason of a change in its location, management, name or ownership.

In the first five accounting years following the accounting year in which the employer sells the goods produced or manufactured by him or renders services, as the case may be, to such establishment, bonus shall be payable only in respect of the accounting year in which the employer derives profit from such establishment. Such bonus shall be calculated in accordance with the provisions of this Act relating to that year but without applying the provisions of Section 15 [Sub-section (IA)]. It may be noted that an employer shall not be deemed to have derived profit in accounting year unless: (a) he has made provision for that year's depreciation to which he is entitled under Income Tax Act or, as the case may be, under the agricultural Income Tax law; and (b) the arrears of such depreciation and losses incurred by or in respect of the establishment for the previous accounting years have been fully set off against his profits.

But in the sixth and seventh accounting year, the provisions of Section 15 shall apply subject to the following modifications, namely: (i) for the sixth accounting year, set on or set off (as the case may be) shall be made in the manner illustrated in the Fourth Schedule, taking into account the excess or deficiency (if any, as the case may be) of the allocable surplus set on or set off in respect of the 5th and 6th accounting years; (ii) for the 7th accounting year, the same principle is to be followed but the excess or deficiency of the allocable surplus set on or set off in respect of the 5th, 6th and 7th accounting years has to be taken into account [Sub-section (IB)].

From the 8th accounting year following the accounting year in which the employer sells the goods produced or manufactured by him or renders services, as the case may be, from such establishment, the provisions of Section 15, shall apply in relation to such establishment as they apply in relation to any other establishment [Sub-section (IC)].

For the purpose of Sub-sections (IA), (IB) and (IC), sale of the goods produced or manufactured during the course of the trial running of any factory or of the prospecting stage of any mine or any oilfield shall not be taken into consideration. Where any question arises with regard to such production or manufacture, the decision of the appropriate Government made after giving the parties a reasonable opportunity of representing the case, shall be final and shall not be called into question by any Court or other authority.

**A. Adjustment of customary or interim bonus against bonus payable under the Act (Section 17) :** If in any accounting year, an employer has paid any puja bonus or other customary bonus to any employee, then the former shall be entitled to deduct the amount of bonus so paid from the **amount of bonus** payable by him to the employee under this Act in



respect of that **accounting** year. The employee shall be entitled to receive only the balance. **The employer** can do the same thing even in a case where he has paid off the **bonus** payable under this Act to an employee before the date on which such bonus **payable** becomes payable.

**B. Deduction of certain amounts from bonus payable under the Act (Section 18)** : If any accounting year, an employee is found guilty of misconduct causing financial loss to the employer, then the employer can lawfully deduct the amount of loss from the amount of bonus payable by him to the employee in respect of that accounting year only. In this case, the employee shall get only the balance, if there be any.

**C. Time Limit for payment of bonus (Section 19)** : The employer is bound to pay his employee bonus within one month from the date on which the award becomes enforceable or the settlement comes into operation, if a dispute regarding payment of bonus is pending before any authority under Section 22. In other cases, however, the payment of the bonus is to be made within a period of 8 months from closing of the accounting year. But this period of 8 months may be extended up to a maximum of 2 years by the appropriate Government or by any authority specified by the appropriate Government. This extension is to be granted on the application of the employer and only for sufficient reasons.

**D. Application of the Act to the establishment in public sector in certain cases (Section 20)** : In any accounting year, an establishment in public sector may sell any goods produced or manufactured by it or it may **render any services in** competition with an establishment in private sector. If it does so, and if the income from such sale or service or both is not less than 20% of the gross income of establishment in public sector, then the provision of the Bonus Act shall apply in relation to establishment in private Sector [Sub-section (1)]. Save as otherwise provided in Sub-section (1), nothing in this Act shall apply to the employees employed by any establishment in the public sector [Sub-section(2)].

**E. Recovery of the bonus due from an employer (Section 21)** : It may so happen that an amount of bonus is due to an employee from his employer under a settlement or an award or agreement and it is not paid. In such a case, the employee is to make an application for the recovery of the amount to the appropriate Government. This application can be made even by his assignee or heirs when the employee is dead. The application is to be made within one year from the date on which the money(bonus) becomes due but it may be entertained even after the expiry of the said period of one year, if the appropriate Government is satisfied that the applicant had sufficient cause for not making the application within the said period.

On the receipt of the aforesaid application for the recovery of the bonus amount, the appropriate Government or such authority as it may specify in this connection is to be satisfied that the money is so due. On being thus satisfied, it must issue a certificate for that amount to



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the Collector. Thereupon, Collector shall proceed to recover the same in the same manner as an arrear of land revenue.

According to the Explanation to Section 21, "employee" (mentioned in Sections 21, 22, 23, 24 and 25) includes a person who is entitled to the payment of bonus under this Act but, who is no longer in employment.

**F. Disputes (Section 22)** : Disputes may arise between an employer and his employees either regarding bonus payable under this Act or regarding the application of this Act to an establishment in public sector. Such a dispute shall be deemed to be an industrial dispute within the meaning of the Industrial Disputes Act, 1947 or any corresponding law relating to investigation and settlement of Industrial disputes in force in State and the provisions of that Act or as the case may be such law shall, save as otherwise expressly provided, apply accordingly.

**G. Presumption about the accuracy of balance sheet and profit and loss account of corporations and companies (Section 23)** : Proceeding may be lying before any arbitrator or Tribunal under the Industrial Disputes Act or under any corresponding law relating to investigation and settlement of Industrial disputes in force in State to which any dispute of the nature specified in Section 22 has been referred. During the course of such proceeding the balance sheet and the profit and loss account of an employer, being a corporation or a company other than a banking company, may be and are actually produced. If these statements of account are audited by the Comptroller and Auditor General of India or by auditors qualified under Section 226(1) of the Companies Act, then the above mentioned State may presume that those are accurate. In view of this presumption, corporation or the company need not prove the accuracy of such statements by affidavit or by any other mode. But if the State is satisfied that those statements are not accurate, it may take such steps as it thinks necessary to find out the accuracy thereof.

Situation may demand a clarification relating to any item in the balance sheet or the profit and loss account. In such a situation, the trade union may apply to the above mentioned State, it being a party to the dispute. If there is no trade union, then the application to the State may be made by the employees, being a party to the dispute. On receipt of such application, the State is to satisfy itself as to the necessity of such clarification. On being thus satisfied, the State may furnish to the trade union or the employees clarification within such time as may be specified in the direction. Thereupon, the company or the corporation must comply with such direction.

**H. Audit of accounts of banking companies not be questioned (Section 24)** : Where any dispute of the nature specified in Section 22 between an employer, being a banking company and its employees has been referred to the said authority under that Section and during the course of proceedings the accounts of the banking company duly audited are produced before



it, the said authority shall not permit any trade union or employees to question the correctness of such accounts, But the trade union or the employees may be permitted to obtain from the banking company such information as is necessary for verifying the amount of bonus under this Act [Sub-section(1)], but these provisions shall not enable the trade union or the employees to obtain any information which the banking company is not compelled to furnish under Section 34A of the Banking Regulation Act, 1949 [Sub-section (2)].

**I. Audit of accounts of employers not being corporation or companies (Section 25)**

Where the dispute of the nature specified in Section 22 has been referred to the said State under Section 22 and the only audited accounts of the employer (not being a corporation or company) have been produced before it then the provision of Section 23 shall apply to the accounts so audited. (You will recapitulate that Section 23 deals with presumptions about the accuracy of balance sheet and profit and loss account).

But if the aforementioned State finds that the accounts of the employer have not been audited by an auditor duly qualified to act as such under Section 226(1) of the Companies Act, it can, if it think necessary to do so ask the employer to get his accounts audited within the stipulated time. Thereupon, the employer must get his accounts audited within the stipulated time. If the employer fails to do so, then the said State may get the accounts audited by such auditor or auditors as it thinks fit. The accounts thus audited, whether by the employer or on his default by the State, shall fall within the provisions of Section 23.

**J. Maintenance of registers, records etc. (Section 26)** : Every employer shall prepare and maintain such registers, records and other documents in such form and in such manner as may be prescribed.

Rule 4 of the Payment of Bonus Rules, 1965 prescribes three kinds of registers to be maintained by the employers, viz., (i) Register in Form A (appended to the rules) showing the computation of allocable surplus referred to in Section 2(4); (ii) Register in Form B showing the set on and set-off the allocable surplus; (iii) **Register in Form C showing the details of the amount of bonus due to** each of the employees, the deductions under Sections 17 and 18 and the amount actually disbursed to the employees.

**K. Inspectors (Section 27)** : The appropriate Government may, by notification in the Official Gazette, appoint such persons as he thinks fit to be Inspectors for the purposes of this Act and may define the limits within which they shall exercise jurisdiction.

An inspector thus appointed has to ascertain whether any of the provisions of this Act has been complied with. And for this purpose, he may: (i) require an employer to furnish such information as he may consider necessary; (ii) at any reasonable time and with assistance, if any, as he thinks fit, enter any establishment or any premises connected therewith and require anyone found in charge thereof to produce before him for examination any account books, registers and other documents relating to the employment of persons or the payment of salary



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or wage or bonus in the establishment; (iii) examine with respect to any matter relevant to any of the purpose aforesaid, the employer, his agent or servant or any other person whom the inspector has reasonable cause to believe to be or to have been an employee in the establishment; (iv) make copies of or take extracts from, any book, register or other document maintained in relation to the establishment; (v) exercise such other powers as may be prescribed.

The Inspector appointed as aforesaid is deemed to be a public servant under Indian Penal Code.

Any person whom an Inspector calls upon to produce any account book, register or other document or to give information, shall be legally to do so.

The provisions of Section 27 do not empower an Inspector to require a banking company to furnish or disclose any statement or information or to produce or give inspection of, any of its books of accounts or other documents, which a banking company cannot be compelled to furnish, disclose, produce or give inspection of, under Section 34-A of the Banking Regulation Act, 1949.

**L. Penalty (Section 28)** : A person shall be liable to punishment: (i) if he contravenes any of the provisions of this Act or any rule framed thereunder; or (ii) if he fails to comply with any direction or requisition which may have been given or made to him under this Act. The punishment may be imprisonment for a term extending up to 6 months or of fine extending up to Rs. 1000 or both.

**M. Offences by Companies (Section 29)** : If any person committing an offence under this Act is a Company, then every person who, at the time the offence was committed was in charge of and responsible to the company for the conduct of its business, and also the company would be deemed to be guilty of the offence and liable to be proceeded against and punished accordingly. But such person shall be exonerated from liabilities and incidental punishment, if he proves that the offence was committed without his knowledge or that he exercised all due diligence to prevent the commission of such offence.

The above mentioned provisions notwithstanding, where an offence under this Act has been committed by a company and it is proved that the offence has been committed by a company with the consent and connivance of **or is attributable** to any neglect on the part of, any director ('director' in relation to a firm means a partner in the firm), manager, secretary, or other officer of the company (meaning anybody corporate and including a firm or other association of individuals), such director, manager, secretary or other officer shall also be deemed to be guilty of that offence and shall be liable to be proceeded against and punished accordingly.

**N. Cognizance of offences (Section 30)** : No Court shall take cognizance of any offence which means any act or omission made punishable by any law for the time being in force [vide





Section 3(38) of the General Clauses Act] punishable under this Act, save and except on complaint made by or under authority of the appropriate Government or an officer of the Government(not below the rank of A Regional Labour Commissioner in the case of an officer of the Central Government and not below the rank of Labour Commissioner in the case of an officer of the State Government) specially authorised in this behalf by that Government. No Court inferior to that of presidency magistrate or a magistrate of the first class try any offence punishable under this Act.

Thus it is evident that Section 30 makes it obligatory, on every Court before it takes cognizance of a complaint against any person for an offence under this Act that the necessary sanction is obtained or complaint is made under the authority of the appropriate Government or specified officer of the Central Government or the State Government.

**O. Protection of an action taken under the Act (Section 31) :** No suit, prosecution or other legal proceedings shall be taken against the Government or any officer or the Government for anything which is in good faith done or intended to be done in pursuance of this Act or any rule thereunder.

It may be noted that"... a thing shall 'be deemed to be done in good faith', where it is in fact done honestly, whether it is done negligently or not" - vide Section 3(22) of the General Clauses Act.

### **3.16 SPECIAL PROVISION WITH RESPECT TO BONUS LINKED WITH PRODUCTION OR PRODUCTIVITY (SECTION 31A)**

There may be an agreement or settlement by the employees with their employer for payment of an annual bonus linked with production or productivity in lieu of bonus based on profits, as is payable under the payment of Bonus Act. Section 31A of the Payment of Bonus Act, inserted by the Amendment Act, 1976, allows such an agreement/settlement made either before or after the commencement of this Amendment Act, 1976. Accordingly, when such an agreement has been entered into the employees are entitled to receive bonus as per terms of the agreement/settlement, subject to the following restrictions imposed by Section 31A :

- a. any such agreement/settlement whereby the employees relinquish their right to receive minimum bonus under Section 10, shall be null and void in so far as it purports to deprive the employees of the right of receiving minimum bonus.
- b. if the bonus payable under such agreement exceeds 20% of the salary/wages earned by the employees during the relevant accounting year, such employees are not entitled to the excess over 20% of salary/wages.

**Effect of laws and agreements inconsistent with the Act (Section 34) :** Subject to the provisions of Section 31A, the provision of the Act shall have effect notwithstanding



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inconsistent therewith contained in any other law for the time being in force or in the terms of any award, agreement or contract of service.

**Saving (Section 35)** : *Nothing contained in this Act shall be deemed to affect the provisions of the Coal Mines Provident Fund, Family Pension and Bonus Scheme Act, 1948 (46 of 1948) or of any scheme made thereunder.*

### 3.17 POWER OF EXEMPTION (SECTION 36)

Though the Act creates liability on the part of employer to pay the minimum bonus and confers a right to the workmen, as mentioned in Section 10, the obligation and right is subject to exemption under Section 36. If the appropriate Government having regard to the financial position and other relevant circumstances of any establishment or class of establishment is of opinion that it will not be in public interest to apply all or any of the provisions of this Act thereto, it may by notification in the Official Gazettee, exempt for such period as may be specified therein and subject to such conditions as it may think fit to impose, such establishment or class of establishments from all or any of the provisions of this Act.

There are two stages in Section 36.

- (1) The Government shall consider the financial position and other relevant circumstances of an establishment or class of establishment.
- (2) It should be of the opinion that it would not be in the public interest to apply all or any of the provisions of the Act.

The expression 'financial position' include loss suffered by the establishment during the accounting year. The expression 'other relevant circumstances' will include every consideration as to whether the workmen had principally contributed to the financial loss of the company during that accounting year.

If the bonus liability is negligible compared to loss suffered, company should not be relieved of liability to pay minimum bonus.

If the losses sustained by the employer is not due to any misconduct on the part of employees, the employer is liable to pay statutory minimum bonus. [*J.K. Chemicals Ltd. vs. Govt. of Maharashtra (1996) Bombay H.C.*].

### 3.18 POWER TO MAKE RULES (SECTION 38)

The Central Government may make rules for the purpose of carrying into effect the provisions of this Act. In particular, and without prejudice to the generality to the said rule-making power, such rules may provide for: (i) the authority for granting permission under the proviso to Section 2(1) (iii) relating to "accounting year", (ii) the preparation of registers, records and other



documents and the form and manner in which such registers, records and documents may be maintained under Section 26; (iii) the powers which may be exercised by an Inspector under Section 27(2)(e);(iv) any other matter which is to be, or may be, prescribed.

Every rule thus made has to be laid, soon after its making, before each House of Parliament while it is in session for a total period of 30 days, which may be comprised in one session or in two or more successive sessions. If before the expiry of the session immediately following the session or the successive sessions aforesaid, both House agree in making any modification in the rule, the modified version of the rule shall be operative; but if both House agree that the rule should not be made, it will not be operative. Such modification, or as the case may be. Annulment shall be without prejudice to the validity of anything previously done under that rule. In other words, any previously done act under that rule will remain unaffected by the said modification or annulment.

### **3.19 APPLICATION OF CERTAIN LAWS NOT BARRED (SECTION 39)**

Save as otherwise expressly provided the provisions of this Act shall be in addition to and not in derogation of the Industrial Disputes Act, or any corresponding law relating to investigation and settlement of industrial disputes in force in a State. This means that the application of certain relevant laws is not excluded.

### **3.20 SELF-EXAMINATION QUESTIONS**

**Choose the correct alternative**

1. The limit of salary of a worker entitled to get bonus is
  - (a) 5000/- per month.
  - (b) 3,500/- per month.
  - (c) 2,500/- per month.
  - (d) None of the above.
2. As per Section 38 of the Payment of Bonus Act, 1965 the power to make/frame rules is vested with
  - (a) Cabinet Secretary
  - (b) Ministry of Finance.
  - (c) Ministry of Labour.
  - (d) Central Government.



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3. Who is entitled to bonus under the Payment of Bonus Act, 1965
  - (a) A part time employee who is engaged on a regular basis.
  - (b) A probationer employee.
  - (c) A dismissed employee reinstated with back wages.
  - (d) All of the above.
4. Ordinarily, the Payment of Bonus Act, 1965 cannot apply on an establishment employing less than 20 persons.
  - (a) True.
  - (b) False.
5. Once the Bonus Act is applicable on an establishment, the Act will continue to apply even if the number of employees comes below the required minimum.
  - (a) True.
  - (b) False.

#### Short/Essay Type Questions

6. What kind of establishment falls within the purview of the Bonus Act ?
7. What is the significance of available surplus ?
8. What is the allocable surplus : (a) in case the employer is a foreign company, (b) in case of any other employer.
9. (a) For the purpose of the Bonus Act, who is an employee ?  
(b) Is an apprentice an employee under this Act ?
10. Who is the employer (a) Where the establishment is a factory, (b) where the establishment is not a factory ?
11. For the purpose of computation of bonus, does an establishment include its departments and branches ?
12. How are the gross profits computed (a) in the case of a banking company (b) in the case of any other company ?
13. How is direct tax payable by the employer to be calculated ?
14. Who is to pay bonus and to whom ?
15. Is there any disqualification for an employee to get bonus ?



16. What is the minimum bonus that is payable to (a) an employee ? (b) an employee under 15 years of age ?
17. (a) What is the maximum amount of bonus payable to an employee ?  
(b) Has this maximum amount any ceiling ?
18. With reference to what is the quantum of bonus payable calculated ?
19. For an accounting year, the allocable surplus exceeds the amount of maximum bonus. How would you treat this excess for the purpose of payment of bonus ?
20. What is the maximum amount of surplus that can be "set on" ?
21. Is adjustment of customary or interim bonus paid permissible against bonus payable under the Act ?
22. In an accounting year, an employer has sustained financial loss due to employee's misconduct. Is this amount of financial loss deductible from the amount of bonus payable to the employee ?
23. Is there any time-limit for bonus payment ?
24. Can the Bonus Act be applicable to an establishment in public sector ?
25. An amount of bonus is due to an employee under a settlement and it is not paid to him. What should he do for the recovery of the amount ?

**Practical Problems**

26. In an accounting year, a company to which the payment of Bonus Act, 1965 applies, suffered heavy losses. The Board of Directors of the said company decided not to give bonus to the employees. The employees of the company move to the Court for relief. Decide in the light of the provisions of the said Act whether the employees will get relief?
27. On 1<sup>st</sup> January, 2002, Aryan Textiles Ltd. agreed with the employees for payment of an annual bonus linked with production or productivity instead of bonus based on profits subject to the limit of 30% of their salary wages during the relevant accounting year. It was also agreed by the employees that they will not claim minimum bonus stated under Section 10 of the Payment of Bonus Act, 1965. As per the agreement the employees of Aryan Textiles Ltd claimed annual bonus linked with production or productivity in the relevant accounting year. On refusal of the company the employees of the company moved to the court for relief.
28. Decide in reference to the provisions of the payment of Bonus Act, 1965 whether the employees will get the relief? In spite of the aforesaid agreement whether the employees are still entitled to receive minimum bonus.

**Answers**

1. (b); 2. (d); 3. (d); 4. (a); 5. (a)

# CHAPTER 4

## THE EMPLOYEES' PROVIDENT FUNDS AND MISCELLANEOUS PROVISIONS ACT, 1952

### Learning Objectives

In this Chapter, the students come to know the

- ◆ Operations of Employees' Provident Fund Scheme
- ◆ Operations of the Employee's Pension Scheme
- ◆ Operations of the Deposit-Linked Insurance Scheme
- ◆ Obligations of the employer and employee towards PF accounts
- ◆ Other provisions of the Act such as powers of the Central Government, determinations of moneys due from employers etc.

Every worker wants security and maintenance for old age. The Provident Fund Act, 1925 deals with the provident funds relating to only Government, Railways and local authorities. So it was considered desirable to introduce a Provident Fund Scheme for the industrial workers.

### 4.1 INTRODUCTION

The Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (hereinafter referred to as 'the Act') extends to the whole of India except the State of Jammu & Kashmir. It seeks to provide for the institution of provident funds, family pension funds and deposit linked insurance funds for employees in factories and other establishments. The Act is at present applicable to 173 industries and classes of establishments of Schedule I.

Subject to the exceptions contained in Section 16 (which we shall discuss later on), this Act applies to the following entities, namely :

- (a) every establishment which is a factory engaged in any industry specified in Schedule I and in which 20 or more persons are employed ; and
- (b) any other establishment which employs 20 or more persons or class of such establishments which the Central Government may, by notification in Official Gazette specify in the behalf.



However, the Central Government may, after giving not less than 2 months' notice of its intention to do so, apply the provisions of this Act to any establishment with less than 20 persons in the employment.

Notwithstanding anything mentioned above or in Sub-section (1) of Section 16, where it appears to the Central Provident Fund Commissioner, whether on an application made to him in this behalf or otherwise, that the employer and the majority of employees in relation to any establishment, have agreed that the provisions of this Act should be made applicable to the establishment, he may, by notification in the Official, Gazette, apply the provision of this Act to the establishment on and from the date of such agreement or from any subsequent date specified in such agreement.

An establishment to which this Act applies must continue to be governed by this Act, even if the number of persons employed therein falls at any time below 20.

#### **4.2 DEFINITIONS (SECTION 2)**

In this Act, unless the context otherwise requires :

(a) "*Appropriate Government*" means :

- (i) in relation to an establishment belonging to, or under the control of Central Government or in relation to an establishment connected with 'a railway' company, a major port, a mine or an oilfield or a controlled industry, or in relation to an establishment having departments or branches in more than one State, the Central Government ; and
- (ii) in relation to any other establishment, the State Government.

(b) "*Basic wages*" means all emoluments which are earned by an employee while on duty or on duty or on leave or on holidays with wages in either case in accordance with the terms of the contract of employment and which are paid or payable in cash to him, but does not include:

- (i) the cash value of any food concessions ;
- (ii) any dearness allowance (that is to say all cash payments, by whatever name called, paid to an employee on account of rise in the cost of living), house rent allowance, overtime allowance, bonus, commission or pay and other similar allowance payable to the employee in respect of his employment or of work done in such employment ; or
- (iii) any presents made by the employer.

(e) "*Employer*" means :

- (i) in relation to an establishment which is a factory, the owner or occupier of the factory including the agent of such owner or occupier, the legal representative of a deceased owner or occupier and where a person has been named as manager of the factory under



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- clause (f) of Sub-section (l) of Section 7 of the Factories Act, 1948 the person so named ;  
and
- (ii) in relation to any other establishment, the person who, or the authority which, has ultimate control over the affairs of the establishment, and where the said affairs are entrusted to a manager or managing director, such manager, managing director or managing agent.
  - (f) "*Employee*" means any person who is employed for wages in any kind of work, manual or otherwise, in or in connection with work of an establishment, and who gets his wages directly or indirectly from the employer, and includes any person, (i) employed by or through a contractor in or in connection with the work of the establishment ; (ii) engaged as an apprentice, not being an apprentice engaged under the Apprentice Act, 1961 (52 of 1961), or under the standing orders of the establishment.
  - (ff) "*Exempted employee*" means an employee to whom a Scheme would, but for the exemption granted under Section 17, have applied.
  - (fff) "*Exempted establishment*" means an establishment in respect of which an exemption has been granted under Section 17 from the operation of all or any of the provisions of any Scheme, whether such exemption has been granted to the establishment as such or to any person or class of persons employed therein.
  - (g) "*Factory*" means any premises, including the precincts thereof, in any part of which a manufacturing process is being carried on or is ordinarily so carried on, whether with the aid of power or without the aid of power.
  - (i) "*Industry*" means an industry specified in Schedule I, and includes any other industry added to the Schedule by notification under Section 4.
  - (ie) "*Manufacture*" or "*Manufacturing process*" means any process for making, altering, repairing, ornamenting, finishing, packing, washing, cleaning, breaking up, demolishing, otherwise treating or adapting any, article or substance with a view to its use, sale, transport, delivery or disposal.
  - (k) "*Occupier of a factory*" means the person who has ultimate control over the affairs of the factory and where the said affairs are entrusted to a managing agent, such agent shall be deemed to be the occupier of the factory.

**Establishment to include all departments and branches (Section 2A) :** If an establishment consists of different departments or has branches whether situated in the same place or in different places, all such departments or branches shall be treated as parts of the same establishment.

**Power to apply the Act to an establishment which has a common Provident Fund with another establishment (Section 3) :** When an establishment covered by this Act has a





common Provident Fund with another establishment immediately before the Act came into force, the Central Government has the power to direct through a notification in the Official Gazette, that the provisions of this Act shall also apply to that another establishment.

The Central Government has also the power, by virtue of Section 4, to add to Schedule I any other industry in respect of the employees whereof it is of the opinion that a provident

fund scheme should be framed under this Act. Thereupon, the industry so added must be deemed to be an industry specified in Schedule I for the purposes of this Act. The addition is to be made through a notification in the Official Gazette and the notification is required to be laid before Parliament as soon as possible after issue.

### **4.3 EMPLOYEES' PROVIDENT FUND SCHEME (SECTION 5)**

The Central Government may, by notification in the Official Gazette, frame a scheme to be called Employees' Provident Fund Scheme for the employees or class of employees of establishments to which the Act applies. It may also specify the establishments or class of establishments to which the said scheme is to apply. As soon as may be after the framing of scheme, a Fund must be established in accordance with provisions of this Act and the Scheme.

The fund shall vest in and be administered by Central Board of trustees constituted under Section 5A by the Central Government (to be discussed later on).

Subject to the provisions of the Act, the Scheme framed under Section 5(1) may provide for all or any of the matters specified in Schedule II [Section 5 (1B)].

#### **Schedule II [See Section 5(1B)]**

##### **Matters for which provision may be made in a Scheme**

1. The employees or class of employees who shall join the Fund and the conditions under which employees may be exempted from joining the Fund or from making any contribution.
2. The time and manner in which contribution shall be made to the fund by employers and by, or on behalf of employees (whether employed by him directly or by or through a contractor) the contribution which an employee may, if he so desires, make under Section 6, and the manner in which such contributions may be recovered.
- 2-A The manner in which employees' contributions may be recovered by contractors from employees employed by or through such contractors.
3. The payment by the employer of such sums of money as may be necessary to meet the cost of administering the Fund and the rate at which and the manner in which the payment shall be made.



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4. The constitution of any Committee for assisting any Board of Trustees.
5. The opening of regional and other offices of any Board of Trustees.
6. The manner in which accounts shall be kept, the investment of moneys belonging to the fund in accordance with any directions issued or conditions specified by the Central Government, the preparation of the budget, the audit of accounts and the submission of reports to the Central Government or to any specified State Government.
7. The conditions under which withdrawal from the Fund may be permitted and any deduction or forfeiture may be made and the maximum amount of such deduction or forfeiture.
8. The fixation, by the Central Government in consultation with the Board of Trustees concerned, of the rate of interest payable to members.
9. The form in which an employee shall furnish particulars about himself and his family whenever required.
10. The nomination of person to receive the amount standing to the credit of member after his death and the cancellation or variation of such nomination.
11. The registers and records to be maintained with respect to employees and the returns to be furnished by employees (or contractors).
12. The form or design or any identity card, token or disc for the purpose of identifying an employee, and for the issue, custody and replacement thereof.
13. The fees to be levied for any of the purposes specified in this Schedule.
14. The contraventions or defaults which shall be punishable under Sub-section (2) or Section 14.
15. The further powers, if any, which may be exercised by inspectors.
16. The manner in which accumulations in any existing provident fund shall be transferred to the Fund under Section 15 and the mode of valuation of any assets which may be transferred by the employers in this behalf.
17. The conditions under which a member may be permitted to pay premium on life insurance from the Fund.
18. Any other matter which is to be provided for in the Scheme or which may be necessary or proper for the purpose of implementing the Scheme.

The above mentioned Scheme may provide that any of its provisions shall be effective either prospectively or retrospectively on such date as may be specified in this behalf in the Scheme.



**Central Board (Section 5A)** : The Central Government may, by notification in the Official Gazette, constitute with effect from such date as may be specified therein, a Board of Trustees for the territories to which this Act extends (hereinafter in this Act referred to as the Central Board) consisting of the following persons, as members, namely :

- 1 (a) a Chairman and a Vice-Chairman to be appointed by the Central Government;  
(aa) the Central Provident Fund Commissioner, *ex-officio*;  
(b) not more than fifteen persons appointed by the Central Government from amongst its officials;  
(c) not more than fifteen persons, representing Governments of such State as the Central Government may specify in this behalf, appointed by the Central Government;  
(d) ten persons representing employers of the establishments to which the Scheme applies, appointed by the Central Government after consultation with such organisations of employers as may be recognised by the Central Government in this behalf; and  
(e) ten persons representing employees in the establishments to which the Scheme applies, appointed by the Central Government after consultation with such organisations of employees as may be recognised by the Central Government in this behalf.
2. The terms and conditions subject to which a member of the Central Board may be appointed and the time, place and procedure of the meetings of the Central Board shall be such as may be provided for in the Scheme.
3. The Central Board, shall [subject to the provisions of Section 6A (and Section 6C)] administer the fund vested in it in such manner as may be specified in the Scheme.
4. The Central Board shall perform such other functions as it may be required to perform by or under any provisions of the Scheme (the Family Pension Scheme and the Insurance Scheme).
5. The Central Board shall maintain proper accounts of its income and expenditure in such form and in such manner as the Central Government may, after consultation with the Comptroller and Auditor-General of India, specify in the Scheme.
6. The accounts of the Central Board shall be audited annually by the Comptroller and Auditor-General of India and any expenditure incurred by him in connection with such audit shall be payable by the Central Board to the Comptroller and Auditor-General of India.



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7. The Comptroller and Auditor-General of India and any person appointed by him in connection with the audit of the accounts of the Central Board shall have the same rights and privileges and authority in connection with such audit as the Comptroller and Auditor-General has, in connection with the audit of Government accounts and, in particular, shall have the right to demand the production of books, accounts, connected vouchers, documents and papers and inspect any of the offices of the Central Board.
8. The accounts of the Central Board as certified by the Comptroller and Auditor-General of India or any other person appointed by him in his behalf together with audit report thereupon shall be forwarded to the Central Board which shall forward the same to the Central Government alongwith its comments on the report of the Comptroller and Auditor-General.
9. It shall be the duty of the Central Board to submit also to the Central Government an annual report of its work and activities and the Central Government shall cause a copy of the annual report, the audited accounts together with the report of the Comptroller and Auditor-General of India and the comments of the Central Board thereon to be laid before each House of Parliament.

**Executive Committee (Section 5AA)** : The Central Government may, by notification in the Official Gazette, constitute, with effect from such date as may be specified therein, an Executive Committee to assist the Central Board in the performance of its functions.

The Executive committee shall consist of the following persons as members, namely :

- (a) a Chairman appointed by the Central Government from amongst the members of the Central Board;
- (b) two persons appointed by the Central Government from amongst the persons referred to in clause (b) of Sub-section (1) of Section 5A.
- (c) three persons appointed by the Central Government from amongst the persons referred to in clause (c) of Sub-section (1) of Section 5A.
- (d) three persons representing the employers elected by the Central Board from amongst the persons referred to in clause (d) of Sub-section (1) of Section 5A.
- (e) three persons representing the employees elected by the Central Board from amongst the persons referred to in clause (e) of Sub-section (1) of Section 5A.
- (f) the Central Provident Fund Commissioner, *ex-officio*.

The terms and conditions subject to which a member of the Central Board may be appointed or elected to the Executive Committee and the time, place and procedure of the meetings of the Executive Committee shall be such as may be provided for in the Scheme.

**State Board (Section 5B)** : It was stated above that the Central Government may constitute Trustees for a State Board in consultation with the Government of that State. The State Board



shall exercise such powers and perform such duties as the Central Government may assign to it from time to time.

**Board of Trustees to be body corporate (Section 5C)** : The above Central Board or the State Board shall be a body corporate under the name specified in the notification constituting it having perpetual succession and a common seal.

**Appointment of Officers (Section 5D)** : The Central Government shall appoint a Central Provident Fund Commissioner who shall be the Chief Executive Officer of the Central Board. He shall be subject to the general control and superintendence of that Board.

The Central Government may also appoint a Financial Adviser and Chief Accounts Officer to assist the Central Provident Fund Commissioner in the discharge of his duties.

The Central Board may appoint subject to the maximum scale of pay, as may be specified in the Scheme as many Additional Central Provident Fund Commissioners, Deputy Provident Fund Commissioners, Regional Provident Fund Commissioners and Assistant Provident Fund Commissioners as it may consider necessary for the efficient administration of the Scheme.

The aforesaid appointments carrying a scale of pay equivalent to Group 'A' or Group 'B' posts under the Central Government must be made only after consultations with Union Public Service Commission. However, such consultation is unnecessary in regard to any such appointment :

(a) for a period not exceeding one year; or (b) if the person to be appointed is at the time of his appointment : (i) an I.A.S. Officer, or (ii) in the Service of the Central Government or State Government or the Central Board in Group A or Group B post.

The State Board may, with the approval of the State Government concerned appoint such staff as it may consider necessary.

The method of recruitment, salary and allowances, discipline and other conditions of service of the aforesaid Commissioner and the Financial Adviser and Chief Accounts Officer shall be such as may be prescribed by the Central Government. Such salary and allowances must be paid out of the Fund.

The method of recruitment, salary and allowances, discipline and other conditions of service of the Additional Central Provident Fund Commissioner, Deputy Provident Fund Commissioner, Regional Provident Fund Commissioner, Assistant Provident Fund Commissioner, and other officers and employees of the Central Board shall be such as may be specified by the Central Board in accordance with the rules and orders applicable to the officers and employees of the Central Government drawing corresponding scales of pay.

Provided that where the Central Board is of the opinion that it is necessary to make a departure from the said rules or orders in respect of any of the matters aforesaid, it shall obtain the prior approval of the Central Government.



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In determining the corresponding scales of pay of officers and employees under clause (a), the Central Board shall have regard to the educational qualifications, method of recruitment, duties and responsibilities of such officers and employees under the Central Government and in case of any doubt, the Central Board shall refer the matter to the Central Government whose decision thereon shall be final.

**Acts and proceedings of the Central Board or its Executive Committee or State Board not to be invalidated on certain grounds (Section 5DD) :** No Act done or proceeding taken by the Central Board or the Executive Committee constituted under Section 5AA or the State Board shall be questioned on the ground merely of the existence of any vacancy in, or any defect in the constitution of the Central Board or the Executive Committee or the State Board, as the case may be.

**Delegation (Section 5E) :** The Central Board may delegate to the Executive Committee or to the Chairman of the Board or to any of its Officers and a State Board may delegate to its Chairman or to any of its Officers such of its powers and functions under this Act as it may deem necessary for the efficient administration of the Scheme. This delegation may be subject to such conditions and limitations, if any, as the said Board may specify.

**Contribution and matters which may be provided for in Scheme (Section 6) :** The employees' contribution to the fund shall be 10%\* of the basic wage, dearness allowance and retaining allowance (if any). An employee can at his will contribute beyond 10%\* if the scheme makes provision therefor subject to the conditions that the employer shall not be under an obligation to pay any contribution over and above his contribution payable under this Section. This rule will prevail irrespective of whether the employer employs the person directly or through contractor.

According to the first proviso to the Section the Central Government may, however, raise the aforesaid percentage of contribution from 10%\* to 12% in respect of any establishments. It may do so after making such enquiries as it deems fit.

*\*[As amended by E.P.F. & M.P. (Amendment) Act, 1988.]*

According to the second proviso if the amount of any contribution involves fraction of a rupee, the Scheme may provide for rounding off such fraction to the nearest rupee, half of a rupee or a quarter of rupee.

It may be noted that the dearness allowance mentioned above shall be deemed to include also the cash value of any food concession allowed to the employees; also that "retaining allowance" means an allowance payable for the time being to an employee of any factory or other establishment during any period in which the establishment is not working for retaining his service.



*Note:* Students may note that in view of the Employees' Provident Funds and Miscellaneous Provisions (Amendment) Act, 1996 coming into force from 16th November, 1995, some structural changes have been introduced in the Act. The Amendment Act, 1996 was assented by the President of India on 16th August, 1996. With reference to the Pension Scheme, a new Section 6A has been substituted for earlier Sections 6A and 6B. Henceforth for the words "family pension" the word "pension" shall be substituted.

#### **4.4 EMPLOYEES' PENSION SCHEME 1995 (SECTION 6A)**

Before the introduction of this new Pension Scheme, social security measures available to employees were inadequate for they did not provide for monthly pension to members on superannuation, widow pension on death of employees with representation, children pension or disablement benefits. To fill the lacunae in the old scheme, the Employees Provident Funds and Miscellaneous Provisions (Amendment) Ordinance 1995 was promulgated by the President of India, dated 5-1-1996 amending the Act w.e.f. 16-11-1995 conferring power on the Central Government to frame a suitable scheme incorporating provisions for superannuation pension, retiring pensions permanent disablement pension to employees and widow or widow's pension, children pension or orphan pension payable to beneficiaries of such employees in the event of death. The Amendment Ordinance, 1995 was repealed by Second Ordinance of 1996, which was again repealed by the Third Ordinance of 1996, which was subsequently repealed by the E.P.F. & M.P. (Amendment) Act, 1996 with retrospective effect from 16-11-1995. The scheme shall apply to all employees who were covered by the Family Pension Scheme and also to new members.

- (1) The Scheme called the Employees' Pension Scheme is to provide for,—
  - (a) superannuation pension, retiring pension or permanent total disablement pension to the employees of any establishment or class of establishments to which this Act applies; and
  - (b) widow or widower's pension, children pension or orphan pension payable to the beneficiaries of such employees.
- (2) Notwithstanding anything contained in Section 6, there shall be established, as soon as may be after framing of the Pension Scheme, a Pension Fund into which there shall be paid, from time to time, in respect of every employee who is a member of the Pension Scheme:
  - (a) such sums from the employer's contribution under Section 6, not exceeding eight and one-third per cent of the basic wages, dearness allowance and retaining allowance, if any, of the concerned employees, as may be specified in the Pension Scheme;
  - (b) such sums as are payable by the employers of exempted establishments under Sub-section (6) of Section 17;



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- (c) the net assets of the Employees' Family Pension Fund as on the date of the establishment of the Pension Fund;
  - (d) such sums as the Central Government may, after due appropriation by Parliament by law in this behalf, specify.
- (3) On the establishment of the Pension Fund, the Family Pension Scheme (hereinafter referred to as the ceased scheme) shall cease to operate and all assets of the ceased scheme shall vest in and shall stand transferred to, and all liabilities under the ceased scheme shall be enforceable against, the Pension Fund and the beneficiaries under the ceased scheme shall be entitled to draw the benefits, not less than the benefits they were entitled to under the ceased scheme, from the Pension Fund.

The Pension Scheme may provide for all or any of the following matters specified in Schedule III.

**Matters for which Provision may be made in the Pension Scheme (Schedule III)**

1. The employees or class of employees to whom the Pension Scheme shall apply.
2. The time within which the employees who are not members of the Family Pension Scheme under Section 6A as it stood before the commencement of the Employees' Provident Funds and Miscellaneous Provisions (Amendment) Ordinance, 1995 (hereinafter, in this Schedule, referred to as the amending Ordinance) shall opt for the Pension Scheme.
3. The portion of employers' contribution to the Provident Fund which shall be credited to the Pension Fund and the manner in which it is credited.
4. The minimum qualifying service for being eligible for pension and the manner in which the employees may be granted the benefit of their past service under Section 6A as it stood before the commencement of the amending Ordinance.
5. The regulation of the manner in which, the period of service for which no contribution is received.
6. The manner in which employees' interest will be protected against default in payment of contribution by the employer.
7. The manner in which the accounts of the pensions fund shall be kept and investment of moneys belonging to pension fund to be made subject to such pattern of investment as may be determined by the Central Government.
8. The form in which an employee shall furnish particulars about himself and the members of his family whenever required.





9. The forms, registers and records to be maintained in respect of employees, required for the administration of the Pension Scheme.
10. The scale of pension and pensionary benefits and the conditions relating to grant of such benefits of the employees.
11. The manner in which the exempted establishments have to pay contribution towards the Pension Scheme and the submission of return relating thereto.
12. The mode of disbursement of pension and arrangements to be entered into with such disbursing agencies as may be specified for the purpose.
13. The manner in which the expenses for administering the Pension Scheme will be met from the income of the Pension Fund.
14. Any other matter which is to be provided for in the Pension Scheme or which may be, necessary or proper for the purpose of implementation of the pension Scheme.”

#### **Employees Pension Fund**

(1) From and out of the contributions payable by the employer in each month under Section 6 of the Act or under the rules of the Provident Fund of the establishment which is exempted either under clauses (a) and (b) of Sub-section (1) of Section 17 of the Act or whose employees are exempted under either paragraph 27 or paragraph 27A of the Employees' Pension Fund Scheme, 1952 a part of contribution representing 8.33 per cent of the Employees' pay shall be remitted by the employer to the Employees' Pension Fund within fifteen days of the close of every month by a separate bank draft or cheque on account of the Employees' Pension Fund contribution in such manner as may be specified in this behalf by the Commissioner. The cost of the remittance, if any, shall be borne by the employer.

(2) The Central Government shall also contribute at the rate of 1.16 per cent of the pay of the members of the Employees' Pension Scheme and credit the contribution to the Employees' Pension Fund :

Provided that where the pay of the member exceeds rupees five thousand per month, the contribution payable by the employer and the Central Government be limited to the amount payable on his pay of rupees five thousand only.

(3) Each contribution payable under sub-paragraphs (1) and (2) shall be calculated to the nearest rupee, fifty paise or more to be counted as the next higher rupee and fraction of a rupee less than fifty paise to be ignored.

(4) The net assets of the Family Pension Scheme, 1971 shall vest in and stand transferred to the Employees' Pension Fund.



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### Payment of contribution

- (1) The employer shall pay the contribution payable to the Employees' Pension Fund in respect of the member of the Employees' Pension Fund employed by him directly or by or through a contractor.
- (2) It shall be the responsibility of the principal employer to pay the contributions payable to the Employees' Pension Fund by himself in respect of the employees directly employed by him and also in respect of the employees employed by or through a contractor.

### 4.5 EMPLOYEES' DEPOSIT-LINKED INSURANCE SCHEME

Section 6C of the Employees' Provident Fund Act provides (Amendment Act of 1976), that the Central Government may, by notification in the Official Gazette, frame a scheme to be called the Employees' Deposit-linked Insurance Scheme for the purpose of providing life insurance benefits to the employees of any establishment or class of establishments to which the Act applies [Section 6C(2)].

The Central Government under the Act (Employees' Provident Funds and Miscellaneous Provisions Act, 1952) framed the Employees' Deposit-linked Insurance Scheme, 1976 *vide* its Notification dated 28th July, 1976. The Insurance Scheme came into force on the 1st day of August, 1976.

Soon after the framing of the above scheme, there was established a Deposit-linked Insurance Fund (called Insurance Fund). The employer shall pay into the fund from time to time in respect of his employees an amount not exceeding 1% of the aggregate of the basic wages, dearness allowance and retaining allowance (if any) as the Central Government may, by notification in the Official Gazette, specify [Section 6(2)]. He shall also pay into the fund such further sum of money not exceeding 1/4th of the contribution which he is required to make as the Central Government may, from time to time, determine. This payment is required to be made to meet all the expenses in connection with the administration of the Employees' Deposit-linked Insurance Scheme other than the expenses towards the cost of any benefits provided by or under that scheme [Section 6C(4)(a)].

The Insurance Fund shall vest in the Central Board and be administered by it in such manner as may be specified in the Insurance Scheme [Section 6C(5)]. The Insurance Scheme may provide for all or any of the matters specified in Schedule IV [Section 6C(7)].

The Insurance Scheme may provide that any of its provisions shall take effect either prospectively or retrospectively on such date as may be specified in this behalf in that Scheme. [Section 6C(7)].

The Central Government may by notification in the Official Gazette add to, amend or vary either prospectively or retrospectively, the Scheme (Section 7).



Notification : August 26, 1997.

The Provident Fund claims complete in all respects submitted along with the requisite documents shall be settled and the benefit amount paid to the beneficiaries within 30 days from the date of its receipt by the Commissioner. If there is any deficiency in the claim, the same shall be recorded in writing and communicated to the applicant within 30 days from the date of receipt of such application. In case the Commissioner fails without sufficient cause to settle a claim complete in all respects within 30 days, the Commissioner shall be liable for the delay beyond the said period and penal interest at the rate of 12% per annum may be charged on the benefit amount and the same may be deducted from the salary of the Commissioner.

Certain amendments were made in this scheme in September, 1992 to provide for periodical submission of certain returns by the employer and for punishment for failure to comply with the same.

#### **4.6 OTHER PROVISIONS**

**Determination of moneys due from employer (Section 7A)** : Section 7A of the Act gives power to the authorities mentioned therein *i.e.*, Central PF Commissioner, Deputy PF Commissioner or any Regional PF Commissioner to determine the amount due from an employer under the provisions of the Act and the Scheme. This involves decisions on various points of quasi-judicial nature, *viz.*

- (i) amount due as contribution.
- (ii) the date from which the same is due.
- (iii) the administrative charges.
- (iv) amount to be transferred under Sections 15 or 17 of the Act.
- (v) any other charges payable by the employer under the Act.

The authorities have been given power to conduct such enquiry as may be deemed necessary and for this they have been granted powers as are vested in a Court.

An order must not be made unless the employer concerned is given a reasonable opportunity of representing his case (Sub-section 3).

Where the employer, employee or any other person required to attend the inquiry under Sub-section (1) fails to attend such inquiry without assigning any valid reason or fails to produce any document or to file any report or return when called upon to do so, the officer conducting the inquiry may decide the applicability of the Act or determine the amount due from any employer, as the case may be, on the basis of the evidence adduced during such inquiry and other documents available on record.



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Where an order under Sub-section (1) is passed against an employer *ex parte*, he may, within three months from the date of communication of such order, apply to the officer for setting aside such order and if he satisfies the officer that the show cause notice was not duly served or that he was prevented by any sufficient cause from appearing when the inquiry was held, the officer shall make an order setting aside his earlier order and shall appoint a date for proceeding with the inquiry.

No such order shall be set aside merely on the ground that there has been an irregularity in the service of show cause notice if the officer is satisfied that the employer had notice of the date of hearing and had sufficient time to appear before the officer. However, where an appeal has been preferred under this Act against an order passed *ex parte* and such appeal has been disposed of otherwise than on the ground that appellant has withdrawn the appeal, no application shall lie under this Sub-section for setting aside the *ex parte* order [Section 7A(4)].

No order passed under this section shall be set aside on any application under Sub-section (4), under notice thereof has been served on the opposite party.

Thus, the scope of enquiry and manner of conducting the enquiry is at the discretion of the authority. As the proceedings shall be quasi-judicial and shall vitally affect the rights of the parties the principle of natural justice must be strictly followed in deciding the dispute in the proceeding. The employer is entitled to a reasonable opportunity of being heard. The order made under this section shall be final and will not be called in question in any Court of law.

**Review of order passed under Section 7A (Section 7B)**

(1) Any person aggrieved by an order made under Sub-section (1) of Section 7A, but from which no appeal has been preferred under this Act, and who, from the discovery of new and important matter or evidence which, after the exercise of due diligence was not within his knowledge or could not be produced by him at the time when the order was made, or on account of some mistake or error apparent on the face of the record or for any other sufficient reason, desires to obtain a review of such order, may apply for a review of that order, to the officer who passed the order.

Such officer may also on his own motion review his order if he is satisfied that it is necessary so to do on any such ground.

Every application for the aforesaid review shall be filed in such form and manner and within such time as may be specified in the Scheme; and

Where it appears to the officer receiving an application for review that there is no sufficient ground for a review, he shall reject the application.



Notice that :

- (a) no such application shall be granted without previous notice to all the parties before him to enable them to appear and be heard in support of the order in respect of which a review is applied for, and
- (b) no such application shall be granted on the ground of discovery of new matter or evidence which the applicant alleges was not within his knowledge or could not be produced by him when the order was made, without proof of such allegation.

No appeal shall lie against the order of the officer rejecting an application for review, but an appeal under this Act shall lie against an order passed under review as if the order passed under review were the original order passed by him under Section 7A.

**Determination of escaped amount (Section 7C) :** Where an order determining the amount due from an employer under Section 7A or Section 7B has been passed and if the officer who passed the order :

- (a) has reason to believe that by reason of the omission or failure on the part of the employer to make any document or report available, or to disclose, fully and truly, all material facts necessary for determining the correct amount due from the employer, any amount so due from such employer for any period has escaped his notice;
- (b) has, in consequence of information in his possession, reason to believe that any amount to be determined under Section 7A or Section 7B has escaped from his determination for any period notwithstanding that there has been no omission or failure as mentioned in clause (a) on the part of the employer.

He may, within a period of five years from the date of communication of the order passed under Section 7A or Section 7B, re-open the case and pass appropriate order re-determining the amount due from the employer in accordance with provisions of this Act.

However, no order re-determining the amount due from the employer shall be passed under this section unless the employer is given a reasonable opportunity of representing his case.

**Employees' Provident Fund Appellate Tribunal (Section 7D) :** The Central Government may, by notification in the Official Gazette, constitute one or more Appellate Tribunals to be known as the Employees' Provident Funds Appellate Tribunal to exercise the powers and discharge the functions conferred on such Tribunal by this Act and every such Tribunal shall have jurisdiction in respect of establishments situated in such area as may be specified in the notification constituting the Tribunal.

A Tribunal shall consist of one person only to be appointed by the Central Government.

A person shall not be qualified for appointment as the Presiding Officer of a Tribunal (hereinafter referred to as the Presiding Officer), unless he is, or has been, or is qualified to be



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a Judge of a High Court; or a District Judge.

Sections 7-E to 7-I provides for the terms and conditions of service of the Presiding Officer and other Staff of the Appellate Tribunal.

**Procedure of Tribunals (Section 7J) :** A Tribunal shall have power to regulate its own procedure in all matters arising out of the exercise of its powers or of the discharge of its functions including the places at which the Tribunal shall have its sittings.

A Tribunal shall, for the purpose of discharging its functions, have all the powers which are vested in the officers referred to in Section 7A and any proceeding before the Tribunal shall be deemed to be a judicial proceeding within the meaning of Sections 193 and 228, and for the purpose of Section 196, of the Indian Penal Code and the Tribunal shall be deemed to be a Civil Court for all the purpose of Section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973.

**Right of appellant to take assistance of legal practitioner and of Government, etc. to appoint presenting officers (Section 7-K) :** A person preferring an appeal to a Tribunal under this Act may either appear in person or take the assistance of a legal practitioner of his choice to present his case before the Tribunal.

The Central Government or a State Government or any other authority under this act may authorise one or more legal practitioner or any of its officers to act as presenting officers and every person so authorised may present the case with respect to any appeal before a Tribunal.

**Orders of Tribunal (Section 7-L) :** A Tribunal may, after giving the parties to the appeal, an opportunity of being heard, pass such orders thereon as it thinks fit, confirming, modifying or annulling the order appealed against or may refer the case back to the authority which passed such order with such directions as the Tribunal may think fit, for a fresh adjudication or order, as the case may be, after taking additional evidence, if necessary.

A Tribunal may, at any time within five years from the date of its order, with a view to rectifying any mistake apparent from the record, amend any order passed by it under Sub-section (1) and shall make such amendment in the order if the mistake is brought to its notice by the parties to the appeal.

However, an amendment which has the effect of enhancing the amount due from, or otherwise, increasing the liability of, the employer shall not be made under this sub-section, unless the Tribunal has given notice to him of its intention to do so and has allowed him a reasonable opportunity of being heard. A Tribunal shall send a copy of every order passed under this section to the parties to the appeal. Any order made by a Tribunal finally disposing of an appeal shall not be questioned in any Court of law.

**Deposit of amount due on filing an appeal (Section 7-O) :** No appeal by the employer shall



be entertained by a Tribunal unless he has deposited with it seventy-five per cent of the amount due from him as determined by an officer referred to in Section 7A.

The Tribunal may, however, for reasons to be recorded in writing, waive or reduce the amount to be deposited under this section.

**Transfer of certain applications to Tribunals (Section 7-P)** : All applications which are pending before the Central Government under Section 19A, before its repeal shall stand transferred to a Tribunal exercising jurisdiction in respect of establishments in relation to which such applications had been made as if such applications were appeals preferred to the Tribunal.

**Interest payable by the employer (Section 7-Q)** : The employer shall be liable to pay simple interest at the rate of 12% per annum or at such higher rate as may be specified in the Scheme on any amount due from him under this Act from the date on which the amount has become so due till the date of its actual payment. However, the higher rate of interest specified in the Scheme cannot exceed the lending rate of interest charged by any scheduled bank.

**Mode of recovery of money due from employers (Section 8)** : Any amount due from such employer as is specified in Section 8 may, if the amount is in arrear, be recovered in the manner specified in Sections 8B to 8G. For order of demand under Section 8, it is necessary that there should be a determination of the amount due, if the liability is disputed. An order under Section 7A(3) is a condition precedent to the making of a demand under Section 8 [*A. T. Union (P.) Ltd. vs. RPF Commissioner*].

(i) **Recovery of moneys by employers and contractors (Section 8A)** : The amount of employers' and employees' contribution and any charges on the basis of such contribution for meeting the cost of administering the fund paid or payable by an employer in respect of an employee employed by or through a contractor may be recovered by such employer from the contractor. The recovery may be made by deduction from any amount payable by the Contractor. The contractor in his turn may recover from such employee the employee's contribution by deducting from the basic wage, dearness allowance, any retaining allowance (if any), payable to such employee. But the contractor cannot deduct the employer's contribution or the charges aforesaid from the total emoluments payable to the employee; nor can he otherwise recover such contribution or charges from such employee. This is true irrespective of whether there is any contract to the contrary.

(ii) **Issue of certificate to the Recovery officer (Section 8B)** : Where any amount is in arrear under Section 8, the authorised officer may issue to the Recovery Officer, a certificate under his signature specifying the amount of arrears and the Recovery Officer on receipt of such certificate, shall proceed to recover the amount specified therein from the establishment or as the case may be, the employer by one or more of the modes mentioned below :



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- (a) attachment and sale of the movable or immovable property of the establishment or, as the case may be, the employer;
- (b) arrest of the employer and his detention in prison;
- (c) appointing a receiver for the management of the movable or immovable properties of the establishment or, as the case may be, the employer.

The attachment and sale of any property under this section shall, however, be first effected against the properties of the establishment and where such attachment and sale is insufficient for recovering the whole of the amount of arrears specified in the certificate, the Recovery Officer may take such proceedings against the property of the employer for recovery of the whole or any part of such arrears.

**(iii) Recovery Officer to whom certificate is to be forwarded (Section 8C) :** The authorised officer may forward the certificate referred to in Section 8B to the Recovery Officer within whose jurisdiction the employer :

- (a) carries on his business or profession or within whose jurisdiction the principal place of the establishment is situate; or
- (b) resides or any movable or immovable property of the establishment or the employer is situate.

Where an establishment or the employer has property within the jurisdiction of more than one Recovery Officer and the Recovery officer to whom a certificate is sent by the authorised officer :

- (a) is not able to recover the entire amount by the sale of the property, movable or immovable, within his jurisdiction; or
- (b) is of the opinion that, for the purpose of expediting or securing the recovery of the whole or any part of the amount, it is necessary so to do, he may send the certificate or, where only a part of the amount is to be recovered, a copy of the certificate in the prescribed manner and specifying the amount to be recovered to the Recovery Officer within whose jurisdiction the establishment or the employer has property or the employer resides, and thereupon that Recovery Officer shall also proceed to recover the amount due under this section as if the certificate or the copy thereof had been the certificate sent to him by the authorised officer.

**(iv) Stay of proceedings under certificate and amendment or withdrawal thereof (Section 8E) :** Notwithstanding that a certificate has been issued to the Recovery officer for the recovery of any amount, the authorised officer may grant time for the payment of the amount and thereupon the Recovery Officer shall stay the proceeding until the expiry of the time so granted.





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Where a certificate for the recovery of amount has been issued, the authorised officer shall keep the Recovery officer informed of any amount paid or time granted for payment, subsequent to the issue of such certificate.

Where the order giving rise to a demand of amount for which a certificate for recovery has been issued has been modified in appeal or other proceeding under this Act, and, as a consequence thereof, the demand is reduced but the order is the subject-matter of further proceeding under this Act, the authorised officer shall stay the recovery of such part of the amount of the certificate as pertains to the said reduction for the period for which the appeal or other proceeding remains pending.

Where a certificate for the recovery of amount has been issued and subsequently the amount of the outstanding demand is reduced as a result of an appeal or other proceeding under this Act, the authorised officer shall, when the order which was the subject-matter of such appeal or other proceeding has become final and conclusive, amend the certificate or withdraw as the case may be.

(v) **Other modes of recovery (Section 8F)** : Notwithstanding the issue of a certificate to the Recovery Officer under Section 8B, the Central Provident Fund Commissioner or any officer authorised by the Central Board may recover the amount by any one or more of the modes provided in this section.

If any amount is due from any person to any employer who is in arrears, the Central Provident Fund Commissioner or any other person authorised by the Central Board in this behalf may require such person to deduct from the said amount the arrears due from such employer under this Act, and such person shall comply with any such requisition and shall pay the sum so deducted to the credit of the Central Provident Fund Commissioner or the officer so authorised, as the case may be :

Nothing in this sub-section shall, however, apply to any part of the amount exempt from attachment in execution of a decree of a Civil Court under Section 60 of the Code of Civil Procedure, 1908 (5 of 1908).

The Central Provident Fund Commissioner or any other officer authorised by the Central Board in this behalf may, at any time or from time to time, by notice in writing, require any person from whom money is due or may become due to the employer or, as the case may be, the establishment or any person who holds or may subsequently hold money for or on account of the employer or as the case may be, the establishment, to pay to the Central Provident Fund Commissioner either forthwith upon the money becoming due or being held or at or within the time specified in the notice (not being before the money becomes due or is held) so much of the money as is sufficient to pay the amount due from the employer in respect of arrears or the whole of the money when it is equal to or less than that amount.



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If the person to whom a notice under this sub-section is sent fails to make payment in pursuance thereof to the Central Provident Fund Commissioner or the officer so authorised, he shall be deemed to be an employer in default in respect of the amount specified in the notice and further proceedings may be taken against him for the realisation of the amount as if it were an arrear due from him in the manner provided in Sections 8B to 8E and the notice shall have the same effect as an attachment of a debt by the Recovery Officer in exercise of his powers under Section 8B.

The Central Provident Fund Commissioner or the officer authorised by the Central Board in this behalf may apply to the Court in whose custody there is money belonging to the employer for payment to him of the entire amount of such money, or if it is more than the amount due, an amount sufficient to discharge the amount due.

(vi) **Application of certain provisions of Income-tax Act (Section 8-G)** : The provisions of the Second and Third Schedules to the Income-tax Act, 1961 and the tax (Certificate Proceedings) Rules, 1962, as in force, from time to time, shall apply with necessary modifications as if the said provisions and the rules referred to the arrears of the amount mentioned in Section 8 of this Act instead of the income-tax.

However, any reference in the said provisions and the rules to the "assessee" shall be construed as a reference to an employer as defined in this "Act".

**Fund to be recognised under the Income-tax Act, 1961 (Section 9)** : For the purposes of Income-tax Act, 1961, the Fund shall be deemed to be a recognised Provident Fund. Even if any provision of the Scheme under which the Fund is established is repugnant to any of the provisions of the Income-tax Act in this regard, the provision of the Scheme remains effective and operative.

**Protection against attachment (Section 10)** : The amount standing to the credit of any member in the Fund or credit of any exempted employee in provident fund shall not in any way be capable of, being assigned or charged and shall not be liable to attachment under any decree or order of any Court in respect of any debt or liability incurred by the member or the exempted employee. Neither the Official Assignee appointed under the Presidency-Town Insolvency Act, 1909 nor any Receiver appointed under the Provincial Insolvency Act, 1920, shall be entitled to or have any claim on any such amount.

The amount standing to the credit of the aforesaid categories of persons at the time of their death and payable to their nominees under the Scheme or the rules vest in nominees. And the amount shall be free from any debt or other liability incurred by the deceased or the nominee before the death of the member or of the exempted employee and shall also not be liable to attachment under any decree or order of any Court.

**Priority of payment of contribution over other debts (Section 11)** : If the employer is adjudged an insolvent or if the employer is a company and an order for winding thereof has



been made, the amount due from the employer whether in respect of the employee's contribution or the employer's contribution must be included among the debts which are to be paid in priority to all other debts under Section 49 of the Presidency-Towns Insolvency Act, Section 61 of the Provincial Insolvency Act, Section 530 of the Companies Act, 1956, in the distribution of the property of the insolvent or the assets of the company. In other words, this payment will be a preferential payment provided the liability therefor has accrued before this order of adjudication or winding up is made.

**Employer not to reduce wage etc. (Section 12)** : No employer in relation to any establishment to which any Scheme applies shall by reason only of his liability for the payment of any contribution to the Funds or any charge under this Act or the Scheme, reduce directly or indirectly the wages of any employee or the total quantum of benefits in the nature of old-age pension, gratuity fund to which the employee is entitled under the term of his employment-express or implied.

**Inspector (Section 13)** : The power to appoint Inspectors has been vested in appropriate Government for the purpose of the Act and Scheme. The area of jurisdiction is also for the appropriate Government to decide upon. Appointment and the area assigned are to be notified in the Official Gazette.

Sub-section (2) deals with the powers of inspectors. These are general powers by means of which the inspectors may carry out their particular duties. The sub-section, *inter-alia*, vested the inspectors with powers to :

- (a) collect information and require the employer or any contractor from whom any amount is recoverable under Section 8A to furnish such information as he may consider necessary;
- (b) at any reasonable time and with necessary assistance, enter and search any establishment or any premises connected therewith;
- (c) require any one found in charge of the above-mentioned establishment or premises to produce before him for examination any accounts, books, registers and other documents relating to the employment of persons or the payment of wages in the establishment;
- (d) examine, in respect of any matter relevant to any of the purposes aforesaid, the employer or any contractor from whom any amount is recoverable under section 8A, his agent or servant or any other person found in charge of the establishment or any premises connected therewith or whom the inspector has reasonable cause to believe to be or to have been, an employee in an establishment
- (e) make copies of, or take extract from any book, register or other document maintained in relation to the establishment and, where he has reason to believe that any offence under this Act has been committed by an employer, seize with such assistance as he may think



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fit, such book, register or other document or portions thereof as he may consider relevant in respect of that offence;

(f) exercise each other powers as the scheme may provide.

By virtue of Sub-section (2A) any inspector may, for the purpose of enquiring into correctness of any information furnished in connection with the Family Pension Scheme or for the purpose of ascertaining whether any of the provisions of the Act or of the Family Pension Scheme have been complied with in respect of an establishment to which the Family Pension Scheme applies, exercise all or any of the powers conferred on him under the clauses mentioned in the preceding paragraph.

Sub-section (2B) provides that the provisions of the Criminal Procedure Code shall, so far as may be, apply to any search or seizure mentioned in the earlier paragraphs.

**Penalties (Section 14):** This Section deals with punishment for breaches of the provisions of the Act and the Scheme. Sub-section (1) provides for penalty for knowingly making or causing to be made, any false statement or false representation for avoiding any payment to be made by himself or of enabling any other person to avoid such payment. Such penalty is in the form of imprisonment for a term extending to one year or of fine extending to Rs. 5,000 or both.

Under Sub-section (1A), an employer who contravenes or makes default in complying with provisions of Section 6 or Section 17(3)(a) in so far as it relates to the payment of inspection charges, or Paragraph 38 of the Scheme in so far as it relates to the payment of administrative charges, shall be punishable with imprisonment for a term which may extend to 3 years, but— (a) which shall not be less than 1 year and a fine of Rs. 10,000 in case of default in payment of the employees' contribution deducted from his wages; (b) which shall not be less than six months and a fine of Rs. 5,000, in any other case. It may, however, be noted that the Court may, for any adequate and special reasons to be recorded in the judgment, impose a sentence of imprisonment for lesser term.

According to Sub-section (1B), an employer who contravenes or makes default in complying with the provisions of Section 6C or Section 17(3A)(a) in so far as it relates to the payment of inspection charges, shall be punishable with imprisonment for a term which may extend to 1 year. But it shall not be less than six months and shall also be liable to fine which may extend to Rs. 5,000. The Court may however, for any adequate and special reasons to be recorded in the judgment, impose a sentence of imprisonment for a lesser term.

Sub-section (2) provides that subject to the provisions of this Act, the Scheme, the family Pension Scheme or the Insurance Scheme may provide that any person who contravenes or makes default in complying with any of the provisions thereof shall be punishable with imprisonment for a term extending to 1 year, or with fine extending to Rs. 4,000, or with both.

Sub-section (2A) provides penalty where no other penalty is provided under this Act:



(i) for contravention or default in complying with the provisions of the Act, or (ii) of any condition subject to which exemption was granted under Section 17 of the Act. The penalty provided is imprisonment upto 6 months but not less than 1 month or/and fine upto Rs. 5,000.

**Offences of company (Section 14A):** This Section deals with prosecution of the companies which include firms and other associations of individuals; it also deals with the liability of officers, directors, partners, etc., of the company. If the offence under the Act is committed by a company, then the liability for the offence lies both on the company and on the person in charge of or responsible to the company at the time when the offence was committed. The company and the person as such would be jointly and severally responsible for the offence. Both can be proceeded against and punished for the offence. According to the proviso, the company and such person can be exonerated from liability if it and/or he proves: (a) that the offence was committed without its/his knowledge; or (b) that it/he exercised all due diligence to prevent the commission of such offence.

Sub-section (2) limits the scope of the Proviso mentioned above. If the prosecution proves that the offence: (a) was committed with the (i) consent; or (ii) connivance; or (b) is attributable to any negligence on the part of a director, manager secretary or other officer of the company, then such director, manager, secretary or other officer shall be deemed to be guilty of the offence and liable to be proceeded against and punished accordingly.

**Enhanced punishment in certain cases after previous conviction (Section 14AA):** This Section deals with imposition of enhanced penalty, after the previous conviction. The conditions are: (a) that there should have been a conviction of offence punishable under this Act or the Scheme of the Family Pension Scheme, or the Insurance Scheme; (b) that the person convicted must be found guilty of an offence involving the commission of the same offence. The punishment for the conviction of the subsequent offence is imprisonment which should not be less than 2 years but can go up to five years. Further, there must be an additional imposition of the fine extending to Rs. 25,000.

**Certain offences to be cognisable (Section 14AB):** This Section renders the offences relating to default in payment of contribution by the employer a cognisable offence. A cognisable offence is one where the police can arrest a person without warrant.

**Cognisance and trial of offence (Section 14AC):** This section deals with the complaints in regard to offences under the Act, the scheme or the Family Pension Scheme or Insurance Scheme and their cognisance.

The essential conditions of cognisance of offences are :

- (a) There must be a report in writing of the facts constituting such offence,
- (b) This report must be made with the previous sanction of the :
  - (i) Central Provident Fund Commissioner; or



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- (ii) Such officer as may be authorised by the Central Government;
- (c) The report must be made by an Inspector appointed under Section 13.

These conditions being co-existent, no Court inferior to that of a Presidency Magistrate or a Magistrate of the first class shall try any offence under this Act, or the Scheme or the Family Pension Scheme or the Insurance Scheme.

**Cognisance means jurisdiction or right to try and determine causes:** Taking cognisance occurs as soon as Magistrate, as such, applies his mind to the suspected commission of an offence [*Ajit Kumar vs. State of West Bengal* AIR 1963 S.C. 765]. Section 190 of the Code of Criminal Procedure, 1973 empowers a Magistrate of the first class to take cognisance of an offence in three ways, viz. (i) on complaint; (ii) on police report; and (iii) on information from any person other than a police officer or on his own knowledge. It may be noted that Section 14-AC of the Act makes it necessary that in order to launch a prosecution, the facts constituting the offence have to be stated. If the facts stated do not disclose an offence, the prosecution cannot be proceeded with; also that complaint means the allegation made orally or in writing to a Magistrate (Court) with a view to his taking action under the Cr. P.C. that some person, whether known or unknown, has committed an offence but it does include the report of a police report [*Gopal Das Sakseria vs. State of Uttar Pradesh, 1956 1 L.J. 11*].

**Power to Recover (Section 14-B):** An employer may make default: (a) in payment of contribution to the fund, family fund or insurance fund; (b) in transfer of the accumulations required to be transferred under Section 15 (to be discussed later on) or (c) in the payment of any charges payable (i) under the provisions of the Act, or (ii) under any Scheme or Insurance Scheme, or (iii) under any of the conditions specified under Section 17 (to be dwelt upon later on). If he so does in any of the aforesaid circumstance, then the Central Provident Fund Commissioner or such officers as may be authorised by the Central Government by notification in the Official Gazette in this behalf may recover from employer certain amount of damages. Such amount may be anything but not exceeding the actual amount of arrears, as specified in the Scheme.

The Central Board may; however, reduce or waive the damages levied under this Section in relation to an establishment which is a sick industrial company and in respect of which a scheme for rehabilitation has been sanctioned by the Board for Industrial and Financial Reconstruction (BIFR) established under Section 4 of the Sick Industrial Companies (Special Provisions) Act, 1985, subject to such terms and conditions as may be specified in the scheme.

However, before levying or recovering such damages, the employer has to be afforded a reasonable opportunity of being heard.

**Power of Court to make orders (Section 14-C):** Where an employer is convicted of an offence of making default of any one of the kinds mentioned in Section 14-B above the Court



may, in addition to awarding any punishment, by order in writing require him within a specified period in the order to pay the amount of contribution or transfer the accumulations, as the case may be, in respect of which the offence was committed. The period referred to in this order may, however, be extended by the Court if it thinks fit and on application in this behalf from time to time.

By virtue of Sub-section (2) of the Section, the impact of the aforesaid order of the Court would be that the clause in the order relating to continuance of the offence would remain suspended. If, however, on the expiry of the specified time, or as the case may be, the extended time, the order remains uncomplied with, then this default will be regarded as a further offence. For this further offence, the employer shall be liable to be punished with imprisonment under Section 14 and shall also be liable to a fine extending upto Rs. 100 for every day after such expiry on which the order has not been complied with.

**Special provisions relating to existing provident funds (Section 15):** This Section deals with the provisions relating to existing provident funds prior to the application of the Scheme or after the application of the scheme.

The implication of the opening phrase, *viz.*, “subject to the provisions of Section 17” (dilated upon later on), is that if an exemption has been granted to the already existing rule regarding Provident Fund, then the provisions of Section 17 and the conditions laid down therein shall apply.

The section saves the existing provident Fund. That is to say, it shall, pending the application of the scheme, be operated and worked as though the Act had not been enforced. Therefore, every employee who is a subscriber to the existing provident fund of an establishment, pending the application of any scheme to the establishment, continues to be entitled to the benefits accruing to him under the provident fund; and the provident fund shall continue to be maintained in the same manner and subject to the same conditions as it would have been if this Act had not been passed.

On the application of the scheme to the fund already in existence, the amount standing to the credit of the employee who becomes a member shall be transferred to the fund established under the scheme. The condition contained in the scheme shall supersede all provisions of law or deed or instrument if there is anything to the contrary.

**Act not to apply to certain establishments (Section 16):** This Act does not apply to the following classes of establishments, namely :

- (a) an establishment under the Co-operative Societies Act, 1912 or under any other law relating to co-operative societies in any State, employing less than 50 persons and working without the aid of power; or
- (b) any other establishment belonging to or under the control of the Central Government or a State Government and whose employees are entitled to the benefit of contributory



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provident fund or old age pension in accordance with any scheme or rule framed by the Central Government or the State Government governing such benefits; or

- (c) to any other establishment set up under any Central, Provincial or State Act and whose employees are entitled to the benefits of contributory provident fund or old age pension in accordance with any scheme or rule framed under the Act governing pension in accordance with any scheme or rule framed under that Act governing such benefits; or

Sub-section (2) of the section further empowers the Central Government to exempt whether prospectively or retrospectively any class of establishments (not an individual establishment unless it constitutes a class within itself) from the operation of the Act, if the Government thinks necessary or expedient after taking into consideration the financial position of the establishment or other circumstances of the case. This exemption can be granted only through notification in the Official Gazette.

**Authorising certain employers to maintain a P.F. Account (Section 16-A) :** The Central Government may, on an application made to it in this behalf by the employer and the majority of employees in relation to an establishment employing one hundred or more persons, authorise the employer by an order in writing, to maintain a provident fund account in relation to the establishment subject to such terms and conditions as may be specified in the Scheme.

No authorisation shall, however, be made under this sub-section if the employer of such establishment had committed any default in the payment of provident fund contribution or had committed any other offence under this Act during the three years immediately preceding the date of such authorisation.

Where an establishment is authorised to maintain a provident fund account as aforesaid, the employer in relation to such establishment shall maintain such account, submit such return, deposit the contribution in such manner, provide for such facilities for inspection, pay such administrative charges, and abide by such other terms and conditions, as may be specified in the Scheme.

Any authorisation made under this section may be cancelled by the Central Government by order in writing if the employer fails to comply with any of the terms and conditions of the authorisation or where he commits any offence under any provision of this Act.

Before cancelling the authorisation, the Central Government shall give the employer a reasonable opportunity of being heard.





**Power to exempt (Section 17):** The exemption from the operation of all or any of the provisions of any scheme may be granted by the appropriate Government. The exemption order is required to be notified in the Official Gazette. The exemption can be conditional. The condition shall have to be specified in the notification published in the Official Gazette. It can be from all or any of the provisions of the Scheme or Family Pension Scheme applicable to the establishment and may be made prospectively or retrospectively.

While granting exemption, the appropriate Government shall see that, in its opinion, the rules in force regarding provident fund or family pension in the establishment :

- (i) with respect to the rates of contribution, or
- (ii) with respect to other provident fund benefits

are not less favourable to employees than the benefits provided in the Act or the Scheme in relation to the establishment;

No exemption under this Section shall be made without consultation with the Central Board.

Where an exemption has been granted to an establishment :

- (a) the provision of Sections 6, 7-A and 14-B shall, so far as may be, apply to the employer of the exempted establishment in addition to such other conditions as may be specified in the notification granting such exemption, and where such employer contravenes, or makes default in complying with any of the said provisions or conditions or any other provision of the Act, he shall be punishable under Section 14 as if the said establishment had not been exempted;
- (b) the employer shall establish a Board of Trustees for the administration of the provident fund as per the terms specified in Section 17(1-A).

Any Scheme may make a provision for exemption of any person or class of persons employed in any establishment to which the Scheme applies from the operation of all or any of the provisions of the Scheme, if the benefits enjoyed (all taken together) in respect of provident fund, gratuity or old-age pension are on the whole not less favourable than the benefits provided under this Act or the Scheme. But no such exemptions can be granted in respect of a class of persons, unless the appropriate Government is of the opinion that the majority of persons constituting such class desire to continue to be entitled to such benefits [Sub-section (2)].



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The Central Provident Fund Commissioner may grant exemption to any establishment from the operation of all or any of the provisions of the Insurance Scheme, whether prospectively or retrospectively. This exemption may be granted by notification in the Official Gazette and subject to such conditions as may be specified in the notification. The Central Provident Fund Commissioner may exempt: (a) if it is requested to do so by the employer and (b) if it is satisfied that the employees of such establishment are, without making any separate contribution or payment of premium, in enjoyment of benefits in the nature of life insurance, whether or not linked to their deposits in the provident fund, and such benefits are more favourable to such employees than the benefits admissible under the Insurance Scheme [Sub-section (2-A)].

Without prejudice to the provisions referred to in the preceding paragraph, the Insurance Scheme may provide for the exemption to any person or class of persons employed in any establishment and covered by that scheme from the operation of all or any of the provisions thereof. This exemption is admissible if the benefits in the nature of life insurance admissible to such person or class of persons are more favourable than the benefits provided under the Insurance Scheme [Sub-section (2-B)].

Where, in respect of any person or class of persons employed in an establishment an exemption is granted, the employer in relation to such establishment: (a) shall in relation to provident fund, pension and gratuity to which any such person or class of persons is entitled, maintain such accounts, submit such returns, make such investment, provide for such facilities for inspection any pay such inspection charges as the Central Government may direct; (b) shall not at any time after the exemption, without the leave of the Central Government, reduce the total quantum of benefits in the nature of pension, gratuity or provident fund to which any such person or class of persons was entitled at the time of the exemption; and (c) shall, where any such person leaves his employment and obtain re-employment in another establishment to which this Act applies, transfer within such time as may be specified in this behalf by the Central Government, the amount of accumulations to the credit of the person in the provident fund of the establishment left by him to the credit of that person's account in the provident fund of the establishment in which he is re-employed or, as the case may be, in the fund established under the Scheme applicable to the establishment [Sub-section (3)].

### **Notification Under Section 17(3):**

In exercise of the powers conferred by clause (a) of Sub-section (3) of Section 17, the Central Government directs that every employer in relation to an establishment exempted under clause (a) or (b) of Sub-section (1) of Section 17 or in relation to any employee or class of employees exempted shall transfer the monthly provident fund contributions in respect of the establishment or as the case may be of the employee or class of employees within 15 days of



the close of the month to the Board of Trustees duly constituted in respect of that establishment, and that the said Board of Trustees shall invest every month within a period of two weeks from the date of receipt of the said contributions from the employee, the provident fund accumulations in respect of that establishment or as the case may be, of the employee or class of employees, that is to say, the contributions, interest, and other receipts as reduced by any obligatory outgoings in accordance with the investment pattern as envisaged in the Notification No. S.O. 937 dated 27th March 1997.

Where an exemption is granted under Sub-section (2-A) or (2-B) mentioned above, the employer in relation to such establishment: (a) shall in relation to the benefits in the nature of life insurance to which any such person or class of persons is entitled or any insurance fund, maintain such accounts, submit such returns, make such investments, provide for such facilities for inspection and pay such inspection charges so the Central Government may direct (b) shall not, at any time after the exemption, without the leave of the Central Government, reduce the total quantum of benefits in the nature of life insurance to which any such person or class of persons was entitled immediately before the date of the exemption; and (c) shall, where any such person leaves his employment and obtains re-employment in another establishment to which this Act applies, transfer within such time as may be specified in this behalf by the Central Government, the amount of accumulations to the credit of that person in the insurance fund of the establishment left by him to the credit of that person's account in the insurance fund of the establishment in which he is re-employed or, as the case may be, in the Deposit-linked Insurance Fund [Sub-section (3-A)].

The exemption granted under this Section can be cancelled in case of failure on the part of an employer to comply with the terms and conditions imposed on which exemptions were granted under various sub-sections mentioned above. In that case, the accumulations to the credit of an employee would be transferred to the relative Funds mentioned above [Sub-sections (4 and 5)].

The appropriate Government may, by notification in the Official Gazette, and subject to the condition on the pattern of investment of pension fund and such other conditions as may be specified therein, exempt any establishment or class of establishments from the operation of the Pension Scheme if the employees of such establishment or class of establishments are either members of any other pension scheme or proposes to be members of such pension scheme, where the pensionary benefits are at par or more favourable than the Pension Scheme under this Act" [Section 17(1)]

**Transfer of accounts (Section 17-A):** This Section provides for the transfer of accounts of an employee in case if his leaving the employment and taking up employment in another establishment and to deal with the case of an establishment to which this Act applies and also



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## **The Employees' Provident Funds and Miscellaneous Provisions Act, 1952**

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to which it does not apply. The option to get the amount transferred is that of the employee.

Where an employee of an establishment to which this Act applies leaves his employment and obtains re-employment in another establishment to which this Act does not apply, the amount of accumulations to the credit of such employee in the Fund or, as the case may be, in the provident fund in the establishment left by him shall be transferred to the credit of his account in the provident fund of the establishment in which he is re-employed, if the employee so desires and the rules in relation to that provident fund permit such transfer. This transfer has to be made within such time as may be specified by the Central Government in this behalf [Sub-section (1)].

Conversely, when an employee of an establishment to which this Act does not apply leaves his employment and obtains re-employment in another establishment to which this Act applies, the amount of accumulations to the credit of such employee in the provident fund of the establishment left by him, if the employee so desires and the rules in relation to such provident fund permit, may be transferred to the credit of his account in the fund or as the case may be, in the provident fund of the establishment in which he is re-employed [Sub-section (2)].

**Act to have effect notwithstanding anything contained in the Life Insurance Corporation Act, 1956 (Section 17-AA):** In case of any inconsistency between this Act and LIC Act, 1956, this Section provides that the Employees Provident Fund, etc. Act will prevail over the provisions of the Life Insurance Corporation Act, 1956.

Liability in case of transfer of establishment (Section 17-B): Where an employer in relation to an establishment, transfers that establishment in whole or in part by sale, gift, lease or licence or in any other manner whatsoever, the employer and the person to whom the establishment is so transferred shall jointly or severally be liable to pay the contribution and other sums due from the employer under any provision of this Act of the Scheme or the Pension Scheme, as the case may be, in respect of the period up to the date of such transfer. It is provided that the liability of the transferee shall be limited to the value of the assets obtained by him such transfer.

It would be thus evident from the foregoing provisions that Section 17-B deals with the liability of transferor and transferee in regard to the money due under: (a) the Act; or (b) the Scheme; (c) Pension Scheme. In the case of transfer of the establishment brought in by sale, gift, lease, or any other manner whatsoever, the liability of the transferor and the transferee is joint and several, but is limited with respect to the period up to the date of the transfer. Also the liability of the transferee is further limited to the assets obtained by him from the transfer of the establishment.



**Protection of action taken in good faith (Section 18):** No suit, prosecution or other legal proceeding shall lie against the Central Government, a State Government, the presiding Officer of a Tribunal, any authority referred to in Section 7-A, an Inspector or any other person for anything which is in good faith done or intended to be done in pursuance of this Act, the Scheme, the Pension Scheme or the Insurance Scheme.

**Presiding Officer and other officers to be public servants (Section 18-A):** The Presiding Officer of a Tribunal, its officers and other employees, the authorities referred to in Section 7-A and every inspector shall be deemed to be public servants within the meaning of Section 21 of the Indian Penal Code.

**Delegation of powers (Section 19):** The appropriate Government may direct that any power or authority or jurisdiction exercisable by it under this Act, the Scheme, the Pension Scheme or the Insurance Scheme shall, in relation to such matters and subject to such conditions, if any, as may be specified in the direction, be exercisable also (a) where the appropriate Government is the Central Government, by such officer or authority subordinate to the Central Government or by the State Government or by such officer or authority subordinate to the State Government as may be specified in the notification; (b) where the appropriate Government is a State Government by such Officer or authority subordinate to the State Government as may be specified in the notification.

**Liability in case of transfer of establishment (Section 17-B):** Where an employer in relation to an establishment, transfers that establishment in whole or in part by sale, gift, lease or licence or in any other manner whatsoever, the employer and the person to whom the establishment is so transferred shall jointly or severally be liable to pay the contribution and other sums due from the employer under any provision of this Act of the Scheme or the Pension Scheme, as the case may be, in respect of the period up to the date of such transfer. It is provided that the liability of the transferee shall be limited to the value of the assets obtained by him by such transfer.

It would be thus evident from the foregoing provisions that Section 17-B deals with the liability of transferor and transferee in regard to the money due under: (a) the Act; or (b) the Scheme; (c) Pension Scheme. In the case of transfer of the establishment brought in by sale, gift, lease, or any other manner whatsoever, the liability of the transferor and the transferee is joint and several, but is limited with respect to the period up to the date of the transfer. Also the liability of the transferee is further limited to the assets obtained by him from the transfer of the establishment.

**Protection of action taken in good faith (Section 18):** No suit, prosecution or other legal proceeding shall lie against the Central Government, a State Government, the Presiding



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Officer of a Tribunal, any authority referred to in Section 7-A, an Inspector or any other person for anything which is in good faith done or intended to be done in pursuance of this Act, the Scheme, the Pension Scheme or the Insurance Scheme.

**Presiding Officer and other officers to be public servants (Section 18-A):** The Presiding Officer of a Tribunal, its officers and other employees, the authorities referred to in Section 7-A and every inspector shall be deemed to be public servants within the meaning of Section 21 of the Indian Penal Code.

**Delegation of powers (Section 19):** The appropriate Government may direct that any power or authority or jurisdiction exercisable by it under this Act, the Scheme, the Pension Scheme or the Insurance Scheme shall, in relation to such matters and subject to such conditions, if any, as may be specified in the direction, be exercisable also (a) where the appropriate Government is the Central Government, by such officer or authority subordinate to the Central Government or by the State Government or by such officer or authority subordinate to the State Government as may be specified in the notification; (b) where the appropriate Government is a State Government by such officer or authority subordinate to the State Government as may be specified in the notification.

Under this Section, both the Central Government and the State Government have been given a right to delegate their powers, authority or jurisdiction exercisable by them to an officer or authority sub-ordinate to them and subject to any condition. The Central Government is also authorised to delegate the powers, etc., to the State Government.

**Power to remove difficulties (Section 19-A):** If any doubt or difficulty arises in giving effect to the provisions of this Act, and particularly, in respect of : (i) cases where an establishment which is a factory, is engaged in any industry specified in Schedule I; (ii) whether any particular establishment is an establishment falling within the class of establishments to which this Act applies by virtue of a notification under Section 1(3) (b); or (iii) the number of persons employed in an establishment; or (iv) the number of years which have elapsed from the date on which an establishment has been set up; (v) whether the total quantum of benefit to which an employee is entitled has been reduced by the employer then the Central Government may, by order, make such provisions or give such directions, not inconsistent with the provisions of this Act, as appear to it to be necessary or expedient for the removal of the doubt or difficulty : and the order of the Central Government in such cases shall be final.



#### **4.7 SELF-EXAMINATION QUESTIONS**

##### **Choose the Correct Alternative**

1. Generally the Employees Provident funds and Miscellaneous Provisions Act, 1952 applies to entities employing more than
  - (a) 10 persons.
  - (b) 20 persons.
  - (c) 100 persons.
  - (d) 1000 persons.
  
2. The Central Government may apply the provisions of this act even if it employs less than required persons.
  - (a) True.
  - (b) False.
  
3. The liability for employer to contribute under the Employees' Provident Fund etc Act, 1952 is 10% pf the employees' emoluments.
  - (a) True.
  - (b) False.
  
4. The maximum contribution that an employee can make to his provident fund account is 10%.
  - (a) True.
  - (b) False.
  
5. An employee getting pay above Rs. 6,500 can never become a member under the Provident Fund Scheme, 1952.



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**The Employees' Provident Funds and Miscellaneous Provisions Act, 1952**

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- (a) True.
- (b) False.

**Short/ Essay Type Questions**

6. Who can frame Employee's Provident Fund Scheme?
7. Who shall administer the Fund created under the said Scheme?
8. Who is to constitute the Central Board of Trustees?
9. How many persons in the maximum shall be there in the Central Board?
10. Who is to constitute State Board of Trustees?
11. Do the aforesaid Board of Trustees have a perpetual succession and a common seal?
12. Can the said Board of Trustees delegate their powers and functions to their chairman or any other officer?
13. (a) What are the percentages of employer's and employee's contribution to the Fund?  
(b) By whom can these percentages be enhanced and to what extent?
14. Who may determine the moneys due from employers?
15. What is the mode of recovery of moneys due from employers?
16. Is provident fund attachable?
17. Is the payment of provident fund contribution a preferential payment in case of the employer being insolvent ?
18. What is procedure for determination and recovery of dues from employer under the Employee's Provident Fund and Misc. Provisions Act?
19. What are the provisions regarding transfer of account under the Employee's Provident Fund etc. Act of an employee who has changed his job?





**Practical Problems**

20. An employee leaves the establishments in which he was employed and gets employment in another establishment wherein he has been employed. Explain the procedure laid down in the Employees' Provident Fund and Miscellaneous Provisions Act, 1952 in this relation.
21. Manorama Group of Industries sold its textile unit to Giant Group of Industries. Manorama Group contributed 25% of total contribution in Pension Scheme, which was due before sale under the provisions of Employees Provident Fund and Miscellaneous Provisions Act, 1952. The transferee company (Giant Group of industries) refused to bear the remaining 75% contribution in the Pension Scheme. Decide, in the light of the Employees Provident Fund and Miscellaneous Provisions Act, 1952, who will be liable to pay for the remaining contribution in case of transfer of establishment and upto what extent?

**Answers**

1. (b); 2. (a); 3. (a); 4. (b); 5. (b);

# CHAPTER 5

## THE PAYMENT OF GRATUITY ACT, 1972

### Learning Objectives

In this Chapter, the students come to know the

- ◆ To whom Gratuity is payable?
- ◆ How to calculate the amount of Gratuity payable?
- ◆ When Gratuity will be forfeited?
- ◆ Procedure for nomination in respect of Gratuity payment.

### 5.1 AN INTRODUCTION

Gratuity is a word derived from a Latin word 'Gratuitas' which simply means a 'Gift.' In the industrial sector, it can be treated as a gift from the employer to his employee for the services rendered to his establishment by him for the development and prosperity of the same. Gratuity is a benefit, which an employee gets at the time of retirement or when he leaves the establishment. Gratuity is a amount ( as a lump sum payment) which is paid by an employer to his employee for his past services when the employment is terminated. When the employment comes to an end due to the retirement or superannuation of the workers, it becomes a good help to the workers, it becomes a good help to the effected employee to meet the new situation which often comes due to reduction in regular earnings or even total stoppage of earnings. In case of death of the worker, it provides financial assistance to the members of his family for their survival, if they have got no other means for their survival. Thus, this gratuity scheme serves as an instrument of social security as well as a reward to a person who sacrifices his whole life in the betterment, development and prosperity of an establishment, and in other way for the Nation.

### 5.2 HISTORICAL BACKGROUND:

Previously, this scheme was introduced in those establishments only where the employers were so kind and generous to the workers or there was an agreement between the employers and the workers. This scheme was confined to the particular establishments and even within those establishments, to certain categories of staff. There was no general legislation for the payment of Gratuity to all industrial workers. In due course of time, it was felt the workers



should get gratuity as a right in return of their long dedicated services to the industry. Industrial Tribunals and Supreme Courts dealt with the disputes on the subject and their awards and decisions brought the revolutionary changes in Social Security Legislations in Indian industrial sector.

In the case of Delhi Cloth and General Mills Co. Ltd. Vs their workers (1968) 36 FJR 247. Supreme Court held that the object of providing a gratuity scheme is to provide a retiring benefit to the workman who have rendered long and unblemished service to the employer and thereby contributed to the prosperity of the employer.

In the Working Journalists (Conditions of Service) & Miscellaneous Provisions Act, 1955, the provision to pay the gratuity to the working journalists was made. After few years, the Government of Kerala enacted the Kerala Industrial Employees Payment of Gratuity Act, 1970 making gratuity a statutory right of the employees. West Bengal Government enacted the West Bengal Employees Payment of Gratuity Act, 1971 relating to the subject. The other states were also thinking to legislate such enactments. Thus, it was felt that there should be an uniform central legislation for the whole country instead of state legislations for each and every separate states. The whole matter was discussed in the Labour Ministers' Conference held 24<sup>th</sup> and the August 1971 and thereafter in the Indian Labour Conference held on 22<sup>nd</sup> and 23<sup>rd</sup> Oct., 1971 it was agreed that the central legislation on the payment of gratuity should be undertaken. Accordingly, the payments of Gratuity Act, 1972 was enacted, largely based on the West Bengal legislation, which was come into force on 16<sup>th</sup> September, 1972.

### **5.3 AIMS AND OBJECTS OF THE ACT:**

As there was no Central Act to regulate the payment of Gratuity to the workers except the Working Journalists (Conditions of Service) & Miscellaneous Provisions Act, 1955. Kerala and West Bengal states enacted their legislations and some other states were thinking for the same. Therefore, it had become necessary to have a Central Law on the subject to ensure a uniform pattern of payment of gratuity to the employees throughout the country. The bill was drafted on the basis of the West Bengal Employees' Payment of Gratuity Act, 1971 with some modification which was made in the light of the views expressed in the Indian Labour Conference relating to the forfeiture of gratuity in cases of dismissal for gross misconduct.

Initially, the Bill provided for gratuity to the employees drawing wages upto Rs. 270/- per month in factories, Plantations, shops, establishments and mines, in the event of superannuation, retirement, resignation and death or total disablement due to accident or diseases. The quantum of gratuity payable will be 15 days' wages based on the rate of last drawn wages by the employees concerned for every completed year of service or part thereof in excess of six months subject to a maximum of 15 months' wages.



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## The Payment of Gratuity Act, 1972

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It was proposed that the appropriate Government for administering the Act in relation to the establishment belonging to or under the control of the Central Govt. or a railway co., or mine, a major part and outfield or in relation to establishments having departments or branches in more than one state, will be the Central Government and in relation to other establishments, the State Government.

### ACT 39 OF 1972

The payment of Gratuity Bill passed by both of the houses of parliament was signed by the President of India on 21<sup>st</sup> August 1972 and came into force on 16<sup>th</sup> September, 1972 as THE PAYMENT OF GRATUITY ACT, 1972 (39 of 1972). This Act was amended time to time as per requirement, the years 1984, 1987, 1994 and 1998.

#### 5.4 EXTENT & APPLICABILITY:

It extends to the whole of India provided that in so far as it relates to plantations or ports, it shall not extend to the State of Jammu & Kashmir. (Section. 1(2).

The Act applies to:

- ◆ Every factory, mine, oilfield, plantation, port and railway company;
- ◆ Every shop or establishment within the meaning of any law for the time being in force in relation to shops and establishments in a state, in which 10 or more persons are employed, or were employed, on any day of the preceding twelve months;
- ◆ Such other establishments or class of establishments, in which 10 or more employee are employed, or were employed on any day of the preceding twelve months, as the Central, specify in this behalf. [Section. 1(3)]
- ◆ A shop or establishment to which this Act has become applicable shall continue to be governed by this Act notwithstanding that the number of persons employed therein at any time after it has become so applicable falls below then. (Section. 3(A1))

The expression 'law ' used in Section 1(3)(b) means any law in respect of shops, establishments, commercial or non-commercial. (K. Gangadhar Vs The Appellate Authority, (1993) 66 FLR 648(A).

The provisions of Section 1(3)(b) of the Act are very much comprehensive. It also includes Municipal Board. (Municipal Board Vs Union of India, (1993) 67 FLR 973 All)

In exercise of the powers conferred by clause (c) of Section 1(3) of the Act, the Central Government has specified Motor Transport undertakings, clubs, chambers of commerce and industry, inland water transport establishments, Solicitors' Officers, Local Bodies and circus Industry, in which 10 or more persons are employed or were employed on any day of the



preceding 12 months, as classes of establishments to which the Act shall apply. Once this Act becomes applicable to a shop or establishments, it will continue to govern by it even if the number of employees falls below 10 after the application of the Act.

Application of the Act to an employed person depends on two factors (i) he should be employed in an establishment to which the Act applies & (ii) he should be an employee under the definition of Section 2(e) of the Act.

### **5.5 IMPORTANT DEFINITIONS:**

#### **(1) APPROPRIATE GOVERNMENT MEANS:**

- ◆ in relation to an establishment -
- ◆ belonging to, or under the control of the Central Government,
- ◆ having branches in more than one states,
- ◆ of a factory belonging to, or under the control of the Central Government,
- ◆ of a major port, mine, oilfield or railway company, the Central Government,
- ◆ in any other case, the State Government; [Section. 2 (a)]

#### **(2) COMPLETED YEAR OF SERVICE** means continuous service for one year [Section. 2 (b)]

**(3) EMPLOYEE** means any person (other than an apprentice) employed on wages, (xxx)<sup>1</sup> in any establishment, factory, mine, oilfield, plantation, port railway company or shop to do any skilled, semi-skilled or u skilled, manual, supervisory, technical or clerical work, whether the terms of such employment are expressed or implied, (and whether or nor such person is employed in a managerial or administrative capacity, but does not include any such person who holds a post under the Central Government or a State Government and is governed by any other Act or by any rules providing for payment of gratuity)<sup>1</sup> [Section. 2 (e)]

#### **(4) EMPLOYER MEANS:**

- ◆ In relation to any establishment, factory, mine, oilfield, plantation, port, railway company or shop –
- ◆ Belonging to, or under the control of the Central Government or a State Government a per or authority appointed by the appropriate Government for the supervision and control of employees, or where no person or authority has been so appointed, the head of the Ministry or Department concerned,
- ◆ Belonging to, or under the control of any local authority, the person appointed by such authority for the supervision, and control of employees or where no person has been so appointed, the chief executive officer of the local authority,



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## The Payment of Gratuity Act, 1972

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- ◆ In any other case, the person, who, or the authority which has the ultimate control over the affairs of the establishment, factory, mine, oilfield, plantation, port, railway company or shop, and where the said affairs are entrusted to any other person, whether called a manager, managing director or by any other name, such person; [Section. 2 (f)]

(6) **FACTORY:** 'factory' has the meaning assigned to it in clause (m) of Section 2 of the Factories Act, 1948 (63 of 1948); [Section. 2 (g)]

(7) **FAMILY:**

In relation to an employee, shall be deemed to consist of –

- ◆ In the case of a male employee, himself, his wife, his children, whether married or unmarried, his dependent parents (and the dependent parts of his wife and the widow)<sup>1</sup> and children of his predeceased son, if any,
- ◆ In the case of a female employee, herself, her husband, her children, whether married or unmarried, her dependent parents and the dependent parents of her husband and the widow and children of her predeceased son, if any;

**EXPLANATION:**

Where the personal law of an employee permits the adoption by him of a child, any child lawfully adopted by him shall be deemed to be included in his/her family, and where a child of an employee has been adopted by another person and such adoption is, under the personal law of the person making such adoption, lawful, such child shall be deemed to be excluded from the family of the employee. [Section. 2 (h)]

(8) **RETIREMENT:**

Means termination of the service of an employee otherwise than on superannuation;

[Section. 2 (q)]

(9) **SUPERANNUATION:**

In relation to an employee, means the attainment by the employee of such age as is fixed in the contract or conditions of service as the age on the attainment of which the employer shall vacate the employment. [Section. 2 (r)]

(10) **WAGES:**

Means all emoluments which are earned by an employee while on duty or on leave in accordance with the terms and conditions of his employments and which are paid or are payable to him in cash and includes D.A. but does not include any bonus, commission, house rent allowance, overtime wages and any other allowances. [Section. 2 (s)]



**(11) CONTINUOUS SERVICE 2: [Section. 2A]**

For the purposes of this Act –

- ◆ An employee shall be said to be in continuous service for a period if he has, for that period, been in uninterrupted service, including service which may be interrupted on account of sickness, accident, leave, absence from duty without leave (not being absence in respect of which an order (xxx)3 treating the absence as break in service has been passed in accordance with the, standing orders, rules or regulations governing the employees of the establishment), lay-off, strike or a lock-out or assertion of work not due to any fault of the employee, whether such uninterrupted or interrupted service was rendered before or interrupted service was rendered before or after the commencement of this Act;
- ◆ Where an employee (not being an employee employed in a seasonal establishment) is not in continuous service within the meaning of clause (1), for any period of one year or six months, he shall be deemed to be in continuous service under the employer –
- ◆ For the said period of one year, if the employee during the period of twelve calendar months preceding the date with reference to which calculation is to be made, has actually worked under the employer for not less than –
- ◆ One hundred and ninety days, in the case of any employee employed below, the ground in mine or in an establishment which works for less than six days in a week; and
- ◆ Two hundred and forty days, in any other case;
- ◆ For the said period of six months, if the employee during the period of six calendar months preceding the date with reference to which the calculation is to be made, has actually worked under the employer for not less than –
- ◆ Ninety five days, in case of an employee employed below the ground in a mine or in an establishment which works for less than six days in a week; and
- ◆ On hundred and twenty days, in any other case

**EXPLANATION:**

For The purposes of clause (2) for number of days on which an employee has actually worked under an employer shall include the days on which –

- ◆ he has been laid-off under an agreement or as permitted by standing order made under the Industrial Employment (Standing Orders) Act, 1946 (20 of 1946), or under the Industrial Disputes Act, 1947 (14 of 1947), or under any other law applicable to the establishment;
- ◆ he has been on leave with full wages, earned in the previous year,



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## The Payment of Gratuity Act, 1972

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- ◆ he has been absent due to temporary disablement caused by accident arising out of and in the course of his employment; and
- ◆ in the case of a female, she has been on maternity leave; so, however, that the total period of such maternity leave does not exceed twelve weeks.

Where an employee, employed in a seasonal establishment, is not in continuous service within the meaning of clause(1), for any period of one year or six months, he shall be deemed to be in continuous service under the employer for such period if he has actually worked for not less than seventy.

\*\* An employee who is re-employed without any break in service will be eligible for gratuity and he can not be denied to get the gratuity simply on the ground of the change in employment. (Jeevan Lal (1929) Ltd. Vs controlling authority; (1982) (LLN217)

A retrenched employee is also entitled for gratuity, it was held in the case of state of Punjab Vs Labour Court (1986))

### **CONTROLLING AUTHORITY:**

The Appropriate Government may, by notification, appoint any officer to be a controlling authority, who shall be responsible for the administration of this Act and different authorities may be appointed for different areas. [Section. 3]

### **5.6 PAYABILITY OF GRATUITY: [SECTION. 4(1)]**

Gratuity shall be payable to an 'employee' on the termination of his employment after he has rendered continuous service for not less than five years –

- ◆ On his superannuation, or
- ◆ On his retirement or resignation, or
- ◆ On his death or disablement due to accident or disease;

The condition of the completion of five years continuous service is not essential in case of the termination of the employment of any employee due to death or disablement. Generally, it is payable to the employee himself. However, in case of death of the employee it shall be paid to his.

\*\* The payability of Gratuity to the employee is his right as well as the obligation of the employer. By the change of ownership, the relationship of employer and employees subsists and the new employer cannot escape from the liability of payment of gratuity to the employees; it was held in the case of Pattathurila K. Damodaran Vs M.Kassim Kanju (1993) ILLJ (1211 (Ker).





An employee resigning from service is also entitled to gratuity; (Texmaco Ltd. Vs Sri Ram Dham, 1992 LLR 369(Del) and Non acceptance of the resignation is no hurdle in the way of an employee to claim gratuity; (Mathur Spinning Mills Vs Deputy Commissioner of Labour, (1983) II LLJ 188).

For the purpose of this Section, disablement means such disablement as incapacitates an employee for the work which he was capable of performing before the accident or disease resulting in such disablement.

### **5.7 CALCULATION OF GRATUITY AMOUNT PAYABLE: (SECTION. 4(2))**

In the establishments other than seasonal establishments, the employer shall pay the gratuity to an employee at the rate of 15 days wages based on the rate of wages last drawn by the employee concerned for every completed year of service or part thereof in excess of 6 months. In case of piece rated employee, daily wages, shall be computed on the average of the total wages received by him for a period of three months immediately preceding the termination of his employment, and, for this purpose, the wages paid for any overtime work shall not be taken into account. In case of an employee who is employed in a seasonal establishment can be classified into two groups

- ◆ those who work throughout the year &
- ◆ who work only during the season.

The former are entitled to get the gratuity at the rate of 15 days wages for every completed year of service or part thereof in excess of six months. The later are, however, entitled to received gratuity at the rate of seven days for each season.

In case of a monthly rated employee; the fifteen days' wages shall be calculated by dividing the monthly rate of wages last drawn by him by twenty six and multiplying the quotient by fifteen. In order to arrive at the figure of daily wage for the purpose of Section.4(2) of the Act, monthly wages is to be divided by 26 (Hindustan Lever Ltd. Vs Kasargoe Devidas Rao, (1990) 61FLR 6231 (BOM)

### **Computation of Gratuity of employee: [Section. 4(4)]**

When an employee becomes disabled due to any accident or disease and is not in a position to do the same work and re-employed on reduced wages on some other job, the gratuity will be calculated in two parts –

for the period preceding the disablement: on the basis of wages last drawn by the employee at the time of his disablement.

For the period subsequent to the disablement – On the basis of the reduced wages as drawn by him at the time of the termination of services.



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\*\* In case of *Bharat Commerce and Industries Vs Ram Prasad*, 200 (LLR 918 (MP)) it was decided that if for the purposes of computation of quantum of the amount of gratuity the terms of agreement or settlement are better than the Act, the employee is entitled for that benefit but the maximum statutory ceiling limit as providing under sub-Section 3 of Section 4 of the Act can not be reduced by mutual settlement or agreement.

### **5.8 FORFEITURE OF GRATUITY: (Section. 4(6))**

If the services of an employee have been terminated for any act, willful omission, or negligence causing any damage or loss to, or destruction of, property belonging to the employer the gratuity shall be forfeited to the extent of the damage or loss so caused;

And if the services of such employee have been terminated for his disorderly conduct or any other act of violence on his part, or if the services of such employee have been terminated for any act which constitutes an offence involving moral turpitude, provided that such offence is committed by him in the course of his employment, the gratuity payable to the employee may be wholly or partially forfeited. (Prior to this amendment of the Act in 1984, the forfeiture in such case was 100%).

### **CASE LAW:**

If the employer has to be paid any amount regarding any type of charge by the employee and he has not paid the same during the course of his service then the employer can adjust the amount from the gratuity of the employee at the time of the payment of the gratuity at the termination of his employment. In *Wazir Chand Vs Union of India* 2001, LLR 172 (SC), it was held that there was no illegality in the amount of gratuity, which was paid by the employer. The appellant even after superannuation continued to occupy the quarter and the government in accordance with the rules charged the rent from him and after adjusting other dues, the gratuity amount offered to be paid.

In *Travancore Plywood Industries Ltd. Vs Regional Joint Labour Commissioner*, (1966) II LLJ 85 (Ker.) it was held that the refusal of employees to surrender land belonging to the employer is not a sufficient ground to withhold the gratuity.

In the case *Parmali Wallance Kimited Vs Stfate of M.P.*, (1996) II LLJ 515 (MP), it was held that the right of the employer to forfeit the amount of earned gratuity of an employee whose services were terminated for any act, willful omission or negligence causing any damage to the employer is limited to the extend of the damage, and the proof of such damage.

When an offence of theft under law involves moral turpitude, gratuity stands wholly forfeited in view of the Section.4(6) of the Act. (*Bharat Gold Mines Ltd. Vs Regional Labour Commissioner (Central)*, (1987) 70 FJR 11 (Kern.)

But when an employee, who has been given the benefit of probation under Section.3 of the Probation of Offenders Act, 1958, can not be disqualified to received the amount of his



gratuity. (S.N.Sunderson (Minerals) Ltd. Vs Appellate Authority-cum-Deputy Labour Commissioner, (1990) 60 FLR 6 (Summary) (M.P.)

In the case of K.C.Mathew Vs Plantation Corporation of Kerala Ltd., 2001 LLR (2) (Ker.), it was clearly held that withholding of gratuity is not permissible under any circumstances other than those enumerated in Section.4(6) of the Act and the right to gratuity is a statutory right and none can be deprived from such right.

### **5.9 COMPULSORY INSURANCE: [SECTION. 4(A)]**

The Payment of Gratuity(Amendment) Act, 1987 has prescribed provisions for compulsory insurance for employees, which introduces employer's liabilities for payment towards the gratuity under the Act from LIC established under LIC of India Act 1956 or any other prescribed insurance company. However, employer of an establishment belonging to or under the control of the Central Government or the State Government are exempted from the operations of these provisions.

The Appropriate Government may also exempt (i) employers who have already established an approved gratuity fund in respect of his employees and who desires to continue such arrangement; and (ii) employers having 500 or more persons, who establishes an approved gratuity fund in the manner prescribed.

For the purposes of this Section, every employer shall within a prescribed time get his establishment registered with the controlling authority in the prescribed manner, and only those employers who have taken an insurance as referred above or has established an approved gratuity fund shall be registered.

To give effect to the provisions of this Section the appropriate government may make rules provided for the composition of Board of Trustees of the approved gratuity fund, and for the recovery by the controlling authority of the amount of gratuity payable to employees of LIC or any other insurer with whom an insurance has been taken, or as the may be, the Board of Trustees of the approved gratuity fund.

If the employer fails to pay the premium to the insurance or to contribute to an approved gratuity fund, he shall be liable to pay them a amount of gratuity including interest, if any, for delayed payments, to the controlling authority. Its contravention is punishable with a find upto Rs. 10000/- and in case of continuing the offence with a further find which may extend to Rs. 1000/- per day upto the duration the offence continues.

### **5.10 POWER TO EXEMPT: [SECTION. 5]**

<sup>1</sup>(1) The Appropriate Government may, by notification, and subject to such conditions as may be specified in the notification, exempt any establishment, factory, mine, oilfield,



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plantation, port, railway company or shop to which this Act applies from the operation of the provisions of this Act, if in the opinion of the appropriate Government the employees in such establishment, factory, mine, oilfield, plantation, port, railway company or shop are in receipt of gratuity or pensionary benefits not less than the benefits conferred under this Act.

- <sup>1</sup>(2) The Appropriate Government may by notification and subject to such conditions as may be specified in the notification, exempt any employee or class of employees employed in any establishment, factory, mine, oilfield, plantation, port, railway company or shop to which this Act applies from the operation of the provisions of this Act, if, in the opinion of the appropriate Government, such employee or class of employees are, in receipt of gratuity or pensionary benefits not less favourable than the benefits conferred under this Act.
- <sup>2</sup>(3) A notification issued under sub-Section (i) or sub Section (ii) may be issued retrospectively a date not earlier than the date of commencement of this Act, but no such notification shall be issued so as to prejudicially, affect the interests of any person.

The provisions of Section. 5 of the Act empowers the appropriate Government to exempt any employer or the class of employers as well as the employee or the class of employees from the application the Act provided that if there are existing beneficial provision regarding gratuity of the employees in comparison with the provisions of the Act. It may be notified with retrospective effect but not before the date of commencement of the Act without any type of prejudice at all.

### **5.11 NOMINATIONS FOR GRATUITY: [SECTION. 6]**

Normally, the gratuity is paid to the employee by his employer, which his services are terminated due to any reason in his lifetime, but after the death of the said employee, the said employee, the earned gratuity is to be paid to his successors and to avoid any type of complications and controversies, the provision of the nomination by the employee to get the gratuity, in case of his death is made. The provisions are as below:

Each employee, who has completed one year of service shall make within such time in such form and in such manner, as may be prescribed, nomination for the purpose of the second proviso to sub-Section (1) of Section. 4

An employee may ion his nomination, distribute the amount of gratuity payable to him under this Act amongst more than one nominee.

If an employee has a family at the time of making a nomination, the nomination shall be made in favour of one or more members of his family, and any nomination made by such employee in favour of a person who is not a member of his family shall be avoid.



If at the time of making a nomination the employee has no family, the nomination may be made in favour of any person or persons but if the employee subsequently acquires a family, such nomination shall forthwith become invalid and the employee shall make within such time as may be prescribed, a fresh nomination in favour of one or more members of his family.

A nomination may, subject to the provisions of sub-Sections (3) or (4) be notified by an employee at any time, after giving to his employer a written notice in such form and in such a manner as may be prescribed, if his intention to do so.

If a nominee predeceases the employee, the interest of the nominee shall revert to the employee who shall make a fresh nomination, in the prescribed form, in respect of such interest.

Every nomination, fresh nomination or alteration of nomination, as the case may be, shall be sent by the employee to his employer, who shall keep the same in his safe custody.

**PROCEDURE FOR NOMINATION:**

A nomination shall be filled in Form 'F' and will be submitted in duplicate by personal service by the employee, after taking proper receipt or by sending through registered post acknowledgement due to the employer.

In case of an employee who is already in employment for a year or more. On the date of commencement of these rules, ordinarily, within ninety days from such date, and

In case of an employee who completes one year of service after the date of commencement of these rules, ordinarily within thirty days of the completion of one year of service.

If the Form 'F' is filed with reasonable grounds for delay shall be accepted by the employer after the specified time and no nomination so accepted shall be invalid because of the reason that it was filed after the specified period.

Within 30 days of the receipt of nomination on Form 'F', the employer shall get the service particulars of the employee, as mentioned in the form, verified with reference to the records of the establishment and return one copy to the employee, after obtaining a receipt thereof, the duplicate copy of Form 'F' duly attested by the employer or his authorized signatory and the other one shall be recorded for future in his office.

If an employee has no family at the time of his first nomination, then within 90 days of acquiring a family, he will submit a fresh nomination in duplicate on Form 'G' to the employer.

A notice of modification of a nomination, including the case where the nominee predeceases, an employee, shall be submitted in duplicate on Form 'H' to the employer. In both of cases as in (3 & 4), the rest procedure will be as mentioned in (1) & (2).

A nomination or a fresh nomination or a notice of modification of nomination shall be duly signed by the employee and if he is illiterate, shall bear the thumb impression of the employee



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in presence of the two witnesses, who shall also sign a declaration to that effect in the nomination, fresh nomination or notice of modification of nomination, as the case may be, and it shall take effect from the date of receipt thereof by the employee.

### 5.12 APPLICATION FOR THE PAYMENT OF GRATUITY: [SECTION. 7]

- (1) An employee who is eligible for payment of gratuity, under the Act, or any person authorized, in writing, to act on his behalf, shall apply, ordinarily within 30 days from the date of the gratuity became payable, in Form 'I' to the employer.

But if the date of superannuation or retirement of an employee is known, the employee may apply to the employer before 30 days of the date of superannuation or retirement.

- (2) A nominee of an employee who is eligible for payment of gratuity in case of death of the employee shall apply to the employer ordinarily within 30 days from the date of the gratuity becomes payable to him in the Form 'J'.

An application on plain paper with relevant particulars shall also be accepted. The employer may obtain such other particulars as may be deemed necessary by him.

(Rule 6)

- (3) If an employee dies without making a nomination, his legal heir, who is eligible for the payment of gratuity, shall apply, ordinarily within one year from the date of gratuity became payable to him on form 'K' to the employer.

An application even after the prescribed period shall also be entertained by the employer, if the sufficient cause for delay has been mentioned in the application. Any dispute in this regard shall be referred to the Controlling Authority for his decision. In any case, the claim for gratuity can not be treated as invalid merely because the claimant failed to submit the application within the prescribed time.

The application shall be presented to the employer either by personal service or by registered post with A/D.

### 5.13 EMPLOYER'S DUTY REGARDING THE PAYMENT:

As soon as gratuity becomes payable, the employer shall, whether the application for the payment of gratuity has been given or not by the employee, determine the amount of gratuity and give notice in writing to the person to whom the gratuity is payable and also the controlling officer specifying the amount of gratuity so determined. [Section. 7(2)]

The employer shall arrange to pay the amount of gratuity within 30 days from the date of its becoming due/payable to the person to whom it is payable. [Section. 7(3)]



**PROVISION OF INTEREST ON GRATUITY AMOUNT:**

If the amount of gratuity payable under sub-Section (3) is not paid by the employer within period specified i.e. 30 days, the employer shall pay, from the date on which the gratuity becomes payable to the date on which it is paid, simple interest at such rate, no exceeding the rate notified by the Central Government from time to time for repayment of long term deposits, as the Government may, by notification specify.

Provided that no such interest shall be payable if the delay in the payment is due to the fault of the employee and the employer has obtained permission in writing from the Controlling Authority for the delayed payment on this ground. [Section. 7(3A)]

**NOTICE FOR PAYMENT OF GRATUITY:**

If the claim is found admissible on verification, the employer shall issue a notice on Form 'L' to the applicant employee, nominee or legal heir, as the case may be, specifying the amount of gratuity payable and fixing a date, not being later than the 30<sup>th</sup> day after the date of receipt of the application, for payment thereof, or

If the claim for gratuity is not found admissible, issue a notice in Form 'M' to the applicant employee, nominee or legal heir, as the case may be specifying the reasons why the claim for gratuity is not considered admissible.

In either of the case, within 15 days of the receipt of an application for the payment of gratuity, the notice has to be issued by employer to the applicant employee, nominee or legal heir, as the case may be, alongwith a copy endorsed to the controlling authority.

If the claimant for gratuity is a nominee or a legal heir, the employer may ask for such witness or evidence as may be deemed relevant for establishing his identity or maintainability of his claim. In that case, the time limit specified for issuance of notices shall be operative with effect from the date such witness or evidence, called for by the employer is furnished to the employer.

The notices on Form 'L' or 'M' shall be served on the applicant either by personal service after taking receipt or by registered post with A/D. (Rule 8)

**5.14 MODE OF PAYMENT OF GRATUITY:**

The gratuity shall be paid either in cash or in demand draft or bank cheque to the claimant. If the claimant desires and the amount of gratuity payable is less than one thousand rupees, payment may be made by postal money order after deducting the commission due to such postal money order from the amount payable. The intimation about the details of payment shall be given to the controlling authority by the employer.



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In case of the nominee or a legal heir, who is minor, the controlling authority shall invest the gratuity amount deposited by him for the benefit of such minor in term deposit with the State Bank of India or any of its subsidiaries or any nationalized Bank. (Rule 9)

### **5.15 DISPUTES:**

If there is any dispute regarding the amount of gratuity payable to an employee or admissibility of any claim of or in relation to, an employee for payment of gratuity or the person entitled to receive the gratuity, the employer shall deposit, such amount as he admits to be payable by him as gratuity, to the controlling authority and for these (one or all) other person raising dispute may make an application to the controlling authority for deciding the dispute.

The controlling authority shall, after due inquiry and after giving the reasonable opportunity of being heard to the parties to the dispute, determine the matter or matters in dispute. After such inquiry any amount is found to be payable to the employee, the controlling authority shall direct the employer to pay such amount or the difference of amount so determined and the amount already deposited by the employer to the controlling authority. The controlling authority shall pay the amount deposited by the employer including the excess amount, if any, to the person entitled thereto.

As soon as the employer made the said deposit, the controlling authority shall pay the amount to the applicant where he is the employee or where the applicant is not the employee, to the nominee or as the case may be, the guardian of such nominee or legal heir of the employee, if he is satisfied that there is no dispute as to the right of the applicant to receive the amount of gratuity. For the purpose of conducting inquiry, the controlling authority shall have the same powers as are vested in the court, while trying a suit, under the code of civil procedure, 1908. The proceedings made by him will be the 'judicial proceedings' within the meaning of Sections 193 & 228 & for the purposes of Section. 196, IPC the controlling authority will avail all the powers like enforcing the attendance, production of documents, receiving evidences on affidavits and issuing commission for the examination of witnesses. [Section. 7(4)]

### **APPLICATION TO CONTROLLING AUTHORITY FOR DIRECTION:**

If an employer refuses to accept nomination or to entertain an application sought to be filed for the payment of gratuity or issues a notice either specifying an amount of gratuity which is considered by the applicant less than what is payable or rejecting eligibility to payment of gratuity or having received an application for the payment of gratuity and fails to issue any notice as required within the specified time (i.e. within 15 days ) the claimant (employee, nominee or legal heir, as the case may be) may, within 90 days of the occurrence of the occurrence of the cause for the application, apply in Form 'N' to the controlling authority for issuing a direction under Section. 7(4) with as many extra copies as are the opposite party.





The controlling authority may accept any application on sufficient cause being shown by the applicant, after the expiry of the specified period also.

The said application and other relevant documents shall be presented in person to the controlling authority or shall be sent to him by registered post with A/D (Rule 10).

#### **5.16 PROCEDURE FOR DEALING WITH APPLICATION FOR DIRECTION:**

On receipt of application for direction the controlling authority shall issue a notice on Form 'O' to call upon the applicant as well as the employer to appear before him on a specified date, time and place, either by himself or through his authorized representative alongwith all the relevant documents and evidences, if any.

Any person desiring to act on behalf of an employer or the claimant shall present a letter of authority from the person concerned to the controlling authority alongwith a written statement explaining his interest in matter and praying for permission to act so. The controlling authority shall record the same according his approval or specifying the reasons, in case of refusal to grant the permission. A party appearing through his representative shall be bound by the acts of his representative. After completion of hearing on the date fixed, or after such further evidence, examination of documents, witnesses, hearing and enquiry, as may be deemed necessary, the controlling authority shall record his findings as to whether any amount is payable to the applicant under the Act. A copy of the finding shall be given to each of the parties.

If the employer fails to appear on the specified date of hearing after due service of notice without sufficient cause, the controlling authority may proceed to hear and determine the application ex parte and if the applicant fails to appear on the specified date of hearing without sufficient cause, the controlling authority may dismiss the application.

Thus, the order passed may be received on good cause being shown within 30 days of the said order and the application reheard after giving not less than 14 days notice to the opposite party of the date fixed for rehearing of the application.

The controlling authority shall record the particulars of each case in Form 'Q' and at the time of passing orders shall sign and date the particulars so recorded and shall also record the findings on the merits of the case and file it alongwith the memoranda of evidence with the order sheet. [Rule 1]

#### **DIRECTION FOR PAYMENT:**

If the findings are recorded that the applicant is entitled for the payment of gratuity under the Act, the controlling authority shall issue a notice to the employer concerned on Form 'R' specifying the amount payable and directing payment thereof to the applicant, under intimation



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to the controlling authority within 30 days from the date of the receipt of the notice, by the employer. A copy of the notice shall be endorsed to the applicant also. [Rule 17]

### **5.17 APPEALS:**

Any person aggrieved by an order made by the controlling authority may, within 60 days from the receipt date of the order, prefer an appeal to the Appropriate Government or such other authority as may be specified by the Appropriate Government in this behalf. After being satisfied with sufficient cause, he may extend this time by another period of 60 days.

The Appropriate Government or the appellate authority, as the case may be, may, after giving a reasonable opportunity of being heard, confirm, modify or reverse the decision of the controlling authority.

The employer's appeal shall not be admitted without producing the certificate of deposit of gratuity amount issued by the controlling authority or the deposit of the said amount with Appellate Authority. [Section. 7 (7)]

### **5.18 APPOINTMENT OF INSPECTORS:**

By notification, the appropriate government may appoint as many Inspectors, as it deems fit, for the purposes of the Act. The Appropriate Government may, by general or special orders, define the area to which the authority or an inspector so appointed shall extend and where two or more inspectors are appointed for the same area, also provide, by such order, for the distribution or allocation of work to be performed by them. Every inspector shall be deemed to be a public servant within the meaning of Section 21 of the IPC. [Section. 7(A)<sup>1</sup>]

### **POWERS OF INSPECTORS:**

An inspector may exercise all or any of the following powers, for the purpose of ascertaining the compliance of the various provisions of the Act, namely,

- to furnish such informations as he may consider necessary,
- to enter and inspect, at all reasonable hours, any premises of or place in any factory, mine, oilfield, plantation, port, railway company, shop or other establishment to which this Act applies, for the purpose of examining any register, record or notice or other documents required to be kept or exhibited under this Act or the rules made thereunder.
- to examine the employer or any person whom he finds in such premises or place and employee employed therein, having a reasonable cause to believe.
- to make copies of, or take extracts from, any register, record, notice or other document, as he may consider relevant, and where he has reason to believe that any offence under



this Act has been committed by an employer, search seize with such assistance as he may think fit, such register, record, notice or other document as he may consider relevant in respect of that offence,

- to exercise such other powers as may be prescribed.

Any person required to produce any type of document or to give any information by an inspector shall be deemed to be legally bound to do so within the meaning of Sections 175 and 176 of the IPC and the provisions of the code of criminal procedure, 1973 shall apply to any search or seizure under this Section as they apply to any search or seizure made under the authority of a warrant issued under Section 94 of the code.

In this way, we can say that the inspector has get all the executive powers to implement he provisions of the Act. [Section. 7(B)]

#### **MACHINERY FOR ENFORCEMENT OF THE ACT OR RULES IN CENTRAL SPHERES:**

All Assistant Labour Commissioners (Central) have been appointed as controlling authorities and all the Regional Labour Commissioners (Central) as Appellate Authorities.

#### **5.19 RECOVERY**

If the gratuity payable under the Act is not paid by the employer within the prescribed time, to the person entitled thereto. The controlling authority shall issue a certificate for the amount to the collector to recover the same alongwith the compound interest at such rate as prescribed by the Central Government from the date of expiry of the prescribed time as land revenue arrears to enable the person entitled to get the amount after receiving the application from the aggrieved person. [Section. 8]

Before issuing the certificate for such recovery the controlling authority shall give the employer a reasonable opportunity of showing cause against the issue of such certificate.

The amount of interest payable under this Section shall not exceed the amount of gratuity payable under this Act in no case. [Section. 8]

#### **APPLICATION FOR RECOVERY OF GRATUITY:**

Where an employer fails to pay the gratuity due under the Act in accordance with the notice by the controlling authority, the employee concerned, his nominee or his legal heir, as the case may be to whom the gratuity is payable may apply to the controlling authority in duplicate on Form 'T' for the recovery of gratuity. [Rule 19]



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### **PENALTIES:**

Any person who is responsible for the purpose of avoiding any payment to be made by himself or of enabling any other person to avoid such payment, knowingly makes or causes to be made any false statement or false representation shall be punishable with the imprisonment for the term which may extend to six months, or with fine which may extend to ten thousand rupees, or with both.

An employee, who contravenes or makes default in complying with, any of the provisions of the Act or any rule or order made there under shall be punishable with imprisonment for the term which shall not be less than three months but which may extend to one year or with fine which shall not be less than Rs.10000/- but may be extended to twenty thousand rupees or with both.

If the offence relates to non-payment of any gratuity payable under the Act, the employer shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to two years unless the court trying the offence, for the reasons to be recorded but it in writing, is of the opinion that a lesser term of imprisonment or the imposition of a fine would meet the ends of justice. [Section. 9]

### **5.20 EXEMPTION OF EMPLOYER FROM LIABILITY:**

Where an employer is charged with an offence punishable under this Act, he shall be entitled to have any other person whom he charges as the actual offender brought before the court at the time fixed for hearing the charge and the employer proves to the satisfaction of the court that he has used due diligence to enforce the execution of this Act, and the said person committed the offence in question without his knowledge, consent or connivance, the other person responsible for the occurrence shall be convicted of the offence and shall be liable to the like punishment as if he were the employer and the employer shall be discharged from any liability under the Act in respect of such offence. [Section. 10]

### **5.21 COGNIZANCE OF OFFENCES:**

No Court shall take cognizance of any offence punishable under this Act save on a complaint made by or under the authority of the appropriate government, provided that where the amount of gratuity has not been paid, or recovered, within six months from the expiry of the prescribed time, the appropriate government shall authorise the controlling authority to make a complaint against the employer, where upon the controlling authority shall within 15 days from the date of such authorization, make such complaint to a magistrate having jurisdiction to try the offence and no court inferior to that of a Metropolitan Magistrate or a Judicial Magistrate of the first class shall try any offence punishable under this Act. {Section. 11}



### **5.22 PROTECTION AGAINST ACTION TAKEN IN GOOD FAITH:**

If a controlling authority or any other person in respect of anything take any action which is in good faith done or intended to be done under this Act or any Rule or any other, no suit or other legal proceedings can be instituted against him because it will be presumed that he has taken all the actions to implement or comply the provisions of the Act on behalf of Government. [Section. 12]

### **5.23 PROTECTION OF GRATUITY:**

In any case, gratuity cannot be attached in execution of any decree or order of any civil, revenue or criminal court. [Section. 13]

### **5.24 MISCELLANEOUS**

#### **POWER TO MAKE RULES:**

The Appropriate Government may be notification make rules for the purpose of carrying the provisions of the Act. In exercise of this power, the Central Government has made the payment of Gratuity (Central) Rules, 1972, notified vide notification dtd. 16.09.1972 published in Part-II, Section. 3, Sub Section. (1) of the Gazette of India, extraordinary, dtd. 16.09.1972.

#### **NOTICE OF OPENING, CHANGE OR CLOSURE OF THE ESTABLISHMENT:**

A notice shall be submitted by the employer to the controlling authority of the area within 30 days of any change in name, address, employer or nature of business. Where an employer intends to close down the business he shall submit a notice to the controlling authority at least 60 days before the intended closure.

#### **DISPLAY OF NOTICE:**

The employer shall display a notice at or near the main entrance of the establishment in bold letters in English and in the language understood by the majority of the employees specifying the name of the officer with designation authorized by the employer to receive on his behalf notices under the Acts and Rules made there under.

#### **DISPLAY OF ABSTRACT OF THE ACT & RULES:**

The employer shall display an abstract of the payment of Gratuity Act and the Rules made there under in English and in other language understood by the majority of the employees at the important place at or near the main entrance of the establishment on Form 'U'.



**5.25 SELF EXAMINATION QUESTIONS**

1. Completed year of service
  - (a) Service for one year
  - (b) Continuous service
  - (c) Continuous service for one year
  - (d) Number of years of service.
2. Superannuation means
  - (a) The attainment of age of 58 years
  - (b) The attainment of age of 60 years
  - (a) Attainment of age as fixed in the contract or condition of services
  - (b) Such age certified medically to be fit
3. Gratuity shall be paid to an employee after he has surrendered continuous service for
  - (a) Not less than three years
  - (b) Not less than five years
  - (c) Not less than seven years
  - (d) None of the above.
4. For calculation of gratuity under the payment of Gratuity Act, 1972 the number of days in a month is to be taken as
  - (a) Actual number of days on employment
  - (b) 26 days
  - (c) 15 days
  - (d) 30 days
5. The Payment of Gratuity come into force on
  - (a) 23rd Oct., 1971
  - (b) 16th Sept., 1972
  - (c) 16th Sept., 1971
  - (d) 23rd Oct., 1972



6. Gratuity is a benefit, which an employee gets at the time of only retirement.
  - (a) True.
  - (b) False.
7. Forfeiture of Gratuity is possible under certain circumstances.
  - (a) True.
  - (b) False.

**Short /Essay Type Questions**

8. When, to whom and how gratuity shall be payable ?
9. An employee was terminated for disorderly conduct during the course of his employment. To what extent gratuity shall be forfeited ?
10. State the procedure for nominations in respect of gratuity payment.
11. There was a dispute regarding the amount of gratuity payable to an employee. How would you resolve the situation ? What procedure you would suggest ?
12. Can a gratuity be attached under any order of a criminal court ?

**Answer**

1. (c); 2. (c); 3. (b); 4. (b); 5. (b); 6. (b); 7. (a);

# CHAPTER 6

## THE COMPANIES ACT, 1956

### UNIT 1

#### Learning Objectives

In this unit the students are exposed to the working knowledge on the introductory part of the Companies Act, 1956 covering the following aspects:

- ◆ Company and Corporate Veil
- ◆ Classes of companies under the Companies Act
- ◆ Registration and incorporation of companies
- ◆ Memorandum of Association and Articles of Association and their alteration
- ◆ Contracts entered at the time of incorporation
- ◆ Promoters and their duties

#### 1.1 WHAT IS A COMPANY?

Section 3(1) of the Companies Act, 1956 defines a 'company': "Company means a company formed and registered under this Act or an existing company". The definition does not bring out clearly the meaning of a company. For a layman, the term "company" signifies a business organisation. But all business organisations cannot be technically called 'companies'. There are distinctive features between different forms of organisations and the most striking feature in the company form of organisation vis-à-vis the other organisations is that it acquires a unique character of being a separate legal entity. In other words when a company is registered, it is clothed with a legal personality. It comes to have almost the same rights and powers as a human being. Its existence is distinct and separate from that of its members. Members may die or change, but the company goes on till it is wound up on the grounds specified by the Act. In other words, it means that it has perpetual succession. A company can own property, have banking account, raise loans, incur liabilities and enter into contracts. Even members can contract with company, acquire right against it or incur liability to it. For the debts of the company, only its creditors can sue it and not its members. Also contrast to other forms of organization, the members of the company usually has a limited liability.





As the company is an artificial person, it can act only through some human agency, viz., and directors. They are at the helm of affairs of the company and act as its agency, but they are not the agents of the members of the company. A company has a common seal to authenticate its formal acts.

## **1.2 LIFTING OF THE “CORPORATE VEIL”**

In *Salomon vs. Salomon & Co. Ltd.* [1897] A.C. 2 the House of Lords laid down that a company is a person distinct and separate from its members. In this case one Salomon incorporated a company named “Salomon & Co. Ltd.”, with seven subscribers consisting of himself, his wife, four sons and one daughter. This company took over the personal business assets of Salomon for £ 38,782 and in turn, Salomon took 20,000 shares of £ 1 each, debentures worth £ 10,000 of the company with charge on the company’s assets and the balance in cash. His wife, daughter and four sons took up one £ 1 share each. Subsequently, the company went into liquidation due to general trade depression. The unsecured creditors contended that Salomon could not be treated as a secured creditor of the company, in respect of the debentures held by him, as he was the managing director of one-man company, which was not different from Salomon and the cloak of the company was a mere sham and fraud. It was held by Lord MacNaghten :

*“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 trustees 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.”*

Thus, this case clearly established that company has its own existence and as a result, a shareholder cannot be held liable for the acts of the company even though he holds virtually the entire share capital. The whole law of corporation is in fact based on this theory of corporate entity. Now, the question may arise whether this *Veil of Corporate Personality* can even be lifted or rend (*i.e.*, torn).

Before going into this question, you should first try to understand the meaning of the phrase “lifting the veil”. *It means looking behind the company as a legal person, i.e., disregarding the corporate entity and paying regard, instead, to the realities behind the legal facade.* Where the Courts ignore the company and concern themselves directly with the members or managers, the corporate veil may be said to have been lifted. Only in appropriate circumstances, are the Courts willing to lift the corporate veil and that too, when questions of control are involved rather than merely a question of ownership.



The following are the **cases where company law disregards the principle of corporate personality** or the principle that the company is a legal entity distinct and separate from its shareholders or members:

- (1) In the law relating to trading with the enemy where the test of control is adopted. The leading case in point is *Daimler Co. Ltd. vs. Continental Tyres & Rubber Co.* [1916] 2 A.C. 307, if the public interest is not likely to be in jeopardy, the Court may not be willing to crack the corporate shell. But it may rend the veil for ascertaining whether a company is an enemy company. It is true that, unlike a natural person, a company hasn't mind or conscience; therefore, it cannot be a friend or foe. It may, however, be characterised as an enemy company, if its affairs are under the control of people of an enemy country. For the purpose, the Court may examine the character of the persons who are really at the helm of affairs of the company.
- (2) In certain matters concerning the law of taxes, death duties and stamps particularly where question of the controlling interest is in issue. [*S. Berendsen Ltd. vs. Commissioner of Inland Revenue* [1953] Ch. 1. (C.A.)]. Where corporate entity is used to evade or circumvent tax, the Court can disregard the corporate entity [*Juggilal vs. Commissioner of Income Tax* AIR (1969) SC (932)]. Where it was found that the sole purpose for the formation of the company was to use it as a device to reduce the amount to be paid by way of bonus to workmen, the Supreme Court uphold the piercing of the veil to look at the real transaction (*The Workmen Employed in Associated Rubber Industries Limited, Bhavnagar vs. The Associated Rubber Industries Ltd., Bhavnagar and another*, AIR 1986 SC1).
- (3) Where companies form other companies as their subsidiaries to act as their agent. The application of the doctrine may operate in favour of such companies depending upon the acts of a particular case. Suppose, a company acquires a partnership concern and registers it as a company, which becomes subsidiary of the acquiring company. In an action for compulsory acquisition of the business premises of the subsidiary, it was held that the parent company (which through itself and nominees held all the shares) was entitled to compensation, maintain action for the same [*Smith, Stone and Knight Ltd. vs. Lord Mayor, etc., of Birmingham* [1939] 4, All. 116].
- (4) Where the benefit of limited liability of shareholders is destroyed and each shareholder's liability has become unlimited. This happens (under Section 45) when the number of members of a public company or a private company or a private company falls below 7 or 2 respectively, and business is carried on for more than six months. In such a situation, every person who is a member and is cognisant of the fact shall be severally liable for the payment of the whole debts of the company incurred during that time.
- (5) Under the law relating to exchange control.



- (6) Where the device of incorporation is adopted for some illegal or improper purpose, e.g., to defeat or circumvent law, to defraud creditors or to avoid legal obligations.

### **1.3 CLASSES OF COMPANIES UNDER THE ACT**

A company may be incorporated as a private company or a public company, depending upon the number of members joining it. Again it may either be an unlimited company, or may be limited by shares or by guarantee or by both. On the basis of control, companies can be classified as Holding companies and Subsidiary companies. Some other popular forms of classification of companies are: foreign company, Government company, One-man company and non-profit making company.

(a) *Company limited by shares*: When the liability of the members of a company is limited by its memorandum of association to the amount (if any) unpaid on the shares held by them, it is known as a company limited by shares. It thus implies that for meeting the debts of the company, the shareholder may be called upon to contribute only to the extent of the amount, which remains unpaid on his shareholdings. His separate property cannot be encompassed to meet the company's debt.

It may be worthwhile to know that though a shareholder is a co-owner of the company, he is not a co-owner of the company's assets. The ownership of the assets remains with the company, because of its nature as you may recollect - as a legal person. The extent of the rights and duties of a shareholder as co-owner is measured by his shareholdings. Thus, all the shareholders of the company are its proprietors, the amount due from all of them is the issued capital of the company. A company limited by shares needs fund for its working it raises its fund by issuing shares. When the shares are issued, these may be subscribed by the signatories to the memorandum or may be allotted to applicants therefore, either for cash or for consideration in kind.

You may now ask whether, in a company limited by shares, a shareholder has to pay the whole nominal value of its share at the time of acquiring the shares. The answer is in the negative. Subject to the provisions of the articles of the company, its directors may at any time demand from the shareholders payment of the unpaid portion of the nominal amount of the shares. Such demands - technically described as 'calls' - may be made either during the lifetime of the company or during the winding up. When the initial working capital provided by the initial payments of the shareholders falls short, directors have the power to make further calls. There is no legal limit as regards the amount of a call. You will therefore, note that both the time for, and the amount of, call are uncertain, depending on the decision of the directors.

(b) *Company limited by guarantee*: Section 12(2)(b) defines it as one having the liability of its members limited by the memorandum to such amount as the members' may respectively undertake by the memorandum to contribute to the assets of the company in the event of its



being wound up. Thus, the liability of the member of a guarantee company is limited by a stipulated sum mentioned in the memorandum. Members cannot be called upon to contribute beyond that stipulated sum.

From what you have read so far, you will observe that the common features between a 'guarantee company' and 'share company' are legal personality and limited liability. In the latter case, the member's liability is limited by the amount remaining unpaid on the share, which each member holds. Both of them have to state in their memorandum that the members' liability is limited. However, the point of distinction between these two types of companies is that in the former case the members may be called upon to discharge their liability only after commencement of the winding up and only subject to certain conditions; but in the latter case, they may be called upon to do so at any time, either during the company's life-time or during its winding up.

It is clear from the definition of the guarantee company that it does not raise its initial working funds from its members. Therefore such a company may be useful only where no working funds are needed or where these funds can be had from other sources like endowment, fees, charges, donations, etc.

**Similarities and dis-similarities between the Guarantee Company and the Company having share capital:** The common features between a "guarantee company" and the "company having share capital" are legal personality and limited liability. In case of the later company, the members' liability is limited by the amount remaining unpaid on the shares, which each member holds. Both of them have to state this fact in their memorandum that the members' liability is limited.

However, the dis-similarities between a 'guarantee company' and 'company having share capital' is that in the former case the members may be called upon to discharge their liability only after commencement of the winding up and only subject to certain conditions; but in latter case, they may be called upon to do so at any time, either during the company's life or during its winding up.

Further to note, the Supreme Court in *Narendra Kumar Agarwal vs. Saroj Maloo (1995) 6 SC C 114* has laid down that the right of a guarantee company to refuse to accept the transfer by a member of his interest in the company is on a different footing than that of a company limited by shares. The membership of a guarantee company may carry privileges much different from those of ordinary shareholders.

It is also clear from the definition of the guarantee company that it does not raise its initial working funds from its members. Therefore, such a company may be useful only where no working funds are needed or where these funds can be had from other sources like endowment, fees, charges, donations etc.



(c) *Non-profit making companies*: Suppose an association is about to be formed as a limited company for promoting commerce, arts, science, religion, charity or any other useful object and intends to apply its profits or other income in promoting its object and to prohibit payment of any dividend to its members. *In such circumstances, the Central Government may, by licence, direct that the association may be registered as a company with limited liability without the addition of words 'Limited' or 'Private limited' to its name.* Therefore, the association may be registered accordingly. On registration (subject to the provisions of Section 25), it will have the same privileges and obligations as a limited company has. This licence is revocable by the Central Government, and on revocation the Registrar shall put 'Limited' or 'Private Limited' against the company's name in the register. But before such revocation, the Central Government must give it a written notice of its intention to revoke the licence and opportunity to be heard in the matter.

(d) *Unlimited company*: A company having not any limit on the liability of its members is termed in the Act as unlimited company. *In such a company the liability of a member ceases when he ceases to be a member.*

The liability of each member extends to the whole amount of the company's debts and liabilities but he will be entitled to claim contribution from other members. In case the company has a share capital the articles of association must state the amount of share capital and the amount of each share (Schedule I, Table E). So long as the company is a going concern the liability on the shares is the only liability which can be enforced by the company, though the liability of the members is unlimited so far as creditors are concerned. [Re. *Mayfair Property Co. Bartlett vs. Mayfair Property Co.* [1898] 2 Ch. 28].

An unlimited company can register it as a limited company if a resolution is passed to that effect [Section 98]. If the unlimited company has share capital, (a) it may increase the nominal value of its shares provided that no part of such increase shall be capable of being called up except in the event and for the purpose of the company being wound-up, or (b) to provide that a specified portion of its uncalled share capital shall not be capable of being called up except in the event and for the purposes of the company being wound-up [Section 98].

(e) *Definition of Private and Public Companies* : Companies are basically classified into "Public companies" and "Private companies". Certain changes in the existing definition were brought into force by the Companies (Amendment) Act, 2000.

**Private Company** [Section 3(1) (iii)]

Earlier private companies had three restrictive conditions in their articles of Association viz.

- (a) Restriction on the right to transfer its shares.
- (b) Limitation on the number of members to fifty (50).
- (c) Prohibition on inviting public to subscribe to any shares or debentures of the company.



- (d) Prohibit an invitation or acceptance of deposits from persons other than its member, directors or their relatives.
- (1) *Restriction on transfer of shares:* The articles contain a provision restricting the right to transfer its shares. The object of such a provision is to confine the ownership of and interest in the company to a choice circle of friends and relatives [Section 3(1)(iii)a]. The right of transfer is generally restricted in the following manner:
- (a) By authorising the directors to refuse transfer of shares to persons whom they do not approve or by compelling the shareholder to offer his shareholding to the existing shareholders first. It may be noted that it can only restrict the right of sale to a member. On this consideration, the articles usually provide that before selling or transferring his share, the directors must be communicated in writing of such intention of the shareholder.
- (b) By specifying the method for calculating the price at which the shares may be sold by one member to another. Generally, it is left to be determined either by the auditor of the company or by the company at a general meeting.
- (c) By providing that the shareholders who are employees of the company shall offer the shares to specified persons or class of persons when they leave the company's service.
- (2) *Limitation of membership:* The articles must contain a provision whereby the company limits the number of its members (exclusive of employees who are members and ex-employees continuing to be members) to 50; in counting the number of shareholders, joint-shareholders are treated as a single member [Sec. 3(1)(iii)(b)]. The reason why 'employee members' are excluded from the computation is perhaps to enable the company to associate workers with the management of the company and to give them the benefit of owning interest in the company. This will in its turn impel the workers to work for the welfare of the company and thereby to promote industrial peace. That is why, it may be pertinent to note here that Section 77 authorises a company to grant loans to its employees, etc. (other than directors) to purchase its shares.
- (3) *Prohibition on making an invitation to public:* The articles must prohibit any invitation to the public to subscribe for any of its shares or debentures [Section 3(1)(iii)(c)]. Such a prohibition is necessary for the substance of the private character of the company. One should note that under Section 67, an offer or invitation to a section of the public selected as members of the company is an offer or invitation to the public or debenture-holders of the company. But such an invitation to the public shall be excluded from the category of 'invitation to the public' if such offer or investigation can be properly regarded in all circumstances:
- (i) as not being calculated to result directly or indirectly in the shares or debentures becoming available for subscription or purchase by person other than those receiving the offer or invitation; or



- (ii) otherwise as being a domestic concern of the persons making and receiving the offer or invitation.

Consequently, a company is permitted to offer shares or debentures to its members or debentures holders. An offer of shares by the directors to their friends by a document marked "private and confidential not for publication" is not an invitation to the public [*Sharewell vs. Combined Incandescent Metals Syndicate* [1907] 23 T.L.R. 482]. Similarly a circular offering the allotment of shares in a company in exchange for existing shares is not a prospectus [*Government Stock, etc. Co. vs. Christopher* [1956] 1 AER 490].

Question may arise as to whether the articles of existing companies need be amended to include this condition.

Even if the articles are not amended, the provisions of Section 9 will apply wherein it is stated that the provisions of the Act will supercede the provisions of the articles. However, it is desirable & advisable as a good secretarial practice to alter the articles.

If these restrictions are not there, the company will be treated as public company. Therefore, the articles of Association should be amended immediately by passing Special Resolution under Section 31 to provide for restriction, in particular item (d) above.

(ii) It may be noted that after the above amendment no private limited company can take any loan/deposit or retain any loan/deposit taken from any outsider (other than its members, director's or their relatives). Therefore, all private limited Companies will have to regularize this matter immediately.

(iii) Every private company should have paid up capital of Rs. one lac. Existing companies will have to issue shares to ensure paid up capital of Rs. 1 lac within 2 years of commencement of Amendment Act. Such capital may be Equity or Preference

(iv) If paid up capital is not increased to Rs. 1 lac within 2 years the company will be deemed to be a defunct company under Section 560, name of such a company will be struck off by ROC.

**Public company** [Section 3(1) (iv)].

(i) The amended definition provides that a company, which is not a private company, will be a public company. Further a private company which a subsidiary of a public company is also covered by definition of a public company.

(ii) It is now necessary that a public company should have paid up capital of atleast Rs. 5 lacs. In the case of an existing company the paid up capital should be increased to Rs. 5 lacs within 2 years from commencement of Amendment Act. If this is not done, name of the company will be removed as a defunct company under Section 560.



(iii) A private company, which is a subsidiary of public company, will have to comply with the above requirement of minimum paid-up capital and other provisions applicable to public companies.

(iv) Section 25 company is not required to have the above minimum capital.

(iv) Subsidiary of public company:

- ◆ 43A company which is subsidiary of a public cannot be converted into a private company in view of definition of public company under Section 3(1) (iv)
- ◆ Such a company to have Minimum capital of Rupees 5 lacs – Minimum directors – 3 and Minimum Members – 7

*(g) Holding and subsidiary companies*

'Holding and subsidiary' companies are relative terms. A company is a holding company of another only if the other is a subsidiary. Any of the three circumstances illustrated below must exist to constitute the relationship of holding and subsidiary companies.

(a) A will be subsidiary of B, if B controls the composition of the Board of Directors of A, *i.e.*, if B can, without the consent or approval of any other person, appoint or remove a majority of directors of A. B will be deemed to possess the power to appoint majority of persons as directors of A: (i) when these persons cannot be appointed in that capacity without B's consent, or (ii) when their appointments follow necessarily from their appointment as directors, manager or the holder of any office in B company, or (iii) when the holding company (*i.e.*, B) itself or its another subsidiary holds the directorship in 'A' company [Section 4(1)(a) & (2)].

(b) (i) A will be a subsidiary of B, if B is entitled to exercise control over more than half the total voting power of A, where A is an existing company in respect of which the holders of preference shares, issued before the commencement of the Companies (Amendment) Act, 1960 had the same voting rights in all respects as the holders of equity shares.

(ii) Again, A will be subsidiary of B, if B holds more than half in nominal value of its equity share capital, where A is any company other than the one specified under (i) above. In other words, B must hold more than 50% of the equity capital on the basis of the nominal capital whatever may be the amount paid up on the shares [Sections 4(1)(a) & (b)].

For the purpose of condition described in para (ii) above, the shares that a company holds must be held in its own right and not merely in fiduciary capacity. Thus, the shares held in trust for an individual are to be excluded. On the other hand, shares held by another person as a nominee for the company or any of its subsidiaries should be regarded as being held by the company for the purpose.

In order to determine whether a company is a subsidiary of another, shares held by any person under the provisions of any debentures are not to be taken into account. Also, where a





company's ordinary business includes money-lending, shares of other company held as security in a normal business transaction are to be disregarded.

(c) A company will be subsidiary of another company called holding company, if it is a subsidiary of a subsidiary of the holding company. For example, B is a subsidiary of A and C is a subsidiary of B. In such a case, C will be the subsidiary of A. In the like manner, if D is a subsidiary of C, D will be subsidiary of B as well as of A and so on [Section 4(1)(c)].

It may be noted that the phrase "controls the composition of board of directors" is to be read in accordance with and only in accordance with Sub-section (2) of Section 4 of this Act and that sub-section conceives of control if but only if, the company which claims control can appoint or remove the holders of all or a majority of the directorships by the exercise of some power exercisable by it at its discretion without the consent or concurrence of any other person. Section 4 of the Companies Act envisages the existence of subsidiary companies in different circumstances. It may be that by acquiring sufficient share capital of a company sufficient control may be obtained over that company to enable control in the composition of board of directors. But it is also possible to obtain such control in regard to the composition of the board without making such an investment in equity capital of the company. Such a control may be by reasons of an agreement such as where one company may agree to advance funds to another company and in return may, under the terms of an agreement surrender control over the right to appoint all or a majority of the board of directors. The first of the cases envisaged in Sub-section (4) is the case where a control is obtained by a company in the matter of composition of the board of directors of another company. That would be sufficient to constitute the former as holding company and the other as subsidiary. The second type of cases is where more than half of the nominal value of the equity share capital is held by another company. By virtue of such holding that other company becomes a holding company and the one whose shares are so held becomes a subsidiary company. That other company is also a subsidiary of the holding company of the subsidiary. Section 4 envisages yet another case and that relates to existing company in respect of which the holders of preference shares issued before the commencement of the act exercise or control more than half of the total voting power of such company [*M. Veldyudhan vs. Registrar of Companies* [1980] *Comp. Case 33 (Ker.)* (41-42)].

#### **Status of private company, which is subsidiary to public company**

Although the Act has segregated the companies into several types, a question may arise about status of a private company, which is subsidiary to public company. In view of Section 3(iv)(c) of the Companies Act, 1956 a Private company, which is subsidiary of a public company and controlled by the latter, is considered as public company. In such a situation privileges available to a private company under the Companies Act, 1956 may not be available to such private company, which is a subsidiary of public company.



**(N.B. The expression, 'Private company which is a subsidiary of a public company appears in several sections of this Act and such a company will be on the same footing as public companies.)**

Indian private companies which are subsidiaries of foreign public companies are divided into two categories: one, where the entire share capital of the private subsidiary company is held by the foreign holding company, either alone or in consortium with other foreign companies, and the second, where the entire share capital is not so held. For the purpose of this Act, the first category of companies will not be subsidiaries of a 'public company' and as such will not be subject to the controlling provision of the Act relating to such companies. But, for the purposes of this Act, the second category of companies will be treated as subsidiaries of a public company [Section 4(7)].

Normally, a subsidiary company cannot be a member of its holding company. Where, however, it was a member before it becomes subsidiary, it shall not have the voting right at a meeting though it may exercise other rights of members [Section 42].

*(h) Public financial institutions:* By virtue of Section 4A the following institutions are to be regarded as public financial institutions.

- (a) The Industrial Credit and Investment Corporation of India Ltd. - a company which was formed and registered under the Indian Companies Act, 1913;
- (b) The Industrial Finance Corporation of India - a company established under Section 3 of the Industrial Finance Corporation Act, 1948;
- (c) The Life Insurance Corporation of India - established under Section 3 of the Life Insurance Corporation Act, 1956;
- (d) The Industrial Development Bank of India - established under Section 3 of the Industrial Development Bank of India Act, 1964;
- (f) The Infrastructure Development Finance Company Ltd.
- (e) The Unit Trust of India - established under Section 3 of the Unit Trust of India Act, 1963;
- (f) The Infrastructure Development Finance Company Ltd.

The Central Government has, however, assumed powers to add any other institution to the above-mentioned list of public financial institution. This addition has to be made through a notification in the Official Gazette. Secondly, the institution, for being added to the existing list, (i) Must have been established or constituted by or under any Central Act; or (ii) at least 51% of the paid-up share capital of such institution is held or controlled by the Central Government.



Other public financial institutions specified (to mention a few) by the Central Government are :

- (g) The General Insurance Corporation of India;
- (h) The National Insurance Co. Ltd.
- (i) The United India Fire and General Insurance Co. Ltd.;
- (j) The Orient Fire and General Insurance Co. Ltd.;
- (k) The India Insurance Co. Ltd.;
- (l) The Industrial Reconstruction Corporation of India Ltd. (Now called the Industrial Reconstruction Bank of India Ltd.)
- (m) Tourism Finance Corporation of India Ltd. (TFCI)
- (n) Shipping Credit & Investment Co. of India Ltd. (SCICI)
- (o) Risk Capital & Technology Finance Corporation Ltd.
- (p) Technology Development and Information Company Ltd.
- (q) Power Finance Corporation Ltd.

#### **1.4 MISCELLANEOUS PROVISIONS (SECTIONS 43-45)**

**Default in complying with the conditions constituting a company a private company [Section 43]** : If contraventions is made in complying with the provisions contained in Section 3(1)(iii), the company shall lose all the privileges and exemptions conferred on it by the Act, and the Act shall apply to it as if it were not a private company. But the Company Law Board may relieve the company from such a consequence, if it is satisfied that the failure in compliance with the said requirement was not deliberate but was accidental or inadvertent or that on other grounds it is just and equitable to grant relief.

**Consequences of membership falling below legal minimum [Section 45]**: If at any time, the number of members of a public company or a private company falls below seven or two respectively and the company continues to carry on its business for a period exceeding six months, subsequent to the fall, the member continuing, provided he is aware of the fact, would be severally liable for payment of the whole debts contracted by the company during the period and may be severally sued there for.

**Conversion of private company into public company - By altering the Articles [Section 44]**: A company, registered as a private company, may in course of time find that any one of the provisions of Section 3(1)(iii) is a hindrance to or an interference with the development of business. In such a situation, it may decide to convert itself into a public company. If it alters its articles, so as to exclude there from the provisions contained in Section 3(1)(iii), it shall



cease to be a private company from the date the alteration, file with the Registrar a prospectus or a statement in lieu of prospectus containing all matters and reports as detailed under Section 56.

If upon conversion, the company decides to make a public issue of shares or debentures, it would be necessary for it to issue a *prospectus*; otherwise it may only issue a *statement in lieu of prospectus*. In either case by reason of the requirements of Schedules II and IV as to disclosure, it would be necessary for it to disclose a great deal of information as regards its affairs not requiring disclosure. It would be necessary for it have at least 7 members and 3 directors. At times, on such a conversion, the company may also decide to include certain provisions in and delete others from its articles to assist in its functioning.

### 1.5 CONVERSION OF PUBLIC COMPANY INTO A PRIVATE COMPANY

A public company can be converted into a private company by passing a special resolution altering its articles so as to include therein the restrictions contained in Section 3(1)(iii) of the Act. A special resolution passed to convert a public company into a private company is binding on dissenting shareholders provided it is *bona fide*, is in the interest of the company as a whole, and is consistent with the objects in the memorandum of association [*Bal Ramba vs. Master Silk Mills AIR 1955 N.U.R. Saurashtra 927*]. Under Section 31(1), any alteration made in the articles to convert a public company into a private company shall not have effect unless such an alteration has been approved by the Registrar of Companies.

Rule 4B of the Companies (Central Government's) General Rules and Forms, 1956 lays down that where the alteration of articles of association of any company has the effect of converting a public company into a private company, the company must have the approval of the Central Government. This approval must be had through an application, within three months from the date when the special resolution for the alteration of the articles of the company was passed. The application must be in writing and in Form No. 1A or in a form as near thereto as the circumstances of the case admit.

(Further, under Section 192, a copy of the special resolution together with a copy of the statement of material facts annexed under Section 173 to the notice of the meeting at which such a resolution has been passed must be filed with the Registrar of Companies within 30 days from the date it was passed by the company. The copies of the above-mentioned documents must be either printed or type written and duly certified under the signature of an officer of the company).

After obtaining the approval of the Central Government in the manner just discussed, it must file with the Registrar a printed copy of the articles as altered within one month of the date of receipt of the order of approval [Section 31(2A)].



When altering the articles for the aforesaid purposes, the company should take care to see that the articles as a whole confirm to the requirements of the Act regarding private companies, e.g., if the articles provide for power to issue share warrants to bearer, the same must be deleted, for a private company cannot issue the same.

### **1.6 PROCEDURE FOR CONVERSION OF A PRIVATE COMPANY INTO A PUBLIC COMPANY**

A private limited company, if it desires to convert itself into a public limited company, will have to follow the under-mentioned procedure:

- (1) It should take the necessary decision in its board meeting and fix up the time, place and agenda for convening a general meeting to alter the articles of association and consequently the name by a *special resolution* as well as to alter by special resolution the “objects clause” of the memorandum subject to the confirmation of the Company Law Board under Section 17 and by ordinary resolution the share capital clause under Section 94 if the alteration of share capital is involved in the process.
- (2) The company has to see that any change in the articles confirms to the provisions of the Companies Act [Section 31(1)]; also to see that such change does not increase the liability of any member who had become the member before the alteration.
- (3) It must issue notices for the general meeting in order to pass there at the special resolutions together with the explanatory statements for the alteration of the articles and the memorandum.
- (4) It will have to convene the general meeting in order to pass there at the special resolution (i) for the purpose of the alteration of the memorandum and article of association; and (ii) also for the purpose of deleting those articles which are required to be included in the articles of a private company only [Section 3(1)(iii)]. Such other articles which do not apply to a public company should be deleted and those which apply should be inserted. Consequent upon the above changes, it will have to delete the word “private” from its name [Section 21].
- (5) It shall file either the prospectus in the Form prescribed under Schedule II or the statement in lieu of prospectus in the form prescribed under Schedule IV within 30 days of the passing of the resolution mentioned in (4) above in the manner stated in Section 44.

The aforesaid prospectus or the statement in lieu of the prospectus must be in conformity with Parts I and II of Schedule II or with Parts I and II of Schedule IV respectively.

- (6) In the matter of the prospectus or the statement in lieu of the prospectus the company has to adopt abundant caution against any untrue statement being included therein,



because inclusion of untrue statement will attract penalty by virtue of Section 44(4). It may be noted that a statement included in a prospectus or statement in lieu of prospectus shall be deemed to be untrue if it is misleading in the form and context in which it is included. Likewise, where the omission from prospectus or a statement in lieu of prospectus of any matter is calculated to mislead, it shall be deemed, in respect of such omission, to be a prospectus or a statement in lieu of prospectus in which an untrue statement is included.

- (7) It shall file with the concerned stock exchange 6 copies of such amendments on both articles and memorandum, one of which must be a certified copy.
- (8) It shall file with the Registrar the said special resolution together with the explanatory statement within 30 days of their passing [Section 192].
- (9) It must take some of the steps regarding further issue of capital under Section 81 which are not in common with the steps discussed in relation to further issue of shares.
- (10) The company has to apply to the Registrar for the issue of a fresh certificate of incorporation for the changed name, namely, the existing name with the word “private” deleted. On issue of such certificate shall the name of the converted company be final and complete [Section 23].

### **1.7 PRIVILEGES AND EXEMPTIONS**

A private company can have a greater degree of secrecy as regards its affairs and enjoys greater freedom in its operation. It enjoys some privileges and exemptions which a public company is deprived of. Briefly these are as follows :

1. Two or more persons may form a private company [Section 12(1)].
2. The restriction on the commencement of business contained in Section 149 [excepting those contained in Section 149(2A) which have been made applicable to all companies] do not govern private companies.
3. A private company may allot shares without issuing a prospectus or delivering to Registrar a statement in lieu of prospectus [Section 70].
4. It need not hold a Statutory Meeting or file a statutory report [Section 165].
5. The provisions of Section 81 as regards further issue of capital do not apply to a private company [Section 81(3)(a)].
6. The consent of directors to act as such, and to take up qualification shares need not be filed with the Registrar [Section 266].
7. There is no restriction on the amount of overall managerial remuneration that it may pay [Section 198].



8. The consent of the Central Government for any increase in the remuneration of directors including managing or wholtime director or upon their appointment at increased remuneration, is not required [Section 310].
9. The directorship of a private company is not includible in the maximum number of directorships that a person may hold [Section 278].
10. The consent of the Central Government for advancing loans to directors is not required [Section 295].
11. There are no restrictions on the powers of the Board of Directors [Section 293].
12. The Central Government is not empowered to prevent a change in the Board of Directors of a company which is likely to affect management prejudicially [Section 409].
13. It can advance loans for the purchase of its own shares [Section 77(2)].
14. Provisions of Section 416 relating to contracts by agents of a company in which the company is an undisclosed principal, are not applicable.
15. A director can vote on a contract in which he is interested [Section 300(2)(a)].

**Whether a limited company can become partner in a partnership firm?**

One of the important features of a company is an artificial juristic person. Being a juristic person, company is capable of entering contract in its own name. According to Section 4 of the Partnership Act, 1932, partnership is a contractual relationship between persons; therefore, there should not be any objection to a company in becoming partner. Further, the limited liability element of a limited company is also do not restrict a company in becoming a partner in an unlimited liability of a partnership firm, because, it is limited liability of members of a limited company and not the company itself. However, the Department of Company Affairs (now Ministry ...) is in the opinion that, a company may become a partner if the Memorandum of Association specifically allows it.

**1.8 WHEN COMPANIES MUST BE REGISTERED?**

No company, association or partnership consisting of more than twenty persons (ten in the case of a banking business) can be formed for the purpose of carrying on any business that has for its objects the acquisition of gains, unless it is registered as a company under the Companies Act, or is formed in pursuance of some other Indian law.

The provision is not applicable to Joint Hindu family carrying on a business. But where two or more joint families are carrying on a business, the provision will be applicable. For example, a Hindu undivided family, consisting of the father, 5 major sons and another such family consisting of the father, 5 major sons and 1 minor son jointly carry on banking business. In



such a case 12 major member of the two joint families would be carrying on the banking business and therefore, the association should be registered under the Companies Act; otherwise it would be regarded as an illegal association. The necessity for such a registration arises on account of the fact that when two or more joint families represented by their Kartas enter into a partnership, the member of the association for the purpose of Section 11 will be not Kartas but also other members of the joint families [*Shymlal Roy vs. Madhu Sudhan Roy AIR 1959 Cat. 330*]. However, for the purpose of computing the number of persons carrying on the business, the minor member of such families are not to be included.

You know that an association, which has membership in excess of the number aforementioned, will be an illegal association. What is the significance of the statement? It signifies that, as a body, it will have no legal existence and it cannot be wound up under the Act, or even as an unregistered company. Neither a member of it would be able to sue it, nor would it be able to sue the member. Nevertheless, a member who has paid any money to the association would be able to recover it from the director or agents or the association before the money so paid has been applied to an illegal purpose [*Greeberg vs. Cooperstein [1965] Ch. 657* followed in *Ram Das vs. Kunut Dhari AIR 1925*]. Every person who is, or continues to be a member of an association in the circumstance described above, is personally culpable for all liabilities incurred in such business and every member is in addition punishable for any person or persons to trade or carry on business under any name or title of which 'limited' is the last word, without being fully incorporated.

The purpose of prohibiting formation of large unincorporated business association is to "prevent the mischief arising from large trading undertakings being carried on by large fluctuating bodies so that persons dealing with them did not know with whom they were contracting and so might be put to great difficulty and expenses" [*Smith vs. Anderson [1980] 15 Ch. D 247*].

A company, association or partnership not compulsorily registrable at the inception under Section 11 of the Act of 1956 would become so registrable if, during its continuance, its number of members exceeds the limit prescribed by the Act [*Nibaran Chandra vs. Lalit Mohan [1939] Cal. 187*].

An association of more than 20 persons, if unregistered, is invalid at its inception and cannot be validated by subsequent reduction in the number of members below 20 [*Madanlal vs. Janakipradsad 48 All. 319*], nor can a contract entered into by such an illegal association before registration be made valid and be sued against on a subsequent registration [*Gujarat Trading Co. vs. Tricumjee, 5 Bom. H.E.R. (O.C.J.) 45*].

Illegality or invalidity in the constitution of an association does not affect its liability to tax or its chargeability as a unit of assessment [*Kumarswamy Chettiar vs. ITO [1957] ITR 457*].





### **1.9 MODE OF REGISTRATION/INCORPORATION OF COMPANY**

In the case of a public company with or without limited liability any 7 or more persons can form a company by subscribing their names to memorandum and otherwise complying with the requirements of the Act. In exactly the same way, 2 or more persons can form a private company [Section 12]. Persons who form the company are known as promoters. It is they who conceive the idea of forming the company. They take all necessary step for its registration.

**(a) Lawful purpose:** The essence of validly incorporated company is that it must consist of a particular number of persons and be an association for a lawful purpose. Unless the purpose appears to be unlawful *ex facie* or is transparently illegal or prohibited by any statute, it cannot be regarded as an unlawful purpose.

Where the purpose is not lawful, *i.e.*, where any of the objects is illegal, the Registrar may refuse to register; and if he register, the certificate of registration is not conclusive for this purpose, and the registration itself may be cancelled by the Central Government taking appropriate proceedings [*Bowman vs. Secular Society Ltd.* 1917 (AC) (at 438-9)].

The Registrar need not enquire into the circumstances in which the company was proposed to be formed; there is no such obligation on him. In spite of this if he undertakes any such enquiry, he would be exceeding his jurisdiction and such an excess is not permissible.

**(b) Applying for the name:** The promoters of the company should decide upon at least three suitable names in order of preference to afford flexibility to the Registrar to decide the availability of the name. In case of a public company the name must end with the word 'Limited' and in case of a private company, with the words '*Private Limited*'. The name should not be undesirable, or identical with the name of an existing company [Section 20]. Also, the name should not be the one which is prohibited under the 'Emblems and names (Prevention of Improper Use) Act, 1950'. Further, the guidelines issued by the Department of Company Affairs should be followed while deciding the name.

An application shall be made in the prescribed form along with fees to the Registrar of Companies of the State in which the registered office of the proposed company is to be situate, for ascertaining the availability of the proposed name. The Registrar shall ordinarily inform availability or otherwise of the name within fourteen days from the date of submission of the application. Such a name shall be available for adoption within six months from the date of intimation by the Registrar.

**(c) Documents to be filed:** After getting the name approved, the following documents along with the application and prescribed fees, are to be filed with the Registrar :

- (1) Memorandum of Association [Section 33(1)(a)].
- (2) Articles of Association, if any [Section 33(1)(b)].



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- (3) The agreement, if any, which the company proposed to enter into with any individual for appointment as its managing or whole time director or manager [Section 33(1)(c)].
- (4) A declaration that the requirements of the Act and the rules framed there under have been complied with. This declaration is required to be signed by an advocate of the Supreme Court or High Court or an attorney or a pleader having the right to appear before High Court or a secretary, or a chartered accountant in whole time practice in India who is engaged in the formation of a company, or by a person named in the articles as a director, manager or secretary of the company [Section 33(2)].
- (5) In case of a public company having share capital, where the articles name a person as director/directors, the list of the directors and their written consent in prescribed form to act as directors and take up qualification shares [Section 266].

Besides the aforementioned documents, the company must give a notice regarding the situation of its registered office under Section 146 within 30 days of registration.

**(d) Subscribing their names:** Subscribing name means signing the names. Section 15 stipulates that each subscriber who should add his address, description and occupation in the presence of one witness should sign the Memorandum. An agent may sign on behalf of the subscriber if he is authorised by a power of Attorney in this behalf (Circular No. 8/15/58-PR dt. 13-9-1958). In the case of a company having share capital, the subscribers to the memorandum should take atleast one share each and state clearly the number and nature of shares taken by them. In the same way, the Articles of Association should be signed.

Both the Memorandum and Articles should be duly stamped and dated.

If you recall Section 12, you will find that only a person can be a signatory to the memorandum. It follows therefore that a firm cannot be signatory to the memorandum, for it is not a person having an individuality separate from that of its partners ; only individuals or other legal entities can be members of a company [*Ganesh Dass vs. R.G. Cotton Mills Co* [1974] C.W.N. (345)]. But under Section 25(4), a firm may continue to be member of any association or company to which a licence has been issued under this section by the Central Government entitling it to be registered as a company with a limited liability. But it is an exception to the generality of the law which precludes the firm being accepted as a shareholder of a company.

**(e) Commencement of business:** A company having a share capital which has issued a prospectus inviting the public to subscribe for its shares cannot commence any business or exercise any borrowing power unless:

- (a) the minimum number of shares which have to be paid for in cash has been subscribed and allotted ;
- (b) every director has paid, in respect of shares for which he is bound to pay an amount equal to what is payable on shares offered to the public on application and allotment ;



- (c) no money is or may become liable to be paid to application of any shares or debentures offered for public subscription by reason of any failure to apply for or to obtain permission for the shares or debentures to be dealt in on any recognised Stock Exchange, and
- (d) a statutory declaration by the secretary or one of the directors that the aforesaid requirements have been complied with, is filed with the Registrar.

If, however, a company having a share capital has not issued a prospectus inviting the public to subscribe for its shares, it cannot commence any business or exercise borrowing powers unless it has issued *a statement in lieu of prospectus* (explained below) and the condition contained in paragraphs (b) and (d) aforementioned have been complied with.

**(f) Statement in Lieu of Prospectus**

If a public company does not issue a prospectus inviting the public to purchase its shares because, the directors think that they can sell the shares even without the issue of the prospectus, it can do so. However, the company must file with the Registrar a “Statement in lieu of prospectus” before it allots the shares or debentures to the applicants. This statement contains almost all those particulars, which are given in the prospectus, but it must be in the same form as is given in Schedule III. In any case, such a statement must be filed at least three days before the allotment is made. A private company is not required to issue either a prospectus or statement in lieu of prospectus.

But the foregoing provisions are not applicable to a private company [Sub-section (7) of Section 149].

By the Companies (Amendment) Act, 1965, Sub-section (2A) has been added with the objective to restrain companies from commencing any business to pursue “other objects of the company” which are not incidental or ancillary to the main objects whether or not any segregation between the two has been made as contemplated by the provisions contained in Section 13(1)(b) of the Companies Act, unless the following conditions have been complied with :

- (i) That the company has approved of the commencement of any such business by a special resolution passed in that behalf at a general meeting; and
- (ii) That the company has filed with the Registrar a declaration duly verified by one of the directors or secretary, in prescribed form, that resolution has been passed or the Central Government in pursuance of an application made under Sub-section (2B) has permitted the company to commence such a business.

If the company commences any such business in contravention of this provision every person who is responsible for the contravention, without prejudice to any other liability, would be punishable with a fine.



In the *Explanation* to Sub-section (2A), it is stated that the restriction contained in the foregoing provision of law is to be construed as one applicable to only business which is not germane to the business which the company was carrying on at the commencement of the Companies (Amendment) Act, 1965, in relation to any of the objects referred to in the said clause.

This provision is intended to prohibit a company from commencing any business not related or ancillary to its main objects without obtaining the prior approval of the shareholders by a special resolution.

**(g) Certificate of incorporation:** Upon the registration of the documents mentioned earlier under the heading “Documents to be filed for registration of the company” and the payment of the necessary fees, the Registrar of Companies issues a certificate that the company is incorporated, and in the case of a limited company that it is limited [Section 34].

Section 35 provides that a certificate of incorporation issued by the Registrar in respect of any association, shall be conclusive evidence of the fact that all the requirements of the Act have been complied with in respect of registration and matters precedent and incidental thereto, and that the association is a company authorised to be registered and duly registered under the Act.

The certificate of incorporation is conclusive as to all administrative acts relating to incorporation and as to the date of incorporation. Thus in *Jubilee Cotton Mills vs. Lewis* [1924] A.C. 958, the Registrar issued on 8th January a certificate dated 5th January. It was held that an allotment of shares made on 6th January could not be declared void on the ground that it was made before the company was incorporated. The certificate is not, however, conclusive evidence of that all the objects of the company, as set out in the memorandum, are legal [*Bowen vs. Secular Society* [1917] A.C. 406, 435].

#### **(h) Effect of Registration [Section 34]**

1. On the registration of the Memorandum of a company, the Registrar shall certify under his hand that the company is incorporated and in the case of a limited company, that the company is limited.

2. From the date of incorporation mentioned in the certificate, the company becomes a legal person separate from the incorporators; and there comes into existence a binding contract between the company and its members as evidenced by the Memorandum and Articles of Association [*Hari Nagar Sugar Mills Ltd. vs. S.S. Jhunjhunwala AIR 1961 SC 1669*]. It has perpetual existence until it is dissolved by liquidation or struck out of the register, and has the common seal. A shareholder who buys shares, does not buy any interest in the property of the company but in certain cases a writ petition will be maintainable by a company or its shareholders.



A legal personality emerges from the moment of registration of a company and from that moment the persons subscribing to the Memorandum of Association and other persons joining as members are regarded as a body corporate or a corporation in aggregate and the legal person begins to function as an entity. A company on registration acquires a separate

existence and the law recognises it as a legal person separate and distinct from its members [*State Trading Corporation of India vs. Commercial Tax Officer AIR 1963 SC 1811*].

It may be noted that under the provisions of the Act, a company may purchase shares of another company and thus become a controlling company. However, merely because a company purchases all shares of another company it will not serve as a means of putting an end to the corporate character of another company and each company is a separate juristic entity [*Spencer & Co. Ltd. Madras vs. CWT Madras [1969] 39 Comp. Case 212*].

As has been stated above, the law recognizes such a company as a juristic person separate and distinct from its members. The mere fact that the entire share capital has been contributed by the Central Government and all its shares are held by the President of India and other officers of the Central Government does not make any difference in the position of registered company and it does not make a company an agent either of the President or the Central Government [*Heavy Electrical Union vs. State of Bihar AIR 1970 SC 82*].

Under Section 35, a certificate of incorporation given by the Registrar in respect of any association shall be conclusive evidence that all the requirements of the Act have been complied with in respect of the registration and matters precedent and incidental thereto, and that the association is a company authorised to be registered and duly registered under this Act.

**Determination of jurisdiction for complaint against the company is depending upon the situation of the registered office of the Company**

The case mentioned herein has upheld that, the location of registered office of the Company is very important to determine the jurisdiction of court against the company.

*The Industrial Credit and Investment Corporation of India Ltd., (ICICI) Vs. H.V.Jayaram (1998) 94 COM Cases 409 (Kant)*

In this Case, the appellant lodged a criminal case for non-delivery of share certificate alleging that the respondent company had committed offence punishable under section 113(2) of the Companies Act, 1956.

The appellant who did not receive share certificate lodged a complaint against the company at his place i.e., Bangalore. The same was challenged by the respondent company on the ground that the registered office is not situated in Bangalore and therefore, as no cause of



action arise in Bangalore, and therefore, the complaint alleging non-delivery of shares could not be lodged in Bangalore, it should be at the place where registered office of the company is situated. The Karnataka High Court upheld the Company's argument. Aggrieved against the order of the High Court, the petitioner filed his petition before the Supreme Court.

The Supreme Court upheld the decision of the Karnataka High Court by a joint reading of Section 53 and 113 of the Companies Act, 1956, and it said that the share certificates are to be delivered either personally or by registered post. Further, the Supreme Court held that, the cause of action for failure to deliver the share certificates within prescribed time would arise at the place where registered office of the company is situated and petition can be lodged only where registered office is situated and not where the complainant is residing.

**(i) Contractual relationship between different parties formed on registration of Memorandum and Articles**

Section 36 of the Act provides that the memorandum and articles of association, when registered, must be binding on the company and the members thereof to the same extent as if each of them had individually signed the documents, so far as covenants contained therein are concerned. As a result, a number of legal relationships are formed between different parties and the company which are described below:

- (a) *Between the members and company:* The memorandum and articles constitute a contract between the members and the company. In consequence, the members are bound to the company under a statutory covenant. For instance, it has been held in *Bradford Banking Co. vs. Briggs* that where the articles give the company a lien upon each share for debts due by shareholders to the company, and where a shareholder mortgages his shares and the mortgagee serves notice thereof upon the company, the mortgagee would have priority over the company, only if the shareholder had incurred a liability to the company after the notice of the mortgage was given to the company. If, on the other hand, the shareholder had incurred a liability before the notice of mortgage was given to the company, the company would have the priority.
- (b) *Between the company and the members:* Views differ on the questions as to whether and how far the memorandum and articles bind the company to the members. One view is that it is bound just as its members are. Another view is that the company is not wholly bound. But it seems that courts, instead of conforming to either of these views, have elected to take a via media. It is not true to say that the company is wholly bound so that any member can enforce any articles against it. But it is bound to the extent that any member can sue it so as to prevent any breach of the article which is likely to affect his right as a member of the company [*Hickman vs. Kent Sheepbreeder's Association* [1985] 1 Ch. 881]. Thus an individual member can file a suit against the company to enforce his individual rights, e.g. right to contest election for directorship of the company, right to get back his shares wrongfully forfeited, right to receive a share certificate, share warrants to



bearer or notice of general meetings etc. [*Pender vs. Lushington* [1817] 7 Ch. D. 70; *Nagaffa vs. Madras Race Club*, AIR 1951 Mad. 83 C.L. *Joseph vs. Los* AIR 1965 (Ker.) 68]. The member suing in such cases “sues not in the rights of a member but in his own right to protect from invasion of his own individual right as a member” [Per *Jenkis L.J. in Edwards vs. Halliwell* [1950] 2 All ER 1964 at p. 1067].

- (c) *Between member inter se*: In the case of *Wood vs. Odessa Water Works Co.* [1989] 42 Ch. D. 363, *Sterling J. Observed* : The articles of Association constitute a contract not merely between the shareholders and the company but between each individual shareholder and every other.

The foregoing principle had been further clarified by the decision in another English case of *Welton vs. Saffary* [1897] A.C. 315. In this case, the learned Judge observed that “It is quite true that the articles constitute a contract between each members of the company but the articles do not, any the less in my opinion, regulate the right *inter se*. Such rights can only be enforced by or against a member through the company or by the liquidator representing the company, but no member has as between himself and another member any right beyond that which the contract with the company gives him”.

This proposition is not free from controversy because of the conflict of judicial opinions; in fact, until the decision in *Rayfide vs. Hands* [1960] Ch. 1, weightage of judicial opinion was against a member being bound to other member. In this case, the articles of a private company provided that “every member who intends to transfer shares shall inform the directors who will take the said shares equally between them at a fair value. “It was held that articles bound the directors as members to do so and that this obligation was a personal one, which could be forced against them by other members directly, without joining the company as a party. Obviously, the Court was influenced by the fact that the company was private company, which “bears a close analogy to partnerships”.

- (d) *Between the company and the outsiders*: The memorandum and the articles do not constitute a contract between the company and outsiders. Neither the company nor the members are bound by the articles to outsiders, since these constitute a contract between members, *inter se*, and the outsider is not a party to the articles although he may be named therein.

Nonetheless, an outsider is entitled to assume that in respect of contract entered into with him all the formalities required to be carried out under the articles or memorandum have been duly complied with [*Royal British Bank vs. Turquand* [1956] 6 E.B. 327].

### **1.10 MEMORANDUM OF ASSOCIATION**

The memorandum of association of company is in fact its charter; it defines its constitution and the scope of the powers with which it has been established under the Act. It is the very



foundation on which the whole edifice of the company is built.

“Fundamentally, there are two objects in registering the memorandum. First, that the intending corporator who contemplates the investment of his capital may know within what fields it will be incurring risks. Secondly, that anyone dealing with the company may know without reasonable doubt whether the contractual relationship which he is proposing to enter into with the company is one relating to matters within its corporate objects”. A company cannot depart from the provisions contained in the memorandum however imperative may be the necessity for the departure. It cannot enter into a contract or engage in any trade or business, which is beyond the power conferred on it by the memorandum. If it does so, it would be *ultra vires* the company and void. A memorandum is a public document under Section 610. Consequently, every person entering into a contract with the company is presumed to have the knowledge of the conditions contained therein.

**(a) Contents of memorandum:** [Section 13] The particulars of clauses which the memorandum of a company must contain are as under :

- (1) The name of the company with ‘Limited’ as the last word and ‘Private Limited’ in the case of a private company.
- (2) The State in which the registered office will be situated.
- (3) The objects of the company, in the case of a company in existence immediately before the commencement of the Companies (Amendment) Act, 1965.

In the case of a company formed after the commencement of the Amendment Act, 1965, the memorandum must contain (a) the main objects of the company, together with other objects incidental or ancillary to the attainment of the main objects; (b) other objects of the company not included in (a) above.

- (4) In the case of a company (other than a trading corporation), with objects not confined to one State, the State to whose territories the objects extend.
- (5) A declaration that the liability of members is limited.
- (6) A statement as to the amount of share capital, and its division into shares of fixed amount.

The memorandum must conclude with a declaration of association signed by the sub-subscribers, who shall add their description, address and occupation, each stating against his name the number of shares he agrees to take. The signatures of the subscribers must be attested, one witness is usually sufficient and he must add his address, description and occupation. It must be printed and divided into paragraphs, numbered consecutively, and should be in one of the forms in Tables B,C,D, and E of Schedule I to the Act as applicable to the type of the company or in a form as near thereto as circumstances admit [Sections 14 and 15].





**(b) Doctrine of ultra vires** : The meaning of the term *ultra vires* is simply “beyond (their) powers”. The legal phrase “*ultra vires*” is applicable only to acts done in excess of the legal powers of the doers. This presupposes that the powers are in their nature limited. To an ordinary citizen, the law permits whatever does the law not expressly forbid. It is only when the law has called into existence a person for a particular purpose or has recognised its existence - such as in the case of a limited company - that the power is limited to the authority delegated expressly or by implication and to the objects for which it was created. In the case of such a creation, the ordinary law applicable to an individual is somewhat reversed, whatever is not permitted expressly or by implication, by the constituting instrument, is prohibited not by any express prohibition of the legislature, but by the doctrine of *ultra vires*.

It is a fundamental rule of Company Law that the objects of a company as stated in its memorandum can be departed from only to the extent permitted by the Act - thus far and no further [*Ashbury Railway Company Ltd. vs. Riche*]. In consequence, any act done or a contract made by the company which travels beyond the powers not only of the directors but also of the company is wholly void and inoperative in law and is therefore not binding on the company. On this account, a company can be restrained from employing its fund for purposes other than those sanctioned by the memorandum. Likewise, it can be restrained from carrying on a trade different from the one it is authorised to carry on.

The impact of the doctrine of *ultra vires* is that a company can neither be sued on an *ultra vires* transaction, nor can it sue on it. Since the memorandum is a “public document”, it is open to public inspection. Therefore, when one deals with a company one is deemed to know about the powers of the company. If in spite of this you enter into a transaction which is *ultra vires* the company, you cannot enforce it against the company. For example, if you have supplied goods or performed service on such a contract or lent money, you cannot obtain payment or recover the money lent. But if the money advanced to the company has not been expended, the lender may stop the company from parting with it by means of an injunction; this is because the company does not become the owner of the money, which is *ultra vires* the company. As the lender remains the owner, he can take back the property *in specie*. If the *ultra vires* loan has been utilised in meeting lawful debt of the company then the lender steps into the shoes of the debtor paid off and consequently he would be entitled to recover his loan to that extent from the company.

An act which is *ultra vires* the company being void, cannot be ratified by the shareholders of the company. Sometimes, act which is *ultra vires* can be regularised by ratifying it subsequently. For instance, if the act is *ultra vires* the power of the directors, the shareholders can ratify it; if it is *ultra vires* the articles of the company, the company can alter the articles; if the act is within the power of the company but is done irregularly. Shareholder can validate it.



### 1.11 ALTERATION OF THE MEMORANDUM

The memorandum may be altered only to the extent and in the manner provided by the Act [Section 16] which allows alterations by a special resolution followed by confirmation thereof by the Company Law Board only for the undermentioned purposes.

A resolution which is passed by 3/4th of the members present is known as Special Resolution. Special resolution and the Company Law Board's confirmation are not necessary in the circumstances mentioned in paras (c), (f) and (h) :

- (a) Changing the place of its registered office from one State to another - Section 17.
- (b) Changing the object - Section 17.
- (c) Change of registered office within a State ( Section 17A)
- (d) Changing the name - Sections 21, 22 and 23 (approval of Central Government necessary).
- (e) Changing any other provisions contained in the memorandum including those relating to the appointment of managing director or manager in the same manner as the articles of the company (that is by special resolution) or in any other manner provided by the Act - Section 16(3).
- (f) Creating reserve liability - Section 99.
- (g) Increasing, consolidating, sub-dividing or otherwise altering the share capital Section 94.
- (h) Reducing the share capital - Section 100.
- (i) Rendering unlimited the liability of its directors or of any director or manager Section 323.

Shareholder's right can be altered or modified according to the provisions contained in Sections 106 and 107, which will be dealt in Study Paper III.

An alteration that has the effect of increasing the liability of a member to contribute to the share capital, or requires him to take more shares, or otherwise to pay money to the company, shall not bind an existing member, unless he agrees to it in writing [Section 38].

According to the proviso to Section 38 where the company is a club or any other association and the alteration requires the member to pay recurring or periodical subscriptions at a higher rate, although he does not agree in writing to be bound by the alteration, it will bind him.

#### (a) Name Clause

No company shall be registered by a name which, in the opinion of the Central Government, is undesirable - Section 20(1). Under the Emblems and Names Act, 1950, names like U.N.O. and W.H.O. cannot be used by the companies without the prior sanction of the Central



Government. If the proposed name of the company is identical with or too nearly resembles the name of another company which is already in existence, the Central Government may refuse to register it [Section 20 (2) ; *Ewing vs. Buttercup Margarine Co. Ltd.*]. The company must also be permitted to mention the fact that it is the successors to proprietary concern or firm, etc. In this way, goodwill is preserved.

The name of public limited company must end with the word "Limited" and that of a private limited company with the word "Private Limited". But, as you have already noticed earlier, the Central Government may, by a licence, authorise a company which is non-profit making association to change its name so as to omit the words, "Limited or Private Limited" as the case may be, by passing a special resolution.

The name and the address of the registered office must be printed or affixed outside every office or place of business in the characters of one of the languages in general use in the locality and mentioned in all business letters, bill heads, letter papers, notices and other official publications. The name alone must be engraved on the seal and mentioned in all bills of exchange, promissory notes, endorsements, cheques and orders for money or goods, invoices, receipts, etc. The characters must be legible. The address of the registered office is also required to be shown [Section 147].

The use of words "Limited" and "Private Limited" by any person or body of persons not incorporated with a limited liability or as a private limited company, as the case may be, is an offence punishable with a fine - [Section 63].

**(b) Change of name**

A company may, by special resolution, and with the approval of the Central Government, signified in writing, change its name [Section 21]. [\*Power under Section 21 has been delegated to the registrar of company. Vide notification GSR 507(E) dt. 24-6-85] The application for change of name is required to be made to the ROC in form IA with a fee of Rs. 500. Where the Registrar is satisfied with the company's proposal, he may accord to the proposal which will be valid for a period of six months. However, such an approval of the Central Government would not be necessary where the only change in the name of the company is the addition thereto or the deletion therefrom of the words "private" consequent upon the conversion as per the provisions of this Act of a public company into a private company or *vice versa* [Proviso to Section 21]. It may be noted that this proviso is designed to obviate the technical necessity of obtaining Government's approval for the mere addition or deletion of the word "private" to and from a company's name in the aforesaid circumstances.

If through inadvertence etc., the name is identical with, or too nearly resembles, the name by which a company, in existence, has been previously registered, it may be changed by ordinary resolution with the sanction of the Central Government within twelve months of the registration. The company shall make the change by ordinary resolution and with the previous



approval of the Central Government within three months of the date of the direction of the Central Government being received or such longer period as the Central Government may deem fit to allow [Section 22(1)].

Where the name of a company has been changed, the Registrar shall issue fresh certificate with the change embodied therein. The change in name shall not affect any of the company's rights or obligations of the company or render any legal proceedings by or against it. Any legal proceedings, which might have been continued or commenced by or against the company by its former name, may be continued by its name [Section 23].

### **(c) Registered Office**

Every company must have registered office where : (a) necessary documents may be served upon, or deposited; (b) notices, letters, etc., may be issued ; (c) inspection may be had, and (d) communication may be made. The domicile and the nationality of a company is determined by the place of its registered office. This is also important for determining the jurisdiction of the Court.

A company must have a registered office as from the day on which it commences business, or as from the 30th day after the date of its incorporation whichever is earlier. It may be noted that the address of the registered office ordinarily is not to be stated in the memorandum of association. For if this was done, every change therein would require amendment of the memorandum. It is advisable to provide in the articles that the registered office should be situated at such place, as the Board should from time to time fix. Otherwise, the registered office cannot be removed outside the city *etc.*, where it is situated, without special resolution.

Notice of the situation of the registered office and of every change therein must be sent to the Registrar (otherwise than through a statement as to the address of the registered office in the annual report) within 30 days of the date of incorporation or the date of change. This provision is designed to locate the spot where the records of the company could be inspected and where the letters should be addressed and notices served upon the company.

### **(d) Alteration of registered office**

The address may be changed within the local limits of any city, town or village where such office is situated by just giving a notice to the concerned Registrar within 30 days after the date of the change. But a special resolution will be required if the change of the registered office is from one village, town *etc.*, in the same State [Section 146].

Where the place of registered offices is to be altered from one State to another State, the company may do so by passing special resolution and getting confirmation of the Company Law Board besides. The change can be permitted only if it is to achieve any of the purposes mentioned in Section 17(1). [Mentioned on subsequent pages of this book].



The Company is required to give an advertisement in the spapers indicating the change proposed to be made and also a notice is to be given to the State Government when it is proposed to transfer the registered office from one State to another. (*Vide* Rule 36 of the Company Law Board) (Bench) Rules, 1975 (App. IV).

The law, as contained in Section 17(3), requires notice for this to be served on all shareholders. In an Orissa High Court case, only two shareholders out of three had passed the special resolution and as such, the resolution was held to be invalid. Again, when an application is made for a change in registered office of a company from one State to another, the former State is the authority whose interests are affected by this change and thus has the *locus standi* to such an application [*Orient Paper Mills Limited vs. State AIR 1977 Orissa 582*].

The Court (now the Company Law Board) must be satisfied as to the *bona fides*, of the company's application for the proposed change. Thus where a company, proposing to change the location of registered office from Orissa to Andhra Pradesh had relied on Section 17(1)(a) for the change on the ground of more direct and economic administration but had failed to clarify how the expenses would be curtailed or how the administration from Andhra Pradesh could be more direct, while the factory or unit or production was in Orissa, it was held that *bona fides* of the company's application for the change were questionable [*Orissa Chemicals and Distilleries Private Ltd. In re. AIR 1961 Orissa 62*].

**(e) Steps to be taken by a company: (i) for transfer of its registered office from one State say West Bengal to another State say Tamil Nadu.**

(i) The Company may, by a special resolution, alter the provisions of its memorandum so as to change the place of its registered office from West Bengal to Tamil Nadu; this change alone needs confirmation of the Company Law Board. When an application is made for a change as aforesaid, it is the State where the registered office is at present situated, whose interests are likely to be affected by the change and thus will have the *locus standi* to oppose such an application [*Orissa Paper Mills Ltd. vs. State AIR 1957 482*]. Furthermore, it shall be necessary to satisfy the Company Law Board as to the *bona fides* of the company's application for the proposed change [*Orissa Chemicals and Distilleries Pvt Ltd., in Re. AIR 1961 Orissa 621*].

As per the Companies (Amendment) Act, 1996, the C.L.B. has the power either to confirm or refuse to confirm alteration relating to change of registered office.

**(ii) Section 17 inserted by the Companies (Amendment) Act, 2000**

(a) The amended provision shall apply only to companies that change their registered office from the jurisdiction of the Registrar of Companies to the jurisdiction of another registrar



of Companies within the same State. (At present the provision shall be applicable to the States of Maharashtra & Tamilnadu which have more than one office of ROC namely at Mumbai & Pune and Chennai & Coimbatore respectively).

- (b) The company cannot do such change of office unless the Regional Director confirms it.
- (c) To obtain confirmation, the company has to apply in the prescribed form.
- (d) The confirmation must be communicated to the company within 4 weeks from the date of receipt of the application.
- (e) Certified copy of the confirmation along with the attested copy of the memorandum of Association must be filed with the ROC for registration within 2 months from the date of confirmation.
- (f) Within one month of filing, the ROC shall certify registration, which shall be the conclusive evidence that all requirements with respect to alteration and confirmation have been complied with.

**(f) Object clause:** The powers of the company are limited to: (a) power expressly given by the memorandum (termed “express” powers) or conferred by statute, (b) powers reasonably incidental or necessary to the company’s main purpose (termed “implied” powers).

You will perhaps recall that acts beyond the company’s powers are *ultra vires* and void, and cannot be ratified even though every member of the company may give his consent [*Ashbury Railway Carriage Co. vs. Riche* [1875] L.R. 7 H.L. 653]. The test to be applied whether a power is implied or not, is not the benefit the transaction is expected to confer on the company, but whether it can reasonably be regarded as arising from the main object of the company.

It is customary to exclude the general rule of construction for the interpretation of the intention contained in different clauses of the memorandum of association, by including a statement that the objects specified in each paragraph of the memorandum shall be in no way limited or restricted by reference to or inference from the terms of any other paragraph or the name of the company.

The subscribers to the memorandum may choose any “object” or “objects” for the purposes of their company. There are two restrictions, however, on the selection of “object” for a company: (i) the objects should not include anything which is illegal or contrary to law or public policy, e.g., floating a company for dealing in lotteries [*Ex. parte More* [1931] 2 K.B. 197]; or trading with alien enemies [*Daimler & Co. vs. Continental Tyre Co.* [1916] 2 A.C. 307]. Objects, which are in restraint of, trade [*Mac. Ellis vs. Ballymacalligot etc. Company* [1919] A.C. 459]; or are blasphemous (but not denying Christianity) have also been held to be bad [*Bowen vs. Secular Society* [1917] A.C. 406]; (ii) the objects should not also contemplate doing anything which is prohibited by the Companies Act. Apart from those two restrictions, the object of a



company may be anything that the proposed company desires to achieve [*Lal Gopal Dutt vs. Khorotriah Mego Zlite Zamindary Co. 16 C.W.N. 297*].

The object clause enables shareholders, creditors shall and all those who deal with the company to know what its powers are and what is the range of its activities and enterprise, it is therefore true that the object clause of the memorandum of association of a company is of fundamental importance to its members as well as to its non-members. In the first place, it gives protection to subscribers (members) who learn from it the purpose to which their money can be applied. In the second place, it protects persons dealing with the company, who can infer from it the extent of the company's powers. The narrower the objects appended in the memorandum, the lesser are the subscriber's risk; the wider these objects, the greater is the security of those who transact business with the company.

**(g) Alteration of objects:** The members of a company may rightly expect that their money would be employed only for the objects for which the company has been established. Accordingly, the Act permits alteration of the objects, only so far as is considered necessary for specified purposes. Section 17(1) permits a company to alter its objects for the under mentioned purposes:

- (a) to carry on business more economically ;
- (b) to attain the main purpose of the company by or improved means ;
- (c) to carry on some business which under the existing circumstances may conveniently or advantageously be combined with the existing business.
- (d) to change and enlarge the local area of operations;
- (e) to restrict or abandon any of the existing objects;
- (f) to sell or dispose of the whole or any part of the undertaking;
- (g) to amalgamate with any other objects or body or person.

Certain amendments have been made by the Companies (Amendment) Act, 1996 in Sections 17 and 18. Accordingly, as per Section 17(2), only, the alteration of the provisions of memorandum relating to change of place of its registered office from one State to another requires to be confirmed by the Company Law Board on petition. In other words, Companies are now under liberty to alter the object change of the memorandum without confirmation of CLB. However, alteration can be made only on grounds stated above in Sub-section (1) of Section 17.

In addition, according to the amended Section 18(1), a company shall file with the Register a copy of the special resolution passed by the company in relation to clauses (a) to (g) of Sub-section (1) of Section 17 within one month from the date of such resolution. The Registrar shall register the same and certify the registration under his hand within one month from the



date of filing such documents. Such certificate shall be conclusive evidence that all the requirements with respect to alteration have been complied with, and memorandum so altered shall be the memorandum of the company.

If the documents required to be filed with the Registrar under Section 18 are not filed within the prescribed time, the alteration shall at the expiry of such period, become void and inoperative. [Section 19].

*Steps to be taken by a company for starting a business for which there is no provision in the objects clause of the memorandum of association:*

Since the present “objects clause” of the company in question does not contain any enabling provisions for the company to carry on proposed business, the objects clause will have to be altered. The alteration can be only for any one or more of purposes specified in Section 17(1) discussed earlier.

Debenture holders and creditors are entitled to be heard by the Company Law Board unless it decides otherwise. However, the Registrar of Companies has a right to be heard. As *Mitra J. Observed in Re Ganeshberi : Tea Co. (Pvt.) Comp. Case 556* “ in deciding as to whether a company should be allowed to start additional business an application made in this behalf is not to be disallowed merely because the business is wholly different form and bears no relation to the existing business of the company. All that is essential is that it should be capable of being conveniently and advantageously combined with the existing business and is not destructive of or inconsistent with the existing business”.

According to the amended Section 18(1) of the Principal Act (as stated previously), a company shall file with the Registrar a special resolution passed by the company relating to clauses (a) to (g) of Sub-section (1) of Section 17 within one month from the date of such resolution or a certified copy of the order of the Company Law Board made under Sub-section (5) of that section confirming the alteration, within three months from the date of order as the case may be, together with a printed copy of the memorandum as altered and the Registrar shall register the same and certify the registration under his hand within one month from the date of filing of such documents.

It should be noted that on the objects being altered as aforesaid, the company would not be automatically entitled to commence the proposed business since the provisions of Section 149(2A) would also require compliance therewith.

Section 149 (2A) prohibits a public limited company from commencing any business other than that covered by the main objects of the company, unless it has by a special resolution, approved of the commencement of such business and a duly verified declaration by one of its Directors or its Secretary in the prescribed form that such a resolution has been passed or as the case may be the provisions of Section 149(2B) have been complied with, has been filed with the Registrar. In the context of this prohibition, a distinction has been made between a





company existing immediately before the commencement of the Amendment Act, 1965 and one formed after such commencement. In the former case, the special resolution is required for commencing a business, in relation to any of the objects mentioned in its memorandum, which is not germane to the business it was carrying on at the commencement of the Amendment Act. In the latter case, the special resolution is necessary to set up a business in relation to any object other than its main objects, or ancillary to it, on its memorandum.

Thus, for commencing the proposed business, a special resolution of the company would be necessary. An ordinary resolution would be sufficient if, in addition the Central Government, on an application by the Board of Directors, allows the company to commence such a business [Section 149(2B)].

**(h) Liability clause:** Liability clause in the memorandum defines the limitations of the liability of members. This liability may be limited liability in either of the two ways: (a) it may be limited to the amount remaining unpaid on shares held by a member or shareholder; or (b) in case of a guarantee company, it may be limited to the amount which each member undertakes to contribute, to the assets of the company in the event of winding up. It may be noticed that the limited liability clause is entirely omitted from the memorandum, in case of unlimited company because the liability of members of such a company is unrestricted.

**(i) Alteration of Liability clause:** No member of a company shall be bound by an alteration made in the memorandum or articles after the date on which he became a member, if such an alteration requires him to take or subscribe for more shares should then the number held by him as the date of alteration or in any way increase his liability. [Section 38]. But the section will not apply where the member agrees in writing either before or after a particular alteration is made, so as to bound by the alteration. Similarly, if the company is a club or association, alteration in the memorandum the articles requiring be a member to pay subscriptions/charges at a higher rate, a member may be bound by the alteration, even though he does not agree in writing.

In the case of registration of unlimited company as a limited company, the liability may either be limited or reduced, such an alteration by way change of registration of such companies shall not, alter any debts, liabilities, obligations or contracts incurred or entered into by or on behalf the company before the registration.

**(j) Capital clause:** The capital clause states the amount of share capital with which the company proposes to be registered and the division thereof, into shares of fixed amount. It is for those who are promoting the company, to decide the amount of capital, which will be necessary for the company. Such capital is called that "Nominal" or "Authorised" Capital. There is no limit to the amount of authorised capital with which a company can be incorporated. The amount of authorised capital should be sufficiently high so that further issue of shares may easily be done to finance the expanding business. It is optional for a company to state the division of the authorised capital into different classes of shares, if any, and the



rights of various classes of shareholders in this clause. Generally, such details are described in the articles of the company.

Note, that an unlimited company having a share capital is not required to have the capital clause in its memorandum. In the case of such company Section 27(i) provides that the amount of share capital with which the company is to be registered must be stated in the Articles of Association of the Company.

**(k) Alteration of capital clause** - For details of such alteration, refer to Unit 3.

### 1.12 ARTICLES OF ASSOCIATION

The articles of association of a company are its rules and regulations, which are framed to manage its internal affairs. Just as the memorandum contains the fundamental conditions upon which along the company is allowed to be incorporated, so also the articles are the internal regulations of the company (*Guinness vs. Land Corporation of Ireland* 22 Ch. D. 349, 381). These general functions of the articles have been aptly summed up by Lord Cairns in *Ashbury Carriage Co. vs. Riche* as follows: "The articles play a part subsidiary to memorandum of association. They accept the memorandum as the charter of incorporation, and so accepting it the articles proceed to define the duties, the incorporation and so accepting it the articles proceed to define the duties the rights and powers of the governing body as between themselves and the company and the mode and form in which the business of the company is to be carried on, and the mode and form in which changes in the internal regulation of the company may from time to time be made."

The document containing the articles of association of a company (the Magna Carta) is a business document; hence it has to be construed strictly. It regulates domestic management of a company and creates certain rights and obligations between the members and the company [*S.S. Rajkumar vs. Perfect Castings (P.) Ltd.* [1968] 38 *Camp. Case* 187].

The articles of association are in fact the bye-laws of the company according to which director and other officers are required to perform their functions as regards the management of the company, its accounts and audit. It is important therefore that the auditor should study them and, while doing so he should note the provisions therein in respect of relevant matters.

Every company limited by guarantee or an unlimited or a private limited company is required to register its articles along with the memorandum of association. If a public company limited by shares does not register articles, the regulations contained in Table A would be applicable as if these were the articles of the company.

In the case of public companies limited by shares and registered after the commencement of the Act. Table A shall apply in so far as it has not been excluded or modified by special articles.



### **1.13 ALTERATION OF ARTICLES**

Section 31 vests companies with power to alter or add to its articles. A company cannot divest itself of these powers [*Andrews vs. Gas Meter Co.* [1897] 1 Ch. 161]. Matters as to which the memorandum is silent can be dealt with by the alteration of article [Section 19(1)]. The alteration must be effected by special resolution. The fundamental right of a company to alter its articles is subject to the following limitations:

- (a) The alteration must not exceed the powers given by memorandum or conflict with the provisions thereof.
- (b) It must not be inconsistent with any provisions of the Companies Act or any other statute.
- (c) It must not be illegal.
- (d) It should not be in fraud on minority, or inflict a hardship on minority without any corresponding benefits to the company as a whole. The Court will not interfere unless the alteration could reasonably be considered as being not for the benefit of the company [*Brown British Abrasive Wheel Co.* [1919] 1 Ch. 290; *Sidebottom vs. Kers Lesse & Co. Ltd.* [1920] 1 Ch. 154].
- (e) The alteration must not be inconsistent with an order of the Court. Under Section 404 any subsequent alteration thereof, which is inconsistent with such, an order can be made by the company only with the leave of the Court.
- (f) It may be regarded as having a retrospective effect so long as it does not affect the things already done by the company [*Allen vs. Gold Reef of West Africa* [1909] S.C. 732].
- (g) If a public company is converted into a private company, then the approval of the Central Government is necessary [Section 31 (1) Proviso]. Printed copy of altered articles shall be filed with the Registrar within one month of the date of Central Government's approval [Section 31(2A)].

It may further be noted that an injunction cannot be granted to prevent the adoption of articles, which constituted a breach of contract. But if the company acts on them it may be liable to damages [*Shirlaw vs. Southern Foundries Ltd.* 1940 A.C. 701 (760)].

- (h) An alteration that has the effect of increasing the liability of a member to contribute to the company is not binding on a present member unless he has agreed thereto in writing (Section 38.).
- (i) A reserve capital once created cannot be unreserved but may be cancelled on a reduction of capital [*Midland Railway Carriage Wagon Co.* [1907] W.N. 175; [(Section 99)]
- (j) Any irregular alterations, which have been acted on for many years, are binding.



*Copies of Memorandum and Articles:* A company is bound on payment of one rupee by a member to supply within seven days of requisition a copy of the memorandum and Articles of Association and even agreement and resolution referred to in Section 192 not embodied in memorandum or articles. The copies must be in accordance with any alterations, which have been made before the date of issue of the copies.

*Doctrines of constructive notice and indoor management:* In consequences of the registration of the memorandum and articles of association of the company with the Registrar of Companies, a person dealing with the company is deemed to have constructive notice of their contents. This is because these documents are construed as “public document” under Section 610 of the Companies Act, 1956. Accordingly if a person deals with a company in a manner incompatible with the provisions of the aforesaid documents or enters into transaction, which is *ultra vires*, *these documents*, he must do so at his peril. If someone supplies goods to a company in which it cannot deal according to its objects clause, he will not be able to recover the price from the company. Suppose the articles provide that a bill of exchange must be signed by two directors, if the bill is actually signed by one director only the holder thereof cannot claim payment thereon. However, the doctrine of constructive notice is not a positive one but a negative one like that of estoppel of which it forms parts. It operates only against the person who has been dealing with the company but not against the company itself; consequently he is prevented from alleging that he did not know that the constitution of the company rendered a particular act or a particular delegation of authority *ultra vires*. Thus, the doctrine is a “cloud” for the strangers.

#### 1.14 DOCTRINE OF INDOOR MANAGEMENT

But the aforesaid doctrine of constructive notice does in no sense mean that outsiders are deemed to have notice of the internal affairs of the company. For instance, if an act is authorised by the articles or memorandum, an outsider is entitled to assume that all the detailed formalities for doing that act have been observed. For example, the directors of R.B.B. Ltd. gave a bond to T. The articles empowered the directors to issue such bonds under the authority of a proper resolution. In fact, no such resolution was passed. Notwithstanding that, it was held that T could sue on the bonds on the ground that he was entitled to assume that the resolution had been duly passed [*The Royal British Bank vs. Turquand* [1956] 6E & B 327.] This is the doctrine of indoor management, popularly known as Turquand Rule, which is the only limitation to the doctrine of constructive notice discussed above.

##### Exceptions

Thus, you will have noticed that the aforementioned rule of Indoor Management is important to persons dealing with a company through its directors or other persons. They are entitled to assume that the acts of the directors or other officers of the company are validly performed, if they are within the scope of their apparent authority. So long as an act is valid under the



articles, if done in a particular manner, an outsider dealing with the company is entitled to assume that it has been done in the manner required. The above mentioned doctrine of Indoor Management or Turquand Rule has limitations of its own. That is to say, it is inapplicable to the following cases, namely :

- (a) When the person dealing with the company has notice, whether actual or constructive, of the irregularity [*Moris vs. Kenssen (1946) A.C. 459; Devi Ditta Mal vs. The Standard Bank of India (1972) I.C. 568*]. Thus director of a company cannot normally claim the benefit of the rule in the Turquand Case where he is also acting for the company in the transaction.
- (b) Where the person dealing with the company is put upon an inquiry, for example, where the transaction is unusual or not in the ordinary course of business. When a sole director and principal shareholder of a company paid into his own account with a bank a cheque drawn in favour of the company, the said bank was held to be put upon an enquiry and the bank could not rely upon the ostensible authority of the director [*Underwood vs. Bank of Liverpool (1924) I.K.B. 775*]. Likewise, a person who deals with a company may be put upon enquiry by reason of the unusual magnitude of the transactions having regard to the position of the agent who is acting for the company, [*Houghom & Co. vs. Nothard Lowe & Wills (1917) 2 KB. 147, 149; Rama Corporation Ltd. vs. Proved Tin & General Investments Ltd. (1952) 2 K.B. 147, 152*].

The company documents “are open to all who are minded to have any dealing whatsoever with the company and those deal with them just be affected with notice of all that is contained in those two documents. After that . . . all that the directors do with reference to what I may call the indoor management of their own concern, is a thing to them only; subject to this observation, that no person dealing with them has a right to suppose that anything has been or can be done that is not permitted (by the company’s documents, namely memorandum or articles). When there are persons conducting the affairs of the company in a manner which appears to be perfectly consonant with the articles of association then those dealing with them externally are not to be affected by any irregularities which may take place in the internal management of the company”, says Lord Hatherly in *Mahony vs. East Holyford Mining Co. [1875] L.R. 7 H.L. 869*.

- (c) When an instrument purporting to be executed on behalf of the company is a forgery. The doctrine of indoor management applies only to irregularities which might otherwise affect a transaction but it cannot apply to forgery which must be regarded as nullity [*Ruben vs. Great Fingal Consolidated (1966) A.C. 439; Official Liquidator vs. Commr. of Police (1969) I Comp. L.J. (Mad.)*].

In view of the exceptions discussed above the rigidity of the doctrine of constructive notice is appreciably elastic. Therefore, if the doctrine of indoor management is at all a silver lining, it is only a slender silver lining of a rather dense cloud.



A critical examination of the statement that the memorandum and articles of association of a company cannot be altered except with the Court's permission: It would be evident from the under-mentioned discussion on the provisions of law that such blanket statement is not correct.

According to Section 16 of the Companies Act, the conditions in the memorandum of a company can be altered only in the cases, in the mode and to the extent for which express provision is made in the Act. For changing the place of registered office of the company from one State to another and its objects, a special resolution and the confirmation of the alteration by the Company Law Board are necessary [Section 17], but *not the Court's permission*. The change of name by a company also requires a special resolution and the approval of the Central Government and not the Company Law Board, and for that matter, not the Court's [Section 21]. The liability clause of the memorandum cannot be altered so as to render the limited liability of members unlimited except in one circumstance as contemplated by Section 45, *i.e.*, where the number of members falls below the statutory minimum of 7 or 2 in the case of public or private limited company respectively and the business of company is carried on for more than 6 months; in this case no other formalities are required to be complied with. Again, under Section 323 (which is not included in your syllabi, nevertheless you should have a knowledge of this as well), a limited company may, if so authorised by the articles, by a special resolution, alter its memorandum so as to render unlimited liability of its directors or manager; in this case too there is *no necessity to seek the Court's permission*. Even for the alteration of the company's share capital in the shape of increasing, consolidating, subdividing, cancelling, Section 94(2) specifically states that no confirmation by the Court *is required*. Only in the matter of reduction of share capital, confirmation by the Court has been prescribed by Section 100.

In the matter of alteration of articles, Section 31(1) requires only a special resolution for the purpose, and if such resolution has the effect of converting a public company into a private company, the proviso thereto requires the approval of the Central Government - *not of the Court* - for its operation.

It is thus clear that the headline statement, unqualified as it is, cannot be said to be correct.

### 1.15 PRELIMINARY OR PRE-INCORPORATION CONTRACTS

Pre-incorporation contracts are those contracts, which are entered into, by agents or trustees on behalf of a prospective company before it has come into existence, *e.g.*, with the proprietor of a business to sell it to the prospective company. Since a company comes into existence from the date of its incorporation, it follows that any act purporting to be performed by it prior to that date is of no effect so far as the company is concerned. It will very likely be the intention of the promoters or persons concerned in the company that the company should, on its formation acquire some property or takeover the existing business, and for this purpose, a



preliminary contract for the acquisition may be entered into before the company is formed. But as the company is non-existent before incorporation it cannot be bound, by any purported ratification [*Kelner vs. Baxter (1862) L.R. 2 C.P. 174*].

The rules in respect of preliminary contracts may be summarised as follows:

- (a) The vendor cannot sue, or be sued by the company thereof, after its incorporation;
- (b) Person who acts for the intended company remains personally liable to the vendor even if the company purports to ratify the agreement, unless the agreement provides that :
  - (i) his liability shall cease if the company adopts the agreement; and
  - (ii) either party may rescind the agreement, if the company does not adopt it within a specified time;
- (c) After incorporation, the company may adopt the preliminary agreement. But this must be by novation which may be implied from the circumstances. But in some cases, the memorandum directs the directors to execute such contracts. The company can enforce a pre-incorporation contract if it is warranted by the terms of incorporation and for purposes of company.

A pre-incorporation contract can be enforced against the company if it is warranted by the terms of incorporation and it is adopted by the company. [Sections 15 and 16 of the Specific Relief Act, 1963]. In such a case, the directors have no discretion in the matter.

### **1.16 PROVISIONAL CONTRACTS**

Pre-incorporation contracts must be distinguished from contracts entered into by a company after incorporation, but before it becomes entitled to commence business.

Contracts entered into by a company after its incorporation and before it is entitled to commence business are provisional only and are not binding on the company until the trading certificate is issued - Section 149(4). The expression "provisional" denotes that the contract should be read subject to an implied term that it shall not be binding until the company becomes entitled to commence business. Consequently, should the company go into liquidation, without commencing business, such contracts cannot be enforced at all [*Re Otto Electrical Co. (1906) 2 Ch. 390*]. This rule is applicable to allotment whether first or subsequent [*Mutual Bank of India vs. Suban Singh (1936) Lah. 790*]. Under similar conditions, moneys for goods supplied (*Re Otto Electrical Co.*) remuneration for service rendered [*Drive & Co. vs. Blackiston (1908) 24 T.L.R. 563*] as well as preliminary expenses incurred on behalf of the company to be incorporated [*Re National Motor Co. 908 2 Ch. 228*] cannot be recovered. It is also not possible to invoke Section 70 of the Contract Act in such a case (*Re Ambica Textiles 54 C.W.N. 157*). Also the company cannot enter into a contract for the sale or purchase of any property [*Kishangarh Electric Co. vs. United States of Rajasthan A.I.R. 1960 Raj. 40*].



### 1.17 PROMOTERS

Persons who initiate promotion of a company are known as promoters. All persons who take steps for the registration of a company e.g., those associated with the preparation of a prospectus or in drawing up the Memorandum of Association of the company and assisting in its registration are regarded as promoters. It should, however, be noted that persons acting only in a professional capacity e.g., the solicitor, banker, accountant etc. are not regarded as promoters. The Act does not define a promoter, and whether a person is a promoter in any particular case depends on the facts having regard to the person's actions and his relationship to the company that is formed. Any one who assists in the formation for a consideration payable if the company is floated, is a promoter. "Picture formed in our minds is that of a person who, after rising to affluence by preying on the susceptibilities of a gullible public, finally retires from the scene in the blaze of a sensational suicide or Old Belley Trial," (Prof. Gower; Modern Company Law, 2nd Edition). "They are those who asset in motion the machinery by which the Act enables them to create an incorporated company", [per Lord Blank burn in *Erlanger vs. Sambrero Phosphate & Co. (1893) 3 App. Case. 1218*].

**(a) Promoter's duty to disclose :** Until a company is incorporated, a promoter stands in a fiduciary capacity towards the company and its prospective shareholders. Hence, he must not make, either directly or indirectly or through a nominee etc., any profit out of his trust, unless the company after full disclosure of the facts, consents. Such disclosure is ineffective if made merely to directors who are nominees of the promoters. Disclosure may be made either to an independent board, or by means of a prospectus to the prospective shareholders. If the promoter makes a secret profit the company can rescind the contract or compel him to account for it. Where all the members of a private company are cognisant of the facts, the rule would not apply.

**(b) Promoters as vendors:** A promoter is entitled to sell his own property to the company provided he makes proper disclosure. This applies also to property which he acquires during the promotion and which he resells to the company. If he fails to make disclosure the company may either (a) rescind the contract, or (b) compel the promoter to surrender the profit.

**(c) Promoter's remuneration:** A promoter has no right to demand any remuneration from the company, for his promotional services in the absence of an express contract with the company. Indeed, in the absence of such a contract, he cannot even recover from the company payments he has made towards legal fees, stamp duties, registration fees, or other expenses in connection with the formation of the company.

### 1.18 BOARD OF COMPANY LAW ADMINISTRATION [SECTION 10E]

In pursuance of Section 10E of the Companies (Amendment) Act, 1963 the Central Government constituted with effect from 28th April, 1964 a Board, called the Board of





Company Law Administration to exercise and discharge such powers and functions conferred on the Central Government by or under this Act or any other law as may be delegated to it by that Government.

Until the Amendment Act, 1988 came into force, the Company Law Board had to function as two separate bodies, one as a delegate and the other as an independent body. The Amendment Act, 1988 has increased the scope of powers and functions of the Company Law Board as an independent body by amending Section 10E, on the one hand, and by substituting 'Company Law Board' for the words 'Central Government' or the word 'Court' as the case may be, in several sections of the Act. Thus, what are now the powers and function of the Company Law Board are not limited to Sections 17, 18, 19, 79, 141, 186 and 635B, but extend to a number of other provisions of the Act. These other provisions of the Act are either Sections 111, 167 and 409 under which the Company Law Board used to exercise the powers and functions of the Central Government delegated to it by virtue of a notification issued under Section 637 or Sections 43 (proviso), 49, (10), 113(3), 118(3), 144(4), 163(6), 188(5), 196(4), 225(3), 284(4), 304(2)(b), 307(9), 388B to 388E, 397 or 405, 407(1)(b) and 614(1) under which the powers and functions were exercisable by the High Court. The Company Law Board has also been clothed with certain powers which do not strictly fall within either of the two categories mentioned above, the examples of such powers are Sections 58A, 80A, 113(1), 235, 237, 247, 250, 269, etc.

The independent character of the Company Law Board can also be gleaned from several other provisions of this section as now amended. For example, Sub-section (2A) now requires Central Government to appoint members with prescribed qualifications and experience. Sub-section (5) makes it binding on the Company Law Board not only to follow the principles of natural justice (which it is even otherwise bound to follow) but is also required to be guided by the dictates of its own sense of discretion. Sub-section (6) entitles the Company Law Board to lay down its own procedure for conduct of its business. In sharp contrast with position hitherto obtaining, the procedure, to be followed by the Company Law Board cannot be prescribed by the Central Government and in the exercise of its powers and discharge of its functions, the Company Law Board is no longer subject to the control of the Central Government.

While providing for an independent Company Law Board with powers statutorily conferred on it under Sub-section 1A, the erstwhile arrangement for delegation of the powers and functions of the Central Government to the Board under this Act has also been retained. Additionally, Sub-section 1A provides for exercise and discharge of such powers and functions of the Central Government under any other law, as may be conferred on it by that Government. In this connection, reference may be made of the provisions of Section 22A of the Securities (Contracts) Regulation Act, 1956 introduced by Securities (Contracts) Regulation Act, 1985 where under the jurisdiction to decide any reference under Section 49(c) has been conferred on the Board. The Central Government has also authorised the Board to decide any question



of the nature referred to in Section 2A of MRTP Act, 1969. Thus, one may say that the dual character of the Board has been maintained to some extent.

The Board shall consist of such number of members, not exceeding nine, as the Central Government deems fit. One of the members is to be appointed as the Chairman of the Board by the Central Government.

### **1.19 NATIONAL COMPANY LAW TRIBUNAL**

#### **Constitution of National Company Law Tribunal (Section 10FB)**

The Central Government shall, by notification in the Official Gazette, constitute a Tribunal to be known as the National Company Law Tribunal to exercise and discharge such powers and functions as are, or may be, conferred on it by or under this Act or any other law for the time being in force.

#### **Composition of Tribunal (Section 10FC)**

The Tribunal shall consist of a President and such number of judicial and Technical Members not exceeding sixty-two, as the Central Government deems fit, to be appointed by that Government, by notification in the Official Gazette.

#### **Qualifications for appointment of President and Members (Section 10FD)**

- (1) The Central Government shall appoint a person who has been, or is qualified to be, a Judge of a High Court as the President of the Tribunal.
- (2) A person shall not be qualified for appointment as Judicial Member unless he—
  - (a) has, for at least fifteen years, held a judicial office in the territory of India; or
  - (b) has, for at least ten years been an advocate of a High Court, or has partly held judicial office and has been partly in practice as an advocate for a total period of fifteen years; or
  - (c) has held for at least fifteen years a Group 'A' post or an equivalent post under the Central Government or a State Government [including at least three years of service as a Member of the Indian Company Law Service (Legal Branch) in Senior Administrative Grade in that service; or
  - (d) has held for at least fifteen years a Group 'A' post or an equivalent post under the Central Government (including at least three years of service as a Member of the Indian Legal Service in Grade I of that service).
- (3) A person shall not be qualified for appointment as Technical Member unless he—
  - (a) has held for at least fifteen years a Group 'A' post or an equivalent post under the Central Government or a State Government [including at least three years of service as a



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Member of the Indian Company Law Service (Accounts Branch) in Senior Administrative Grade in that Service; or

- (b) is, or has been, a Joint Secretary to the Government of India under the Central Staffing Scheme, or any other post under the Central Government or a State Government carrying a scale of pay which is not less than that of a Joint Secretary to the Government of India for at least five years and has adequate knowledge of, and experience in, dealing with problems relating to company law; or
- (c) is, or has been, for at least fifteen years in practice as a chartered accountant under the Chartered Accountants Act, 1949 (38 of 1949); or
- (d) is, or has been, for at least fifteen years in practice as a cost accountant under the Costs and Works Accountants Act, 1959 (23 of 1959); or
- (e) is, or has been, for at least fifteen years working experience as a Secretary in whole-time practice as defined in clause (45A) of section 2 of this Act and is a member of the Institute of the Companies Secretaries of India constituted under the Company Secretaries Act, 1980 (56 of 1980); or
- (f) is a person of ability, integrity and standing having special knowledge of, and professional experience of not less than twenty years in, science, technology, economics, banking, industry, law, matters relating to industrial finance, industrial management, industrial reconstruction, administration, investment, accountancy, marketing or any other matter, the special knowledge of, or professional experience in, which would be in the opinion of the Central Government useful to the Tribunal; or
- (g) is, or has been, a Presiding Officer of a Labour Court, Tribunal or National Tribunal constituted under the Industrial Disputes Act, 1947 (14 of 1947); or
- (h) is a person having special knowledge of, and experience of not less than fifteen years in, the matters relating to labour.

Explanation.—For the purposes of this Part,—

- (i) “Judicial Member” means a Member of the Tribunal appointed as such under sub-section (2) of section 10FD and includes the President of the Tribunal;
- (ii) “Technical Member” means a Member of the Tribunal appointed as such under sub-section (3) of section 10FD.

### **Term of office of President and Members (Section 10FE)**

The President and every other Member of the Tribunal shall hold office as such for a term of



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three years from the date on which he enters upon his office but shall be eligible for re-appointment:

Provided that no President or other Member shall hold office as such after he has attained,—

- (a) in the case of the President, the age of sixty-seven years;
- (b) in the case of any other Member, the age of sixty-five years :

Provided further that the President or other Member may retain his lien with his parent cadre or Ministry or Department, as the case may be, while holding office as such.

### **Financial and administrative powers of Member Administration (Section 10FF)**

The Central Government shall designate any Judicial Member or Technical Member as Member Administration who shall exercise such financial and administrative powers as may be vested in him under the rules which may be made by the Central Government :

Provided that the Member Administration shall have authority to delegate such of his financial and administrative powers as he may think fit to any other officer of the Tribunal subject to the condition that such officer shall, while exercising such delegated powers continue to act under the direction, superintendence and control of the Member Administration.

### **Salary, allowances and other terms and conditions of service of President and other members (Section 10FG)**

The salary and allowances and other terms and conditions of service of the President and other members of the Tribunal shall be such as may be prescribed:

Provided that neither the salary and allowances nor the other terms and conditions of service of the President and other Members shall be varied to their disadvantage after their appointment.

### **Vacancy in Tribunal (Section 10FH)**

(1) In the event of the occurrence of any vacancy in the office of the President of the Tribunal by reason of his death, resignation or otherwise, the senior-most Member shall act as the President of the Tribunal until the date on which a President, appointed in accordance with the provisions of this Act to fill such vacancy, enters upon his office.

(2) When the President is unable to discharge his functions owing to absence, illness or any other cause, the senior-most Member or, as the case may be, such one of the Members of the Tribunal, as the Central Government, may, by notification, authorise in this behalf, shall discharge the functions of the President until the date on which the President resumes his duties.



(3) If, for reason other than temporary absence, any vacancy occurs in the office of the President or a Member, the Central Government shall appoint another person in accordance with the provisions of this Act to fill the vacancy and the proceedings may be continued before the Tribunal from the stage at which the vacancy is filled.

**Resignation of President and Member (Section 10FI)**

The President or a Member of the Tribunal may, by notice in writing under his hand addressed to the Central Government, resign his office :

**Provided** that the President or a Member shall, unless he is permitted by the Central Government to relinquish his office sooner, continue to hold office until the expiry of three months from the date of receipt of such notice or until a person duly appointed as his successor enters upon his office or until the expiry of the term of office, whichever is the earliest.

**Removal and suspension of President or Member (Section 10FJ)**

(1) The Central Government may, in consultation with the Chief Justice of India, remove from office the President or any Member of the Tribunal, who—

- (a) has been adjudged an insolvent; or
- (b) has been convicted of an offence which, in the opinion of the Central Government, involves moral turpitude; or
- (c) has become physically or mentally incapable of acting as such President or Member of the Tribunal; or
- (d) has acquired such financial or other interest as is likely to affect prejudicially his functions as such President or Member of the Tribunal; or
- (e) has so abused his position as to render his continuance in office prejudicial to the public interest:

**Provided** that no such President or a Member shall be removed on any of the grounds specified in clauses (b) to (e) without giving him reasonable opportunity of being heard in respect of those charges.

(2) The President or a Member of the Tribunal shall not be removed from his office except by an order made by the Central Government on the ground of proved misbehaviour or incapacity after an inquiry made by a Judge of the Supreme Court in which such President or a Member had been informed of the charges against him and given a reasonable opportunity of being heard in respect of those charges.



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(3) The Central Government may suspend from office the President or Member of the Tribunal in respect of whom a reference has been made to the Judge of the Supreme Court under sub-section (2) until the Central Government has passed orders on receipt of the report of the Judge of the Supreme Court on such reference.

(4) The Central Government may, by rules, regulate the procedure for the investigation of misbehaviour or incapacity of the President or a Member referred to in sub-section (2).

### **Officers and employees of Tribunal (Section 10FK)**

(1) The Central Government shall provide the Tribunal with such officers and other employees as it may deem fit.

(2) The officers and other employees of the Tribunal shall discharge their functions under the general superintendence of the Member Administration.

(3) The salaries and allowances and other terms and conditions of service of the officers and other employees of the Tribunal shall be such as may be prescribed.

### **Benches of Tribunal (Section 10FL)**

(1) Subject to the provisions of this section, the powers of the Tribunal may be exercised by Benches, constituted by the President of the Tribunal, out of which one shall be a Judicial Member and another shall be a Technical Member referred to in clauses (a) to (f) of sub-section (3) of section 10FD:

Provided that it shall be competent for the Members authorised in this behalf to function as a Bench consisting of a single Member and exercise the jurisdiction, powers and authority of the Tribunal in respect of such class of cases or such matters pertaining to such class of cases, as the President of the Tribunal may, by general or special order, specify :

Provided further that if at any stage of the hearing of any such case or matter, it appears to the Member of the Tribunal that the case or matter is of such a nature that it ought to be heard by a Bench consisting of two Members, the case or matter may be transferred by the President of the Tribunal or, as the case may be, referred to him for transfer to such Bench as the President may deem fit.

(2) The President of the Tribunal shall, for the disposal of any case relating to rehabilitation, restructuring or winding up of the companies, constitute one or more Special Benches consisting of three or more Members, each of whom shall necessarily be a Judicial Member, a Technical Member appointed under any of the clauses (a) to (f) of sub-section (3) of section 10FD, and a Member appointed under clause (g) or clause (h) of sub-section (3) of section 10FD :



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Provided that in case a Special Bench passes an order in respect of a company to be wound up, the winding up proceedings of such company may be conducted by a Bench consisting of a single Member.

(3) If the Members of a Bench differ in opinion on any point or points, it shall be decided according to the majority, if there is a majority, but if the Members are equally divided, they shall state the point or points on which they differ, and the case shall be referred by the President of the Tribunal for hearing on such point or points by one or more of the other Members of the Tribunal and such point or points shall be decided according to the opinion of the majority of Members of the Tribunal who have heard the case, including those who first heard it.

(4) There shall be constituted such number of Benches, as may be notified by the Central Government.

(5) In addition to the other Benches, there shall be a Principal Bench at Delhi presided over by the President of the Tribunal.

(6) The Principal Bench of the Tribunal shall have powers of transfer of proceedings from any Bench to another Bench of the Tribunal in the event of inability of any Bench from hearing any such proceedings for any reason:

Provided that no transfer of any proceedings shall be made under this sub-section except after recording the reasons for so doing in writing.

### **Benches of Tribunal (Section 10FL)**

(1) Subject to the provisions of this section, the powers of the Tribunal may be exercised by Benches, constituted by the President of the Tribunal, out of which one shall be a Judicial Member and another shall be a Technical Member referred to in clauses (a) to (f) of sub-section (3) of section 10FD:

Provided that it shall be competent for the Members authorised in this behalf to function as a Bench consisting of a single Member and exercise the jurisdiction, powers and authority of the Tribunal in respect of such class of cases or such matters pertaining to such class of cases, as the President of the Tribunal may, by general or special order, specify :

Provided further that if at any stage of the hearing of any such case or matter, it appears to the Member of the Tribunal that the case or matter is of such a nature that it ought to be heard by a Bench consisting of two Members, the case or matter may be transferred by the President of the Tribunal or, as the case may be, referred to him for transfer to such Bench as the President may deem fit.

(2) The President of the Tribunal shall, for the disposal of any case relating to rehabilitation, restructuring or winding up of the companies, constitute one or more Special Benches consisting of three or more Members, each of whom shall necessarily be a Judicial Member, a



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Technical Member appointed under any of the clauses (a) to (f) of sub-section (3) of section 10FD, and a Member appointed under clause (g) or clause (h) of sub-section (3) of section 10FD :

Provided that in case a Special Bench passes an order in respect of a company to be wound up, the winding up proceedings of such company may be conducted by a Bench consisting of a single Member.

(3) If the Members of a Bench differ in opinion on any point or points, it shall be decided according to the majority, if there is a majority, but if the Members are equally divided, they shall state the point or points on which they differ, and the case shall be referred by the President of the Tribunal for hearing on such point or points by one or more of the other Members of the Tribunal and such point or points shall be decided according to the opinion of the majority of Members of the Tribunal who have heard the case, including those who first heard it.

(4) There shall be constituted such number of Benches, as may be notified by the Central Government.

(5) In addition to the other Benches, there shall be a Principal Bench at Delhi presided over by the President of the Tribunal.

(6) The Principal Bench of the Tribunal shall have powers of transfer of proceedings from any Bench to another Bench of the Tribunal in the event of inability of any Bench from hearing any such proceedings for any reason :

Provided that no transfer of any proceedings shall be made under this sub-section except after recording the reasons for so doing in writing.

### Order of Tribunal (Section 10 FM)

(1) The Tribunal may, after giving the parties to any proceeding before it, an opportunity of being heard, pass such orders thereon as it thinks fit.

(2) The Tribunal may, at any time within two years from the date of the order, with a view to rectifying any mistake apparent from the record, amend any order passed by it under subsection (1), and shall make such amendment if the mistake is brought to its notice by the parties.

(3) The Tribunal shall send a copy of every order passed under this section to all the parties concerned.

### Power to review (Section 10FN)

The Tribunal shall have power to review its own orders.





**Delegation of powers (Section 10FO)**

The Tribunal may, by general or special order, delegate, subject to such conditions and limitations, if any, as may be specified in the order, to any Member or officer or other employee of the Tribunal or other person authorised by the Tribunal to manage any industrial company or industrial undertaking or any operating agency, such powers and duties under this Act as it may deem necessary.

**Power to seek assistance of Chief Metropolitan Magistrate and District Magistrate (Section 10FP)**

(1) The Tribunal or any operating agency, on being directed by the Tribunal may, in order to take into custody or under its control all property, effects and actionable claims to which a sick industrial company is or appears to be entitled, request, in writing, the Chief Metropolitan Magistrate or the District Magistrate within whose jurisdiction any property, books of account or any other document of such sick industrial company, be situate or be found, to take possession thereof, and the Chief Metropolitan Magistrate or the District Magistrate, as the case may be, shall, on such request being made to him,—

- (a) take possession of such property, books of account or other documents; and
- (b) cause the same to be entrusted to the Tribunal or the operating agency.

(2) For the purpose of securing compliance with the provisions of sub-section (1), the Chief Metropolitan Magistrate or the District Magistrate may take or cause to be taken such steps and use or cause to be used such force as may, in his opinion, be necessary.

(3) No act of the Chief Metropolitan Magistrate or the District Magistrate done in pursuance of this section shall be called in question in any court or before any authority on any ground whatsoever.

**PART IC**

**NATIONAL COMPANY LAW APPELLATE TRIBUNAL**

**Formation (Section 10FR)**

The Central Government by notification in the official gazette constitute National Company Law Appellate Tribunal consisting of a chairperson and not more than two members for hearing appeals against the orders of the tribunal. The Chairperson of Appellate Tribunal shall be a person who has been judge of a Supreme Court or a Chief Justice of a High Court. Members shall be a person of ability, integrity and having special knowledge of, any professional experience for more than 25 years in, science, technology, economics, banking, industry, law matters relating to labour, industrial finance, industrial management, industrial reconstruction, administration, investment, accountancy or any other matter in the opinion of Central Government which may be useful to the appellate tribunal.



**Appeal from order of Tribunal (Section 10FQ)**

Any person aggrieved by an order or decision of the Tribunal, within the period of 45 days from the date on which a copy of the order or decision of the tribunal, may preferred an appeal to Appellate Tribunal. On receipt of an appeal from an aggrieved person, the Appellate Tribunal may pass such orders, after giving an opportunity of being heard, as it thinks fit, confirming, modifying or setting aside the order appealed against. The Appellate Tribunal shall be made to dispose the appeal within six months from the date of the receipt of the appeal.

**Term of office (Section 10FT)**

The Chairperson or a Member of the Appellate Tribunal shall hold office as such for a term of three years from the date on which he enters upon his office, but shall be eligible for re-appointment for another term of three years. However, the maximum age limit in the case of chairperson 70 years and in the case of any other member 67 years.

**Resignation (Section 10FU)**

The Chairperson or a Member of the Appellate Tribunal may resign his office by giving notice in writing to the Central Government. However, the Chairperson or member shall, unless he is permitted by the Central Government to relinquish his office sooner, continue to hold office until the expiry of three months from the date of receipt of such notice or until a person duly appointed as his successor enters upon his office or until the expiry of his term of office, whichever is the earliest.

**Removal and suspension of Chairperson and Members of Appellate Tribunal (Section 10FV)**

(1) The Central Government may, in consultation with the Chief Justice of India, remove from office the Chairperson or any Member of the Appellate Tribunal, who—

- (a) has been adjudged an insolvent; or
- (b) has been convicted of an offence which, in the opinion of the Central Government, involves moral turpitude; or
- (c) has become physically or mentally incapable of acting as such Chairperson or Member of the Appellate Tribunal; or
- (d) has acquired such financial or other interest as is likely to affect prejudicially his functions as such Chairperson or Member of the Appellate Tribunal; or



- (e) has so abused his position as to render his continuance in office prejudicial to the public interest.
- (2) The Chairperson or a Member of the Appellate Tribunal shall not be removed from his office except by an order made by the Central Government on the ground of proved misbehaviour or incapacity after an inquiry made by a Judge of the Supreme Court in which such Chairperson or Member had been informed of the charges against him and given a reasonable opportunity of being heard in respect of those charges.
- (3) The Central Government may suspend from office the Chairperson or a Member of the Appellate Tribunal in respect of whom a reference has been made to the Judge of the Supreme Court under sub-section (2) until the Central Government has passed orders on receipt of the report of the Judge of the Supreme Court on such reference.
- (4) The Central Government may, by rules, regulate the procedure for the investigation of misbehaviour or incapacity of the Chairperson or a Member referred to in sub-section (2).

**Vacancy (Section 10FS)**

In the event of the occurrence of any vacancy in the office of the Chairperson of the Appellate Tribunal by reason of his death, resignation or otherwise, the senior-most Member of the Appellate Tribunal shall act as the Chairperson of the Appellate Tribunal until the date on which a Chairperson appointed in accordance with the provisions of this Act to fill such vacancy enters upon his office.

When the Chairperson of the Appellate Tribunal is unable to discharge his functions owing to absence, illness or any other cause, the senior-most Member or, as the case may be, such one of the member of the Appellate Tribunal, as the Central Government may, by notification, authorize in this behalf, shall discharge the functions of the Chairperson resumes his duties.

If for reason other than temporary absence, any vacancy occurs in the office of the Chairperson or a Member, the Central Government shall appoint another person in accordance with the provisions of this Act to fill the vacancy and the proceedings may be continued before the Appellate Tribunal from the stage at which the vacancy is filled.

**Salary, allowances and other terms and conditions of service of Chairperson and Members (Section 10FW)**

The salary and allowances and other terms and conditions of service of the Chairperson and other Members of the Appellate Tribunal shall be such as may be prescribed and shall not be varied to their disadvantage after appointment.

**Selection Committee (Section 10FX)**

The Chairperson and Members of the Appellate Tribunal and President and Members of the



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Tribunal shall be appointed by the Central Government on the recommendations of a Selection Committee consisting of—

- |     |  |              |
|-----|--|--------------|
| (a) | Chief Justice of India or his nominee  | Chairperson; |
| (b) | Secretary in the Ministry of Finance and Company Affairs   | Member;      |
| (c) | Secretary in the Ministry of Labour  | Member;      |
| (d) | Secretary in the Ministry of Law and Justice (Department of Legal Affairs or Legislative Department) | Member;      |
| (e) | Secretary in the Ministry of Finance and Company Affairs (Department of Company Affairs)             | Member.      |

The Joint Secretary in the Ministry or Department of the Central Government dealing with this Act shall be the Convener of the Selection Committee.

The Central Government shall, within one month from the date of occurrence of any vacancy by reason of death, resignation or removal of the Chairperson and Members of the Appellate Tribunal and President and Members of the Tribunal and six months before the superannuation or end of tenure of the Chairperson and Members of the Appellate Tribunal and President and Members of the Tribunal, make a reference to the Selection Committee for filling up of the vacancy. The Selection Committee shall recommend within one month a panel of three names for every vacancy referred to it.

Before recommending any person for appointment as the Chairperson and Members of the Appellate Tribunal and President and Members of the Tribunal, the Selection Committee shall satisfy itself that such person does not have financial or other interest which is likely to affect prejudicially his functions as such Chairperson or Member of the Appellate Tribunal or President or Member of the Tribunal, as the case may be.

No appointment of the Chairperson and Members of the Appellate Tribunal and President and Members of the Tribunal shall be invalidated merely by reason of any vacancy or any defect in the constitution of the Selection Committee.

### **Chairperson, etc., to be public servants (Section 10FY)**

The Chairperson, Members, officers and other employees of the Appellate Tribunal and the President, Members, officers and other employees of the Tribunal shall be deemed to be public servants within the meaning of section 21 of the Indian Penal Code (45 of 1860).

### **Protection of action taken in good faith (Section 10FZ)**

No suit, prosecution or other legal proceedings shall lie against the Appellate Tribunal or its Chairperson, Member, officer or other employee or against the Tribunal, its President,



Member, officer or other employee or operating agency or liquidator or any other person authorised by the Appellate Tribunal or the Tribunal in the discharge of any function under this Act for any loss or damage caused or likely to be caused by any act which is in good faith done or intended to be done in pursuance of this Act.

**Procedure and powers of Tribunal and Appellate Tribunal (Section 10FZA)**

The Tribunal and the Appellate Tribunal shall not be bound by the procedure laid down in the Code of Civil Procedure, 1908 (5 of 1908), but shall be guided by the principles of natural justice and, subject to the other provisions of this Act and of any rules made by the Central Government, the Tribunal and the Appellate Tribunal shall have power to regulate their own procedure.

The Tribunal and the Appellate Tribunal shall have, for the purposes of discharging its functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908 (5 of 1908) while trying a suit in respect of the following matters, namely:—

- (a) summoning and enforcing the attendance of any person and examining him on oath;
- (b) requiring the discovery and production of documents;
- (c) receiving evidence on affidavits;
- (d) subject to the provisions of sections 123 and 124 of the Indian Evidence Act, 1872 (1 of 1872), requisitioning any public record or document or copy of such record or document from any office;
- (e) issuing commissions for the examination of witnesses or documents;
- (f) reviewing its decisions;
- (g) dismissing a representation for default or deciding it ex parte;
- (h) setting aside any order of dismissal of any representation for default or any order passed by it ex parte; and
- (i) any other matter which may be prescribed by the Central Government.

Any order made by the Tribunal or the Appellate Tribunal may be enforced by that Tribunal in the same manner as if it were a decree made by a court in a suit pending therein, and it shall be lawful for the Tribunal or the Appellate Tribunal to send in case of its inability to execute such order, to the court within the local limits of whose jurisdiction,—

- (a) in the case of an order against a company, the registered office of the company is situate; or



- (b) in the case of an order against any other person, the person concerned voluntarily resides or carries on business or personally works for gain.

All proceedings before the Tribunal or the Appellate Tribunal shall be deemed to be judicial proceedings within the meaning of sections 193 and 228, and for the purposes of section 196, of the Indian Penal Code (45 of 1860) and the Tribunal and the Appellate Tribunal shall be deemed to be a civil court for the purposes of section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973 (2 of 1974).

**Power to punish for contempt (Section 10G)**

The Appellate Tribunal shall have the same jurisdiction, powers and authority in respect of contempt of itself as the High Court has and may exercise, for this purpose under the provisions of the Contempt of Courts Act, 1971 (70 of 1971), shall have the effect subject to modifications that—

- (a) the reference therein to a High Court shall be construed as including a reference to the Appellate Tribunal;
- (b) the reference to Advocate-General in section 15 of the said Act shall be construed as a reference to such law officers as the Central Government may specify in this behalf.

**Staff of Appellate Tribunal (Section 10GA)**

The Central Government shall provide the Appellate Tribunal with such officers and other employees as it may think fit. The officers and other employees of the Appellate Tribunal shall discharge their functions under the general superintendence of the Chairperson of the Appellate Tribunal. The salaries and allowances and other conditions of service of the officers and other employees of the Appellate Tribunal shall be such as may be prescribed.

**Civil court not to have jurisdiction. (Section 10GB)**

No civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which the Tribunal or the Appellate Tribunal is empowered to determine by or under this Act or any other law for the time being in force and no injunction shall be granted by any court or other authority in respect of any action taken or to be taken in pursuance of any power conferred by or under this Act or any other law for the time being in force.

**Vacancy in Tribunal or Appellate Tribunal not to invalidate acts or proceedings (Section 10GC)**

No act or proceeding of the Tribunal or the Appellate Tribunal shall be questioned or shall be invalid merely on the ground of existence of any vacancy or defect in the establishment of the Tribunal or the Appellate Tribunal, as the case may be.



**Right to legal representation (Section 10GD)**

The applicant or the appellant may either appear in person or authorise one or more chartered accountants or company secretaries or cost accountants or legal practitioners or any officer to present his or its case before the Tribunal or the Appellate Tribunal, as the case may be.

Explanation.—For the purposes of this section,—

- (a) “chartered accountant” means a chartered accountant as defined in clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949 (38 of 1949) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (b) “company secretary” means a company secretary as defined in clause (c) of sub-section (1) of section 2 of the Company Secretaries Act, 1980 (56 of 1980) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (c) “cost accountant” means a cost accountant as defined in clause (b) of sub-section (1) of section 2 of the Cost and Works Accountants Act, 1959 (23 of 1959) and who has obtained a certificate of practice under sub-section (1) of section 6 of that Act;
- (d) “legal practitioner” means an advocate, a vakil or any attorney of any High Court, and includes a pleader in practice.

**Limitation (Section 10GE)**

The provisions of the Limitation Act, 1963 (36 of 1963) shall, as far as may be, apply to an appeal made to the Appellate Tribunal.

**Appeal to Supreme Court (Section 10GF)**

Any person aggrieved by any decision or order of the Appellate Tribunal may file an appeal to the Supreme Court within sixty days from the date of communication of the decision or order of the Appellate Tribunal to him on any question of law arising out of such decision or order:

Provided that the Supreme Court may, if it is satisfied that the appellant was prevented by sufficient cause from filing the appeal within the said period, allow it to be filed within a further period not exceeding sixty days.



**1.20 SELF-EXAMINATION QUESTIONS**

1. The minimum number of members in a private company and public company are
  - (a) Three and Seven respectively.
  - (b) Two and seven respectively.
  - (c) Two and nine respectively.
  - (d) None of the above.
2. A public Company can commence business after receiving
  - (a) Certificate of incorporation.
  - (b) Certificate to commence business.
  - (c) Both (a) and (b).
  - (d) None of the above.
3. As per Companies (Amendment) Act, 2000, a private company and public company must have paid up capital of
  - (a) Rs. One lakh and two lakhs respectively.
  - (b) Rs. One lakh and five lakhs respectively.
  - (c) Rs. Two lakhs and six lakhs respectively.
  - (d) None of the above.
4. Contracts, which entered into, by agents or trustees on behalf of a prospective company before it has come into existence are called
  - (a) Provisional contracts.
  - (b) Preliminary or pre-incorporation contracts.
  - (c) Both (a) and (b).
  - (d) None of the above.
5. A private company can be converted into a public company under
  - (a) Conversion by default.
  - (b) Conversion by operation law.
  - (c) Conversion by choice.
  - (d) Any of the above.





6. A company limited by shares
  - (a) Has unlimited liability
  - (b) Exists only in contemplation of law.
  - (c) Has a perpetual succession
  - (d) Comes to an end on the death of all the members.
7. An Act is said to be ultra virus a company when it is beyond the powers.
  - (a) Of the company
  - (b) Of the directors
  - (c) Of the directors but not the company
  - (d) Conferred on the company by the Articles.
8. The charter of a company is its
  - (a) Articles of Association
  - (b) Prospectus
  - (c) Statement in lieu of Prospectus
  - (d) Memorandum of Association.
9. Which of the following is benefit from incorporation of a company
  - (a) Loss of privacy
  - (b) Possibilities of frauds
  - (c) Greater public accountability
  - (d) Independent legal entity.
10. Which one of the following is not the content of the memorandum of association
  - (a) Name clause
  - (b) The registered office clause
  - (c) The objects clause
  - (d) The Board of Directors clause.

**State Yes or No**

11. An association of persons may form a company and get it registered as such under the Companies Act. What are the considerations, which may actuate it, do so?



12. If the members composing the company die or dissociate themselves, the company also gets extinct. Is it a correct statement?
13. A company can own property, have a banking account, raise loans, incur liabilities and enter into contracts, whereas its members cannot contract with the company, acquire rights against it or incur liability to it. Examine the veracity of this statement.
14. For the debts of the company, its creditors (a) can (b) cannot, sue the members of the company. Which is correct?
15. Are the directors of company agents or the members thereof?
16. S had been in the leather business for many years and solvent. Later he decided to form a company, the members thereof being S himself, his wife and five children (each having one share) and transferred his business to the company. In consideration thereof S was allotted fully paid-up shares and debentures; the latter were secured on the assets of the company. Eventually, the company had to be liquidated and the assets being insufficient to repay either the debentures or the trade creditors. S claimed preference on the ground of being a secured creditor in respect of the debentures held by him. The unsecured creditors objected to this claim on the ground that S and his company were one and put in a counter claim that their debts should be discharged first. In the circumstances, could S get repayment in priority to the unsecured creditors?
17. An English company was formed for selling in England tyres produced by a German company in Germany. The German company held the bulk of English company's shares. The overwhelming majority of the shareholders and all the directors were German nationals residing in Germany. The English company filed a suit during the World War I to recover a trade debt. Could the company be allowed to proceed with the action? [*Dalmier Co. Ltd. vs. Continental Tyre and Rubber Co.* [1916] 2 A.C. 307].
18. X, having huge dividend and interest income, formed four private companies. He agreed with each of such companies to hold a block of investment as an agent for the company. The income received was credited to the accounts of the company but the company gave it back to X as a pretended loan. In this way, X divided his income with a view to reduce his tax-burden. In a legal proceeding against X, the court ignored the company and concerned itself directly with X. Could the court do so? [In re *Sir Dinshaw Maneckjee Petit* AIR [1927] 371].
19. H was appointed the managing director of A & Co. on the term that he must not, at any time during the tenure of his office as such, or afterwards, entice away the customers of A & Co. Subsequent to the cessation of H's employment under an agreement he set up a business in the name of H & Co. which solicited the customers of A & Co. Evidence showed that H & Co. was formed to enable H to commit a breach of his covenant against



- solicitation. Could H & Co. and H be restrained from doing so ? [*Gilford Motor Co. vs. Horne* [1932] I. Ch. 935].
20. A Hindu undivided family consisting of 11 persons carries on banking with a view to acquiring profit for itself or its members without itself being registered under the Banking Regulation Act, 1949(a) Will it be a legal association? (b) Will your answer be the same, if two undivided families would have carried on the said business?
  21. At the inception the association was not registrable under the Act as its membership number did not exceed the statutory limit. But long thereafter the number of its members exceeded that statutory limit. Could the association continue with the business for gain without registration?
  22. For determining the legality or otherwise of the object of an incorporated company, can the motive which actuated the founders of the company to form the association be looked into?
  23. Can a firm be a signatory to memorandum?
  24. According to Section 25(4) a firm may continue to be a member of a company to which a licence has been granted by the Central Government entitling it to be registered as a limited company. How can you reconcile this position with your answer to question 13?
  25. The memorandum of a company stated that it was formed to work German patent to manufacture coffee from dates, to acquire and purchase any other inventions for similar purpose and import and export all description of produce for the purpose of food. The German patent was not granted. But the company was solvent and the majority of the shareholders wished that the company should continue. Could the company be allowed to continue? [*Re German Date Coffee Co. (1882) Ch. D. 169*]
  26. (a) Suppose, the company wants to shift its registered office from Asaf Ali Road to Parliament Street, Delhi. Is a sanction for it through a resolution necessary?  
(b) If the registered office is proposed to be changed from Brabourne Road, Calcutta to Howrah, what kind of resolution is needed for the purpose?
  27. The registered office of a company is situated in Orissa. Its factory was also in Orissa. It applies to the Court for the change of its registered office from Orissa to Andhra Pradesh on the ground of more direct and economic administration. But fails to clarify how the expenses will be curtailed or how the administration from Andhra Pradesh can be more direct when the factory will remain in Orissa. Can you in the circumstances, question the *bona fides* of the company's application for the proposed change?
  28. The object of the company was to promote, assist and protect cyclists. Later on, it sought power to assist motorists. Would alteration of the memorandum for the purpose be permissible?



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## The Companies Act, 1956

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29. A sole director and principal shareholder of a company paid into his own account with a bank a cheque drawn in favour of the company. Could the bank rely on the Turquand case?
30. The doctrine of indoor management (a) applies, (b) does not apply, in the following cases:
  - (i) When the person dealing with the company has notice of the internal irregularity.
  - (ii) Where he is put upon an enquiry. Which is correct?
31. Where a public company has been converted into a private company, will the approval of the Central Government be necessary?
32. The alteration in the articles has in consequence increased the liability of a member to contribute to the company. In such a circumstances, will the alteration be binding on a present member?
33. If any irregular alterations have been acted upon for many years, will these be binding?
34. The original articles of a company contained no powers to issue preference shares. Later, the articles were altered by a special resolution so as to assume the necessary power, and preference shares were issued accordingly. Would the alteration be effective? [*Andrews vs. Gas Meter Co. (1897) 8 Ch. 361*]
35. The articles of a company give it a lien upon each share for debts due to the company by shareholders. A shareholder mortgages his shares and the mortgagee serves notice thereof upon the company. Who will have prior claim over the shares, if the shareholder has incurred a liability to the company (a) before the service of the notice of mortgage, (b) after the service.
36. The articles of a company provided that the salary of the managing director shall not exceed Rs. 1,500 per month and the rate of commission payable to him should not exceed 5% of the profit. Notwithstanding this it was resolved in a general meeting of the company that the managing director be paid a salary of Rs. 2,500 per month, and commission of 8% and the resolution was declared by chairman to have been carried by a show of hands. One of the shareholders subsequently brought an action against the company and the directors for a declaration that the resolution was not binding on the company. Could he bring such a suit without the permission of the company?
37. A company was being formed to purchase a hotel from K.A contract was entered into on behalf of the company by A, B and C for the purchase of stock of certain value from K. The company was formed and the goods were made over to it and consumed. But before payment was made, the company went into liquidation. (a) Could the company by subsequent ratification of the contract bind to K? (b) Could A, B and C be held personally liable on the said contract?



38. A syndicate of which E was the head, bought an island which is said to contain valuable mines of phosphate for \$55,000. E formed a company to purchase the island, and contract was made between X (a nominee of the syndicate) and the company for its purchase at \$1,10,000. The promoters of the company did not disclose the profit they were making. Could the company rescind the contract and recover the purchase money from E and other members of the syndicate?
39. The registrar issued on 8th January a certificate of incorporation dated 6th January. An allotment of shares was made on 5th January. Could the allotment be declared void on the ground that it was made before the company was incorporated?
40. What will be the consequences if a private company defaults on complying with any of the provisions contained in Section 3(1)(iii)?
41. The number of members of a private limited company falls below 2 on 1-7-89. The company continues to carry on its business with the reduced number till 1-11-89. During the intervening period between 1-7-89 and 1-11-89; the company contracts a debt of Rs. 5,000. Will the continuing member be severally liable for the whole debt, if the company with the reduced number had continued business say up to 3-1-90 and the said debt had been incurred during the period between 1-7-89 and 1-11-89?
42. All seven signatures on a Memorandum of Association were forged by a single person and a certificate of incorporation was obtained. Is the certificate valid?

#### **Essay / Practical Questions**

43. 'A company is a person separate from its members Explain. Examine the circumstances under which the Courts may disregard the Company's Corporate Personality.
44. Define a Private Company. Explain the procedure for conversion of a Public Company into a Private Company.
45. Explain the circumstances in which a company can alter its 'Objects' as slated in the Memorandum of Association. What procedure shall such a company follow to give effect to the alteration?
46. Explain clearly the doctrine of 'Indoor Management' as applicable in cases of companies registered under the Companies Act, 1956. Explain the circumstances in which an outsider dealing with the company cannot claim any relief on the ground of 'Indoor Management'
47. XYZ Co. Ltd. was in the process of incorporation. Promoters of the company signed an agreement for the purchase of certain furniture for the company and payment was to be made to the suppliers of furniture by the company after incorporation. The company was incorporated and the furniture was used by it. Shortly after incorporation, the company



went into liquidation and the debt could not be paid by the company for the purchase of above furniture. As a result suppliers sued the promoters of the company for the recovery of money.

Examine whether promoters can be held liable for payment under the following situations:

- (i) When the company has already adopted the contract after incorporation?
  - (ii) When the company makes a fresh contract with the suppliers in terms of pre-incorporation contract?
48. Explain fully the doctrine of Ultra Vires and state its implications.
  49. Explain the limitations relating to alternation of Articles of Association of a company.
  50. Explain clearly the meaning of Lifting the Corporate Veil, as applicable in case of companies incorporated under the Companies Act, 1956. Under what circumstances the veil of a company can be lifted by the court?
  51. Explain clearly the concept of "Perpetual Succession" and "Common Seal" in relation to a company incorporated under the Companies Act, 1956.
  52. State the conditions of restrictions with which a private company is incorporated under the Companies Act, 1956.
  53. Briefly explain the doctrine of "ultravires" under the Companies Act, 1956. What are the consequences of ultravires acts of the company?
  54. The Articles of Association of Mars Company Ltd. provides that documents may be served upon the company only through Fax. Ramesh despatches a document to the company by post, under certificate of posting. The company does not accept it on the ground that it is in violation of the Articles of Association. As a result Ramesh suffers loss. Explain with reference to the provisions of the Companies Act, 1956:
    - (i) What refusal of document by the company is valid?
    - (ii) Whether Ramesh can claim damages on this basis?
  55. What do you understand by Pre-incorporation Contracts? Distinguish between Pre-incorporation contracts and Provisional contracts.
  56. What is the procedure laid down in the provisions of the Companies Act, 1956 for converting a private company into a public company ?
  57. The Articles of Association of a Limited Company provided that 'X' shall be the Law Officer of the company and he shall not be removed except on the ground of proved misconduct. The company removed him even though he was not guilty of misconduct. Decide, whether company's action is valid?



58. Which of the institutions are regarded as “Public Financial Institutions” under the Companies Act, 1956?
59. Explain the provisions of the Companies Act, 1956 relating to registration of a non-profit organisation as a company. What procedure is required to be adopted for the said purpose?
60. What are the purposes for which “objects” can be altered by a company under the Companies Act, 1956? Briefly explain the procedure to be applied to such matters.
61. Some of the creditors of M/s Get Rich Quick Ltd. have complained that the company was formed by the promoters only to defraud the creditors and circumvent the compliance of legal provisions of the Companies Act, 1956. In this context they seek your advice as to the meaning of corporate veil and when the promoters can be made personally liable for the debts of the company.
62. What is meant by a Guarantee Company? State the similarities and dissimilarities between a Guarantee Company and a Company having Share Capital.

#### **1.21 Answers**

1. (b); 2. (c); 3. (b); 4. (b); 5. (d); 6. (c); 7. (a); 8. (d); 9. (d); 10. (d);
11. Limitation of individual risk, procurement of capital and technical and managerial personnel, corporate personality, transferability of shares etc.
12. No; 13. Partially, correct; 14. (b);
15. Agents, may also be members;
16. Yes. (*Saloman vs. Saloman & Co. Ltd.*); 17. No; 18. Yes;
19. Yes character of company;
20. (a) Yes; 20. (b) No; 21. No; 22. No; 23. No;
24. By stating that it is an exception to the general rule that firm cannot be accepted as shareholders of the company.
25. No; 26. (a) No; 26. (b) Special; 27. Yes; 28. No; 29. No 30 (b) 31. Yes;
32. No; rules he has in writing agreed; 33. Yes; 34. Yes; 35. (a) Company;
- 35 (b) Mortgagee; 36. Yes; 37. (a) No; 37. (b) Yes; 38. Yes; 39. No;
40. Forfeiture of the statutory privileges and exemptions and subject to the whole of the Act.
41. No; 42. No;



## UNIT 2

### Learning objectives

You might recall that from Unit 1 you have understood there are certain distinctions between a private and a public company. Besides private company have certain privileges and exemptions under the Companies Act, 1956. However, one aspect that you might have observed is that a private company is prohibited from access to the public in raising its capital. Contrast to this a public company shall have access to the public for raising the share capital. For doing so, it has to observe certain formalities like issue of prospectus, compliance of certain requirements in getting minimum subscription, share allotment etc. Also a company is permitted under the Act, after issuing shares to buy back its own shares. In this unit the following aspects of study are covered:

- ◆ Requirement for issue of prospectus
- ◆ Consequences in case of mis-statements in prospectus
- ◆ Acceptances of Fixed Deposits and Small Depositors
- ◆ Allotment of shares and irregular allotment
- ◆ Buy back of shares and the procedure
- ◆ Membership in a company

### 2.1 PROSPECTUS – MEANING AND ROLE

You may recollect that we mentioned in the preceding unit that one great advantage of floating a public limited company was the raising of capital required for business from the general public. But this does not mean that it must necessarily approach the public for money. The promoters, if they are resourceful enough, can very well tap their private resources or contacts for raising the requisite capital. In such a case, the promoters need not prepare a 'prospectus' proper; but they must prepare a document, akin to the prospectus known as "Statement in lieu of prospectus". This document must contain matters set out in Schedule III to the Act. The matters to be disclosed in this regard are more or less the same as those required to be disclosed in prospectus.

*Now you should know what a prospectus is.*

Section 2(36) of the Companies Act defines the term. Accordingly, it means any document described or issued as prospectus, 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 body corporate. In this context, it should be noted that prospectus is not an offer in itself but an invitation to make an offer, signifying thereby that on





acceptance of such an invitation by any member of the public, no binding contract between him and the company comes into being. Application for purchase of shares or debentures or for making a deposit constitutes an offer by the subscriber to the company and it is only on its acceptance by the company that a binding contract comes into existence.

You have seen from the definition that a document cannot be regarded as a prospectus, unless it is an invitation for an offer to the public. What is the connotation of the term “public” in this context. According to Section 67(1) it includes any section of the public, “whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner”.

The prospectus must be in writing. An oral invitation to subscribe for shares will not be considered prospectus. Television or film advertisement cannot be treated as prospectus.

The next issue worthy of consideration is this: When can the invitation for offer (which we referred to earlier) be not treated as having been made to the public? You have noticed that Sections 67(1) & (2) treats an offer or invitation made to a section of the public selected as members of the company, as an offer or invitation to the public. But Section 67(3) excludes from the category of: “invitation to the public” any invitation or offer to the members or debenture holders of the company in either of the two circumstances specified therein *viz.*:

(1) If the invitation or offer can properly be ‘regarded in all circumstances as not being calculated to result directly or indirectly in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation, it shall not be treated as having been made to the public. (2) If it can be properly regarded as being a domestic concern of the persons making and receiving the offer or invitation, it will not be treated as having been made to the public. Thus, to determine whether or not an offer has been made to the public, *the test is not who receives the offer or the invitation but who can accept it*. If only the persons to whom it has been made are entitled to accept it and nobody else, then it is hit by Section 67(3); it is not one made to the public. For example, when a prospectus was issued only to a small circle of friends of the directors, or to the existing members, it was held that it was not an offer to the public [*Lynde v. S. Nash* (1928) 2 K.B. 23].

The prospectus is the basic document on the basis of which the intending investors decide whether or not they should subscribe to the shares or debentures. Therefore, the law requires unstinted disclosure of various matters through prospectus and forbids variations of any terms and conditions of a contract contained therein except with the approval and authority of the company in general meeting [Section 61].

“Those who issue prospectus holding out to the public great advantage which will accrue to persons who take up shares on the representations contained therein, are bound to state everything with scrupulous accuracy and not only to abstain from stating as fact that which is



not so but to omit no fact within their knowledge, the existence of which might in any degree affect the nature or extent or quality of the privilege and advantages which the prospectus holds out as an inducement to take shares [as per *Kindersely V.C. in Burnswick and Canada Railway Co. vs. Mullridge*].

It is therefore essential that the information statutorily needing disclosure is stated fully and precisely so that the investing public which is ignorant of the present and future prospects of the company may get all the information which is likely to affect the public mind. It is only to protect the members of the public against their being misguided by half truths or falsehoods that the law casts a liability on various persons connected with the issue of the prospectus to compensate every person (who subscribes on the faith of the prospectus) for any loss or damage he may have sustained because of the inclusion of any untrue statements in the prospectus [Section 62].

## **2.2 SECTION 55A: POWERS OF SEBI**

(i) In the case of a listed public company and in the case of a public company, which intends to list its securities on a recognized Stock Exchange, the provisions of the following sections shall be administered by SEBI.

(a) Sections 55 to 58 – Matters relating to Prospectus.

(b) Sections 59 to 84:

Matters relating to prospectus – 68B	59
Allotment	69 – 75
Commission and Discounts	76 – 77B
Issue of Shares at Premium/Discount	78-79A
Issue and Redemption of Preference Shares–80A	80
Further Issue of Capital	81
Nature, Numbering and Certificate of shares	82 – 84

(c) Sections 108, 109, 110 and 112–Transfer of Shares & Debentures:

(d) Section 113– Limitation of time for issue of share

(e) Sections 116, 177– Provisions relating to Debentures

(f) Sections 118 to 122– Provisions relating to Debentures

(g) Sections 206, 206A, 207– Distribution / Payment of Dividend (So far as they relate to issue and transfer of Securities and non-payment of Dividend)

(ii) Other sections are to be administered by the Central Government.



### **2.3 WHEN PROSPECTUS IS NOT REQUIRED TO BE ISSUED? [SECTION 56]**

The issue of a prospect is not necessary in the following cases:

- (i) When shares or debentures are offered to existing holders of shares or debentures Sub-section (5).
- (ii) When the issue relates to shares or debentures uniform in all respects with shares or debentures previously issued and dealt in or quoted in a recognised stock exchange Sub-section (5).
- (iii) Where a person is *bona fide* invited to enter into an underwriting agreement - Sub-section (3).
- (iv) Where shares are not offered to the public - Sub-section (3).

However, private placement of shares out of promoters' quota or otherwise will attract the provisions relating to prospectus. In this connection, the Department of Company Affairs, *vide* its press note No. 17/6/92-CL.V dated 6th July, 1992 pointed out that some companies utilise the services of the brokers and other intermediaries for private placement of equity shares, out of promoters' quota or otherwise, insert advertisements in the print media and also mass mail literature/material/brochures superscribed by the caption "Confidential/For private circulation only". It was also noticed that the rights of renunciation are floated in the market by the companies themselves, charging unofficial premia from the investing public. Under Section 67(3) of the Companies Act, 1956, no offer or invitation shall be treated as made to the public, only if the same can be regarded, in all the circumstances:

- (a) as not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation; or
- (b) otherwise as being a domestic concern of the persons making and receiving the offer or invitation.

The Companies (Amendment) Act, 2000 further "provided that nothing contained in this Sub-section shall apply in a case where the offer or invitation to subscribe for shares or debentures is made to fifty persons or more" [Sub-section (3) (first proviso) of Section 67]. The effect is that an offer or invitation to subscribe for shares or debentures made to fifty persons or more will be a public issue. Also the second proviso to the Sub-section (3) provides that an offer or invitation to subscribe to shares or debentures to 50 persons or more by Non-Banking Financial Institutions (NBFC) or public financial institution under Section 4A of the Companies Act, 1956 will not be a public issue.

Further a Sub-section 3A has been inserted by the Amendment Act, 2000 which provides that the Securities and Exchange Board of India has been empowered to prescribe Guidelines in respect of offer or invitations by such above mentioned companies, in consultation with the RBI.



In the context of the above provisions of law, such offers cannot be treated as private placement and provisions relating to prospectus under the Companies Act are applicable. The companies concerned, their promoters and their intermediaries were warned that making of so-called private placement of shares or collecting unofficial premia without recording the same in the books of account of the company, are serious contravention of the Companies Act and would invite penal action under the Act by the Government. It may be noted that marketing of rights of renunciation by a private company is prohibited under Section 3(1)(iii)(c) of the Companies Act, as it cannot make any invitation to the public to subscribe for its shares.

#### 2.4 REQUIREMENTS AS TO THE ISSUE OF PROSPECTUS

Comprehensive rules and regulations have been incorporated into the Companies Act in respect of this basic document which is the only source for the investors to ascertain the soundness or otherwise of the company. Since the prospectus is intended to save the investing public from victimisation, the Legislature has aimed at securing the fullest disclosure of all material and essential particulars and laying the same before all the prospective buyers of shares. Briefly the rules and regulations are as follows:

**(i) Dating of prospectus** - According to Section 55, every prospectus must be dated. This requirement is designed to ensure a *prima facie* evidence of the date of its publication. However, this evidence may be rebutted by a contrary evidence.

**(ii) Registration of prospectus** - It is absolutely necessary for the company to deliver to the Registrar a copy of every prospectus for registration. It must be made on or before the prospectus is published. But the prospectus must not be issued more than 90 days after the date on which a copy of it is delivered to the Registrar for Registration. If it is issued, say 91 days after it shall be deemed to be a prospectus a copy of which has not been delivered for registration.

Before delivering a copy of the prospectus to the Registrar, it may be signed by every person who has been named therein as a director or a proposed director or his agent duly authorised in writing. Moreover, the copy must be accompanied by: (i) consent of the expert, when the report of an expert is to be published; (ii) a copy of every contract regarding managerial personnel's appointment and remuneration; (iii) every other material contract except a contract entered into in the ordinary course of business or within 2 years prior to the date of the prospectus; (iv) a report required by Part II of Schedule II indicating by way of adjustments as regards the figures of any profits or losses or assets and liabilities; (v) the written consent of persons named in the prospectus as the auditor, legal adviser, attorney, solicitor, banker of the company or intended company, to act in the capacity.

Every prospectus must state that a copy thereof has been delivered for registration. It must specify any document needing endorsement on or attached to the copy delivered for registration, or refer to statements included in the prospectus which specified those documents.



The company and every person, knowingly a party to the issue of the prospectus without registration, shall be liable to a fine extending upto Rs. 5,000 [Section 60].

**(iii) Approval of prospectus by various agencies :** The draft prospectus has to be approved by various agencies before it is filed with the ROC of the concerned State. The various authorities who approve the prospectus are the following:

- (i) All the lead managers to the issue.
- (ii) Each of the stock exchanges where the shares of the company are listed and where the shares/debentures are proposed to be listed.

**(iii) The lead financial institution underwriting the issue, if applicable.**

The draft prospectus is vetted by SEBI to ensure adequacy of disclosures. However, vetting by SEBI does not amount to approval of prospectus. SEBI does not take any responsibility for the correctness of the statements made or opinions expressed in the prospectus.

The Department of Company Affairs, *vide* its circular 10/8/87-CL V No. 7/91, dated 28-2-1991 advised the ROCs to ensure that in respect of every prospectus of public issues which comes up for filing with them the merchant bankers to the issue, whether as lead managers, co-managers, advisers or consultants are only those authorised by SEBI. Each merchant bankers has been given a code number.

It was also decided that ROC shall not register a prospectus where prior to registration of the prospectus, the ROC before whom the prospectus is filed for registration is informed by SEBI that the contents of prospectus filed are in contravention of any law or statutory rules and regulations.

In connection with the above, the SEBI has recently issued in its Circular No. 3(95-96) dated 29-9-1995, Clarification No. XII, under Guidelines for disclosure and investor protection, that the draft prospectus filed with SEBI is not a public document. The final prospectus becomes available to the public only 2-3 weeks prior to the opening of the issue. To introduce greater transparency, the draft prospectus filed with SEBI would be made as a public document. The Lead managers shall simultaneously file copies of the draft document with the stock exchanges where issue is proposed to be listed, and can charge an appropriate sum to the person requesting such copy(ies).

## **2.5 ABRIDGED FORM OF PROSPECTUS**

### **What is abridged prospectus?**

As per the definition contained in the Companies (Amendment) Act, 2000, abridged prospectus means a memorandum containing such salient features of a prospectus as may be prescribed. [(Section 2(1)]



Earlier, the application form for issue of shares was required to be accompanied by a full prospectus. The Amendment Act of 1988 (w.e.f. 31-5-1991) permits a company to furnish alongwith the application form for shares/debentures an abridged form of prospectus, instead of the full prospectus, which however, is to be furnished on demand. The memorandum containing salient features of the prospectus accompanying the application forms shall be as per rules prescribed by the Central Government in this behalf. It is, however, open to a company to attach full prospectus along with the application forms.

The Government has recently revised the format of this memorandum (abridged prospectus) to provide for greater disclosure of information to prospective investors so as to enable them to take an informed decision regarding investment in shares and debentures.

The abridged prospectus (in Form 2A) and the share application form should bear the same printed number. The investor may detach the share application form along the perforated line after he has had an opportunity to study the contents of the abridged prospectus, before submitting the same to the company or its designated bankers. The same procedure be also followed while making available copies of the prospectus under Section 56 of the Act.

*Exceptions:* There are, however, certain *exceptions* to the above provision, where an abridged prospectus containing all the prescribed details need not accompany the Application Forms sent out. These exceptions are:

- (a) In the case of *bona fide* underwriting agreement [Section 56(3)(a)].
- (b) Where the shares or debentures are not offered to the public [Section 56(3)(b)].
- (c) Where the offer is made only to existing members or debenture holders of the company, whether with or without the right of renunciation [Section 56(5)(a)].
- (d) In the case of issue of shares or debentures, which are in all, respects similar with those previously issued and dealt in on a recognised stock exchange [Section 56(5)(b)].

The logic behind these exceptions should be noted. In the first two exceptions the public is not involved, hence no need of protection. In the case of last two, the offeree, being already a member for the shares being quoted one, must have enough information about the company to protect himself.

## **2.6 MATTERS TO BE STATED IN THE PROSPECTUS [SECTION 56]**

Every prospectus must state the matters specified in Part I of Schedule II and set out the reports specified in Part II and the said Parts I and Part II have effect subject to provisions contained in Part III of that Schedule.

The Government has revised the format of prospectus given in Schedule II of the Companies Act, 1956 w.e.f. 1-11-1991. This has been done to provide for greater disclosure of information



regarding the company, its management, the project proposed to be undertaken by the company, the financial performance of the company for the last five years and management perception of risk factors so as to enable the investors to take an informed decision regarding investment in shares or debentures offered through public issue. The company will also be required to furnish particulars in regard to other listed companies under the same management within the meaning of Section 370(1B) of the Companies Act, which have made any capital issue during the last three years. The company will inform whether they have obtained credit rating for debenture/preference share issue. A declaration will also have to be furnished to the effect that all the relevant provisions of the Companies Act, 1956 and the guidelines issued by the government have been complied with and no statement made in prospectus is contrary to the provisions of Companies Act, 1956 and rules made thereafter.

The Government has also prescribed rules on similar lines regarding salient features of the prospectus for the purpose of Sub-section (3) of Section 56 (abridged prospectus) of the Companies Act, 1956 and has prescribed Form 2A in this regard.

The Company issuing prospectus should fulfill the requirements as per Schedule II of the Companies Act, 1956 and the SEBI guidelines for disclosure and investor protection. The Schedule II of the Companies Act, 1956 is as follows:

#### **PART I**

##### **I. General information:**

- (a) Name and address of registered office of the company.
- (b) (i) Consent of the Central Government for the present issue and declaration of the Central Government about non-responsibility for financial soundness or correctness of statements.  
(ii) Letter of intent/industrial licence and declaration of the Central Government about non-responsibility for financial soundness or correctness of statements.
- (c) Names of regional stock exchange and other stock exchanges where application made for listing of present issue.
- (d) Provisions of sub-section (1) of section 68A of the Companies Act, relating to punishment for fictitious applications.
- (e) Statement/declaration about refund of the issue if minimum subscription of 90% is not received within 90 days from closure of the issue.
- (f) Declaration about the issue of allotment letters/refunds within a period of 10 weeks and interest in case of any delay in refund at the prescribed rate under section 73(2)/(2A).
- (g) Date of opening of the issue.



Date of closing of the issue.

Date of earliest closing of the issue.

- (h) Names and addresses of auditors and lead managers.
- (i) Name and address of trustee under debenture trust deed (in case of debenture issue).
- (j) Whether rating from Crisil or any rating agency has been obtained for the proposed debenture/preference shares issue.

If no rating has been obtained, this should be answered as "No".

If "yes" the rating should be indicated.

- (k) Underwriting of the issue

(Names and addresses of the underwriters and the amount under-written by them).

(Declaration by Board of directors that the underwriters have sufficient resources to discharge their respective obligations).

- <sup>29</sup>(l) a statement by the Board of directors stating that-

- (i) all monies received out of issue of shares or debentures to public shall be transferred to a separate bank account other than the bank account referred to in sub-section (3) of section 73;
- (ii) details of all monies utilised out of the issue referred to in sub-item (i) shall be disclosed under an appropriate separate head in the balance sheet of the company indicating the purpose for which such monies had been utilised; and
- (iii) details of all unutilised monies out of the issue of shares or debentures, if any, referred to in sub-item (i) shall be disclosed under an appropriate separate head in the balance-sheet of the company indicating the form in which such unutilised monies have been invested.]

- II. Capital structure of the company

- (a) Authorised, issued, subscribed and paid-up capital.
- (b) Size of present issue giving separately reservation for preferential allotment to promoters and others.
- (c) Paid-up capital
  - i. after the present issue.

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<sup>28</sup> Substituted by Notification No. SO666(E), dated 3.10.1991

<sup>29</sup> Inseted by Notification No. GSR-265(E), dated 15.5.1997





- ii. After conversion of debentures (if applicable).
- III. Terms of the present issue
  - (a) Terms of payments.
  - (b) Rights of the instrument holders.
  - (c) How to apply- availability of forms, prospectus and mode of payment.
  - (d) Any special tax benefits for company and its shareholders.
- IV. Particulars of the issue.
  - (a) Objects.
  - (b) Project cost.
  - (c) Means of financing (including contribution of promoters).
- V. Company, management and project.
  - (a) History and main objects and present business of the company.
  - (b) Subsidiary(ies) of the company, if any. (For financial data, refer to auditor's report in Part II).
  - (c) Promoters and their background.
  - (d) Names, addresses and occupation of manager, managing director and other directors including nominee-directors, wholetime directors (giving their directorships in other companies).
  - (e) Location of project.
  - (f) Plant and machinery, technology, process, etc.
  - (g) Collaboration, any performance guarantee or assistance in marketing by the collaborators.
  - (h) Infrastructure facilities for raw materials and utilities like water, electricity, etc.
  - (i) Schedule of implementation of the project and progress made so far, giving details of land acquisition, civil works, installation of plant and machinery, trial production date of commercial production, etc.
  - (j) The products:
    - (i) Nature of the product/s – consumer/industrial and end users.
    - (ii) Approach to marketing and proposed marketing set up.
    - (iii) Export possibilities and export obligations, if any (in case of a company providing any "service" particulars, as applicable, be furnished).



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- (k) Future prospects – expected capacity utilisation during the first three years from the date of commencement of production, and the expected year when the company would be able to earn cash profits and net profits.

Stock market data for shares/debentures of the company high/low price in each of the last three years and monthly high/low during the last six months (where applicable).

- VI. Following particulars in regard to the company and other listed companies under the same management within the meaning of section 370(1B), which made any capital issue during the last three years:

Name of the company

Year of issue

Type of issue

(Public/rights/composite)

Amount of issue

Date of closure of issue

Date of completion of delivery of share/debenture certificates

Date of completion of the project, where object of the issue was financing of a project.

Rate of dividend paid.

- VIII. (a) Outstanding litigation pertaining to-
- (i) matters likely to affect operation and finances of the company including disputed tax liabilities of any nature; and
  - (ii) criminal prosecution launched against the company and the directors for alleged offences under the enactments specified in paragraph I of Part I of Schedule XIII to the Companies Act, 1956.
- (b) Particulars of default, if any, in meeting statutory dues, institutional dues, and towards instrument holders like debentures, fixed deposits, and arrears on cumulative preference shares, etc. (also give the same particulars about the companies promoted by the same private promoters and listed on stock exchanges).
- (c) Any material development after the date of the latest balance sheet and its impact on performance and prospects of the company.



VIII. Management perception of risk factors (i.e., sensitivity to foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost/time overrun, etc).

## **PART II**

### **A. General information**

1. Consent of directors, auditors, solicitors/advocates, managers to the issue, Registrar of Issue, bankers to the company, bankers to the issue and experts.
2. Expert opinion obtained, if any.
3. Change, if any, in directors and auditors during the last three years, and reasons thereof.
4. Authority for the issue and details of resolution passed for the issue.
5. Procedure and time schedule for allotment and issue of certificates.
6. Names and addresses of the company secretary, legal adviser, lead managers, co-managers, auditors, bankers to the company, bankers to the issue, and brokers to the issue.

### **B. Financial information**

#### **Reports to be set out**

1. A report by the auditors of the company with respect to-
  - (a) profits and losses and assets and liabilities, in accordance with sub-clause (2) or (3) of this clause, as the case may require; and
  - (b) the rates of the dividends, if any, paid by the company in respect of each class of shares in the company for each of the five financial years immediately preceding the issue of the prospectus, giving particulars of each class of shares on which such dividends have been paid and particulars of the cases in which no dividends have been paid in respect of any class of shares for any of those years.

and if no accounts have been made up in respect of any part of the period of five years ending on a date of three months before the issue of the prospectus, containing a statement of that fact (and accompanied by a statement of the accounts of the company in respect of that part of the said period up to a date not earlier than six months of the date of issue of the prospectus indicating the profit or loss for that period and the assets and liabilities position as at the end of that period together with a certificate from the auditors that such accounts have been examined



and found correct by them. The said statement may indicate the nature of provision or adjustments made or are yet to be made).

2. If the company has no subsidiaries, the report shall-
  - (a) so far as regards profits and losses, deal with the profits or losses of the company (distinguishing items of a non-recurring nature) for each of the five financial years immediately preceding the issue of the prospectus; and
  - (b) So far as regards assets and liabilities, deal with the assets and liabilities of the company at the last date to which the accounts of the company were made up.
3. If the company has subsidiaries, the report shall-
  - (a) so far as regards profits and losses, deal separately with the company's profits or losses as provided by sub-clause (2) and in addition deal either-
    - (i) as a whole with the combined profits or losses of its subsidiaries, so far as they concern members of the company; or
    - (ii) individually with the profits or losses of each subsidiary, so far as they concern members of the company;or, instead of dealing separately with the company's profits or losses, deal as a whole with the profits or losses of the company, and, so far as they concern members of the company, with the combined profits or losses of its subsidiaries; and
  - (b) so far as regards assets and liabilities, deal separately with the company's assets and liabilities as provided by sub-clause (2) and in addition, deal either-
    - (i) as a whole with the combined assets and liabilities of its subsidiaries, with or without the company's assets and liabilities; or
    - (ii) individually with the assets and liabilities of each subsidiary;and shall indicate as respects the assets and liabilities of the subsidiaries, the allowance to be made for persons other than members of the company.
4. If the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly-
  - (i) in the purchase of any business; or
  - (ii) in the purchase of an interest in any business and by reason of that purchase, or anything to be done in consequence thereof, or in connection therewith; the company will become entitled to an interest as respects either the capital or profits and losses or both, in such business exceeding fifty per cent, thereof;



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a report made by accountants (who shall be named in the prospectus) upon

- (a) the profits or losses of the business for each of the five financial years immediately preceding the issue of the prospectus; and
- (b) the assets and liabilities of the business at the last date to which the accounts of the business were made up, being a date not more than one hundred and twenty days before the date of the issue of the prospectus.

5. (1) If -

- (a) the proceeds, or any part of the proceeds, of the issue of the shares or debentures are or is to be applied directly or indirectly in any manner resulting in the acquisition by the company of shares in any other body corporate; and
- (b) by reason of that acquisition or anything to be done in consequence thereof or in connection therewith, that body corporate will become a subsidiary of the company;

a report made by accountants (who shall be named in the prospectus) upon-

- (i) the profits or losses of the other body corporate for each of the five financial years immediately preceding the issue of the prospectus; and
- (ii) the assets and liabilities of the other body corporate at the last date to which its accounts were made up.

(2) The said report shall -

- (a) indicate how the profits or losses of the other body corporate dealt with by the report would, in respect of the shares to be acquired, have concerned members of the company and what allowance would have fallen to be made, in relation to assets and liabilities so dealt with for holders of other shares, if the company had at all material times held the shares to be acquired; and
- (b) where the other body corporate has subsidiaries deal with the profits or losses and the assets and liabilities of the body corporate and its subsidiaries in the manner provided by sub-clause (2) above in relation to the company and its subsidiaries.

6. Principal terms of loan and assets charged as security.

### **C. Statutory and other information**

- 1. Minimum subscription.
- 2. Expenses of the issue giving separately fee payable to:
  - (a) Advisers.



- (b) Registrars to the issue.
- (c) Managers to the issue
- (d) Trustees for the debenture-holders
- 3. Underwriting commission and brokerage.
- 4. Previous issue for cash.
- 5. Previous public or rights issue, if any;  
(during last five years)
  - (a) Date of allotment: Closing date:  
Date of refunds:  
Date of listing on the stock exchange:
  - (b) If the issue(s) at premium or discount and the amount thereof.
  - (c) The amount paid or payable by way of premium, if any, on each share which had been issued within two years preceding the date of the prospectus or is to be issued, stating the dates or proposed dates of issue and, where some shares have been or are to be issued at a premium and other shares of the same class at a lower premium, or at par or at a discount, the reasons for the differentiation and how any premiums received have been or are to be disposed of .
- 6. Commission or brokerage on previous issue.
- 7. Issue of shares otherwise than for cash.
- 8. Debentures and redeemable preference shares and other instruments issued by the company outstanding as on the date of prospectus and terms of issue.
- 9. Option to subscribe.  
<sup>30</sup>9A. The details of option to subscribe for securities to be dealt with in a depository.]
- 10. Purchase of property:
  - (i) As respects any property to which this clause applies-
    - (a) the names, addresses, descriptions and occupations of the vendors;
    - (b) the amount paid or payable in cash, shares or debentures to the vendor and, where there is more than one separate vendor, or the company is a

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<sup>30</sup> Inserted by the Depositories Act, 1996 w.e.f. 20.9.1995.



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- sub-purchaser, the amount so paid or payable to each vendor, specifying separately the amount, if any, paid or payable for goodwill;
- (c) the nature of the title or interest in such property acquired or to be acquired by the company;
  - (d) short particulars of every transaction relating to the property completed within the two preceding years, in which any vendor of the property to the company or any person who is, or was at the time of the transaction, a promoter, or a director or proposed director of the company had any interest, direct or indirect, specifying the date of the transaction and the name of such promoter, director or proposed director and stating the amount payable by or to such vendor, promoter director or proposed director in respect of the transaction.
- (ii) The property to which sub-clause (i) applies, is a property purchased or acquired by the company or proposed to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus or the purchase or acquisition of which has not been completed at the date of issue of the prospectus, other than property-
    - (a) the contract for the purchase or acquisition whereof was entered into in the ordinary course of the company's business, the contract not being made in contemplation of the issue nor the issue in consequence of the contract; or
    - (b) as respects which the amount of the purchase money is not material.
  - (iii) For the purpose of this clause, where a vendor is a firm, the members of the firm, shall not be treated as separate vendors.
  - (iv) If the company proposes to acquire a business which has been carried on for less than three years, the length of time during which the business has been carried on.
11. (i) Details of directors, proposed directors, wholetime directors, their remuneration, appointment and remuneration of managing directors, interests of directors, their borrowing powers and qualification shares.
- Any amount or benefit paid or given within the two preceding years or intended to be paid or given to any promoter or officer and consideration for payment of giving of the benefit.
- (ii) The dates, parties to, and general nature of-



- (a) every contract appointing or fixing the remuneration of a managing director or manager whenever entered into, that is to say, whether within or more than, two years before the date of the prospectus;
- (b) every other material contract, not being a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company or a contract entered into more than two years before the date of the prospectus.

A reasonable time and place at which any such contract or a copy thereof may be inspected.

- (iii) Full particulars of the nature and extent of the interest, if any, of every director or promoter-
  - (a) in the promotion of the company; or
  - (b) in any property acquired by the company within two years of the date of the prospectus or proposed to be acquired by it.

Where the interest of such a director or promoter consists in being a member of a firm or company, the nature and extent of the interest of the firm or company, with a statement of all sums paid or agreed to be paid to him or to the firm or company in cash or shares or otherwise by any person either to induce him to become, or to qualify him as, a director, or otherwise for services rendered by him or by the firm or company, in connection with the promotion or formation of the company.

- 12. Rights of members regarding voting, dividend, lien on shares and the process for modification of such rights and forfeiture of shares.
- 13. Restrictions, if any, on transfer and transmission of shares/debentures and on their consolidation/splitting.
- 14. Revaluation of assets, if any (during last five years).
- 15. Material contracts and inspection of documents, e.g.
  - A. Material contracts.
  - B. Documents.
  - C. Time and place at which the contracts together with documents will be available for inspection from the date of prospectus until the date of closing of the subscription list.





**PART III**

*PROVISIONS APPLYING TO PARTS I AND II OF THE SCHEDULE*

16. Every person shall, for the purpose of this Schedule, be deemed to be a vendor who has entered into any contract, absolute or conditional, for the sale or purchase or for any option of purchase, of any property to be acquired by the company, in any case where-
  - (a) the purchase money is not fully paid at the date of the issue of the prospectus;
  - (b) the purchase money is to be paid or satisfied, wholly or in part, out of the proceeds of the issue offered for subscription by the prospectus;
  - (c) the contract depends for its validity or fulfillment on the result of that issue.
17. Where any property to be acquired by the company is to be taken on lease, this Schedule shall have effect as if the expression "vendor" included the lessor, the expression "purchase money" included the consideration for the lease, and the expression "sub-purchaser" included a sub-lessee.
18. If in the case of a company which has been carrying on business, or of a business which has been carried on for less than five financial years, the accounts of the company or business have only been made up in respect of four such years, three such years, two such years or one such year, Part II of this Schedule shall have effect as if references to four financial years, three financial years, two financial years or one financial year, as the case may be, were substituted for references to five financial years.
19. Where the five financial years immediately preceding the issue of prospectus which are referred to in Part II of this Schedule or in this Part cover a period of less than five years, references to the said five financial years in either Part shall have effect as if references to a number of financial years the aggregate period covered by which is not less than five years immediately preceding the issue of the prospectus were substituted for references to the five financial years aforesaid.
20. Any report required by Part II of this Schedule shall either —
  - (a) indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary; or
  - (b) make those adjustments and indicate that adjustments have been made.
21. Any report by accountants required by Part II of this Schedule--
  - (a) shall be made by accountants qualified under this Act for appointment as auditors of the company; and



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- (b) shall not be made by any accountant who is an officer or servant, or a partner or in the employment of an officer or servant, of the company or of the company's subsidiary or holding company or of a subsidiary of the company's holding company.

For the purposes of this clause, the expression "officer" shall include a proposed director but not an auditor.

### 22. Inspection of documents:

Reasonable time and place at which copies of all balance sheets and profit and loss accounts, if any, on which the report of the auditors is based, and material contracts and other documents may be inspected.

Note: Term "year" wherever used hereinafter, means financial year.

**3a[Declaration:** *That all the relevant provisions of the Companies Act, 1956, and the guidelines issued by the Government or the guidelines issued by the Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992, as the case may be, have been complied with and no statement made in prospectus is contrary to the provisions of the Companies Act, 1956 or the Securities and Exchange Board of India Act, 1992 or rules made thereunder or guidelines issued, as the case may be].*

Place:.....

.....

Date:.....

Signature of directors

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## 2.7 ADDITIONAL DISCLOSURES TO BE MADE IN PROSPECTUS

Vide Circular No. 1 (1992-93) (G1 series) dated 1-3-1993 and Circular Nos. 1 and 2 (1993-94) (G1 series), dated 29-4-1993 and 26-5-1993 respectively, SEBI has directed that lead managers should ensure proper disclosures to the investors, keeping in mind their increased responsibilities consequent upon the notification of the Merchant Bankers Rules and Regulations. The lead manager should, therefore, not only furnish adequate disclosures but also ensure due compliance with the Guidelines for Disclosure and Investor Protection issued by SEBI, both in letter and in spirit.

Lead Manager should ensure inclusion of the following information in the offer documents:

- (i) *Disclaimer clause:* (To be printed in bold in the offer document in Part I after Issue Details under the head "General Information"). "It is to be distinctly understood that the

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<sup>1</sup> 3a substituted by Notification No. GSR 650(E), dated 17-9-2002, w.e.f. **17.9.2002**



vetting of the draft prospectus/letter of offer by SEBI should not in any way be deemed/construed as approval from SEBI for the proposed Issue. SEBI does not take any responsibility for the financial soundness of any scheme or project or for the statements made or opinions expressed in the offer document. SEBI merely ensures, on the basis of information furnished to it, that adequate disclosures have been made in the offer document to enable the investors to take informed investment decisions”.

- (ii) Reservation for Non-Resident (NRIs) Overseas Corporate Bodies (OCBs) in Public Issues:
  - (a) “Name and address of at least one source in India from where individual NRI applicants can obtain the application forms”—at the appropriate place.
  - (b) “NRI applicants may please note that only such applications as are accompanied by payment in free foreign exchange will be considered for allotment under the reserved category. Such NRIs who wish to make payment through Non-Resident Ordinary (NRO) accounts shall not use the forms meant for reserved category but must use the form meant for Resident Indians”—at the appropriate place.
- (iii) *Stockinvest*: Manner of obtaining Stockinvest and disposal of applications accompanied by Stockinvest as also a paragraph, on the following lines, at the appropriate place.

“Registrars to the issue have been authorised by the Company (through Resolution of the Board passed on. . . .) to sign on behalf of the Company to realise the proceeds of the Stockinvest from the issuing bank or to affix non-allotment advice on the instrument or cancel the stockinvest of the non-allotees or partially successful allottees who have enclosed more than one stockinvest. Such cancelled stockinvest shall be sent back by the Registrars directly to the Investors”.

- (iv) Buy-back arrangement for purchase of non-convertible portion (khokha) of partly convertible debentures:
  - (a) Full information relating to the terms of offer or purchase including the name(s) of the party offering to purchase the Khokhas, the discount at which such offer is made and the ultimate price that would work out to the investor including the discount portion.  
Any such offer shall be on spot-delivery basis, so as to be consistent with the provisions of the Securities Contracts (Regulation) Act, 1956.
  - (b) Where no such arrangement has been disclosed in the offer document, the Lead Manager may not allow such offer being made during the period he is associated with the issue.
- (v) *Performance vis-a-vis promises relating to previous issues*: In case the issuer has come out with a public or rights issue within the previous 3 years of the proposed issue, details



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relating to the objects of the previous issues, schedule of implementation thereof and the status against the same should be disclosed under the head.

- (vi) *Deployment of proceeds of the issue* : The offer document shall give details of avenues of investment in which the management proposes to deploy issue proceeds pending utilisation in the proposed project.
- (vii) *Stock market data* : Along with high/low and average prices of shares of the Company, during preceding 3 years details relating to volume of business transacted should also be stated for respective periods.
- (viii) *Statement relating to allotment and refund* : Lead manager shall ensure that the offer document does not contain statements to the effect that ". . .or in the event of unforeseen circumstances within such further time as may be allowed by the Stock Exchange. Extension, if any, granted by the Stock Exchange would be without prejudice to the Company's liability to pay interest under Section 73 of the Companies Act, 1956". (This is as per instructions contained in Circular No. 1/3/92-CL. V, dated February 17, 1993, of the Department of Company Affairs, Ministry of Law, Justice and Company Affairs).

The SEBI has also in its guidelines for disclosure and investor protection [Circular No. 4 dated 12-10-1995, Clarification No. XIII] has stated that every prospectus submitted to it shall, in addition to the requirements of Schedule II of the Companies Act, contain/specify the followings information. Some of them to mention are:

An index of the contents of the prospectus, details of actual project expenditure, and its financing, details of bridge-loan, bifurcated details of turnover (separately) into products manufactured, traded, not normally traded in, statement of assets and liabilities after providing for revaluation, a statement by directors regarding last financial statements affecting materially the profitability of the company if any, details of share holding by the promoter group, stock market data, management perception of internal and external risk factors, discussion of the financial conditions and results of the operations, details regarding major shareholders etc.

(NOTE: *Though students at the PE-II level are not expected to be fully conversant with SEBI Guidelines, they can pass on just as a reference, as these guidelines relate to the contents of Prospectus*).

Legal significance: It was stated in earlier pages of this book that a company cannot normally vary at any time the terms of a contract in the prospectus and that it can do so only with the approval and authority obtained from its general meeting [Section 61]. Suppose, there is a condition in the prospectus, which requires or binds an applicant for shares or debentures to waive compliance with any of the requirements relating to statutory matters and reports. In such a case it will be void. Similarly, if there is a condition, which has the effect of affecting



him with the notice of any contract, document or a matter not specifically referred to in the prospectus, then such a condition shall be void [Section 56(2)].

Suppose, the requirements of Section 56 have not been complied with but the application for shares has been accepted by the company. Can the applicant ask for the rescission of the contract or rectification of the register? The answer is “no”. But he can sue the person responsible for the issue of the prospectus for any damages he may have suffered [*South of England Natural Gas and Petroleum Co. (1911) 1 Ch. 573*].

## **2.8 STATEMENT BY EXPERTS**

Before we go into this aspect, we must know who is an ‘expert’. The term includes an engineer, valuer, accountant and any other person whose profession gives authority to a statement made by him [Section 59(2)]. The report of an expert cannot be included in a prospectus if he is in any way connected with the formation or promotion or management of the company [Section 57]. In other words, the person must be independent to “function as an expert”. Even if he is unconcerned or unconnected or impartial, his report in this capacity cannot be included: (a) unless he has given his written consent to the issue of the prospectus and has not withdrawn such consent before the delivery of the copy of the prospectus to the Registrar for registration, and (b) unless a statement as to his consent and non-withdrawal of it appears in the prospectus [Section 58]. It is a sound rule designed to protect a prospective investor by making the ‘expert’ a party to the issue of the prospectus and making him liable for untrue statements. If the report of the expert is published in contravention of the provisions of Section 57 or 58, every person who is knowingly a party to the issue of the prospectus shall be punishable with fine which may extend to Rs. 50,000 [Section 59].

Suppose, an expert has given his consent to the inclusion of his report in the prospectus (as required under Section 59) and has withdrawn his consent before the issue of the prospectus and in spite of this the prospectus has been issued. In either of these circumstances, the directors of the company and every other person who authorised the issue of the prospectus shall be liable to indemnify the expert against all damages, costs and expenses which he may have incurred on account of his being associated with the issue of the prospectus as an expert [Section 62(3)].

## **2.9 SHELF PROSPECTUS [SECTION 60A – COMPANIES (AMENDMENT) ACT, 2000]**

- (1) Any public financial institution, public sector bank or scheduled bank whose main object is financing shall file a shelf prospectus.
- (2) A Company filing a shelf prospectus with the Registrar shall not be required to file prospectus afresh at every stage of offer of securities by it within a period of validity of such shelf prospectus.



- (3) A company filing a shelf prospectus shall be required to file an information memorandum on all material facts relating to charges created, changes in the financial position as have occurred between the first offer of securities, previous offer of securities and the succeeding offer of securities within such time as may be prescribed by the Central Government, prior to making of a second or subsequent offer of securities under the shelf prospectus.
- (4) An information memorandum shall be issued to the public along with shelf prospectus filed at the stage of the first offer of securities and such prospectus shall be valid for a period of one year from the date of opening of the first issue of securities under that prospectus:

Provided that where an update of information memorandum is filed every time an offer of securities is made, such memorandum together with the shelf prospectus shall constitute the prospectus.

*Explanation.*—For the purpose of this section,—

- (a) “financing” means making loans to or subscribing in the capital of, a private industrial enterprise engaged in infrastructural financing or, such other company as the Central government may notify in this behalf;
- (b) “Shelf prospectus” means a prospectus issued by any financial institution or bank for one or more issues of the securities or class of securities specified in that prospectus.

#### **2.10 INFORMATION MEMORANDUM [SECTION 60B COMPANIES (AMENDMENT) ACT, 2000]**

Section 2(19B) of the Companies Act defines, **Information memorandum** means a process undertaken prior to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited, and the price and the terms of issue for such securities is assessed, by means of a notice, circular, advertisement or document.

The other provisions are as follows:

- (1) A public company making an issue of securities may circulate information memorandum to the public prior to filing of a prospectus.
- (2) A Company inviting subscription by an information memorandum shall be bound to file a prospectus prior to the opening of the subscription lists and the offer as a red-herring prospectus, at least three days before the opening of the offer.
- (3) The information memorandum and red-herring prospectus shall carry same obligations as are applicable in the case of a prospectus.



- (4) Any variation between the information memorandum and the red-herring prospectus shall be highlighted as variations by the issuing company.

*Explanation.*—For the purposes of Sub-sections (2), (3) and (4), “red-herring prospectus” means a prospectus which does into have complete particular on the price of the securities offered and the quantum of securities offered.

- (5) Every variation as made and highlighted in accordance with Sub-section (4) above shall be individually intimated to the persons invited to subscribe to the issue of securities.
- (6) In the event of the issuing company or the underwriters to the issue have invited or received advance subscription by way of cash or post-dated cheques or stock-invest, the company or such underwriters or bankers to the issue shall not encash such subscription moneys or post-dated cheques or stockinvest before the date of opening of the issue, without having individually intimated the prospective subscribers of the variation and without having offered an opportunity to such prospective subscribers to withdraw their application and cancel their post-dated cheques or stock-invest or return of subscription paid.
- (7) The applicant or proposed subscriber shall exercise his right to withdraw from the application on any intimation of variation within seven days from the date of such intimation and shall indicate such withdrawal in writing to the company and the underwriters.
- (8) Any application for subscription which is acted upon by the company or underwriters or bankers to the issue without having given enough information of any variations, or the particulars of withdrawing of offer or opportunity for cancelling the post-dated cheques or stock invest or stop payments for such payments shall be void and the applicants shall be entitled to receive a refund or return of its post-dated cheques or stock-invest or subscription moneys or cancellation of its application, as if the said application had never been made and the applicants are entitled to receive back their original application and interest at the rate of fifteen per cent for the date of encashment till payment of realisation.
- (9) Upon the closing of the offer of securities, a final prospectus stating therein the total capital raised, whether by way of debt or share capital and the closing price of the securities and any other details as were not complete in the red-herring prospectus shall be filed in a case of a listed public company with the Securities and Exchange Board and Registrar, and in any other case with the Registrar only.’

### **2.11 MISSTATEMENT IN PROSPECTUS AND ITS CONSEQUENCES**

According to Section 65, an untrue statement or misstatement is one, which is misleading, inform and context in which it has been included in the prospectus. Where a certain matter



which is material enough has been omitted from the prospectus, and the omission is calculated to mislead those who act on the faith of the prospectus, the prospectus shall be deemed, in respect of such omission, to be a prospectus in which an untrue statement is included. The prospectus in these circumstances may also be described as a 'misleading prospectus'.

The legal consequence of inclusion of mis-statement in a prospectus is that it attaches civil liability to certain persons. They are as follows:

- (1) Every person who is a director of the company at the time of the issue of the prospectus.
- (2) Every person who has authorised himself to be named and is named in the prospectus either as a director or as having agreed to become a director immediately or after an interval of time.
- (3) Every promoter including a person who participated in the preparation of the prospectus or the untrue part thereof but not acting in a mere professional capacity (e.g., banker, broker and solicitor) of the company.

Before we dilate upon the nature of the liability (referred to earlier) for making an untrue or wrong statement, we must know the principle on which this liability is based. The principle is that directors and other persons who are responsible for the issue of the prospectus indirectly hold out to the public that great advantages are likely to accrue to those members of the public who would take up shares in the company. This "holding out" casts onerous duty on them, i.e., they must state the facts honestly and faithfully. They must not only abstain from stating something as a fact when it is not actually so, but also must not omit a fact which they know or should have known and the existence of which might in any degree affect the nature or quality of the privileges and advantages which the prospectus holds out as an inducement to take shares. This principle was propounded in *Burswick, etc. Land Co. vs. G. Muggerridge*.

If the persons responsible for the issue of the prospectus fail to discharge such an onerous obligation resulting in an untrue statement being crept into the prospectus, then certain rights accrue to the shareholders against the company and the directors and others. We shall discuss them hereunder :

**(1) Remedies against the company** - A company is liable for a misstatement if it is shown that the prospectus was issued by the company or by some one with the authority of the company. The subscriber may have the following remedies against the company:

- (i) *Rescission of the contract* : A contract made with the company to purchase shares is an *uberrimae fidei* contract (i.e., a contract based on the utmost good faith). It implies that if a misrepresentation or non-disclosure of fact renders a statement untrue in a material particular or renders the whole prospectus untrue, the contract is voidable at the option of the aggrieved party. In other words, the subscriber to the shares can file a suit against





the company to rescind the contract under the general law of contracts. But before this right can be exercised, the following conditions must prevail, namely:

- (i) the statement was an omission of material fact or material misrepresentation of fact;
  - (ii) it induced the shareholder to take the shares;
  - (iii) the shareholder relied on the statement in the prospectus in applying for the shares. A purchaser of shares in the open market has no remedy against the company or any other person even if he purchased shares by being influenced by misrepresentation in the prospectus [*Peek vs. Gurney, (1873) 6 LR 377 (HL)*].
  - (iv) the omission of material fact or misrepresentation of a material fact was misleading;
  - (v) those acting on behalf of the company acted fraudulently;
  - (vi) those purporting to act on behalf of the company were authorised to act on its behalf;
  - (vii) he suffered a loss or damage;
  - (viii) the proceeding for rescission was started as soon as the allottee came to know of the misleading statement.
- (ii) *Damages for deceit* - The second remedy against the company is damages for deceit under the general law of contract. The allottee may recover damages from the company for any loss he may have suffered if he was induced to take shares based on a fraudulent misrepresentation of material facts.

Another remedy is to sue the company for damages for deceit. The allottee cannot, however, both retain the shares and get damages against the company. He must show that he has repudiated the shares and has not acted as a shareholder after discovering the misrepresentation.

## **(2) Remedies against Directors, Promoters and Experts**

- (i) *Compensation for misstatement* : According to Section 62, every director, promoter and every person who is responsible for the issue of the prospectus containing false or untrue information are liable to compensate all those persons who subscribe to the shares on the faith of the prospectus. But the action for damages must be taken within 3 years from the date of the allotment of the shares.

It should be remembered that the above-mentioned remedy by way of damage will not be available to a person if he has not purchased the shares on the basis of the prospectus. A person cannot be said to have bought shares on the basis of the prospectus, if he has done so from an existing shareholder or from the share market; therefore, in these circumstances he cannot bring an action for deceit against the directors (*Peek vs. Gurney*).



The subscribers may institute a suit for damages against those responsible for the issue of the prospectus, in spite of the fact that the contract to purchase shares has been repudiated. This is an action for deceit under the general law [Derry vs. Peek (1889) 14 A.C. 337] and this action can be taken even if the remedy by way of rescission (as against the company) has been lost through or negligence or even if the company goes into liquidation.

Example: A limited company willing to purchase a tea estate in Assam. Extracts from experts report mentioning number of tea plants and other relevant information was incorporated in the prospectus. The expert report was found to be incorrect. Does any prospective applicant shareholder buying the shares on the basis of false information has any remedy against the company?

In the case of mis-statement in a prospectus, the allottees shall have the right to claim compensation from the company for any loss that they might have sustained in terms of the value of shares.

- (ii) *Criminal Liability for misstatements [Section 63]* : Apart from the liability to compensate shareholders who have suffered a loss due to untrue statement in the prospectus, directors and other persons responsible for the issue of the prospectus may also render themselves punishable with imprisonment for a term which may extend to two years or with fine up to five thousand rupees, or with both. That is to say, every person who had authorised the issue of the prospectus containing an untrue statement is *prima facie* guilty of criminal offence under Section 63 of the Act. However, such persons may plead that the statement was immaterial or that they had reasonable ground to believe and did, up to the time of the issue of the prospectus, believe that the statement was true in order to exonerate themselves from this criminal liability.
- (iii) *Liability for omission* : An omission to state in a prospectus a matter required as per Section 56, may give rise to an action for damages by a subscriber who has suffered loss thereby even if the omission does not make the prospectus false or misleading but he has to prove that he has sustained damage by reason of this omission. The Act does not specifically mention that the directors will be liable but this seems to be implied from Section 56(4).

You should note that a director or other person responsible for the issue of the prospectus does not incur any liability for the non-compliance with or contravention of the requirements of Section 56, if he is able to prove, as regards any matter not disclosed, that he had no knowledge of the lapse; or that non-compliance or contravention was the result of an honest mistake of fact on his part or in respect of matters which were not material [Section 56(4)].

*When a director is not liable [Section 62(2)]* : A person who is held liable for the issue of a prospectus containing an untrue statement as a director will be exonerated from such a liability if he can show:



(a) *In a suit under Section 62 :*

- (i) that he (having consented to become a director) had withdrawn his consent to become a director before the issue of the prospectus and that it was issued without his authority or consent;
- (ii) that the prospectus was issued without his authority or consent; and that on becoming aware of its issue, he forthwith gave reasonable public notice of the issue having been made without his knowledge or consent; or
- (iii) that after the issue of the prospectus and before allotment thereunder he, on becoming aware of any untrue statement therein, had withdrawn his consent and given a reasonable public notice of the withdrawal and of the reasons therefore; or
- (iv) that he had reasonable ground to believe and, until allotment, did believe that the statement was true. This provision pertains to the untrue statement not purporting to have been made on the authority of an expert or of a public official document or statement.
- (v) that the untrue statement, purporting to be a statement by an expert or contained in a report or valuation of an expert was a correct and fair representation of the expert's statement and he had reasonable ground to believe and, until issue of prospectus, did believe that the expert was competent to make it and the expert had given and had not withdrawn his consent to the issue of the prospectus and had not withdrawn it before delivery of a copy of the prospectus for registration; and
- (vi) that the untrue statement, arising from the statement made by an official person or from the public official documents was a correct and fair representation or correct copy or correct and fair extract of the document.

(b) *In a suit under Section 56 :*

A director or other person sued for non-compliance of Section 56 may defend himself by proving :

- (i) that he had no knowledge of the matter not disclosed;
- (ii) that the contravention was an honest mistake of fact;
- (iii) that in the opinion of the Court, the matter not disclosed was immaterial or was otherwise such as ought to be excused.

**(3) When an expert is not liable [Section 62(3)] :** An expert who would be liable by reason of having given his consent under Section 58 to the issue of the prospectus containing a statement made by him wouldn't be liable if he can prove:

- (i) that having given his consent to the issue of the prospectus, he withdrew it in writing before the delivery of a copy of the prospectus for registration; or



- (ii) that after the delivery of a copy of the prospectus for registration but before allotment, he on becoming aware of the untrue statement withdrew his consent in writing and gave reasonable public notice thereof and the reasons therefore; or
- (iii) that he was competent to make the statement and he had reasonable ground to believe, and did up to the time of allotment of the shares or debentures believe, that the statement was true [Section 62(3)].

**Note :** The defence under (i) is available only to a director; defence under (i), (ii), (iii) & (iv) to all persons mentioned in Section 62(1)(a) to (d) and the defence under Section 62(3) is available only to an expert.

**(4) Right of directors and Expert to indemnity [Section 62(4)] :** Where the prospectus names any person as a director (or as having agreed to become a director) and he (i) has not consented to become a director; or (ii) has withdrawn his consent before the issue of the prospectus and has not authorised or consented to its issue, then (i) the directors of the company (excluding those without whose knowledge or consent, the prospectus was issued) and (ii) any other person who authorised its issue are liable to indemnify the person so named (as a director) or whose consent was required against all damages, cost and expenses which he may incur, consequent upon his name being included or consent thereto being accorded.

The expert can also claim indemnity against the persons aforementioned in case where (i) he has not given the consent or (ii) he has withdrawn his consent before the issue of the prospectus and in spite of this fact consent to its issue is mentioned in the prospectus as required under Section 58.

**(5) Penalty for fraudulently inducing a person to invest money [Section 68] :** Under Section 68, any person who, by making (knowingly or recklessly) any false, deceptive or misleading statement, promise, etc. or by dishonest concealment of material facts, induces another person to enter into :

- (i) an agreement for the acquisition, disposal, subscribing or underwriting of shares or debentures, or
- (ii) an agreement for securing any profit to any of the parties from the yield of shares or debentures or from fluctuations in the value of shares or debentures, shall be punishable with imprisonment up to 5 years or fine up to Rs. 1,00,000 or with both.

Example: X applied for 500 shares in a limited company in a fictitious name. The shares were allotted in that fictitious name. Referring to the relevant provisions of Companies Act, 1956 state whether X will incur any liability. X shall be punishable with imprisonment for a term, which may extend to 5 years. (Section 68A (1) The Companies Act, 1956.)

**(6) Personation for acquisition of shares [Section 68A] :** Under Section 68A, the following acts are punishable with imprisonment for a term extending to five years, viz., (a) making an



application to a company for acquiring or subscribing for its shares therein under a fictitious name; or (b) inducing a company to allot or register any transfer of shares therein to him or any other person in a fictitious name.

It is obligatory for every company to prominently state the foregoing provisions in every issue of a prospectus as well as in the form or application for shares.

**(7) SECTION 68B – Issue of Securities only in Demat Form:** Initial Public offer of Securities of Rs. 10 crores or more should be only in Dematerialised form, by complying with the requisite provisions of the Depositories Act, 1996 and Regulations made thereunder. However, the section is not synchronising with the provisions of Section 8 the Depositories Act, 1996 which provides an option to the subscribers to receive security certificate or hold securities in demat form with a depository. It would therefore appear that the option is being withdrawn, and subscribers can hold securities only in dematerialised form. Further SEBI Guidelines (para 2.1.5 of DIP, 2000) provides that a company can make an issue of securities to the public or a right basis only in demat form, while this section implies that only with regard to initial offer it should be in demat form, whereas for any subsequent issue it could be in physical form. A listed company has been defined under Section 2 (23A) to mean a public company which has any of its securities listed in any recognised Stock Exchange.

#### **2.12 OFFER FOR SALE OR PROSPECTUS BY IMPLICATION OR DEEMED PROSPECTUS [SECTION 64]**

It was at one time possible for a company to evade the statutory provisions relating to prospectus by allotting its shares or debentures to one or more persons so that such allottee or allottees should sell all or any of these shares or debentures to the public. Such a transfer was not considered as a sale to the public and no documents offering the securities were issued by the company. The exemption for such a practice does not exist any more. Section 64(1) provides :

“Where a company allots or agrees to allot any shares in, or debentures of the company with a view to all or any of these shares or debentures, being offered for sale to the public, any document by which the offer for sale to the public is made, shall, for all purposes, be deemed to be a prospectus issued by the company; and all enactments and rules of law as to the contents of prospectus and as to the liability in respect of statements in and omissions from prospectuses, or otherwise relating to prospectuses, shall apply with the modification specified in Sub-sections (3), (4) and (5) and have effect accordingly, as if the shares or debentures had been offered to the public for subscription and as if persons accepting the offer in respect of any shares or debentures were subscribers for those shares or debentures, but without prejudice to the liability, if any, of the persons by whom the offer is made in respect of misstatements contained in the documents or otherwise in respect thereof”



Such a document under Section 64(2) shall be treated as a prospectus (unless the contrary is proved) where: (a) an offer of all or any of the securities for sale to the public was made within six months after the allotment or agreement to allot; or (b) at the date when the offer for sale to the public was made, the company had not received the whole consideration in respect of the said shares or debentures.

The following additional information is required to be given in the deemed prospectus :

- (a) the net amount of the consideration received or to be received by the company in respect of the shares or debentures to which the offer relates;
- (b) the place and time at which the contract under which the said shares or debentures have been or are to be allotted may be inspected.

It is sufficient if the prospectus is signed on behalf of the company or firm by two directors of the company or by not less than one half of the partners in the firm, as the case may be, either themselves or by their agents authorised in writing.

### 2.13 ACCEPTANCE OF DEPOSITS

Deposits from the public are an important mode of finance in the corporate sector. It is accordingly necessary to control the companies inviting deposits from the public in order to safeguard the general and wider interest of the public at large. It was with this purpose that Sections 58A and 58B were inserted by the Companies (Amendment) Act, 1974, which came into force w.e.f. 1-2-1975.

**(a) What is deposit ?** : The term 'Deposit' means any deposit of money with, and includes any amount borrowed by a company but shall not include such categories of amount as may be prescribed in consultation with the Reserve Bank of India. Rule 2B of the Companies (Acceptance of Deposits) Rules, 1975 may be referred to for the details regarding items which are not treated as deposits in terms of Section 58A of the Companies Act.

*Exemption of deposits accepted from directors or shareholders in joint names* : The amount received by a company in the joint names of a director and a non-director, or in the case of a private company in the joint names of shareholder and a non-shareholder will not be exempted from the definition of deposit. If all the partners of a lending firm are not directors on the Board of the borrowing company, the deposits accepted from such a firm will also not fall within the purview of the said rules [Circular No. 1/1/80-CL. V dated 3-5-1980]. The loan taken by a private company from a firm, all of whose partners are shareholders of the borrowing company will stand on the same footing as loans taken from the shareholders themselves. Such loans are not to be regarded as deposits [Circular No. 3/13/84-CL. X dated 27-11-1984]. The deposit by a director out of borrowings from a third party would not be entitled to exemption under the rules.



**(b) Meaning of public :** As per its normal connotation the expression 'Public' includes a section of the public also. As a matter of fact Sub-section (1) of Section 58A makes a distinction between the public and the members of the company. However, neither Sub-section (1) nor Sub-section (2) excludes from its ambit the employees of the company. It is therefore, felt that the employees and ex-employees are also to be regarded as those falling in the category of public and the deposits accepted from them would as much attract the provisions of Section 58A and the rules made thereunder as deposits from other categories of public.

**(c) Deposits not to be invited without advertisement :** Section 58A is designed to regulate acceptance of deposits. It gives the Central Government the power to prescribe, in consultation with the Reserve Bank, the limit up to which, the manner in which and the conditions subject to which deposits may be invited or accepted either from the public or from the members of the company [Section 58A(1)].

A company shall not itself or through any other person invite deposits unless it publishes an advertisement including therein a statement showing its financial position. The Central Government may prescribe the form and the manner of such an advertisement [Section 58A(2)]. Refer to Rules 4 and 4A of the Companies (Acceptance of Deposits) Rules.

As per the Companies (Amendment) Act, 1996, no company shall invite, or allow any other person to invite or cause to be invited on its behalf, any deposit unless the company is not in default in the repayment of any deposit or part thereof and any interest thereupon in accordance with the terms and conditions of such deposit.

*Deposit vs. Loan :* Apparently there seems to be little difference between a 'deposit' and a 'loan'. But if you closely analyse the terms, you shall find an appreciable amount of difference between the two. Under the Limitation Act, 1963, the limitation in case of a loan and in case of a deposit, begins at different points of time. In case of a loan, it commences from the date of incurring that loan, whereas in the case of a deposit, it begins from the date where the demand is made. In simple words, unlike a loan there is no immediate obligation to repay in the case of deposits.

Earlier there was a controversy as to whether inter corporate deposits are loans or not so as to attract the provisions of earlier Section 370 (now Section 372A) of the Act. This controversy has been settled by the Companies (Amendment) Act, 1988, by inserting an explanation at the end of Section 370 (now Explanation to Section 372A of the Companies (Amendment) Act, 1999. The Explanation to Section 370A provides that loan includes any deposit of money made by one company with another company not being a banking company. Thus inter-corporate deposits are now to be governed by provisions of Section 370A of the Companies (Amendment) Act, 1999.



**(d) Repayment of deposits:** Repayment of deposits has been made obligatory under Sub-section (3A) of Section 58, inserted by the Companies (Amendment) Act, 1988. Accordingly every deposit accepted by a company after September 1, 1989, shall unless reed in accordance with the rules made under Sub-section (1), be repaid in accordance with terms and conditions of such deposit.

Where deposits are accepted by a company in violation of rules made by the Central Government, repayment thereof shall be made by the company within 30 days. But the time of refund may be extended by the Central Government on sufficient cause being shown, but not beyond another 30 days [Section 58A(4)].

In case the repayments are not made in the manner indicated above, every officer in default is punishable with imprisonment for a term extending upto 5 years as also with a fine. The company is also liable to be punished with a fine equal to twice the amount not refunded. If the fine is realised then the Court shall pay an amount equal to the amount of the refunded deposit to the depositor and with that the company's liability to the depositor comes to an end [Section 58A(5)].

The amended provisions of Sub-section (9) of Section 58A empower the Company Law Board to take cognizance of any case of repayment of deposits on maturity and to direct the company to make repayment of such deposits within such time and subject to such conditions, as may be specified in the order. Non-compliance of the orders of the Company Law Board would attract penalty by way of imprisonment, which may extend to three years and shall also be liable to a fine of not less than Rs. 500 for every day till such non-compliance continues. The amended provisions have come into force with effect from 1st September, 1989.

The deposits which had matured before the amended provisions of Section 58A came into force but have not been re-paid, would be covered by the said amended provisions of law.

The Company Law Board may, if it is satisfied, also pass orders under Section 58A(9), on its own motion.

**(e) Nomination for Deposits :** A depositor may at any time, make a nomination in the prescribed manner, a person to whom his deposits with the company shall vest in an event of his death. The provisions of Sections 109 and 109B relating to nomination of shares shall, as far as apply to the nomination made under the Sub-section 6(11) of Section 58A (as amended by the Companies (Amendment) Act, 1999).

Non-compliance of the order of the Company Law Board has now been made a punishable offence attracting penalty by way of imprisonment upto 3 years and fine of not less than Rs. 50 for every day till such non-compliance continues. The amended provisions have come into force w.e.f. 1-9-1989. The aggrieved depositors, whose deposits had matured before or after 1-9-1989 and who have not been repaid, may make an application (in triplicate) to the Company Law Board Bench (located at Delhi, Calcutta, Bombay and Madras depending upon





the registered office of the company) in the prescribed Form No. 11, alongwith an application fee of Rs. 50 by bank draft in favour of the "Pay and Accounts Officer, Department of Company Affairs". The application can either be filed with the concerned Bench Officer personally or sent by post.

It may be clarified that, in the following circumstances, application under Section 58A(9) of the Act will not lie :

- (i) Deposit made for booking/purchase of scooter, car, etc. is not a deposit for purposes of Section 58A of the Act.
- (ii) Deposits accepted by financial companies like hire-purchase finance company, a housing finance company, an investment company, a loan/mutual benefit financial company, and equipment leasing company, a chit fund company or a company, which receives deposits under any scheme or arrangement by way of contribution/subscriptions or by sale of units/certificates.
- (iii) Deposits accepted by a sick industrial company covered by the Sick Industrial Companies (Special Provisions) Act, 1985, in respect of which the Board of Industrial & Financial Reconstruction (BIFR) has specifically, by order, suspended the operation of any contract, agreement, settlement, etc., under Section 22(3) of the said Act.
- (iv) Deposits accepted by relief undertakings which are notified as such under the various State laws. Proceedings under Section 58A(9) of the Companies Act, 1956 shall remain stayed during the notified period.

In addition to the relief available under the Companies Act, 1956, the depositors can also take action against the defaulting companies under the normal civil law of the country.

**(f) Acceptance of deposits in contravention to rules** : Apart from this, Sub-section (6) levies penalties on the company for accepting or inviting deposits in contravention of the rules made by the Central Government. If the contravention relates to the acceptance of deposit, the amount of fine is equal to, or more than, the amount of the deposit so accepted. But in the case of invitation of any deposit in contravention of the said rules, the minimum amount of fine is at least Rs. 50,000 and the maximum limit is Rs. 10 lakhs. Besides, every officer of the company who is in default shall be punishable with imprisonment for a term extending up to 5 years and also with fine.

**(g) Power to grant exemption or extension**: The provisions of Section 58A shall not apply to a banking company, or such other company as the Central Government may, after consultation with the Reserve Bank, specify in this behalf [Section 58A(7)].



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According to Sub-section (8) the Central Government may, if it considers necessary for avoiding any hardship or for any other just and sufficient reason, by order, issued either prospectively or retrospectively from a date not earlier than the commencement of the Companies (Amendment) Act, 1974, grant extension of time to a company or class of companies to comply with or exempt any company or class of companies from all or any of the provisions of this section either generally or for any specified period, subject to such conditions as may be specified in the order. Provided that no order under this sub-section shall be issued in relation to a class of companies accept after consultation with the Reserve Bank of India.

In exercise of the powers conferred by Sub-section (8), the Central Government has exempted from provisions of Sub-sections (1) to (7) (w.e.f. 1-1-1990), the class of companies which satisfy the eligibility criteria laid down by the Reserve Bank of India in the Non-Banking Companies (Acceptance of Deposits through commercial paper) Directives, 1989 subject to the following conditions:

- (i) the companies shall comply with the terms and conditions stipulated from time to time by the RBI.
- (ii) The companies shall, in their annual accounts disclose the maximum amount raised at any time during a financial year and the amount outstanding as at the end of financial year [Notification GSR 1075(E), dated 29-12-1989].

Similarly in exercise of the powers conferred by Section 58A(7) of the Companies Act, the Central Government has specified that the provisions of Section 58A, shall not apply to the companies which are small scale industrial units and fulfil the following conditions, namely:

- (a) The paid up capital of the company does not exceed Rs. 25 lakhs;
- (b) The company accepts deposits from not more than 100 persons;
- (c) There is no invitation to public for deposits; and
- (d) The amount of deposits accepted by the company does not exceed Rs. 20 lakhs or the amount of its paid-up capital, whichever is less.

Here:

- (i) a "Small Scale Industrial Unit" means any industrial undertaking registered with the Directorate of Industries or Small Scale Industries, as the case may be, of the State Government and in respect of which the investment in plant and machinery is not in excess of 3 crores of rupees in value;
- (ii) "Deposit" has the same meaning as in clause (b) of Rule 2 of the Companies (Acceptance of Deposits) Rules, 1975.

**(h) Provisions relating to prospectus to apply to advertisement [Section 58B] :** Under



Section 58B, the provisions of this Act relating to a prospectus shall, so far as may be, apply to an advertisement referred to in Section 58A. The advertisement referred to is the one which is to be issued by the companies for inviting or accepting deposits. Such an advertisement is covered under the definition of 'Prospectus' laid down in Section 2(36) of the Act, as amended recently. Accordingly, all the provisions of the Act relating to prospectus automatically become applicable to such an advertisement. But having regard to the words "so far as may be" as used in Section 58B, wherever in respect of certain matters specific provisions have been made in Section 58A or the Companies (Acceptance of Deposits) Rules, 1975, the corresponding provisions in the Act relating to prospectus would not apply to this advertisement. For example, Section 56(1) requires a prospectus to contain information on matters specified in Schedule II. This will not be applicable on an advertisement inviting deposits because of Rule 4 of the Companies (Acceptance of Deposit) Rules, 1975. The other provisions will mutatis mutandis apply to such an advertisement. [Vide Circular No. 7/75 dated 7-6-1975].

**2.14 "SMALL DEPOSITORS" - SECTION 58AA [COMPANIES (AMENDMENT) ACT, 2000].**

- (a) A 'small depositor' means a depositor who has deposited in a financial year a sum not exceeding twenty thousand rupees in a company and includes this successors, nominees and legal representatives. It does not include those depositors who re their deposits and those depositors whose repayment is not made due to death or has been stayed by a competent court.
- (b) As per provisions of Section 58AA, every company accepting deposits from the small depositors shall intimate to the CLB within sixty days, the name and address of each small depositor(s) to whom it had defaulted in repayment of depositor interest thereon. Thereafter, intimation shall be given on a monthly basis.
- (c) On receipt of the intimation as aforesaid, it shall: -
- exercise the powers conferred on it under Section (9) of Section 58A- i.e. direct the company to repay the deposit.
  - pass an appropriate order within thirty days from the date of receipt of intimation.
- Where the order is passed after the expiry of 30 days, the small depositor must be given an opportunity of being heard, it shall not be necessary for a small depositor to be present at the hearing of the proceedings.
- (d) Restrictions on the company: -
- ◆ Unless the company repays all matured small deposits along with interest due thereon, it shall not accept further deposits from small depositors.



- ◆ If on any occasion, a company makes a default in repayment of small deposits, it shall state in all its future advertisements and applications inviting deposits the following details:
  - ◆ total number of small depositors are
  - ◆ the amount due to them in respect of which the default was committed.
  - ◆ Where the interest accrued as small deposits has been waived, the fact of such waiver must be mentioned in every future advertisement and application for inviting deposits.
  - ◆ The application form inviting deposits must contain a statement that the applicant had been appraised of every past default, waiver of interest etc.
  - ◆ If the company subsequent to acceptance of small deposits avails any working capital from any bank, it shall be first utilised for repaying the principal and interest due to small depositors before applying the funds for any other purpose.
  - ◆ One may wonder & ponder, whether any bank will give loan to the company for repaying to outstanding small depositors also?
  - ◆ The penalty for failure to comply with the provisions of this section or order of CLB is subject to a fine of Rs. 500 per day and imprisonment up to three years. Directors are also liable to be proceeded against.

**2.15 NON-REFUND OF DEPOSITS TO BE COGNIZABLE. (SECTION 58AAA) [COMPANIES (AMENDMENT) ACT, 2000]**

- Any offence relating to acceptance of deposits under section 58A or Section 58AA shall be an offence cognizable under the Criminal Procedure Code.
- No court shall take cognizance of any offence under this provision except on a complaint made by the Central Government or any officer authorised by it in this behalf.

**2.16 COMPANIES (ACCEPTANCE OF DEPOSITS) RULES, 1975 ALONGWITH RELEVANT CIRCULARS AND CLARIFICATIONS**

The Central Government in exercise of the powers conferred by Sub-section (1) of Section 58A of the Companies Act, has in consultation with the Reserve Bank of India, framed Companies (Acceptance of Deposits) Rules, 1975. These rules supplement the provisions of Section 58A. These are not applicable to Banking companies and financial companies. They specify the limits up to which, the manner in which and the conditions subject to which the deposits can be invited and accepted by non-banking non-financial companies.

These regulations override the provisions contained in memorandum and articles of



association of the companies regarding their borrowing power. Sections 58A and 58B are supplemented by the Companies (Acceptance of Deposits) Rules, 1975. These rules are reproduced below:

**Short title, commencement and application**

1. (1) These Rules may be called the Companies (Acceptance of Deposits) Rules, 1975.
- (2) They shall come into force on the date of their publication in the *Official Gazette*.
- (3) They shall apply to such companies as are not banking companies and are not also financial companies.

**Definitions**

2. In these Rules, unless the context otherwise requires :
  - (a) "Act" means the Companies Act, 1956 (1 of 1956);
  - (b) "Deposit" means any deposit of money with, and includes any amount borrowed by a company, but does not include:
    - (i) any amount received from the Central Government or a State Government or any amount received from any other source and whose repayment is guaranteed by the Central Government or a State Government, or any amount received from a local authority or a foreign Government or any other foreign citizen, authority or person;
    - (ii) any amount received as a loan from any banking company or from the State Bank of India or any of its subsidiary banks or from a banking institution notified by the Central Government under Section 51 of the Banking Regulation Act, 1949 (10 of 1949), or a corresponding bank as defined in clause (d) of Section 2 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970), or from a co-operative bank as defined in clause (b-ii) of Section 2 of the Reserve Bank of India Act, 1934 (2 of 1934);
    - (iii) any amount received as a loan from the Industrial Finance Corporation of India established under the Industrial Finance Corporation Act, 1948 (15 of 1948), or from a State Financial Corporation established under the State Financial Corporation Act, 1951 (63 of 1951), or from the Shipping Development Fund Committee constituted under Section 15 of the Merchant Shipping Act, 1958 (44 of 1958) or from the Unit Trust of India established under the Unit Trust of India Act, 1963 (52 of 1963), or from the Industrial Development Bank of India established under the Industrial Development Bank of India Act, 1964 (18 of 1964), or from an Electricity Board constituted under the Electricity (Supply) Act, 1948 (54 of 1948) or from the Life Insurance Corporation of India constituted under Section 3 of the Life Insurance



Corporation Act, 1956 (31 of 1956), or from the Rehabilitation Industries Corporation of India Limited or the State Trading Corporation of India Limited or the Minerals and Metals Trading Corporation of India Limited or the Rural Electrification Corporation Limited or the Agricultural Finance Corporation Limited or the Industrial Reconstruction Corporation of India Limited or the Industrial Credit and Investment Corporation of India Limited or the National Industrial Development Corporation of India Limited or the Tamil Nadu Industrial and Investment Corporation Limited or the State Industrial and Investment Corporation of Maharashtra Limited or from the General Insurance Corporation of India and its subsidiaries, namely, the National Insurance Company Limited, the India Assurance Company Limited, the Oriental Fire and General Insurance Company Limited and the United Fire and General Insurance Company Limited, or from the Gujarat Industrial Investment Corporation Limited or from any financial company wholly owned by the Central Government or State Government or from the Oil Industry Development Board or Housing Development Finance Corporation Limited, or from any other Financial Company or Public Financial Institutions which may be notified by the Central Government in this behalf in consultation with the Reserve Bank of India.

- (iv) any amount received from an employee of the company by way of security deposit;
- (v) any amount received by way of security or as an advance from any purchasing agent, selling agent, or other agents in the course of or for the purposes of the business of the company or any advance received against orders for the supply of goods or properties or for the rendering of any service;
- (vi) any amount received by way of subscriptions to any shares, stock, bonds or debentures such bonds or debentures as are covered by sub-clause (ix) pending the allotment of the said shares, stock, bonds or debentures and any amount received by way of calls in advance on shares, in accordance with the Articles of Association of the Company so long as such amount is not repayable to the members under the Articles of Association of the Company;
- (vii) any amount received in trust or any amount in transit;
- (viii) any amount received from a person who at the time of the receipt of the amount was a Director of the company or any amount received from its shareholders, by a private company or by a private company which has become a public company under Section 43A of the Act and continues to include in its Articles of Association provisions relating to the matters specified in clause (iii) of Sub-section (1) of Section 3 of the Act.

*Provided* that the Director or shareholder, as the case may be, from whom the money is received furnishes to the company at the time of giving the money, a



declaration in writing to the effect that the amount is not being given out of funds acquired by him by borrowing or accepting from others;

*Explanation:* For the removal of doubts, it is hereby declared that any deposit received or reed by a company before the commencement of the Companies (Acceptance of Deposits) Amendment Rules, 1975, shall continue to be governed by the rules applicable at the time of such deposit or real as the case may be.

- (ix) any amount raised by the issue of bonds or debentures secured by the mortgage of any immovable property of the company or with an option to convert them into shares in the company provided that in the case of such bonds or debentures secured by the mortgage of any immovable property the amount of such bonds or debentures shall not exceed the market value of such immovable property.
- (x) any amount brought in by the promoters by way of unsecured loans in pursuance of stipulations of financial institutions subject to the fulfilment of the following conditions, namely:
  - (a) the loans are brought in pursuance of the stipulation imposed by the financial institutions in fulfilment of the obligation of the promoters to contribute such finance;
  - (b) the loans are provided by the promoters themselves and/or by their relatives, and not from their friends and business associates; and
  - (c) the exemption under this sub-clause shall be available only till the loans of financial institutions are repaid and not thereafter.

*Explanation:* For the purpose of this sub-clause the term 'financial institution' shall mean:

- (a) a public financial institution specified in or under Section 4A of the Companies Act, 1956;
- (b) a State Financial, Industrial or Investment Corporation;
- (c) the State Bank of India or a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959);
- (d) a nationalised bank, that is to say, a corresponding bank as defined in Section 2 of:
  - (i) the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970); or
  - (ii) the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980);



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- (e) the General Insurance Corporation of India established in pursuance of the provisions of Section 9 of the General Insurance Business (Nationalisation) Act, 1972 (57 of 1972);
- (f) the Industrial Reconstruction Corporation of India; or
- (g) any other Institution which the Central Government may, by notification, specify in this behalf.

“Depositor” includes any person who has given a loan to a company.

“Financial company” means a non-banking company which is a financial institution within the meaning of clause (c) of Section 45-I of the Reserve Bank of India Act, 1934 (2 of 1934).

“Free reserves” includes the balance in the share premium account, capital and debenture redemption reserves and any other reserves shown or published in the balance-sheet of the company and created by appropriation out of the profits of the company, but does not include the balance in any reserve created :

- (i) for repayment of any future liability or for depreciation in assets or for bad debts;
- (ii) by the revaluation of any assets of the company.

*Note:* As per clarification given by Dept. of Company Affairs, Capital Redemption Reserve will be treated as ‘free reserve’ vide their letter No. 4/18/76-CL. XIV dated 29-12-1976.

### Acceptance of deposits by companies

3. (1) On and from the commencement of these rules,
- (a) no company shall accept or receive any deposit which is repayable on demand or on notice or after a period of less than twelve months or more than sixty months from the date of acceptance or realisation of such deposit;  
*Provided* that a company may for the purpose of meeting any of its short term requirements for funds, accept or receive, such deposits as are referred to in clause (i) of sub-rule (2) for repayment earlier than twelve months from the date of deposit or realisation, as the case may be, subject to the condition that such deposit:
    - (i) shall not exceed ten per cent of the aggregate of the paid-up share capital and free reserves of the company, and
    - (ii) are repayable not earlier than three months from the date of such deposit or realisation thereof, as the case may be;
  - (b) is not mentioned here





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**Provided further** that where a company has before the 1st day of April, 1978, accepted any deposit repayable after a period of more than thirty-six months, such deposits shall, unless reed after the said date, be repaid in accordance with the terms of such deposits.

- (c) no company shall invite or accept or re any deposits in any form, on a rate of interest exceeding, fourteen per cent per annum at rests which shall not be shorter than monthly rests.
- (d) no company shall pay brokerage to any broker at a rate, exceeding one per cent of the deposits for a period up to one year, one and half per cent of the deposits for a period of more than one year but up to two years, and two per cent of the deposits for a period exceeding two years, collected by or through such broker, and such payment shall be on one time basis.

*Explanation:* Any person who is authorised by a company, in writing, to solicit deposits on its behalf and through whom deposits are procured will only be entitled to brokerage and payment of brokerage to any other person for procuring deposits shall be deemed to be not in conformity with the rules.

- (2) No company, other than a Government company, shall accept :
  - (i) any deposit against an unsecured debenture or any deposit from a shareholder (not being a deposit accepted by a private company from its shareholder) or any deposit guaranteed by any person who, at the time of giving such guarantee is a director of the company if the amount of any such deposit together with the amount of such other deposits of all or any of the kinds of deposits referred to in this clause and outstanding on the date of acceptance or real of such deposit exceeds ten per cent including any deposit accepted under the proviso to sub-rule (1) of rule 3 of the aggregate of the paid-up share capital and free reserves of the company:

**Provided** that for the purpose of calculation of the amount of deposits outstanding on the date of such acceptance or real, any deposit guaranteed by a person who, at the time of giving such guarantee was the managing agent or secretary and treasurers of the company and outstanding on such date shall be taken into account.

- (ii) any other deposit, if the amount of such deposit together with the amount of such other deposit other than any of the deposits referred to in clause (i), outstanding on the date of acceptance or real exceeds twenty-five per cent of the aggregate of the paid-up share capital and free reserves of the company.



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- (2A) No Government company shall accept any deposit, if the amount of such deposit exceeds thirty five per cent including any deposit accepted under the proviso to sub-rule (1) of rule 3 of the aggregate of its paid-up share capital and free reserves.
- (3) If, immediately before the commencement of these Rules, the aggregate amount of deposits, of the nature referred to in clause (i) of sub-rule (2), accepted by a company before such commencement, exceeds the limit specified in the said clause (i), the company shall, on or before the 31st day of March, 1978 bring down the deposits to the limit aforesaid and for this purpose the company shall repay such deposits, as may be necessary.

*Explanation* : For the purpose of this rule in arriving at the aggregate of the paid-up of the paid-up share capital and free reserves as appearing in the latest audited balance-sheet of the company, the amount of accumulated balance of loss, balance of deferred revenue, expenditure and other intangible assets, if any, as disclosed in the said balance sheet;

“Government company” means a company as defined in Section 617 of the Companies Act, 1956.

- (4) On and from the 1st day of April, 1978, where a company has any outstanding loans which were excluded from deposits by virtue of Explanation I as it stood immediately before the said date, then such company shall before the first day of April, 1981, repay or bring such loan down to an amount which alongwith other outstanding deposits, is within the limits specified in this rule”.

*Note* : ‘Free reserves’ for the purpose of these Rules will not include any amount shown in the Balance sheet under the Heading ‘Share Premium Account’ having regard to the provisions of Section 78(1), such amounts are to be regarded as part of the paid-up share capital.

### **Maintenance of liquid assets**

- 3A. (1)** Every company shall before the 30th day of April of each year deposit or invest, as the case may be, a sum which shall not be less than 15 per cent of the amount of its deposits maturing during the year ending on the 31st day of March next following in any one or more of the following methods, namely :
- (a) in a current or other deposit account with any scheduled bank, free from charge or lien;
  - (b) in unencumbered securities of the Central Government or of any State Government;
  - (c) in unencumbered securities mentioned in clauses (a) to (d) and (ee) of Section 20 of the Indian Trusts Act, 1882 (2 of 1882).



- (d) in unencumbered bonds issued by the Housing Development Finance Corporation Limited, Bombay, a company incorporated under the Companies Act, 1956 (1 of 1956), and notified under clause (i) of Section 20 of the Indian Trusts Act, 1882 (2 of 1882).

**Provided** that with relation to the deposits maturing during the year ending on the 31st day of March, 1979, the sum required to be deposited or invested under the sub-rule shall be deposited or invested before the 30th day of September, 1978.

*Explanation* : For the purpose of this sub-rule, the securities referred to in clause (b) or clause (c) shall be reckoned at their market value.

- (2) The amount deposited or invested, as the case may be, under sub-rule (1), shall not be utilised for any purpose other than for the repayment of deposits maturing during the year referred to in that sub-rule, provided that the amount remaining deposited or invested, as the case may be, shall not at any time fall below ten per cent of the amount of deposits maturing until the 31st day of March of the year.

**Form and particulars of advertisements**

4. (1) Every company intending to invite or allowing or causing any other person to invite deposits shall issue an advertisement for the purpose in a leading English paper and in one vernacular paper circulating in the State in which the registered office of the company is situated.
- (2) No company shall issue or allow any other person to issue or cause to be issued on its behalf, any advertisement, inviting deposits, unless such advertisement is issued on the authority and in the name of the Board of Directors of the company and contains a reference to the conditions subject to which deposits shall be accepted by the company, the date on which the said Board of Directors has approved the text of advertisement and the following information namely :
- (a) name of the company;
  - (b) the date of the incorporation of the company;
  - (c) the business carried on by the company and its subsidiaries with the details of branches or units, if any;
  - (d) brief particulars of the management of the company;
  - (e) names, addresses and occupations of the Directors;
  - (f) profits of the company, before and after making provision of tax, for the three financial years immediately preceding the date of advertisement;
  - (g) dividends declared by the company in respect of the said years;



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(h) a summarised financial position of the company as in the two audited balance-sheets immediately preceding the date of advertisement in the following form, namely :

**Summarised financial position of the company as appearing in the two latest audited balance-sheets**

<i>Liabilities</i>	<i>Figures for the financial year previous to the year referred to in column 5</i>	<i>Figures for the latest which</i>	<i>Assets the financial year for the year audited accounts available</i>	<i>Figures for the financial year previous to referred to in column 2 are</i>	<i>Figures for the latest financial year for which audited accounts are available</i>
1.	2.	3.	4.	5.	6.
Share Capital			Fixed assets		
Reserves and surplus			Investments		
Secured loans			Current assets		
Unsecured loans			Loans and Advances		
Current liabilities and provisions			Miscellaneous expenditure		
			Profit and loss account		
<b>Total</b>			<b>Total</b>		

Note: brief particulars of contingent liabilities may be added by way of footnote.

- (i) the amount which the company can raise by way of deposits under these rules and the aggregate of deposits actually held on the last day of the immediately preceding financial year.
- (j) a statement to the effect that on the day of the advertisement the company has no overdue deposits other than unclaimed deposits, or a statement showing the amount of such overdue deposits as the case may be.
- (k) a declaration to the effect :



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- (i) that the company has complied with the provisions of these rules;
  - (ii) that compliance with these rules does not imply that repayment of deposits is guaranteed by the Central Government; and
  - (iii) that the deposits accepted by the company (other than secured deposits, if any, accepted under the provisions of these rules, the aggregate amount of which may be indicated) are unsecured and ranking *pari passu* with other unsecured liabilities.
- (3) An advertisement issued in accordance with this rule shall be valid until the expiry of six months from the date of closure of the financial year in which it is issued or until the date on which the balance sheet is laid before the company in general meeting, or, where the Annual General Meeting for any year has not been held, the latest day on which that meeting should have been held in accordance with the provisions of the Act, whichever is earlier, and a fresh advertisement shall be made, in each succeeding financial year, for inviting deposits during that financial year.
- (4) No advertisement shall be issued by or on behalf of a company unless on or before the date of its issue, there has been delivered to the Registrar for registration a copy thereof signed by a majority of the Directors on the Board of Directors of the company as constituted at the time the Board approved the advertisement or their agents, duly authorised by them in writing.

### **Notes**

It will be treated as sufficient compliance with this provision if the advertisement is signed by every director or by his agent authorised in writing [Department clarification dated 25-9-1975].

*Explanation* : For the purpose of this rule, the date of the issue of the paper in which the advertisement appears shall be taken as the date of issue of the advertisement.

### **Statement in lieu of advertisement**

- 4A.** (1) Where a company intends to accept deposits without inviting or allowing or causing any other person to invite, such deposit, shall before accepting deposits deliver to the Registrar for registration a statement in lieu of advertisement containing all the particulars required to be included in the advertisement by virtue of sub-rule (2) of Rule 4 and duly signed in the manner provided in sub-rule (4) of that Rule.
- (2) A statement delivered under sub-rule (1) shall be valid until the expiry of six months from the date of closure of the financial year in which it is so delivered or until the date on which the balance sheet is laid before the company in general meeting, or where the Annual General Meeting for any year has not been held, the latest day on which that meeting should have been held in accordance with the provisions of the Act, whichever is earlier.



**Form of application for deposits**

5. (1) On and from the commencement of these rules, no company shall accept, or re any deposit, unless an application is made by the intending depositor for the acceptance of such deposit and such application contains a declaration by such person to the effect that the amount is not being deposited out of the funds acquired by him by borrowing or accepting deposits from any other person.
- (2) The application referred to in sub-rule (1) shall be made in the form supplied by the company and such form shall be accompanied by a statement by the company containing all the particulars specified in sub-rule (2) of Rule 4 and incorporating therein all changes in relation to such particulars up to the date on which the form is issued by the company.

**Furnishing of receipts to depositors**

6. (1) Every company shall, on the acceptance or real of a deposit, furnish to the depositor or his agent a receipt for the amount received by the company within a period of eight weeks from the date of receipt of money or realisation of cheques.
- (2) The deposit receipt referred to in sub-rule (1) shall be signed by an officer of the company duly authorised by the company in this behalf, and shall state the date of deposit, the name and address of the depositor, the amount received by the company as deposits, the rate of interest payable thereon and the date on which the deposit is repayable.
- (3) The company shall not reserve to itself either directly or indirectly a right to alter, to the prejudice or disadvantage of the depositor, the terms and conditions of the deposit after it is accepted.

**Registers of deposits**

7. (1) Every company accepting deposits shall keep at its registered office one or more registers in which there shall be entered separately in the case of each depositor the following particulars, namely;
  - (a) name and address of the depositor;
  - (b) date and amount of each deposit;
  - (c) duration of the deposit and the date on which each deposit is repayable;
  - (d) rate of interest;
  - (e) date or dates on which payment of interest will be made;
  - (f) any other particulars relating to the deposit.



- (2) The register or registers referred to in sub-rule (1) shall be preserved in good order for a period of not less than eight calendar years from the financial year in which the latest entry is made in the register.

**General provisions regarding repayment of deposits**

8. (1) Where a company makes repayment of a deposit after the expiry of a period of six months from the date of such deposit but before the expiry of the period for which such deposit was accepted by the company, the rate of interest payable by the company on such deposit shall be reduced by one per cent from the rate which the company would have paid had the deposit been accepted for the period for which such deposit had run and the company shall not pay interest at any rate higher than the rate as so reduced.

**Provided** that nothing contained in this rule shall apply to the repayment of any deposit before the expiry of the period for which such deposit was accepted by the company, if such repayment is made solely for the purpose of :

- (a) complying with the provisions of the Non-Banking Non-financial Companies (Reserve Bank) Directions, 1966; or
- (b) complying with the provisions of rule 3; or
- (c) converting with the consent of the depositors, into secured debentures in accordance with the guidelines, issued by the Government of India from time to time, regarding the issue of "rights" debentures; or
- (d) providing war risk or other related benefits to the personnel of the naval, military or air forces or to their families, on an application made by the associations or societies formed by such personnel, during the period of emergency declared under Article 352 of the Constitution.

**Provided further** that where a company permits a depositor to re his deposit, before the expiry of the period for which such deposit was accepted by the company, for a availing of the higher rate of interest, the company shall pay interest to such depositor at higher rate if:

- (i) such deposit is reed in accordance with the other provisions of these rules and for a period longer than the unexpired period of the deposit, and
- (ii) the rate of interest as stipulated at the time of the acceptance or real of deposit is reduced by one per cent for the expired period of the deposit and is paid or adjusted or recovered accordingly.

*Explanation* : For the purposes of this rule, where the period for which the deposit had run contains any part of a year, then, if such part is less six



months, it shall be excluded and if such part is six months or more, it shall be reckoned as one year.

- (2) Where depositors so desire, deposits may be accepted in joint names not exceeding three, with or without any of the clauses, namely, "either or survivor", "number one or survivor", "Anyone or survivor".

**9. Power of Central Government to decide certain questions :** If any question arises as to whether these rules are or not applicable to a particular company, such question shall be decided by the Central Government in consultation with the Reserve Bank of India.

**10. Return of deposits to be filed with the Registrar :** Every company to which these Rules apply shall on or before the 30th day of June, of every year, file with the Registrar, a return in the form annexed to these rules and furnishing the information contained therein as on the 31st day of March of that year duly certified by the Auditor of the Company.

- (2) A copy of the return shall also be simultaneously furnished to the Reserve Bank of India.

**11. Penalty :** If a company or any other person contravenes any provision of these rules for which no punishment is provided in the Act, the company and every officer of the company who is in default or such other person shall be punishable with fine which may extend to five hundred rupees and where the contravention is a continuing one, with a further fine which may extend to fifty rupees for every day after the first, during which the contravention continues.

**12. Repeal and savings :** On the commencement of these rules, all rules, orders or directions in force in relation to any matter for which provision is made in these Rules shall stand repealed, except as respects things done or omitted to be done before such repeal.

## 2.17 ALLOTMENT OF SHARES

Before we deal with the statutory restrictions in this regard, it will be worthwhile to understand the meaning of the term 'allotment'. As you know, the intending subscribers send, in reply to the prospectus issued by the company, applications to the company. These applications are mere offers to take, shares since the prospectus is just an invitation to make offer. Allotment is the acceptance by the company of such offers to take shares. It is an appropriation of shares to an applicant for shares—and appropriation out of the previously unappropriated capital of the company. That is why, if the shares which have been forfeited are reissued, you cannot call it an "allotment". The word "allotment" gives us the notion of a "lot". Therefore, there must first be a lot of shares, then the division of them into value or classes and lastly allocation of them among various applicants [Calcutta Stock Exchange Association, *In re.*, 61 C.W.N. 418 - 0957 Cal. 438].

We shall now discuss the restrictions imposed by the Act on allotment of shares.





### **2.18 MINIMUM SUBSCRIPTION AND REFUND**

In terms of Section 69 of the Act, every prospectus for shares must contain an indication, as to the minimum amount which in the opinion of the Board of directors must be raised. The amount so stated in the prospectus which shall be reckoned exclusively of any amount payable otherwise than in money is referred to as the "minimum subscription". The amount payable on application of each share shall not be less than 5% of the nominal amount of the share.

If the applications are not received by the company for such quantum of shares for making the minimum subscription, within 120 days of the issue of prospectus, all moneys received from the applicants for shares shall be repaid without interest. If any such money is not repaid within 130 days after the issue prospectus, moneys will be repaid with interest at the rate of 6% p.a. from the expiry of 130 days.

#### **Position as per SEBI Guidelines**

*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 being 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 as per section 73 of the Companies Act, 1956".

*For Underwritten Public Issues:* "If the company does not receive the minimum subscription of 90% of the net offer to public including development 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 a delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest prescribed under section 73 of the Companies Act, 1956."

#### *For Composite Issues*

- (a) The Lead Merchant Banker shall ensure that the requirement of "minimum subscription" is satisfied both jointly and severally, i.e., independently or both rights and public issues.
- (b) If the company does not receive the minimum subscription to either of the issues, the company shall refund the entire subscription received.

The aforesaid requirement of 90% minimum subscription will not be relevant in case of offer for sale of securities (i.e., the management offering their shareholdings through public offer with a view to convert a closely held company into a widely held company).

Again, the requirement of 90 per cent subscription for issue of capital by an infrastructure company shall not be mandatory, if disclosures are made in the prospectus regarding the



alternate sources of funding. The lead manager shall verify and confirm the same as part of their due diligence.

### **2.19 RESTRICTION ON USE OF APPLICATION MONEYS**

The issuer company cannot use the moneys received with the applications and kept deposited with the bankers to the issue until the date the shares or debentures are allotted. Until that date the said amount shall not be utilised for any purpose other than the following :

- (1) Adjustment of excess moneys against allotment of shares permitted to be dealt with in a Stock Exchange; or
- (2) Repayment of money if, failure to get permission from the Stock Exchange.

#### **(a) Utilisation of said moneys for purposes stated in the prospectus**

On and from the date the allotment is made the moneys in respect of applications for shares or debentures which have been allotted can be utilised by the company for the purposes for which the issue was made.

#### **(b) Approval of Stock Exchange for basis of allotment**

It may be noted that the necessary particulars of applications received shall be furnished to the Stock Exchange concerned and the basis of allotment approved by the Stock Exchange before allotment is made by the Board or Committee of Directors appointed for the purpose by the Board.

The basis of allotment of the issue need not be intimated to the applicant and it will be sufficient if the companies publish the same in a widely circulated paper.

**(c) Prospectus to be filed [Section 70]** : The company shall file with the Registrar a prospectus or statement in lieu of prospectus before allotment. Further it may be recalled that no public company having a share capital which does not issue a prospectus or which does not proceed to allot shares in pursuance thereof shall be entitled to allot any of its shares unless a statement in lieu of prospectus is filed with Registrar at least three days before the first allotment in terms of Section 70 of Act. But this Section does not apply to a private company.

**(d) Opening of subscription list** : The subscription list for public issues should be kept open for at least 3 working days and a disclosure to this effect should be made in the prospectus.

The maximum period for which the issue should be kept open has not been stipulated for public issues. The Ministry of Finance, Stock Exchange Division has clarified that the subscription list for public issues can be kept open for a maximum period of 21 working days



where the issue is not underwritten and for a maximum of 10 working days where the issue is underwritten. Where, after a prospectus is first issued generally, a public notice has been given by some person (responsible under Section 62) so as to exclude, limit, or diminish his responsibility, then the shares cannot be allotted until the beginning of the 5th day after the date on which such public notice was given. The reason for the prescription of this period of 5 days is to enable the public to digest the contents of the prospectus as also to obtain independent advice to form a judgement before they could stake their money. An application of shares is not revocable until the end of the 5th day from the opening of the subscription list [Section 72].

**(e) Listing of shares on stock exchange [Section 73] :** (i) Where, the prospectus states that application has been made for permission for the shares or debentures offered for subscription to be dealt in on one or more recognised stock exchange, in such a case prospectus shall state the name of the stock exchange or as the case may be, each stock exchange. The eligibility criteria for listing of securities of a company on the stock exchange were revised w.e.f. 4-7-1995, that

- (a) in respect of companies, the invest hold limit for listing will be issued capital of Rs. 5 crores.
- (b) in respect of existing, and now seeking listing as the Bombay Stock Exchange, all the following criteria will have to be fulfilled
  - (i) minimum issued equity capital of Rs. 3 crores,
  - (ii) minimum Book value of Rs. 5 crores (Capital + Free reserves) and
  - (iii) minimum Market capitalisation of Rs. 10 crores.

SEBI has prescribed norms for minimum quantity of capital of 25 per cent being offered to the public beyond all reservations to different categories of persons and institutions.

(ii) If the permission has not been granted by the stock exchange or each such stock exchange before the expiry of 10 weeks from the date of the closing of the subscription lists the allotment made shall become void [Sub-section (1)] as amended by the Amendment Act of 1988].

(iii) An appeal may be preferred against the decision of any recognised stock exchange refusing the aforesaid permission for enlistment under Section 22A of the Securities Contract (Regulation) Act, 1956, and then such allotment shall not be void until the dismissal of the appeal.

(iv) Where the permission has not been applied for or having been applied for, has not been granted, the application money received must be refunded to the applications forthwith without any interest. If the money is not refunded within 8 days after the company becomes liable to repay it, the company and every Director of the company who is an officer in default shall, on and from the expiry of the eighth day be jointly and severally liable to repay that money with



interest at such rate which shall not be less than 15 per cent, as may be prescribed, having regard to the length of the period of delay in making the repayment of such money [Sub-section (2)].

(v) If the permission has been granted by the recognised stock exchanges and the moneys received from applicants for shares or debentures are in excess of the aggregate of the application money relating to the shares or debentures in respect of which allotments have been made, the company shall repay the moneys to the extent of such excess forthwith without interest. But if such moneys are not repaid within 8 days the company and every director of the company who is an officer in default shall, on and from the expiry of the eighth day, be jointly and severally liable to repay that money with interest at such rate, not less 15 per cent, depending upon the period of delay [Sub-section 2(A)].

If default is made in complying with these provision then the company and every officer of the company who is in default shall be punishable with fine extending up to Rs. 50,000 and where repayment is not made within 6 months from the expiry of the 8th day also with imprisonment for a term which may extend to one year [Sub-section 2(B)].

(vi) All moneys received as application or allotment moneys shall be kept in a separate bank account maintained with a schedule bank "until the permission has been granted or where an appeal has been preferred against the refusal to grant permission, until the disposal of the appeal, and the moneys standing in such separate account shall, where the permission has not been applied for as aforesaid or has not been granted, be repaid within the time and in the manner specified in Sub-section (2)". If default is made in complying with this sub-section, then the company and every officer of the company who is in default shall be punishable with fine extending up to Rs. 50,000 [Sub-section (3)].

(vii) Moneys standing to the credit of the separate bank account referred to in Sub-section (3) above shall not be utilised for purpose other than either of the following purposes namely :

(a) adjustment against allotment of shares, where the shares have been permitted to be dealt in on the stock exchange or specified in the prospectus, (b) repayment of money received from applicants in pursuance of the prospectus, where shares have not been permitted to be dealt in on the stock exchange or each stock exchange specified in the prospectus, as the case may be, or where the company is for any other reason unable to make the allotment of shares [Sub-section (3A)].

It shall be deemed that permission has not been granted if the application for permission, where made has not been disposed of within the time specified in Sub-section (1) above [Sub-Section (5)].

**(f) Effect of Irregular Allotment:** When the shares are not allotted in pursuance of



Sections 69 and 70 such an allotment is known as irregular allotment. In spite of the stringent provisions of Sections 69 and 70, one may find that allotment has been made in utter contravention thereof. The directors may choose to take a chance and proceed to allot shares although minimum subscription has not reached or a prospectus or statement in lieu of prospectus has not been filed. Such an allotment is treated by the Act not as void *ab initio* but as irregular.

The applicant for the shares may avoid the allotment. If he does so within the time specified by Section 71, namely,

- (a) where the allotment was made before the statutory meeting, within 2 months after the holding of statutory meeting of the company and not later; or
- (b) where no statutory meeting is required to be held by the company, within 2 months after the date of allotment and not later; or
- (c) where the allotment was made after the statutory meeting within 2 months of allotment [and not later] the allotment shall be voidable despite the fact that the company is in the course of being wound up.

Within the above-mentioned period, the allottee must intimate to the company that he wants to avoid the allotment. If legal proceedings are required to be taken, these need not be within the period of two months provided the notice of avoidance was served on the company within the aforesaid time, but they should be reasonably prompt thereafter if they are required to be brought [Re. *National Motor Mail Coach Co. (1908) 2 Ch. 228*].

Furthermore, Sub-section (3) of Section 71 makes every director of a company, who knowingly contravenes or authorises the contravention of any of the provisions of Section 69 or Section 70 with respect to allotment, liable to compensate the company and the allottee for any loss, damages or costs which they may have sustained or incurred thereby. But the proceedings for such compensation can only be taken within two years from the date of allotment. As the allotment is only voidable at the option of the shareholder, the shareholder may keep the shares and yet sue the directors who have knowingly contravened either of the two Sections (69 and 70) to compel them to make good the loss to him as a result of the irregular allotment.

**(g) Return of allotment [Section 75]:** The company is to submit a report in prescribed Form No. 2 called 'Return of Allotment', to the Registrar within 30 days of allotment of shares. It must state:

- (1) *In case shares are allotted in cash :*
  - (a) the number and nominal amount of the shares allotted;
  - (b) the names, addresses and occupations of the allottees and the amount, if there be any, paid or due and payable on each shares.



But the company must not show shares as having been allotted for cash, if cash has not been actually received by it.

- (2) *In case shares allotted are not bonus shares and allotted as fully or partly paid up otherwise than in cash* : The company must produce for the inspection and examination of the Registrar certain documents. These documents are:
- (a) a contract in writing constituting the title of the allottee; and
  - (b) any contract of sale or contract of service or other consideration in respect of which the allotment was made.

These documents must be duly stamped. Also along with these documents the company must file with the Registrar:

- (i) copies of the said contracts after verifying them in the prescribed manner, and
- (ii) a return stating the number and nominal amount of the shares so allotted, the extent to which they are to be treated as paid-up and the consideration for which they have been allotted.

Under Rule 5 of the Companies (Central Government's) General Rules and Forms, 1956 these copies of contracts must be verified by affidavit of a responsible officer of the company. Where such a contract is not in writing, the company must within 30 days after allotment, file with the Registrar a document embodying the said particulars of the contract. The document must bear the same amount of stamp duty as would have been payable if the contract had been in writing.

- (3) *In the case of issue of bonus shares* : The return is required to indicate the number and nominal amount of shares allotted, the names, addresses and occupations of the allottee and resolution authorising the issue of bonus shares.
- (4) *In the case of issue of shares at a discount* : The return must be accompanied :
- (i) by a copy of the company's resolution authorising such an issue,
  - (ii) by copy of the order of Court which sanctions the issue, and
  - (iii) where the maximum rate of discount exceeds 10 per cent by a copy of the Central Government's order permitting the issue at a higher percentage.

The 30 days period for filing the return is extendable by the Registrar. But the company has to seek this extension by an application either before or after the expiry of this period.

While explaining the meaning of the word 'allotment', we have stated why a re-issue of forfeited shares does not constitute an allotment. In consonance with that reasoning, Section 75(5) specifically states that the provisions of Section 75 do not apply to such case; thus the question of filing a return in respect of it does not arise.



## **2.20 UNDERWRITING**

The expression 'underwriting' presupposes a contract. What is that contract? Between whom? What is the consideration therefor? It is a contract entered into between the company and certain parties (called underwriters) before the shares or debentures are offered to the public for subscription. The contract is that in case the whole or an agreed portion of the shares or debentures are not applied for, then the underwriters will themselves apply for unsubscribed shares or debentures; alternatively, they will procure persons to apply for them. The company is least concerned with how the underwriters procure the purchasers. Thus, the underwriters expose themselves to a great risk in 'placing' the shares before the public. And in return for this exposure to the risk the underwriters get commission. The commission is payable on the amount of shares underwritten. It will be payable even if the underwriters are not ultimately called upon to take up any shares.

**Note:** Students may note that according to S.E.B.I, Main Guidelines Section D, Underwriting However, if the issue is not underwritten and the minimum subscription of 90% of offer to the public is not received, the entire amount as received as subscription would have to be refunded in full.

Under Section 76, the circumstances in which underwriting commission can be paid are as follows:

- (i) The payment of commission should be authorised by the articles.
- (ii) The names and addresses of the underwriters and the number of shares or debentures underwritten by each of them should be disclosed in the prospectus.
- (iii) The amount of commission should not exceed, in the case of shares, 5 per cent of the price at which the shares have been issued or the amount or rate authorised by the articles whichever is less; and in the case of debentures it should not exceed 2½ per cent.
- (iv) The rate should be disclosed in prospectus, or in the statement in lieu of prospectus (or in a statement in prescribed form signed in the like manner as the statement in lieu of prospectus) and should be filed with the Registrar along with a copy of the underwriting contract before the payment of the commission.
- (v) The number of shares or debentures which persons have agreed to subscribe absolutely or conditionally for commission, should be disclosed in the manner aforesaid; and
- (vi) A copy of the contract for the payment of the commission should be delivered to the Registrar along with the prospectus or the statement in lieu of prospectus for registration.

Section 76(4A) clarifies that commission to the underwriters is payable only in respect of those shares or debentures which are offered to the public for subscription. However,



where (i) a person, who for a commission has subscribed (or agreed to subscribe) for shares or debentures of a company and before the issue of the prospectus (or statement in lieu of prospectus) for such shares or debentures, some other person (or persons) has subscribed for any or all of them, and (ii) such a fact together with the aggregate amount of commission payable to the underwriter is disclosed in such prospectus (or statement in lieu of prospectus), *then the company may pay* commission to the underwriter in respect of his subscription irrespective of the fact that the shares or debentures have already been subscribed.

*Brokerage* : It is the sum paid to a person by the company for placing shares. Section 76(3) states that a company may pay brokerage which is lawful. It must be reasonable and must be paid only to a person carrying business of broker.

Brokerage must be distinguished from underwriting commission. A broker undertakes 'to place shares' i.e. finds person who will buy shares in consideration of an agreed brokerage and if he fails to place any share, he is not personally liable to take them nor he is entitled to any brokerage. The underwriter on the other hand, is bound to take over the shares which have not been taken.

**“Placing” shares:** The difference between subscribing for shares and “placing” shares has been well explained by Mellish L.J. in Gorrissen’s Case where he said “It appears to me that an agreement to “place” shares, even although the person making it binds himself that within a specified time or within a reasonable time, he will place a certain number of shares, is a materially different thing from an agreement to “take” shares. If a person agrees to “take” shares, then by agreeing to take shares, he does at that moment become a shareholder and the company are entitled and are indeed bound at that moment to put him on the register. But if he agrees to “place” shares, he does not agree to become a shareholder nor is the company entitled to put him on the Register as a shareholder but he simply agrees that he will procure other persons to take the shares. Paying “brokerage” to brokers for “placing” shares is therefore legitimate. “Placing” is generally done by Issue Houses who take up large blocks of shares which they thereafter transfer to clients and friends. There is no “invitation to the public” in this case, and, therefore, no need for a prospectus. “Placing” may however, in certain cases, amount to an “offer to the public” to subscribe for the shares. Thus “placing” may or may not require a prospectus according to the facts of each case.

An “underwriting agreement” is different. The word “underwriter” means to agree to take up by way of subscription in a company or issue, a certain number of shares, if and so far as not applied for by the public. *Australian Investment Trust v. S. Strand etc. Properties*. In substance, it is a contract of guarantee or indemnity, whereby the





underwriter guarantees that the whole of the shares in question will be subscribed by undertaking that to the extent to which they are not otherwise subscribed, he will apply for them himself. It is in effect equivalent to a contract of insurance and might be expressed as such.

## **2.21 PURCHASE OF OWN SHARES AND FINANCIAL ASSISTANCE FOR PURCHASE OF OWN SHARES**

*Purchase of or loans for purchasing its own shares by company prohibited* - A fundamental principle of Company Law was that a Company cannot buy its own shares. This is laid by Section 77, which provides that no company limited by shares, and so guarantee company having a share capital shall buy its own shares, except as provided by (i) section 77 (see exception below (ii) by Sections 100-104 (by way of reduction of capital), (iii) by Section 402 (by way of preventing oppression) and (iv) by Section 80 or by a corresponding provision of the early Act (by way of redemption of redeemable preference shares). Further, no public company and no private company (being subsidiary of a public company), can give financial aid to any person (either directly or indirectly) and whether by way of loan, guarantee or surety or otherwise, for, or in connection with, purchase or subscription made or to be made of any shares of its own or of its holding company. On contravention of the above, the company and every officer in default is liable to a fine (upto Rs. 10,000).

There are, however, certain exceptions to this rule, namely :

- (a) a banking company may lend money for the purpose in the ordinary course of its business but not on the security of its own shares; or
- (b) the company in pursuance of a scheme for the purchase of or subscription for fully paid shares of the company (or those of its holding company) to be held by trustees for the benefit of the employees of the company, may advance loan for the purpose;
- (c) the company may advance a loan to a person *bona fide* in its employment (other than directors, or managers) to enable them to purchase or subscribe for fully paid shares for an amount not exceeding their salary or wages for a period of six months [Section 77].
- (d) nothing in Section 77 shall affect the right of a company to redeem any of its redeemable preference shares issued under Section 80 or under any corresponding provision in any previous Companies Act.
- (e) The company may buy its own shares from any member by a Court order under Section 402. By implication, an unlimited company may buy its own shares.



## 2.22 WHETHER A COMPANY CAN 'BUY-BACK' ITS OWN SHARES ?

While the answer to this question before passing the Companies (Amendment) Act, 1999 was emphatically No, the position is now quite opposite. Section 77A of The Companies (Amendment) Act, 1999 provides for a company to purchase its own shares or other specified securities subject to certain conditions and regulations.

**(1) Sources of funds for buy-back of shares:** A company can purchase its own shares or other specified securities. The purchase should be out of:

- (i) its free reserves; or
- (ii) the securities premium account; or
- (iii) the proceeds of any shares or other specified securities.

However, buy-back of any kind of shares or other specified securities cannot be made out of the proceeds an earlier issue of the same kind of shares or same kind of other specified securities [Section 77A(l)].

*"Specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time.*

**(2) Conditions for buy-back :** The company shall not purchase its own shares or other specified securities unless:

- (a) the buy-back is authorised by its articles;
- (b) a special resolution (also Declaration of Solvency to be filed with ROC & SEBI in case shares are listed on any recognised stock exchange), authorising the buy-back is passed in general meeting of the company;
- (c) the buy-back is or less than 25% of the total paid-up capital and free reserves of the company;

Provided that the buy-back of equity shares in any financial year shall not exceed 25% of its total paid up equity capital in that financial year.

- (d) the ratio of the debt owed by the company is not more than twice the capital and free reserves after such buy-back;

Provided that the Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies. The expression 'debt' includes all amounts of unsecured and secured debts,

The expression "free reserves" shall have the same meaning assigned to it in Clause (b), Explanation to Section 372A, which means those reserves which, as per latest audited balance-sheet of the company are free for distribution as dividend and shall include



balance to the credit of the securities premium account but shall not include share application money.

- (e) all the shares or other specified securities for buy-back are fully paid-up;
- (f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by SEBI in this behalf;
- (g) the buy-back in respect of shares or other specified securities other than those specified in Clause (f) is in accordance with guidelines as may be prescribed. [Sections 77A(2) and 77A(6)].

**(3) Procedure before buy-back :** The notice of the meeting at which special resolution is proposed to be passed shall be accompanied by an explanatory statement stating -

- (a) a full and complete disclosure of the all material facts;
- (b) the necessity for the buy-back;
- (c) the class of security intended to be purchased under the buy back;
- (d) the amount to be invested under the buy-back; and
- (e) the time limit for completion of buy-back.

**(4) Time limit for completion of buy-back :** Every buy-back shall be completed within twelve months from the date of passing the special resolution or a resolution passed by the Board under clause (b) of Sub-section (2).

**(5) Buy-Back from Whom ? :** The buy-back under Sub-section (1) may be -

- (a) from the existing security holders on a proportionate basis; or
- (b) from the open market; or
- (c) from odd lots, that is to say, where the lot of securities of a public company, whose shares are listed on a recognised stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange; or
- (d) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

**(6) Declaration of Solvency :** Where a company has passed a special resolution under clause (b) of Sub-section (2) or the Board has passed a resolution under the first proviso to clause (b) of Sub Section (2) to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will



not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any;

**Provided** that no declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.[Sub-section 6]

**(7) Extinguishment of Securities** : Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.

**(8) Cooling Period**: Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of further shares under clause (a) of Sub-section (1) of Section 81 or other specified securities within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option schemes, sweat equity or conversion of preference shares or debentures into equity shares.

**(9) Register of Buy Back** : Where a company buys-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of existing and physically destroying of securities and such other particulars as may be prescribed.

**(10) Filing of Buy-back Return** : A company shall, after completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such completion, as may be prescribed :

**Provided** that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

**(11) Penalty for Default** : If a company makes default in complying with the provisions of this section or any rules made thereunder or any regulations made under clause (f) of Sub-section (2), the company or any officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to fifty thousand rupees, or with both.

**Transfer of certain sums to Capital Redemption Reserve account - Section 77AA**: Where a company purchases its own shares out of free reserves, then a sum equal to the nominal value of the share so purchased shall be transferred to the capital redemption reserve account referred to in clause (d) of the proviso to Sub-section (1) of Section 80 and details of such transfer shall be disclosed in the balance sheet.



**Prohibition of buy-back in certain circumstances - Section 77B:** (1) No company shall directly or indirectly purchase its own shares or other specified securities-

- (a) through any subsidiary company including its own subsidiary companies; or
  - (b) through any investment company or group of investment companies; or
  - (c) if a default, by the company, in repayable of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank, is subsisting.
- (2) No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 159, 207 and 211.

### **2.23 MEMBERSHIP**

Section 41 of the Act enables you to become a member of a company by subscribing to the memorandum. The subscriber to the memorandum is deemed to have agreed to become a member of the company, and on its registration, is entered as member in its register of members. The subscriber to the memorandum becomes a member, on registration of the company, even without the shares having been allotted to him and is liable as a contributory when the company is wound up [*Universal Transport Co. vs. Jagjit Singh* (1956) Comp. Case. 36 *Babulal vs. Naraina Sugar Mill* (1958) Comp. Case. 155].

Membership can also be had by any other person who agrees in writing to become a member of the company and whose name is entered in its register of members, since in such a case, he is deemed to be a member. Since his agreement needs to be in writing, one cannot be deemed to be a member on ground of estoppel, simply because his name appears in the register of members. Where, however, a person's name is there in the register and he has, in fact, accepted the position and acted as a member, the agreement will be presumed to be in writing until the presumption is rebutted by proof to the contrary.

Apart from subscribers to memorandum [Section 41(1)] and every other person who agrees in writing to become a member of a company [Section 41(2)], a newly added Sub-section (3) provides that "every person holding equity share capital of company and whose name is entered as beneficial owners in the records of the depository shall also be deemed to be a member of the concerned company".

A person can also become a member through transfer of shares under Section 108 or by transmission [*We shall discuss transfer and transmission in Chapter 3*].

**(a) Can a minor become a member ?** : Now a question may arise in your mind, whether a minor or a company can become a member. It is true that the Act prescribes no qualification



for membership. Membership entails an agreement and this agreement can be enforced in the Court. Therefore, the contractual capacity as envisaged by the Indian Contract Act should be taken into consideration. It has been held in *Mohri Bibi vs. Dharmadas Ghose* (1930) 30 Cal 531 (P.C.) that since a minor has no contractual capacity, the agreement with a minor is void. Therefore, a minor or a lunatic cannot enter into an agreement to become a member.

For example, a father applied for shares in a company as guardian of his minor daughter. The company issued shares and registered them in the name of the minor describing her as minor. The transaction was void and the father who signed the application on the minor's behalf could not be treated as having contracted for the shares; as such he could not be placed on the list of contributories when the company was wound up [*Palaniappa vs. Official Liquidator* AIR 1942 Mad. 470]. But what will happen if the directors allot share to a minor in response to his application, without knowing that he was a minor and enter his name in the register of members? As soon as the company comes to know of this fact, it can eschew the allotment and strike the name of the minor off the register of members. But the company must refund the entire money to the minor, which it obtained in relation to the shares allotted. Can the minor be likewise compelled to restore to the company the benefits (if any) received by him from the allotment of shares? It is a matter for the Court to decide, regard being had to the facts and circumstances of each case.

But as regards the rescission of the contract, in point of time, the minor and the company are on a little different footing. Even after attaining majority, the minor can deny his liability on the shares on the ground of minority. But the company cannot successfully impeach the action of the minor's repudiation by setting up the plea that he received the dividend during his minority or that he had made a fraudulent representation of his age in the application [*Sadiq Ali vs. Jay Kishore*, 30 Bomb. L.R. 1346 (1); *P.C. Balangowada vs. Godigeppa* 3 Bomb. L.R. 350]. If, in this illustration, the minor received dividends after he had attained majority, could he be legally allowed to shirk his liability on the shares? The answer is 'no'. This is because he would be deemed to have intentionally led the company to believe him to be a shareholder and on the faith of such belief to pay him the dividends. Therefore, he would be estopped by this conduct, while being a person sui juris, from denying as between himself and the company that he is a shareholder [*Fazalbhoj vs. The Credit Bank of India Ltd.* 39 Bomb. 331].

However, notice that in some later decisions, a minor has been permitted to be a shareholder. The Company Law Board has laid down in *Nandita Jain v. Bennet Coleman & Co. Ltd.* that a minor can become a member provided four conditions are fulfilled:

- (a) Company must be a Co. Ltd. by shares.
- (b) Shares are fully paid up.
- (c) Application for transfer is made on behalf of minor by lawful guardian.
- (d) The transfer is manifestly for the benefit of the minor.



This was also confirmed in *S.L. Bagree v. Britannia Industries*.

In also *Diwan Singh v. Minerva Films Ltd.* [(3958) 28 Comp. Cases 191 (Punj.), (1959) 29 Comp. Cases 263 (Punj.)], the Punjab High Court held that there is no legal bar to minor becoming a member of a company by acquiring shares (by way of transfer) provided the shares are fully paid and no further obligation or liability is attached to them.

Minor can become member by transfer or transmission, but a company may not allow a minor to be a member by allotment.

**(b) Can a company become a member?** : A company can be a member of another company if it is so authorised by its memorandum. But under Section 42(1), a company except in certain specified cases, cannot become a member of its holding company. Any allotment or transfer of shares in a company to its subsidiary or a nominee for its subsidiary will be void. But in two cases, Section 42(1) will not apply, viz., where, the subsidiary is concerned as the legal representative of a deceased member of the holding company, or where the subsidiary is concerned as trustee unless the holding company or a subsidiary thereof is beneficially interested under the trust and is not so interested only by way of security for the purposes of a transaction entered into by it in the ordinary course of a business including money lending [Section 42(2)]. A subsidiary which was a member of its holding company at the commencement of the Act or before becoming a subsidiary of the holding company, may continue to be a member. But it shall not, except in two cases mentioned in Section 42(2) have any voting right at the holding company's meeting.

Sub-section (4) of Section 42 extends the restriction contained in Sub-section (1) to the cases where a body corporate which is a subsidiary is not holding any shares in the holding company in its own name but through its nominee.

In other words, where shares in the holding company are held by a nominee of the subsidiary company for it, the prohibition contained in Sub-section (1) shall apply as if the shares were held by the subsidiary company.

Moreover, the prohibition contained in Sub-section (1) is applicable in the case of a subsidiary having any membership interest in the holding company which is either a company limited by guarantee or an unlimited company, whether it has a share capital or not.

**(c) Termination of membership** : Membership is terminated when a person's name is removed from the register of members for some proper reason. This may occur when: (a) he transfers all of his shares; (b) his shares are forfeited, surrendered or sold to enforce a lien; (c) he holds redeemable preference shares and they are redeemed; (d) he dies and his legal representative transfers the shares or secures their registration in his own name; (e) his contract to take the shares is rescinded or repudiated; (f) he becomes insolvent and the Official Assignee or Receiver disclaims the shares or transfers them; and (g) the shares are held by a company in the course of liquidation, and the liquidator disclaims the shares or



transfers them.

The Register of members, however, is only, *prima facie* evidence as to whether a person is a member or not and if a person's name is improperly removed, all his rights and obligations as a member continue to remain the same.

On a member's death, his name remains on the register and his estate continues to be member until his legal representative takes either of the steps mentioned in clause (d) above i.e., he transfer the shares or secures their registration in his own name. He can receive dividends, notice of meeting but cannot vote; but the Board can compel him to make an election under clause (d) above. [See Regulation 28, Proviso, Table A of Schedule I].

**(d) Members and shareholders** : At this stage of your study, you know the different ways in which you can become a member of a company. Here, we would draw your attention to the fact that in the parlance of Company Law, the two words "member" and "shareholder", are loosely used by common people, thereby giving an impression that they are *absolutely* synonymous. Such an impression needs to be qualified. You will perhaps recollect that in a member and a shareholder can be differentiated on the following grounds:

1. A registered member may not be a shareholder, since a company limited by guarantee and not having a share capital, does have members, but not shareholders. But a registered shareholder is a member, since his name appears in the Register of members maintained by the company.
2. A person who owns a share warrant (shares) is not a member since his name does not appear in the Register of members maintained by the company. He is a share- holder only [Section 115 (1)].
3. A legal representative of a deceased member is a shareholder, but not a member, till he applies for registration and his name is entered in the Registrar of members.

**(e) Rights of a member** : These are as follows :

- (i) To have the certificate of shares held or the certificate of stock issued to him within the prescribed time [Section 113].
- (ii) To have his name borne on the register of members.
- (iii) To transfer shares subject to any restrictions imposed by the articles [Section 82].
- (iv) To attend meetings of shareholders, receive proper notice and to vote at the meetings.
- (v) To associate in the declaration of dividends and to apply to the Court for an injunction restraining the directors from paying dividends on an *ultra vires* declaration or out of capital.





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- (vi) To inspect the registers, indexes, returns and copies of certificates, etc. kept by the company and to obtain extracts or copy thereof [Section 16].
- (vii) To obtain copies of Memorandum and Articles on request on payment of the prescribed fees [Section 39].
- (viii) To have the first option in case of issue of shares or a further issue of shares (*i.e.*, the right of pre-emption) by the company [Section 81].
- (ix) To receive a copy of the statutory report [Sections 165(1) & (2)].
- (x) To apply to the Court to have any variation or abrogation to his rights set aside by the Court [Section 107].
- (xi) To have notice of any resolution requiring special notice [Section 190(2)].
- (xii) To obtain on request minutes of proceedings at general meeting [Section 196(2)].
- (xiii) To remove directors by joining with others [Section 284].
- (xiv) To obtain a copy of the profit and loss account and the balance sheet with the auditor's report [Sections 210 and 219].
- (xv) To apply for the appointment of one or more competent inspectors by the Government to investigate into the affairs of the company as well as for reporting thereon [Sections 235 and 237].
- (xvi) To participate in the appointment of an auditor or auditors at the Annual General Meeting [Section 224].
- (xvii) To inspect the auditor's report at the Annual General Meeting of the company [Section 230].
- (xviii) To receive a share in the capital of the company and in the surplus assets, if any, on the company's liquidation.
- (xix) To participate in passing of the special resolution that the company may be wound up by the Court or voluntarily [Sections 433 and 484(1)(b)].
- (xx) To participate in appointment and in fixation of remuneration of one or more liquidators in the case of a Member's Voluntary Winding up and to fill any vacancy in the office of a liquidators so appointed by him [Sections 490 and 492].

### **(f) Liabilities and duties of a member**

- (i) To take shares, when they are allotted in due time and in compliance with the provisions of the Act, unless the refusal to accept the shares has been sent on the ground of non-



compliance with the provisions of the Act as regards the issue of the prospectus or as regards allotment.

- (ii) To pay for the shares allotted to him when the allotment is made and when calls have been made validly and in conformity with the provisions of the articles.
- (iii) To abide by the doing of the majority of members unless the majority acts vindictively, oppressively, *mala fide* or fraudulently.
- (iv) to contribute to the assets of the company in the case of winding up when the shares held are partly paid-up.
- (v) Members are severally liable for debts of the company contracted, where its business is carried on beyond the expiry of six months from the date at which its membership is redeemed below the legal minimum (i.e., seven members in the case of public company and two members in the case of a private company). However, such members are not liable for debts contracted before the expiry of six months. No liability will accrue to those members who are not cognisant of the fact that the business of the company is being carried on with members fewer than the legal minimum [Section 45].

Example: X purchased 100 equity shares of ABC Ltd. from Y. Though the amount of transaction was paid to the seller, the transferee name is not appearing in the list of members. Subsequently, the company declared dividend. Referring to the provisions of the Companies Act, 1956 state to whom the company will be paying the dividend.

According to section 206 of the Companies Act, 1956 dividend shall be paid only to the registered holder of shares or to his order or to his bankers or to the bearer of a share warrant. Where shares have been sold but not yet registered, the dividend shall be paid to the transferee only in case the transferor gives a mandate in writing to that effect. Otherwise, the dividend in respect of such shares shall be transferred to the 'unpaid dividend account'.

## 2.24 CONTRACTS

With the extent of knowledge of the company law so far acquired, you will now be able to follow the procedures regarding contracts and deeds, investments, seal etc., which we shall presently deal with.

"A contract to take shares in company is governed by the same rule as any other contract".

There being no difference between a contract to take shares and any other contract, it is not necessary that an agreement to take shares should be formal. If in substance, an agreement is made, the form is immaterial (Risto's case 4 Ch. D. 782). The only requirement under



Section 41(2) of the Act for a person to become a member of the company is to agree in writing.

The same rules, which govern the contract under the law of contracts also apply to a contract to take shares. The intending candidate sends in response to a prospectus, his application to the company for such number of shares as he wants to have or as the company may allot to him. It is treated as an offer from the applicant, which needs to be accepted by the company before a binding contract can come into being. The fact of acceptance is then communicated to the applicant through a notice of allotment [*Polatt's case (1867) L.R. 2 Ch. Appl. 527*]. The application for shares or debentures, made in pursuance of a prospectus issued generally, cannot be revoked until after the expiry of the 6th day after the opening of the subscription list, or the giving, before the expiry of the said 5th day by some person responsible under Section 62 for the prospectus, of a public notice having the effect of excluding, limiting or diminishing the responsibility of that person. The applicant, however, can revoke his application, before the notice of allotment is put in the course of transmission to him, e.g., by post [*Maclangan's case (1882) 51 L.J. Ch. 841; Wallace's case, (1920) 2 Ch. 671*]. Where handing over of the notice of allotment to a postman, however, does not constitute its posting (*Re. London & Northern Bank Exp. Jons (1900) 1 Ch. 210*). On proper posting of the notice the contract is complete even if it goes astray [*Harri's case, (1872) L.R. 7 Ch. App. 587*]. Again the acceptance must be communicated to the applicant in some way, whether by writing or verbally or conduct [*Gunn's case, (1867) by L.R. Ch. App. 40*]. Even a notice of allotment brought home to the applicant, not from the company but from elsewhere will be binding on him [*Wall's case (1863) L.R. 3 Ch. App. 325*].

Where shares have been applied for prior to the company's incorporation, allotment and notice after incorporation in response to such application constitute a complete contract. This is because the application operates as a continuing offer and when the company accepts it after incorporation, it matures into a binding contract [*Lawarence's case, (1866) 2 Ch. App. 413; Downnes vs. Ship (1868) L.R. 3 H.L. 344*].

The aforesaid application may be either simple or conditional. In the former case, a simple allotment to the applicant with the notice thereof will constitute the agreement.

If it is conditional, the allotment must be made in pursuance of the specified conditions [In *Re. Universal Banking Co.; Roger's case; Harison's case (1858) 3 Ch. App. 633*]. Where it has been made subject to a condition precedent, the applicant becomes a member only when the condition is complied with. But where the application has been made subject to a collateral condition or a condition subsequent, the applicant becomes a member in present, when he accepts the notice of allotment and his name has been placed on the register of members. Consequently, even if the company goes into liquidation, he cannot escape the liability as contributory, though the condition has not been complied with by the company before that time. He may be entitled to damages against the company for its failure in carrying out the



condition [*Elkington's case (1867) 1 Ch. App. 511; Fisher's case (1885) 31 Ch. D. 120*]. But since the liability of a contributory arises *ex lege* and not *ex contractu*, he cannot set up the non-fulfilment of the condition as a defence against his statutory liability as a contributory, which is the direct result of his being a member of the company [*Hansraj vs. Astana 35 Bom. L.R. 012 (P.G.)*].

Even where an applicant waives notice of allotment or where there is no necessity for such notice, the contract for shares is nevertheless complete and the allottee becomes entitled to the membership of the company.

Besides, according to Section 41, the applicant, by agreeing to take shares, merely agrees to become a member but does not actually become a member; he becomes a member only when his name is entered on the register of members [*Nicol's case 32 Ch. D. 421; and Mussel White & Sons Ltd. (1962) 1 All E.K. 20*].

Further, to decree specific performance of a contract by a person to take or a company to allot shares is well within jurisdiction of the Court [*Burnswich etc. Land Co. vs. Muggeridge (1860) Dr. & sm. 363; Odessa Tramways Co. vs. Monde (1878) 7 Ch. D. 235*].

In view of the foregoing discussion it may thus be concluded that the statement that a "contract to take shares in a company is governed by the same rules as any other contract" is fully correct.

**(a) Forms of contract** : You will notice from Section 46 that a company can enter into contracts just like an individual person. Suppose, a contract between private persons requires, for its validity, to be in writing signed by the parties to be charged. A similar contract may be made exactly in the same manner by any person acting under the authority of the company. Such an authority may be express or implied. Such a contract may be varied or discharged by the authorised representative of the company in the same manner as the one by private persons.

Likewise, where a private person can verbally make a legally valid contract, a company can also do so. The same rule will apply in respect of any variance or discharge of such type of contracts.

It is thus evident that a company can enter into oral contract when writing is not legally necessary as well as a written contract where writing is a 'must'. As a general rule, it is permissible for a company to transact a contract without seal. As long as the contract is made by an expressly or impliedly authorised person on behalf of the company and is signed by him, it would be enough.

**(b) Bill of Exchange and Promissory Note and Hundi** : The next important question is whether a company can make, accept, endorse, or issue a bill of exchange, promissory note, hundi and such other negotiable instruments. The answer to this query will depend on the



conditions laid down in the memorandum. Under Section 47, a bill of exchange, hundi or promissory note shall be deemed to have been made, accepted, drawn or endorsed on behalf of the company if drawn, accepted, made or endorsed in the name of, or on account of, or on behalf of, the company by any person acting under its authority, express or implied. It is, however, important to note that unless the person is signing the note on behalf of the company only, and not on his own account, he runs the risk of being held personally liable on the instrument signed by him.

**(c) Execution of deeds:** According to Section 48, there must be either a general power of attorney or special power of attorney given to a person by a company to execute deeds on its behalf anywhere in or out of India. This power of attorney, the company must give under its common seal. Thereafter, if the attorney, signs the deed under his seal where sealing is required, it will bind the company. Thus, you would have noticed that company's common seal is necessary for giving the power of attorney but not for actual execution of deed on its behalf by such attorney. But it should be remembered that its power of attorney and the scope of its operation are strictly construed; any person dealing on the basis of such power is put on enquiry though not as to the existence of the special circumstances.

## **2.25 INVESTMENT BY COMPANY [SECTION 49]**

All investments made by a company on its own behalf are required to be made and held by it in its own name. But this rule is subject to the exceptions discussed hereunder. Where the company has a right to appoint any person(s), or where a nominee(s) has/have been appointed as director(s) of any other body corporate, shares in such body corporate to an amount not exceeding the nominal value of the qualification shares which are required to be held by a director thereof, may be registered or held by such company jointly in the names of itself and of each such person or nominee or in the name of each such person or nominee. A company may hold any shares in its subsidiary in the name or names of nominee or nominees of the company, if and insofar as it is necessary to do to ensure so that the number of members of the subsidiary does not fall below 2 to 7 (as the case may be). Where a company's principal business is one of buying and selling shares or securities, this restriction of Section 49 does not apply; that is to say, an investment company need not hold shares in its own name.

Section 49 does not stop a company from depositing with a bank, which is its banker, any shares or securities for collecting dividends or interest payable thereon. The company may deposit with, or hold in the name of the State Bank or a Scheduled Bank (which is the banker of the company) shares or securities for facilitating the transfer thereof. If within 6 months from such an action of the company no transfer of such shares or securities takes place then at the earliest opportunity after the expiry of 6 months the company must get these shares or securities transferred to it from the bank and again start holding them in its own name.



Moreover, a company is not prevented from depositing with or transferring to any person any shares or securities by way of security for repayment of any loan advanced to the company or the performance of any obligation undertaken by it.

With the introduction of the Depository System and consequent Amendments in the Companies Act, 1956, Sub-section 5 clause C do not prevent a company from holding investments in the name of a depository when such investments are in the form of securities held by the company as a beneficial owner.

The certificate or letter of allotment relating to shares or securities must be in the custody of the company or with the State Bank or a scheduled bank which is the banker of the company. The provision is, however, subject to the provisions discussed above in relation to investment companies, and securities deposited for collection of dividend, interest or as security.

If the company does not hold these shares or securities in its own name, it must maintain a register in which it must record the nature, value and such other particulars as may be necessary to fully identify the shares or securities in question. It must also mention the bank or person in whose name or custody the shares or securities are held. The register must be kept open for inspection by a member or a debenture holder. At least two hours must be set apart every day for such inspection.

If default is made in complying with any provision of Section 49 then the company and every office in default will be punishable with a fine which may extend up to Rs. 50,000.

## **2.26 SERVICE OF DOCUMENTS**

Under Section 51, a document may be served *on a company* or on its officer at the registered office of the company. It must be sent either by post or by leaving it at its registered office. If it is sent by post, it must be either by post under a certificate of posting or by registered post. When a notice has been addressed to the company and served on the directors, it constitutes a good service [Panabo vs. Fay and Printed Ltd. (1941) Ch. 25]. The articles of a company, which contain the provisions contrary to Section 51 cannot be enforced nor can they limit the mode of service to only one of the modes provided by the Statute [Sadasiv vs. Gandhi Seva Samaj (1958) Bombay 247].

When the securities are held within a depository, the records of beneficial ownership may be served by such depository on the company by means of electronic mode or by delivery of floppies or discs. [Amendment in Section 51 through Depositories Related Laws (Amendment) Act, 1997].

A document may be served *on the Registrar* by sending it to him at his office by post under a certificate of posting or by registered post, or by delivering it to, or leaving it for, his office [Section 52].



Under Section 53, a company may serve a document on its member either personally or by sending it by post to him to his registered address; or if he has no registered address in India to the address (if any) within India supplied by him to the company for giving notices to him.

**Authentication of documents** : There may be a case, where a company has to authenticate a document or any proceeding. In terms of Section 54 it may be authenticated by being signed by a director, the manager or secretary or other authorised officer of the company. But it need not be under the common seal of the company.

## **2.27 SELF-EXAMINATION QUESTIONS**

### **State YES or NO**

1. Can a company vary the terms of a contract in the prospectus?
2. What are the rights of the applicant for shares or debentures (i) against company (ii) against the directors and others?
3. Is there any limitation period for bringing an action against directors on ground of misstatement contained in the prospectus?
4. One person bought shares from an allottee who became the shareholder in pursuance of the prospectus and another person bought shares from the share market. Later on, both of them came to know that the prospectus contained culpable misstatement. Would they have any remedy either against the company or against the directors?
5. Mr. Alfa applies for 200 shares in a public limited company in a fictitious name. Does he incur any penalty?
6. (i) State whether the following type of conditions contained in a prospectus are valid :
  - (a) A condition requiring an applicant to waive compliance with any of the statutory requirements regarding prospectus.
  - (b) A condition affecting an applicant with notice of any contract, document or matter not specifically referred to in the prospectus.(ii) Explain the consequences of an untrue statement in a prospectus.
7. A company has forfeited some shares and re-issued them. Will it be an allotment of shares as conceived by the Companies Act ?
8. What will be the effect of allotment in the following circumstances ?



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- (a) Where, according to the prospectus, permission for dealing in the shares on a recognised stock exchange is to be sought but has not been sought within the statutory period and the allotment has been made.
- (b) Where the application for the aforesaid permission has been duly made but the permission has not been granted within the statutory period and the allotment has been made.
9. What are the statutory periods for the application of permission and for the actual grant of the permission as aforesaid ?
10. What do you understand by the phrase, "time of opening of the subscription list" ?
11. What is the necessity of making the subscription list open only after the specified statutory period ?
12. How can a person become a member of a company?
13. Can a minor or a lunatic enter into an agreement to become a member of the company?
14. The directors have allotted shares to a minor without the knowledge of his minority and entered his name in the register of members; (a) Can both the company and the minor rescind the contract? (b) Can the company be compelled to return the entire money to minor? (c) The minor be likewise compelled to restore to the company the benefits, if any, received by him from the allotment?
15. A minor, on attaining majority, repudiates the contract. The company contends that he cannot rescind the contract, because he received dividends during his minority and dividends apart he fraudulently represented his age in the application for shares. Who will succeed?
16. Does the company confirm to the same forms of contracts as a private individual?

### Choose the correct alternative

17. A process undertaken prior to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited and the price and the terms of issue for such securities is assessed, by means of a notice, circular, advertisement or document, is called as
- (a) Memorandum of information.
- (b) Information Memorandum.
- (c) A red-herring prospectus.





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- (d) None of the above.
18. A prospectus issued by the any financial institution or bank for one or more issues of the securities or class of securities specified in that prospectus is called
- (a) Deemed prospectus.
  - (b) Shelf prospectus.
  - (c) Red prospectus.
  - (d) None of the above.
19. The alteration of objects clause of a memorandum of association can be made on which of the following grounds
- (a) To carry on is business more economically and more efficiently.
  - (b) To attain its main purpose by or improved means.
  - (c) To enlarge or change the local areas of its operation.
  - (d) Any of the above.
20. The model form of articles contained in Table A deals with regulations for management of a company limited
- (a) By shares
  - (b) By guarantee
  - (c) By shares and by guarantee
  - (d) Section 25 company
21. Shelf prospectus means a prospectus issued by any
- (a) Public financial institution
  - (b) Public sector bank
  - (c) Scheduled bank
  - (d) All the above.
22. A small depositor means a depositor who has deposited
- (a) A sum not exceeding Rs. 20,000/- in a company in a financial year
  - (b) A sum not exceeding Rs. 40,000/- in a company in a financial year



- (c) A sum not exceeding Rs. 50,000/- in a company in a financial year
  - (d) A sum not exceeding Rs. 100,000/- in a company in a financial year
23. Sources of funds for buy back are
- (a) Free reserves or securities premium account
  - (b) The profits of any shares or other specified securities
  - (c) A&B
  - (d) None of the above.
24. If a company does not receive the minimum subscription, it should refund all moneys received from applicants for shares
- (a) Immediately
  - (b) Within 60 days of issue of prospectus
  - (c) Within 90 days of issue of prospectus
  - (d) Within 120 days of issue of prospectus
25. Allotment of shares is made by
- (a) Registrars to the issue
  - (b) Share transfer agents
  - (c) Board of Directors
  - (d) Fund managers.
26. The underwriting commission must not exceed
- (a) 2 percent
  - (b) 2 ½ Percent
  - (c) 5 percent
  - (d) 10 percent.

**Essay / Practical Questions**

27. A public company proposes to purchase its own shares. State the source of funds that can be utilised by the company for purchasing its own shares and the requirements to be



complied with by the company under the Companies Act before and after the shares are so purchased.

28. In what way does the Companies Act, 1956 regulate and restrict the/allowing in respect of a company going/or public issue of shares :
  - (i) Minimum Subscription: and
  - (ii) Application Money payable on shares being issued ? Explain.
29. Explain clearly the meaning of the term 'Underwriting' and 'Underwriting' Commission'. In what way, does the Companies Act, 1956 regulate payment of such Commission ? Explain.
30. State the remedies available against a company to a subscriber for allotment of shares on the faith of a misleading prospectus. What conditions must be satisfied by such a subscriber before opting for the remedies?
31. M Company Limited issued 2,00,000 equity shares of Rs 10 each. You are allotted 100 shares. Explain any ten rights you have as a member of the company.
32. Can a Public Limited Company reduce its Share Capital? If so, when and how? Also state the procedure it has to follow for doing so.
33. What conditions as required under the Companies Act, 1956 must be satisfied by a company for the forfeiture of shares of a member, who has defaulted the payment of calls? What are the consequences of such forfeiture? (November, 2001)
34. When is an Allotment of Shares treated as an irregular allotment? State the effects of an irregular allotment.
35. Whether a company can issue shares at premium? State the purposes for which the Share Premium account can be used under the provisions of the Companies Act, 1956.
36. Who is an 'Expert'? When an expert is not liable for the mis-statement in the prospectus of a public company?
37. ABC Company Limited at a general meeting of members of the company pass an ordinary resolution to buy-back 30% of its Equity Share Capital. The articles of the Company empower the company for buy-back of shares. The company further decide that the payment for buy-back be made out of the proceed of the company's' earlier issue of equity shares. Explaining the provisions of the Companies Act, 1956, and stating the sources through which the buy-back of companies own shares be executed. Examine.
  - (i) Whether company's proposal is in order?



- (ii) Would your answer be still the same in case the company instead of 30% decide to buy-back only 20% of its Equity Share Capital?
38. Explain the concept of "Shelf Prospectus" in the light of Companies (Amendment) Act, 2000.
- What is the law relating to issuing and filing of such prospectus?
39. The Board of Directors of a company decide to pay 5% of issue price as underwriting commission to the underwriters. On the other hand the Articles of Association of the company permit only 3% commission. The Board of Directors further decide to pay the commission out of the proceeds of the share capital. Are the decisions taken by the Board of Directors valid under the Companies Act, 1956?
40. Can a company issue shares at discount? What is the law, in this relation, laid down in the *Companies Act, 1956*?

### **2.28 Answers**

1. Yes, only with Central Government approval;
2. (i) To repudiate the contract;
2. (ii) To sue for damages;
3. Yes, 3 years from the date of allotment;
4. No;
5. Yes. Imprisonment upto five years under Section 68A;
6. Void under Section 56(2);
7. No;
8. (a) Void; 8. (b) Void;
9. 10 days respectively;



## **Business Laws, Ethics and Communication**

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10. 5 days period after the publication of the prospectus for keeping the subscription list open;
11. To enable the public to digest the contents of the prospectus and to obtain independent advice before deciding to invest their money;
12. By subscribing to the memorandum by allotment and by transfer or transmission;
13. No;
14. (a) Yes; 14. (b) Yes;
14. (c) A matter for the court to decide;
15. Minor; 16. Yes;
17. (b); 18. (b); 19. (d); 20. (a); 21. (d);
22. (a); 23. (c); 24. (d); 25. (c); 26. (c);



## UNIT – 3

### Learning Objectives

The share capital is the lifeblood for running the affairs of the company. Sometimes after the issue of capital a company may either alter or reduce the share capital depending upon the exigencies of the situation. Desired share capital, a company may also raise a debenture which have to be registered as a charge. There are certain guidelines, which have to be observed under the Companies Act as well as under the SEBI (DIP) Guidelines 2000. The SBEI (DIP) Guidelines have been given as a part for understanding the whole gamut of the matter. In this unit the following headings are covered:

- ◆ Share capital and shares
- ◆ Rise of shareholders and its variation
- ◆ Alteration and reduction of share capital
- ◆ Issue of shares at a premium and at a discount
- ◆ Transfer and transmission of shares
- ◆ Issue of debentures and related SEBI (DIP) Guidelines.

### 3.1 CONCEPT OF CAPITAL

The term Capital has a variety of meanings. It means one thing to economists; another to accountants and still another to businessmen and lawyers. In relation to a company limited by shares, the word capital means share-capital, *i.e.*, the capital or figure in terms of so many rupees divided into shares of fixed amount. In other words, the contributions of persons to the common stock of the company form the capital of the company. The proportion of the capital to which each member is entitled, is his share. A share is not a sum of money; it is rather an interest measured by a sum of money and made up of various rights contained in the contract.

In the domain of Company Law, the term 'capital' is used in the following senses:

**(a) Nominal or authorised or registered capital:** It is the sum stated in the memorandum as the capital of the company with which it is to be registered being the maximum amount which it is authorised to raise by issuing shares, and upon which it pays the stamp duty. It is usually fixed at the amount, which, it is estimated, the company will need, including the working capital and reserve capital, if any.

**(b) Issued capital:** It is that part of authorised capital which is offered by the company for subscription and includes the shares allotted for consideration other than cash.



Part I of Schedule VI has made it obligatory for a company to disclose its issued capital in the balance sheet.

**(c) *Subscribed capital:*** It is the nominal amount of shares taken up by the public. Where any notice, advertisement or other official communication or any business letter, bill head or letter paper of a company states the authorised capital, the subscribed and paid-up capital must also be stated in equally conspicuous characters. A default in this regard is punishable with fine extending up to Rs. 10,000 [Section 148].

**(d) *Called-up capital:*** It is the total amount called up on the shares issued. Paid-up capital is the total amount paid or credited as paid up on shares issued. It is equal to called up capital less calls in arrears.

**(e) *Reserve capital:*** This is that part of the uncalled capital of the company which can be called up only in the event of its winding up. A limited company may, by a special resolution, determine that a portion of its uncalled capital shall be called up.

- (i) in the event of winding up,
- (ii) for the purposes of winding up [Section 99].

Reserve capital cannot be turned into uncalled capital without the leave of the Court. It is available only for the creditors on the winding up of the company. The company can neither charge reserve capital nor cancel it in a reduction of capital [*Midland Rly Carriage Co. Re* (1904) W.N. 175].

But the expression “capital reserve” does not include any amount regarded as free for distribution through the profit and loss account. Any reserve other than a capital reserve shall be “revenue reserve” [*Vide* Part III, Schedule VI, 7(1)(c)].

Capital reserves comprise profits that arise in special circumstances and are connected with special circumstances. A few examples of these are given below :

- (i) Profit prior to incorporation;
- (ii) Profit on acquisition of business, that is, where the value of assets acquired is more than the liabilities taken over and the purchase consideration;
- (iii) Profit on sale of fixed assets, the excess of sale proceeds over the original cost;
- (iv) Premium on issue of debentures;
- (v) Profit on redemption of debentures;
- (vi) The credit to the capital Redemption Reserve Account (for redemption of redeemable preference shares);
- (vii) Premium on issue of shares; and



(viii) Profit on re-issue of forfeited shares.

Some of the capital profits may ultimately become available for dividend on the fulfilment of certain conditions. These conditions are that profits have been realised in cash and that they remain on a fair revaluation of assets and that the articles do not forbid the utilisation of such a profit for distribution of dividends [*Foster vs. New Trinidad Lake Asphalt Co.*, and *Lubbock vs. British Bank of South America*]. It is possible, therefore, that a profit may be a capital profit later to become a revenue profit.

**(f) Equity share capital:** Please see under the heading 'kinds of share capital'.

**(g) Preference share capital:** Please see under the heading 'kinds of share capital'.

**(h) Loan or debenture capital:** It is the money that a company borrows on the security of its debentures. It is not capital in the true sense it being a debt due from the company in respect of which the company might or might not have created a charge on its assets. The debentureholders or persons who have advanced loans are creditors and are not members of the company. The loans so raised are described as a capital only on the consideration that these, not being repayable for some length of time, can be regarded as of a permanent character which is one of the attributes of capital.

### 3.2 SHARES

**(a) Nature of shares:** A share means a share in the share capital of a company and includes stock except where a distinction between stock and shares is expressed or implied [Section 2(46)]. A share thus represents such proportion of the interest of the shareholders as the amount paid up thereon bears to the total capital payable to the company. It is a measure of the interest in the company's assets to which a person holding a share is entitled.

Farwell Justice, in *Borland Trustees vs. Steel Bors. & Co. Ltd.* observed that "a share is not a sum of money but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a sum of money of a more or less amount". You should note that the shareholders are not, in the eyes of law, part owners of the undertaking. The undertaking is somewhat different from the totality of the shareholders. The rights and obligations attaching to a share are those prescribed by the memorandum and the articles of a company. It must, however, be remembered that a shareholder has not only contractual rights against the company, but also certain other rights which accrue to him according to the provisions of the Companies Act.

The shares or other interests of a member of a company are movable properties transferable in the manner prescribed by the articles of the company [Section 82]. Each share in a company, having a share capital, must be distinguished by its appropriate number [Section 83].





**(b) Kinds of share capita:-** As per the Companies (Amendment Act, 2000), there will now be two types of share capital as under:

- (a) Equity Share Capital
  - (i) With voting Rights
  - (ii) With differential rights. The expression “shares with differential voting rights” is defined as a share that is issued in accordance with the provision of Section 86. When read with Section 86, it means shares issued with differential rights as to” dividend, voting or otherwise” in accordance with such rules and subject to such may be prescribed. The rules called as the Companies (Issue of Share Capital with Differential Voting Rights) Rules, 2001 were notified by the Department of Company Affairs and came into force with immediate effect.
- (b) Preference Share Capital. [New Section 86, Companies (Amendment) Act, 2000.]–  
Section 88 prohibiting disproportionate rights has been omitted by the Companies (Amendment) Act, 2000.

**(i) Equity shares:** Equity shares, with reference to any company limited by shares, are those which are not preference shares [Section 85(2) of 1956 Act].

The important characteristics of equity shares are as follows:

1. Equity shares carry voting rights at the general meetings of the company and have the right to control the management of the company.
2. Equity shares carry the right to share in the profits of the company in the form of distribution of dividend and bonus shares.
3. In the event of winding up of the company, equity share capital is repayable only after repayment of the claims of the creditors and preference share capital.
4. Equity shareholders enjoy various rights as members, which include, *inter alia*, the following rights :
  - (a) Right of pre-emption in the matter of fresh issue of capital [Section 81].
  - (b) Right to apply to the Court to have any variation of their rights set aside [Section 107].
  - (c) Right to receive a copy of the statutory report [Section 165].
  - (d) Right to apply to Central Government to call an annual general meeting when the company fails to call such a meeting [Section 167].
  - (e) Right to apply to CLB for calling an extraordinary general meeting of the company [Section 186].



- (f) Right to receive copies of annual accounts along with auditors report [Sections 210 & 219].

**(ii) Preference shares:** Preference share capital means, with reference to any such company, that part of the share capital which fulfils both the following requirements, namely:

- (a) as respects dividend it carries or will carry a preferential right to be paid a fixed amount or an amount calculated at a fixed rate, and
- (b) as respects capital, it carries or will carry, on the winding up or repayment of capital, a preferential right to be repaid the amount of the capital paid up or deemed to have been paid up, whether or not there is a preferential right to the payment of either or both of the following amounts, namely :
- (i) any money remaining unpaid, in respect of the amount specified in clause (a), up to the date of the winding up or repayment of capital; and
- (ii) any fixed premium any fixed scale, specified in the memorandum or articles of the company [Section 85].

Capital shall be deemed to be preference capital, notwithstanding that it is entitled to either or both of the following rights, namely:

- (i) that, as respects dividends, in addition to the preferential right to the amount specified in clause (a) it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right aforesaid;
- (ii) that, as respects capital, in addition to the preferential right to the repayment, on a winding up, of the amounts specified in clause (b) it has a right to participate, whether fully or to a limited extent, with capital not entitled to the preferential right in any surplus which may remain after the entire capital has been repaid.  
[Explanation to Section 85(1)].

**(iii) Deferred shares:** Deferred shares are also known as “founders’ shares”, since they are often held by the promoters of the company. Where such shares are issued, ordinary shares get a fixed dividend just like preference shares. After paying dividends on all other kinds of shares (or returning capital in the case of winding up), such shares are the last to receive both as regards dividends and repayment of capital. They carry disproportionate voting rights so that by a small investment management may be controlled and it is for this reasons that they are also known as ‘management shares’.

Under the Companies Act, 1956, no public company or deemed to be public company under Section 43A, or private company which is subsidiary of a public company can issue deferred shares [Sections 86 and 88]. However, an independent private company is still entitled to issue deferred shares [Section 92(2)]. Such shares are not all common now a days.



**(iv) Kinds of preference shares:** There may be different kinds of preference shares depending upon the terms of issue which are either defined in the Articles of Association or in the prospectus of the company. A company may issue the following types of preference shares:

1. *Cumulative preference shares:* They carry the right to cumulative dividends if the company fails to pay the dividend in a particular year. The accumulated arrears of dividends shall be paid, if any dividend is declared in subsequent years, before any dividend is paid to the equity shareholders. If the company goes into liquidation, no arrears of dividends are payable unless either the Articles contain an express provision to this effect or such dividends have been declared. Of course the arrears of undeclared dividends shall be payable, even if the Articles are silent, out of any surplus left, after returning in full the preference and equity share capital.

All preference shares are always presumed to be cumulative unless the contrary is stated in the Articles or in the terms of issue.

2. *Non-cumulative preference shares:* Such shares do not carry the right to receive the arrears of dividend in a particular year, if the company fails to declare dividend in previous year or years. If no dividend is paid in any particular year, it lapses.
3. *Participating preference shares:* These are preference shares, which receive their fixed dividend e.g., 13 per cent, in the normal way, but which then participate further in the distributed profits along with the equity shares after a certain fixed percentage has been paid to equity shareholders as well. The holders of such shares may also be entitled to get a share in the surplus assets of the company on its winding up if specified provision exists to that effect in the Articles.
4. *Non-participating preference shares:* These shares are entitled to only a fixed rate of dividend and do not participate further in the surplus profits irrespective of the magnitude of such profit. If the articles are silent, all preference shares are deemed to be non-participating unless stated otherwise in the terms of issue.
5. *Convertible preference shares:* The holder of these shares is given the right of conversion of his shares into equity shares at a later date.
6. *Non-convertible preference shares:* Here the preference shareholder is not given the right of conversion of his shares into equity shares. If the articles are silent, all preference shares are deemed to be non-convertible unless provided otherwise in the terms of issue.
7. *Redeemable preference shares :* Ordinarily capital received on the issue of shares can be returned on the winding up of the company only, because if the company is allowed to return it any time it so wished, the creditors could not rely on the company having any



money at all. But Section 80 of the Companies Act, authorises a company limited by shares to issue “redeemable preference shares”. Capital received on such shares can be paid back to the holders of such shares during the life-time of the company. The paying back of capital is called the redemption. After the commencement of the *Companies (Amendment Act, 1996*, no company limited by shares, shall issue any preference shares which is irredeemable or is redeemable after the expiry of a period of *twenty years* from the date of its issue.

- 8 *Irredeemable preference shares*: When the preference shares are not redeemable except on the happening of certain specified events, which may not happen for an indefinite period, for example, winding up, such shares are known as irredeemable preference shares. Issue of irredeemable preference shares was permitted till the amendment in the Companies Act, 1956 was made by the introduction of Section 80A with effect from 15th June, 1988.

Pursuant to Section 80A, all preference shares existing on 15-6-1988 which were not redeemable within ten years from the date of the issue and had not been redeemed before the commencement of the Companies Amendment Act, *i. e.*, on 15-6-1988 were to be compulsorily redeemed by the company on the due date of redemption or within a period not exceeding ten years from 15-6-1988. The said section provides that notwithstanding anything contained in the terms of issue of any preference shares, every preference share issued before the commencement of the Companies (Amendment) Act, 1988:

- (a) which is irredeemable should be redeemed within a period not exceeding five years from such commencement;
  - (b) which is not redeemable before the expiry of ten years from the date of issue thereon should be redeemed in accordance with the terms of the issue or within a period not exceeding ten years from such commencement, whichever is earlier. Where a company is not in a position to redeem any such shares within the period aforesaid and to pay the dividend, if any, due thereon, it may with the consent of the Company Law Board (CLB), on a petition made by it in this behalf issue further redeemable shares equal to the amounts due (including the dividend thereon) in respect of the unredeemed preference shares, and on the issue of such further redeemable preference shares, the unredeemed shares shall be deemed to have been redeemed.
9. *Cumulative convertible preference shares (C.C.P.)* : Introduced in 1985, the objects of the issue of the instrument should be for setting up new projects, expansion or diversification of existing projects, capital expenditure for modernisation and working capital requirements. The amount of issue of CCP shares will be to the extent the company would be offering equity shares to the public for subscription. These shares are



deemed to be equity issue for the purpose of calculating debt-equity ratio. The entire issue would be convertible into equity shares between the end of 3 years and 5 years. The rate of dividend payable on CCP would be 10 per cent. The face value of these shares will ordinarily be Rs. 100 each, and the holders are entitled to receive arrears of dividend, if any, even after conversion.

### **3.3 VARIATION OF SHAREHOLDERS RIGHTS**

Where a share capital of a company is divided into different classes of shares, it may sometimes be necessary for it to amend the rights attached to one or more classes of shares. Its memorandum or articles may authorise the variation of the rights attaching to any of the shares. Also, there might be a situation where the memorandum or the articles of the company are silent on the point of variation of shareholder's rights. In either of these circumstances can the company straightway vary the shareholders' rights without undergoing any other formality? The answer is 'No'. These rights can be varied only if the consent in writing of the holders constituting not less than three-fourths of the issued shares of the concerned class has been taken, or only if the sanction through a special resolution passed at a separate meeting of the holders of the issued shares of that class has been taken prior to the variation of the rights. However, if such variation is prohibited by the terms of the aforesaid class of shares, then the variation will not be possible [Section 106].

You must note that the variation as contemplated by Section 106 is the variation which is to the prejudice of any class of shareholders. That is to say, in case the variation involves curtailment of rights of any class or classes of shareholders, the aforesaid consent or sanction of the said class or classes will be required. If the variation pertains to adding or enhancing right of any classes, then also the compliance with the provisions of Section 106 is necessary. It has been held that a variation which affects only the enjoyment of a right without modifying the right itself does not fall within the purview of Section 106 [*In re Hindustan General Electrical Corporation*, A.I.R. 190 Cul. 672]. Once the variation is effected in strict consonance with the provisions of Section 106, it is complete, no further steps being necessary to adopt it [*In re Ramuria Cotton Mills Ltd.* 53 C.W.N. 11], in the event of the variation of right being a part of a scheme or arrangement with the intervention of the Court under Section 391 (this is excluded from the syllabus), Section 106 will be inapplicable in *General Electrical Corporation* [*Supra*].

If the minority feels oppressed or prejudiced by the variation as aforesaid, then Section 107 will have to be invoked.

In the light of the above-mentioned provisions, the procedure which is generally followed in regard to variation of rights attached to a particular class of shares is as under:

A meeting of the shareholders, holding the shares of the class, rights attached to which are sought to be altered, is convened. (The quorum for meeting shall be at least 2 persons present



in person or by proxy in the case of a private company; in the case of a public company, the number of member present should be 5). If the meeting passes the special resolution then variation can be proceeded with [Section 170(2)(b); Section 174(1)].

Shareholders holding not less than 10 per cent, in the aggregate, of issued shares of that class, being persons who have not consented to or voted for the resolution for the variation of the rights may apply to the Court to have the variation cancelled. The application has to be made within 21 days from the date of passing of the resolution. In the case where an application has been made, the variation shall be effective only after it has been confirmed by the Court. The decision of the Court on any such application shall be final. If the Court has made an order, the company must, within 30 days after the service on the company of any order by it, forward copy of it to the Registrar [Section 107]. It would be worth noting in this context that sub-division of shares is not tantamount to variation.

### **3.4 VOTING RIGHTS OF A MEMBER**

Section 87 governs the voting rights of members. Every holder of an equity share has the right to vote, by virtue of his share in the capital, on every resolution placed before the company. And his voting right on a poll shall be in proportion to the amount paid upon his share. A member's right to vote on a role may be exercised by him personally or through a proxy.

Every holder of preference shares has a right to vote only on a resolution which directly affects the rights attached to the preference share capital. A resolution for the winding up of the company or repayment or reduction of its share capital is deemed to directly affect the rights of holders of preference shares. Where preference shares are cumulative as to dividend and the dividend thereon has remained unpaid for an aggregate period of not less than 2 years preceding the date of any meeting of the company, the preference shareholders shall have the right to vote on every resolution placed before the meeting. On the other hand, if the preference shares are not cumulative as regards dividend, then the holders thereof will be able to exercise the above-mentioned extended right of voting only if dividend due on shares has remained unpaid for not less than 2 years ending with the expiry of the financial year immediately preceding the commencement of the meeting or for an aggregate period of not less than 3 years out of 6 years ending with the expiry of the financial year aforesaid. In all the above cases, the right of preference shareholders to vote on a poll shall be in the same proportion as the capital paid up on such shares bears to the total paid-up equity capital of the company. Dividend on preference shares, whether declared or not, shall be deemed to be due on the last date of the period specified for payment in the articles or other instrument executed by the company in that behalf. Alternatively, if no such date is specified, the dividend shall be deemed to be due on the day immediately following such period. The provisions stated above are, however, subject to the provisions of Sections 89 and Section 92(2) which we shall discuss hereunder :



A company may, by making a provision in the articles, restrain a shareholder from exercising his voting rights in respect of any shares registered in his name on which any call or other amount due has not been paid or on which the company has a lien or exercised a lien. But a public company or a private company which is a subsidiary of the public company cannot prohibit a member from voting on the ground that he has not held his share or other interest for a specified period before the time of voting or on any other ground except as mentioned above.

A company may, if so authorised by its articles, accept from any member the whole or any part of the uncalled amount on shares, but the member will not be entitled to voting rights in respect of the sum paid by him until it becomes payable [Section 92]. It is an exception to the rule that the voting rights of equity and preference shareholders on a poll will be in the same proportion as the capital paid up on those shares bears to the total paid-up equity capital.

### **3.5 FURTHER ISSUE OF CAPITAL (RIGHT SHARES I.E. RIGHT OF PRE-EMPTION OR PRE-EMPTIVE RIGHT)**

Sometimes, it may so happen that a company may desire to expand its activities or it may stand in need of more financial resources even in the absence of expansion of activities. In such a situation, it may issue a part or the whole of its unissued share capital. A company can bring out a public issue for equity shares/preferential shares with the consent of existing shareholders who have the pre-emptive right to purchase the additional shares of the company contemplated to be issued under the provisions of Section 81 of the Companies Act, 1956. Under the provisions of the Act, when shares are offered to the existing shareholders it is called the Right issue. The issue of Right shares require the following norms to be fulfilled :

- (i) Compliance under Section 81 of the Companies Act, 1956.
- (ii) Approval of Financial Institutions for Right issue.
- (iii) Compliance under FEMA, if applicable to the subject company.
- (iv) Compliance of the Central Government/SEBI guidelines issued from time to time.
- (v) Compliance of the Stock Exchange requirements.

Some of the above compliance are precisely narrated below :

1. Compliances under the Companies Act, 1956 [Section 81]: Discussed separately under the next heading.
2. *Approval of financial institutions for rights issue:* Where the company has availed of term loans from financial institution/banks, it is required to obtain their prior approval for making the rights issue in terms of the loan agreement entered into with them.



3. *Compliance under FEMA, if applicable to the subject company:* For FEMA companies, RBI permission is required for issuing right shares to non-residents vide Section 19(i)(d) or to any foreigners (whether resident or non-resident) or to any company with more than 40 per cent non-resident interest.
4. SEBI Guidelines on Rights Issue :
  - (a) **Object:** The Guidelines on Rights Issue will enable companies listed on a recognised stock exchange to raise capital by issuing securities to its shareholders on a right basis, with or without the right renunciation without being required to submit the letter of offer for vetting or to obtain an acknowledgement card from SEBI in respect of the said rights issue.
  - (b) **Applicability of the Guidelines :** The Guidelines will be applicable to all rights issue to be made by companies listed on a recognised stock exchange after 1st July, 1995. However guidelines will not be applicable to composite issues, i.e., on issue of securities on a rights basis made either simultaneously or preceded or followed by an issue of securities to public within a period of 3 months before or after the closure of rights issue as the case may be.
  - (c) **Vetting of offer documents :** Rights issue which are not accompanied by public issues 3 months prior or subsequent to the days of the rights issue will not be required to be vetted by SEBI.
  - (d) **Prohibition of rights issue over Rs. 50 lakhs unless guidelines are complied with :** A listed company shall not make a rights issue, where the aggregate value of the securities, including premium, if any exceeds Rs 50 lakhs, unless a category I merchant Broker, holding a valid certificate of registration issued by SEBI has been appointed to manage the issue and has submitted to the offer document to SEBI.
  - (e) **Duty of Merchant Banker :** (1) It shall be the duty of the merchant banker, acting as the lead manager to ensure that the letter of offer provides a true and correct view of the state of affairs of the company which are adequate for the investors to arrive at a well-informed decision.  
(2) The merchant banker shall, however, submit the draft of the letter of offer to SEBI six weeks before the issue is scheduled to after for subscription, if any suggested by SEBI, within 3 weeks of receipt of such draft, shall be incorporate/complied with by the merchant broker before filing a copy of the letter of offer.  
(3) A copy of the letter of offer shall be submitted by the merchant banker to SEBI two weeks before the issue opens for subscription.





- (4) The merchant broker shall submit along with the letter of offer a due diligence certificate to SEBI in the prescribed form.
  - (5) The merchant banker submitting the letter of offer shall be responsible for ensuring compliance with SEBI Rules, regulations and guidelines and requirements of other laws for the time being in force.
  - (f) All listed companies desirous of making rights issue shall variably issue an advertisement prominently in not less than 2 All India newspapers about the details of right offer.
  - (g) Shareholders who have neither received the original composite application forms nor in a position to obtain duplicate forms, may make an application to subscribe to the rights on a plain paper.
  - (h) No preferential allotment may be made along with any right issue. If the issue company desires to do so, they may do so independent of rights issue by complying with the provisions of the Companies Act, 1956.
  - (i) Rights issue should not be kept open for more than 60 days.
5. *Compliance with stock exchange requirements* : A listed company intending to make rights issue is required to comply with the following requirements as contained in clause 23 of the listing agreement :
- (i) Unless the shareholders in General Meeting decide otherwise, to close the transfer books at such a date or in such a manner as is suitable in the settlement of transactions in consultation with the exchange.
  - (ii) To make such issues or offers in a form to be approved by the exchange and forward supply of the renunciation forms promptly to the exchange.
  - (iii) To issue where necessary, coupons or fractional certificates or provide for the payment to the equivalent value in cash as the company's General Meeting or as the Exchange decides.
  - (iv) The minimum time for which the rights issue is to be kept open is not stipulated. As per the listing requirements with stock exchange, rights issue are to be kept open for at least 4 weeks although a minimum time of 2 weeks has been stipulated under Section 81 of the Companies Act.
  - (v) To issue letters of allotment or letters of rights within 6 weeks of the record date or date of reopening of transfer books after their closure for the purpose of making a bonus or rights issue and to issue allotment letters or certificates within 6 weeks of the last date fixed by the company for submission of list of renunciation or application for new securities.



### 3.6 SECTION 81 OF THE COMPANIES ACT, 1956

After the expiry of two years from the date of the company's incorporation or after one year from the date of the first allotment of shares, whichever is earlier, a public company limited by shares may wish to issue further shares within the limits of the authorised capital. In such circumstances, the directors of the company must first offer such further shares to existing equity shareholders in proportion, as nearly as circumstances admit, to the amount paid up on their shares at the time of the further issue. The company must give notice to each of the equity shareholder, giving him the option to buy the shares offered to him by the company. The shareholders must be informed of the number of shares they had the option to buy. At least 15 days must be allowed to each of the equity shareholder to consider whether he would exercise his option or not. If the shareholder does not accept the offer within the said 15 days or any extended time allowed by the company, then he shall be deemed to have declined the offer. In that case or if he declines the offer expressly, the directors can proceed to dispose of those shares in such manner as they may think most beneficial to the company. Unless the company's articles otherwise provide, the directors must under Section 81(1)(c) state in the notice of offer the fact that the shareholder has also the right to renounce the offer, in whole or in part, in favour of some other person. That some other person or persons may not or may be member or members of the company. If the person in whose favour the renunciation is made, declines to buy the shares renounced by the equity shareholders in his favour, the directors may proceed to dispose of all those shares in such manner as they may think fit; the equity shareholders cannot for a second time exercise the right of renunciation on the ground that the persons in whose favour the renunciation was first made have declined to take the shares comprised in the renunciation [Section 81(1)].

#### Exceptions

However, the company may, (i) by a special resolution at a general meeting decide that the directors need not offer the shares (in the further issue) to the existing equity shareholders and that they (the directors) may dispose of all the shares (in the further share capital) in any manner whatsoever, (ii) where no such special resolution is passed, if the votes cast (whether on a show of hands, or on a poll, as the case may be) in favour of the proposal contained in the resolution moved in that general meeting (including the casting vote, if any, of the chairman) by members who, being entitled so to do, vote in person, or where proxies are allowed, by proxy, exceed the votes, if any cast against the proposal by members so entitled and voting, *provided the Central Government has sanctioned* such issue after being satisfied that such a disposal was most beneficial to the company [Section 81(IA)]. The impact of this provision is that the manner of distribution of any further shares, decided to be issued by the Board of Directors, may be changed and the shares may be issued wholly or partly to any person otherwise than in accordance with Sub-section (1) discussed above. But either a special resolution must sanction it, or an ordinary resolution together with the Central



Government's approval would be necessary. Unless the issue to such person or persons is beneficial to the company the Central Government will not accord its approval.

It has been held by the Supreme Court that neither Section 81(1) nor Section 81(1A) would apply to a private company which has become a public company by virtue of Section 43A but has retained in its articles the three matters referred to in Section 3(1)(iii). The provision contained in Section 81(1)(c) of the Companies Act, 1956, cannot be construed in a manner which will lead to the negation of the option exercised by a private company which has become a public Company by virtue of Section 43A to retain in its articles the three matters referred to in Section 3(1)(iii). Both these are statutory provisions and they are contained in the same statute and must be harmonised, unless the words of the statute are so plain or unambiguous and the policy of the statute so clear that to harmonise will be doing violence to those words and to that policy. The policy points in the directions that integrity and structure of "Section 43A proviso-companies" should, as far as possible, not be broken up. Since Section 81(1)(c) of the Companies Act, 1956, is subject to the qualification 'unless' the articles of the company otherwise provide, while interpreting that section and allied provisions of the Act, it would be necessary to have regard to the relevant articles of association of a company. In the context in which a private company becomes a public company under Section 43A and by reason of the option available to it under the proviso, the word 'provide' must be understood to mean "provide expressly or by necessary implication". The necessary implication of a provision has the same effect and relevance in law as an express provision has, unless the relevance of what is necessarily implied is excluded by the use of clear words. Considering particularly the genesis of 'Section 43A proviso companies', in order to attract the opening words of clause (c) of Section 81(1), it is not necessary that the article of the company must contain an express provision otherwise than what is contained in clause (c) [*Needle Industries (India) Ltd. and others vs. Needle Industries and Newey (India) Holding Ltd. and others (1987) 51 Com. Case. (SC) 743 at pp. 745-746*].

**The provisions of Section 81 do not apply:** (a) to private companies; or (b) to the increase of the subscribed capital of a public company caused by the exercise of an option attached to debentures issued or loans raised by the company. The option should be (i) to subscribe for shares of the company, or (ii) to convert such loans or debentures in the company. However, the terms of issue of such debentures or terms of such loans must include a term providing for such option; and such term either has been approved by the Central Government before the issue of the debentures or the raising of the loans, or is in conformity with the rules, if any, made by the Government in this connection. In the case of debentures or loans other than debentures issued to, or loans obtained from, the Government or any institution specified by the Central Government in this behalf the option should have also been approved by a special resolution passed by the company in general meeting before such issue or raising of the loans.



Moreover, the Central Government may allow a Government holder of the debentures or a Government lender of money to the company to ask for shares of the company in lieu of the loan or debentures even though the instrument of debentures or of the loan does not contain any provision giving the holder or the lender the option to convert loans or debentures into shares of the company. In such a case, the Central Government may impose such terms and conditions as it may think fit. It is the duty of the Central Government, in imposing the terms and conditions, to see that it pays due regard to the financial position of the company, the terms of the issue of the debentures or of the loans, as the case may be, the rate of interest payable thereon, the capital of the company, its loan liabilities, its reserves, its profits during the preceding 5 years and the current market price of the shares of the company. It must take all these facts into account before imposing the terms and conditions of conversion into shares. Such an order can be made if, in the opinion of the Central Government, it is necessary to do so. A copy of every such order issued by the Central Government must be laid in draft before each House of Parliament while it is in session for a total period of 30 days which may be comprised in one session or in two or more successive sessions. If the terms and conditions of the conversion ordered by the Central Government are not acceptable to the company, the company may, within 30 days from the date of communication to it of such order or within such further time as may be granted by the Court, appeal to the Court in respect of those terms and conditions. The decision of the Court on such appeal shall be final and conclusive and binding both on the company and the Central Government.

You should note that since the Companies Act, 1956 does not prescribe for a written application for allotment of shares, there can be an oral offer for the purpose and allotment on its basis. Therefore, once the allotment has been made on the basis of such an oral offer for allotment of shares under Section 81, the absence of a written application cannot be subsequently implied, so as to question the allotment [See *Ayyangar Spinning and Weaving Mills Ltd. vs. V.V. Rajendra & others* [1973] 43 *Comp. case* 225]. It should further be noted that the issue and allotment of shares in payment for (a) property sold or transferred or (b) goods or machinery supplied or (c) services rendered to the company in or about the formation or promotion of or the conduct of business which would not fall within the purview of Section 81, it being applicable only when the company proposes to increase its subscribed capital by allotment of shares to the public. Where the articles empower the directors to issue and allot shares as fully or partly paid up in full or part payment for the said purposes and the allotment was made pursuant to this power, then only it would be outside the ambit of Section 81(*ibid*).

### **3.7 STEPS TO BE TAKEN BY A COMPANY IN RESPECT OF ISSUE FURTHER SHARES**

1. Check whether the rights issue is within the authorised share capital of company. If not, steps should be taken to increase the authorised share capital.



2. In case of a listed company, notify the stock exchange concerned the date of Board Meeting at which the rights issue is proposed to be considered.
3. As per the SEBI guidelines, the gap between the closure dates of rights issues and public issues should not exceed 30 days. Therefore, if the company has made a simultaneous issue of public and rights shares, it should ensure that the gap between the closure dates of these two does not exceed 30 days.
4. As per the SEBI guidelines for rights issue of listed companies exceeding Rs. 50 lakhs, the appointment of a merchant banker is mandatory. Therefore, steps should be taken to appoint a merchant banker where the issue amount exceeds Rs. 50 lakhs. Appointment of Underwriters, as per SEBI guideline is now optional.
5. Convene the Board meeting and place before it the proposal for rights issue.
6. The Board should decide on the following matters :
  - (i) Quantum of issue and the proportion of rights shares.
  - (ii) Whether the shares shall be issue at par or premium keeping in view of the SEBI guidelines. The price is to be fixed by the Board of Directors in consultation with the lead manager to the issue.
  - (iii) Alteration of share capital, if necessary, and offering shares to persons other than existing holders of shares in terms of Section 81(1A).
  - (iv) Fixation of record date.
  - (v) Appointment of merchant bankers and underwriters.
  - (vi) The letter of offer should conform to the disclosures prescribed in Form 2A under Section 56(3) of the Companies Act (memorandum containing the salient features of prospectus). Full justification and parameters used for issue price should clearly be mentioned in letter of offer.
7. Immediately after the Board Meeting notify the concerned Stock Exchanges about particulars of Board's decision.
8. Send the draft letter of offer to SEBI for vetting. As stipulated by SEBI guidelines, the lead managers is responsible for obtaining SEBI clearance to the letter of offer before approaching Stock Exchange(s) for fixing the record date for the proposed issue.
9. If the issue does not require appointment of lead managers (in case of rights issue not exceeding Rs. 50 lakhs) a copy of letter of offer is to be forwarded to SEBI for its information.



10. If it is proposed to offer shares to persons other than the shareholders of the company, a General Meeting has to be convened and a resolution passed for the purpose in terms of Section 81(1A) of the Companies Act.
11. If rights shares are to be offered to NRIs, obtain RBI approval.
12. Forward 6 sets of letter of offer to concerned Stock Exchange(s).
13. Despatch letters of offer to shareholders by registered post.
14. Make arrangement with bankers for acceptance of share application forms.
15. If the company does not receive 90 per cent of the issue amount including accepted devolvement from underwriters within 120 days from the date of opening of the issue, the amount of subscription received is required to be refunded.
16. Prepare a scheme of allotment in consultation with Stock Exchange(s).
17. Convene Board Meeting and make allotment of shares.
18. File return of allotment in Form 2 with Registrar of Companies within 30 days of allotment.
19. Within 45 days of the closure of rights issue, a report in the prescribed form along with the compliance certificate from statutory auditor/practising chartered accountant/ company secretary in practice is to be forwarded by the lead managers to SEBI.
20. Make an application to the Stock Exchange(s) where the company's shares are listed for permission for listing of new shares.

### **3.8 CONVERSION OF SHARES INTO STOCK**

“Stock” is an aggregate of fully paid shares that have been legally consolidated. The consolidated amount is divisible into fractions of any amount, regardless of the nominal value of the shares that have been consolidated. It thus represents a part of the capital of the company which is fully paid.

By virtue of the powers contained in Section 94(1)(c) of the Act, a company limited by shares if authorised by its articles, may by means of a resolution passed at a general meeting alter the conditions of its memorandum with a view to converting all or any of its fully paid shares into stock and also reconvert its stock into shares. However, the company cannot issue stock *ab initio*. It must issue shares and after they are fully paid up, convert them into stock.

The main advantage claimed for stock is that it is transferable in any denomination which is not limited to the nominal value of the share converted into a stock. This advantage may be limited by such a regulation as contained in the proviso to regulation 37 of Table A. This regulation runs thus : provided that the Board may from time to time fix the minimum amount



of stock transferable, so however that such minimum shall not exceed the nominal amount of shares from which the stock arose.

### **3.9 ALTERATION OF SHARE CAPITAL [SECTION 94]**

A limited company having a share capital may, if so authorised by its articles, alter its share capital in the following manner:

- (a) by increasing its nominal capital by issuing new shares ;
- (b) by consolidating and dividing all or any of its share capital into shares of larger denomination;
- (c) by converting fully paid-up shares into stock or *vice versa* ;
- (d) by sub-dividing its shares or any of them into shares of smaller amount ;
- (e) by cancelling shares which have not been taken up and diminishing the amount of its share capital by the amount of the shares so cancelled.

The powers conferred by Section 94 shall be exercised by the company in general meeting and shall not require to be confirmed by the Court. A cancellation of the shares under Section 94 will not amount to a reduction of share capital within the meaning of the Act. The powers of alteration may be exercised by passing an ordinary resolution of the company in a general meeting.

Within 30 days of the shares having been consolidated, converted, sub-divided, redeemed, or cancelled or the stock having been reconverted, notice should be given to the Registrar specifying the alteration made. The Registrar shall made the necessary alterations in the memorandum or articles [Section 94].

**(a) Share capital to stand increased where an order is made under Section 81(4):** The provisions in this regard are contained in Section 94A inserted by the Companies (Amendment) Act, 1974. Section 81(4) empowers the Central Government to convert its debentures or loan amount in a company into capital. Any such conversion has naturally the effect of increasing the share capital of the company. Section 94A has been enacted to provide for the same. Sub-sections (1) and (2) of Section 94A provide that where the Central Government or any public financial institution has converted its debentures or loans into capital, the capital of the company shall stand increased by an equal amount and the company's memorandum shall stand altered accordingly. According to Sub-section (3) of Section 94A, in either case mentioned in Sub-sections (1) and (2) the Central Government is required to send a copy of the order to the Registrar and also to the company. On the receipt of such order from the Central Government, the company shall file in the prescribed form, within 30 days from the date of such receipt, a return with the Registrar with regard to the increase of capital. On the receipt of the Central Government's order as aforesaid and the



return from the company, the Registrar shall carry out the necessary alterations in the memorandum of the company.

### **3.10 REDUCTION OF THE SHARE CAPITAL**

You have already read in earlier Study Papers that it is to the capital of the company which members have invested or undertaken to invest and the assets represented thereby, that creditors look for the satisfaction of their claims. This has, therefore, been the principle, of the Company Law that share capital shall be reduced only subject to special safeguards.

Section 100 of the Companies Act, provides that a company, limited by shares or guarantee and having share capital, if so *authorised by the articles, may by special resolution and the confirmation of the Court*, reduce its share capital in any way and in particular by :

- (a) extinguishing or reducing the liability of members in respect of the capital not paid up ;
- (b) writing off or cancelling any paid-up capital which is in excess of the needs of the company.
- (c) paying off any paid-up share capital which is in excess of the needs of the company.

Reduction in (b) and (c) may be made either in addition or without extinguishing or reducing the liability of the members for uncalled capital.

Reduction of share capital may in reality take three forms, namely, (i) reducing the value of shares in order to absorb the accumulated losses suffered by the company without any payment to the shareholders ; (ii) extinction of liability of capital not paid ; and (iii) paying off any paid-up share capital. Only in the circumstances referred to in (ii) and (iii) is the interest of creditors really involved.

After passing the special resolution under Section 100, the company has to apply under section 101 to the Court for an order confirming the reduction. After the petition for Court's confirmation has been filed, the Court must settle the list of creditors who are entitled to object e.g., the creditors having a debt or a claim admissible on a winding up. For settling it, the Court must ascertain the names of those creditors and the nature and amount of their debts or claims. The Court may publish notices fixing a day or days within which the creditors not entered on the list are to claim to be so entered or are to be excluded from the right of objecting to the reduction [Section 101(2)(b)].

When a creditor (entered on the list) whose debt or claim is not discharged or has not been determined, does not consent to the reduction, then the Court has the power to dispense with the consent of that creditor, on the company securing the paying of the debt or claim by appropriating the full amount or the amount fixed by the Court [Section 101(2)(c)].

However, the Court has discretionary power having regard to any special circumstances of the





case to direct that the provisions of Section 101(2) shall not apply as regards any classes of creditors [Section 101(3)]. As regards the “special circumstances”, these must be such as would convince the Court that with reasonable foresight it can be said the proposed reduction of capital would not adversely affect the relevant creditor and would not render him any worse off than if he had attended and objected to the application for confirmation [*Re. Lucanic Temp-scule Billard Hall (London) Ltd.* [1965] 3 All E.R. 879].

In regard to every creditor of the company, who under Section 101 is entitled to object to the reduction, if the Court is satisfied that either his consent to the reduction has been obtained or his debt or claim has been discharged, or has been determined or has been secured, then it may make an order confirming the reduction on such terms and conditions as it thinks fit [Section 102(1)].

The Court may order that the words “and reduced” be added to the name of the company for a certain period. The Court may further require the company to publish the reasons for the reduction and the causes which have led to it [Section 102(2)].

**(a) Registration of order and minutes of reduction:** According to Section 103, the Registrar must register the order and minutes (approved by the Court) of reduction. It must be done (1) on the production of an order of the Court confirming the reduction and (ii) on the delivery of a certified copy of the order and minutes approved by the Court.

The certified copy of the order must show the following items namely :

- (i) The amount of share capital ;
- (ii) The number of shares into which it has to be divided ;
- (iii) the amount of each share ; and
- (iv) the amount if any at of the date of registration deemed to be paid up on each share.

On registration of the order and the minutes, but not before, the resolution shall become effective. The notice of registration must be published in such a manner as the Court may direct. The Registrar then will issue a certificate which will be conclusive evidence that the requirements of the Act as to the reduction have been complied with and that the shares of the company are only that as stated in the minutes. The minutes shall be deemed to be substituted for the corresponding part of the memorandum thereby altering the memorandum within the meaning of Section 40.

Therefore, the copies of the memorandum which will be issued subsequently must be in accordance with the alteration.

**(b) Liability of members in respect of reduced share :** Under Section 104 on a reduction of



share capital, the extent of the liability of any past or present member on any call or contributions shall not exceed the difference between :

- (a) the amount paid on shares or the reduced amount, if any, which is deemed to have been paid thereon by the member ; and
- (b) the amount of the shares as fixed by the minutes of reduction.

It may so happen that the name of a creditor has not been entered on the list of creditors owing to his ignorance of the proceedings for reduction or owing to his ignorance of the nature and effect of such proceedings in respect of his claim. It may also happen that, after the reduction, the company is unable, within the meaning of the provisions, of Section 434 of the Act with respect to winding up by the Court to pay the amount of his debt or claim. In all these circumstances, (a) every person who was a member of the company at the time of registration of the order for reduction and minutes, is liable to contribute for the payment of debt or claim of an amount not exceeding the amount which he would have contributed if the winding up of the company had commenced on the day immediately before the date of registration of order and minutes ; and (b) if the company is wound up, the Court, on the application by the creditor as also on the proof of his ignorance, may settle a list of contributories and made and enforce calls and orders on the contributories settled on the list as if they were ordinary contributories in a winding up.

### **3.11 REDUCTION OF SHARE CAPITAL VS. DIMINUTION OF SHARE CAPITAL**

Section 100 of the Companies Act provides for the reduction of capital. For this, the articles must give the authority ; it is not enough to provide for it in the memorandum. If the articles do not so authorise, then these must be altered by a special resolution first and thereafter a second special resolution will have to be passed to reduce the capital in the manner proposed. Reduction of capital may be a reduction in the nominal capital, reduction at the same time in issued capital, a reduction in the paid-up capital or in the capital that has been issued but not paid up (e.g. where an uncalled liability is cancelled).

The term “diminution” denotes a cancellation of that portion of the issued capital which has not been subscribed for Section 94(1)(e) of the Act states it, the cancellation of “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”.

Section 94(3) specifically states that diminution does not constitute a reduction within the meaning of the Companies Act. The expression “diminution of share capital” and “reduction of share capital” differ from each other in the following respects.

- (1) Reduction may involve reduction *inter alia* of issued capital, whereas diminution may be



in respect of authorised capital but not of issued capital.

- (2) If the articles authorise the procedure, diminution can be effected by an ordinary resolution, while reduction (which also need authorisation by articles), can be effected only by a special resolution.
- (3) Diminution needs no confirmation by the Court [Section 94(2)], but reduction needs such confirmation [Section 101].
- (4) Where a company is ordered to add to its name the words “and reduced” these words shall until the expiry of the period specified in the order, be deemed to be part of the company’s name [Section 102(3)], but such a provision does not exist in the case of diminution of the share capital as envisaged in Section 94(1)(e).
- (5) In the case of diminution, notice is to be given to the Registrar within 30 days from the date of cancellation whereupon the Registrar shall record the notice and make the necessary alteration in the memorandum or articles or both [Section 95(1)(f) & (2)] ; whereas in the case of reduction more detailed procedure regarding notice to the Registrar has been prescribed by Section 103, though there is no such time limit as aforesaid (*i.e.* 30 days).

### **3.12 ISSUE OF SHARES AT A DISCOUNT**

*A company cannot issue shares in disregard of Section 79. It may issue at a discount, share of a class already issued, only if all the following conditions are fulfilled :*

- (a) The issue must have been authorised by a resolution passed by the company in general meeting, and sanctioned by the Company Law Board (CLB).
- (b) The said resolution must specify the maximum rate of discount, at which the shares are to be issued. By virtue of the proviso added to Section 79 by the Amendment Act, 1974 no such resolution shall be sanctioned by the Company Law Board if the maximum rate of discount specified in the resolution exceeds 10 per cent unless the CLB is of the opinion that a higher percentage of discount may be allowed in the special circumstances of the case.
- (c) At the date of issue, not less than one year ought to have elapsed since the date on which the company was entitled to commence business.
- (d) Lastly, the shares to be issued at a discount have been issued within 2 months after the date of the CLB’s sanction or within the time extended by it.

On passing the resolution authorising the said issue, the company may apply to the CLB for its sanction thereon. Thereupon, if the CLB thinks it proper to sanction, it may do so on such



terms and conditions as it thinks fit.

Every prospectus relating to issue of the shares must contain particulars of the discount allowed on the issue of the shares or so much of that discount as has been written off at the date of the issue of the prospectus. A default in compliance with this requirement will render the company, and every officer thereof who is at fault punishable with fine extending to Rs. 500.

**(a) Director's liabilities in respect of improper issue of shares at a discount:** In such a case, the directors render themselves liable to compensate the company to the extent of the amount of discount [*Hirsche vs. Sims* [1894] A.C. 654]. Even the acceptor of shares, in such a case has to pay back to the company the amount of discount if he holds the shares [*Re. Pitkin (James) & Co.* [1916] 95 L.J. Ch. 318]. This he would have to do if the conditions of Section 79 are not satisfied, despite the fact that he did not know the legal effect of his contract to take shares at a discount or that the memorandum or articles give the directors the power to issue shares at a discount [*Welden vs. Saffery* [1897] A.C. 229; *Re. Pitkin Supra*]. But the allottee may avoid liability to take the shares if he applies on discovery of illegality of the discount allowed without delay, before commencement of the winding up of the company, to have his name removed as a shareholder provided he has not otherwise agreed to keep the shares [*Re. Midland Electric Co.* [1889] 60 L.T. [1892] Bom. 7].

### 3.13 ISSUE OF SWEAT EQUITY

*Sweat equity shares means equity shares issued by the company to employees or directors at a discount or for consideration other than cash for providing know-how or making available right in the nature of intellectual property rights or value additions, by whatever name called. (Explanation II to Section 79A)*

Notwithstanding anything contained in Section 79, a company may issue sweat equity shares of a class of shares already issued if the following conditions are fulfilled, namely: —

- (a) the issue of sweat equity shares is authorised by a special resolution passed by the company in the general meeting;
- (b) the resolution specifies the number of shares, current market price, consideration, if any, and the class or classes of directors or employees to whom such equity shares are to be issued;
- (c) not less than one years has, at the date of the issue elapsed since the date on which the company was entitled to commence business;
- (d) the sweat equity shares of a company whose equity shares are listed on a recognised stock exchange are issued in accordance with the regulations made by the Securities



and Exchange Board of India in this behalf :

**Provided** that in the case of a company whose equity shares are not listed on any recognised stock exchange, the sweat equity shares are issued in accordance with the guidelines as may be prescribed.

The expression “a company” for the purposes of Sub-section (1) of Section 79A means the company incorporated, formed and registered under this Act and includes its subsidiary company incorporated in a country outside India.

All the limitations, restrictions and provisions relating to equity shares shall be applicable to such sweat equity shares issued under Sub-section (1).

### **3.14 ISSUE OF SECURITIES AT A PREMIUM**

There is no provision in the Act, which can prevent a company from issuing securities at a premium, e.g., Rs. 100 securities at the price of Rs. 125. However, SEBI Guidelines prescribes, classes of companies which can price their issues at par or at premium. This is subject to however conditions applicable for promoters contribution and lock-in Period. For easy reference and understanding, a table is given below showing classes companies which can thier issues at par or at premium. But a sum equal to the aggregate amount of value of the premium on those securities must be transferred to an account described as “securities premium account”. The word ‘amount’ refers to a cash premium and the word ‘value’ to a premium other than cash. Securities issued for a consideration other than cash will be treated as having been issued at a premium if the value of the assets in consideration of which they are issued is more than the nominal value of the securities. Where a holding company, formed for the purpose of amalgamating two existing companies, acquires assets of a greater value than the nominal value of the shares issued by it in exchange for the existing securities of the amalgamated companies, it is required to transfer the excess value of the assets acquired to its securities premium account [*Head Henry & Co. vs. Ropner Holdings Ltd.* [1951] 1 All E.R. 944]. Thus, it is clear that a company can issue securities at a premium also for a consideration other than cash.

The provision of the Act, relating to reduction of share capital (except as provided in Section 78) apply as if the securities premium account was the paid-up share capital of the company. According to the provision of Section 78(2) the securities premium account can be utilised only for the under-mentioned purposes :

- (a) in paying up unissued securities of the company to be issued to members of the company as fully paid bonus shares ;
- (b) in writing off the preliminary expenses of the company ;
- (c) in writing off the expenses of or commission paid or discount allowed on any issue of



shares or debentures of the company ;

- (d) in providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company.

There is no prohibition in the Act against issue of securities at differential premium. The value which the acquirer of securities may pay in excess of the par value for acquiring the shares, depends upon the contract between the company and the acquirer of such securities [*CIT vs. Standard Vacuum Oil Company AIR [1966] SC 1363*].

### 3.15 SHARE CERTIFICATE

A share certificate is a document of title issued by the company declaring that the person named therein is the owner of a specified number of shares in the capital of the company. A company shall deliver share certificate :

- (a) within three months of the allotment of shares, or  
(b) within two months after the application for registration of the transfer of any such shares.

For the purposes of this section the expression 'transfer' means a transfer duly stamped and otherwise valid and does not include any transfer which the company is entitled to refuse to register and does not register.

The share certificate issued to promoters', directors, friends, relatives and associates etc. should carry the inscription 'not transferable' for a period of 5 years (in case of promoters' contribution) or 3 years (in case of firm allotments, preferential allotments to collaborators, shareholders of promoters companies) as may be applicable from the date of commencement of production or date of allotment whichever is later (SEBI Guidelines issued on 11-6-1992).

*Extension of time in case of debentures :* The above provisions also apply to debentures and debentures stock. The Company Law Board may, on being satisfied, extend the period of 3 months or 2 months, as the case may be, within which the certificates of all debentures and debentures stock allotted or transferred shall be delivered to a further period not exceeding 9 months. The company shall have to make an application to the Company Law Board for seeking this extension of time.

**(a) Implications of a share certificate:** The issue of a share certificate by the company creates an estoppel as to title and also as to payment.

- (a) Estoppel as to title : The company cannot deny the truth of the certificate as against a person who has relied upon it and who, in consequence, has changed his position. But if an officer of the company, who has no authority to issue certificates, issues a forged certificate, then there is no estoppel [*Rubpen vs. Great Fingal Consolidated [1906] A.C.*]



439; South London Greyhound Racecourses Ltd. vs. Wake 1931 Ch. 496].

- (b) Estoppel as to payment: Where a company states that shares are fully paid up, it cannot later contend that they were not, unless the person relying upon the certificate knew that the shares were not in fact fully paid up [Bloomenthal vs. Ford [1897] A.C. 156]. It has also been held in another case that the bona fide holder of the share certificate, who had no notice that the shares were not actually paid up fully, could sell those shares away as fully paid to a person who knew that they were not fully paid so as to give the latter a good title to shares as fully paid because the latter derived title from the transferor who had a good title [Gulabdas's [1982] 17 Bom 672].

A certificate, however, does not confirm the existence of an equitable interest in the share and as such, the company owes no obligation to a person who holds such an interest. The title of mortgagee, with whom a share certificate and bank transfer have been deposited, may be defeated by the borrower selling all the shares and procuring the registration of the purchaser by obtaining a duplicate certificate. The purchaser in such cases would obtain priority over the mortgagee, since the mortgagee would have no remedy against the company [*Reinford vs. James Keith Blackman and Co.* [1905] 1 Ch. 296].

Section 84 provides that a certificate under the common seal of the company, which specifies any shares by any member shall be *prima facie* evidence of the title of the member to such shares. The certificate is not conclusive proof of the title of the member, specified in the certificate, to certain shares mentioned therein. To the shareholder this evidence is useful in so far as it enables him to prove his title to any shares that he might be desiring to transfer, pledge, or charge. A share certificate, however cannot be described as "share". It is just *prima facie* evidence of the title to a share or shares represented by the certificate [*Gopal Paper Mills Ltd. vs. CIT Central Calcutta* [1966] 1 Com. L.J. 1 174].

Section 84(2) provides that a company may renew or issue a duplicate certificate if it is proved to have been lost or destroyed or having been defaced, mutilated or torn, after the certificate is surrendered to the company. Section 84(4) makes it obligatory for companies to follow the rules prescribed by Government in regard to the following matters :

- (i) The manner of issue or renewal of a certificate or issue of a duplicate thereof.
- (ii) The form of a certificate (original or renewed or a duplicate thereof).
- (iii) The particulars to be entered in the Register of Members or in the register of renewed or duplicate certificate.
- (iv) The form of such registers.
- (v) The fee on payment of which the terms and conditions, if any including terms and conditions as to evidence and indemnity and reimbursement for expenses incurred in connection with investigating evidence on which a certificate may be renewed or



duplicate thereof may be issued.

*[The Company (Issue of Share Certificates) Rules, 1960].*

The Company Law Board, having discovered that a certain group of companies had been fraudulently issuing duplicate, triplicate, sometimes quadruplicate share certificate without the original certificate having been surrendered to the company, framed the foregoing rules. These rules have been issued by virtue of the provisions of Section 84. The principal provisions thereunder are briefly summarised below :

*Rule 3* : “Board means the Board of Directors of the company or a committee thereof consisting of at least two directors if their number does not exceed 6 and on the number exceeding 6 of at least 3 directors ; also that at least half of the members of the Committee of the Board concerned with the issue of shares shall consist of persons who are not managing or whole-time directors or representatives of directors”.

*Rule 4(1)* : Before a share certificate can be issued, the Board must pass a resolution to that effect and either the letter of allotment or fractional coupons of requisite values shall be surrendered to the company. Where such documentary evidence is not available due to the same having been lost destroyed, the Board shall prescribe such reasonable conditions as regards indemnity and payment of incidental expenses which the company may have to incur in investigating the evidence for the purpose of proving the title of the shares.

*Rule 4(2)* : A certificate cannot be issued in exchange of sub-divided or consolidated share or in replacement of defaced, torn, old, decrepit worn-out ones or where cases in the reverse for recording transfers have been duly made use of unless the certificate in lieu of which it is issued, has been surrendered to the company.

*Rule 4(3)* : The duplicate share certificate must not be issued in lieu of the lost or destroyed share certificate, without prior consent of the Board having been obtained or without payment having been made of fees not exceeding Rs. 2 and on such reasonable terms as regards evidence, etc., as the Board thinks fit.

*Rule 5(1)* : Every certificate must contain the names of persons who are owners of the shares to which the certificate relates and amount paid up, thereon.

*Rule 5(2)* : Where a certificate has been issued in replacement of an old certificate, such a fact must be entered on the face of the certificate and against the stub or counterfoil.

*Rule 5(3)* : When a certificate is issued in lieu of one lost or destroyed, it must contain the statement “Duplicate issued in lieu of Certificate N...” In addition, the word ‘duplicate’ shall be stamped or punched in bold letters across the face of the share certificate.

*Rule 6* : The share certificate must be issued under the common seal of the company which must be affixed in the presence of two directors or their attorneys and the Secretary or any other persons appointed for the purpose by the Board. Also, all these persons must sign the





share certificate. One of the two directors must be a person other than the managing or wholetime director.

*Rule 7* : Particulars in respect of the certificate issued under Rule 4(1) must be entered on the Register of Members against the names of persons and in whose favour the certificates have been issued, indicating the date of the issue. Similarly, entries must also be made in respect of certificates issued under Rules 4(2) and (3) in a register of renewed and duplicate certificates indicating against the names of members, the number and date of issue of certificate, in lieu whereof the new certificate has been issued. Both these categories of entries should be authenticated either by the Secretary or by a person appointed by the Board.

*Rule 8* : All forms intended for the issue of share certificates must be printed under the authority of a resolution of the Board and a person appointed by the Board shall be having the custody of all blocks and other equipment of their printing.

*Rule 9* : The Managing Director, if any, but otherwise every director of the company must be responsible for the safe custody of all books and documents pertaining to the issue of share certificate.

**(b) Penalty for impersonation of shareholders** : If any person deceitfully impersonates an owner of any share or interest in the company, or any share warrant or coupon and thereby obtains or attempts to obtain any such share or interest or any such warrant or coupon or receives or attempts to receive any money due to any such owner, then he shall be liable to imprisonment upto three years and shall be liable to fine (Section 116).

**Who is responsible to prove delivery of share certificate?**

***Cardiff Chemicals Ltd. Vs. Fortune Bio-Tech Ltd. and another [2004] 414 CLB.***

The petitioner company has allotted some shares against application and the company has failed to deliver the share certificates in spite of its repeated demands. Hence, the appellant filed petition under section 113 of the Companies Act, 1956 before the Company Law Board seeking directions against the company for delivery of share certificates. The respondent company challenged the petition on the ground that the director of the petitioner took physical delivery of share certificates from the company. However, the respondent company has failed to produce conclusive proof that it had delivered the share certificates to the petitioner. It was held that, the burden of proving delivery of the share certificates to the petitioner is upon the company; failure of which it could not be said that the company becomes discharged its obligations imposed under section 113(1). Hence, Company Law Board upheld the default of company in delivering the share certificates and further directed the company to deliver share certificates to the petitioner.



### 3.16 SHARE WARRANT

You must first know what a share warrant is. It is a document which a public company issues in conformity with the statutory requirements ; it is issued under the common seal of the company and states that the holder of the warrant is entitled to certain number of shares specified therein. It is a bearer document and the title to the shares specified therein can be transferred by mere delivery of the share warrant. To that extent, it is a negotiable instrument. Under Section 114 of the Act, the issue of such share warrant can be made only if the company is so authorised by its articles and permission of the Central Government has been obtained (Table A contains regulations permitting issue of share warrants). Further, share warrants to bearer can be issued only in respect of fully paid shares. Dividend coupons are attached to the share warrants providing for the payment of future dividends on the shares specified in the warrants.

The particulars under Section 115 which must be entered in the Register of Members upon the issue of a share warrant are as follows, namely :

- (i) the fact of the issue of warrant ;
- (ii) a statement of the shares included in the warrant, distinguishing each share by its number; and
- (iii) The date of the issue of warrant.

A private company cannot assume power in its articles to issue share warrants. Since share warrants are transferable by delivery, such a condition would be opposed to the restriction on transferability which is an essential requirement in the case of a private company.

The articles of a public company may provide that the bearer of a share warrant shall be deemed to be a member of the company for the purposes defined by the articles. However, holding of a share warrant does not operate as a qualification for being a director of a company, where such is required under the articles.

On the issue of a share warrant to a member, his name must be struck off the Register of Members, But the bearer of warrants shall, subject to the articles of the company, be entitled on surrendering the warrant for canceling and paying such fee to the company as may be prescribed from time to time by the Board of Directors, to have his name entered as a member in the Register of Members. The company shall be responsible for any loss incurred by any person by reason of the company entering in its Register of Members the name of a bearer of share warrant in respect of the shares therein specified without a warrant being surrendered or cancelled.



**Share certificate and share warrant.**

1. A share certificate is a prima facie evidence of document of title, stating that the holder is entitled to specified number of shares. Share warrant is a bearer document stating that the holder is entitled to certain number of shares specified therein.
2. The holder of a share certificate is a member of the company, but whereas the bearer of a share warrant can be a member only if the articles provide.
3. A share warrant is a negotiable instrument. A share certificate is not so.
4. A public company can only issue a share warrant, whereas, a share certificate can be issued by a public and private company.
5. In order to qualify as a director, the person should acquire a share certificate instead of a share warrant.
6. A share certificate can be issued for a fully paid and partly paid up shares. A share warrant can be issued in respect of only fully paid up share.

**3.17 CALLS ON SHARES**

Regulations 13-18 of Table A of Schedule 1 to the Act deal with calls on shares.

A 'call' may be defined as a demand made by a company on its shareholders to pay the whole or a part of the balance, remaining unpaid on each share at any time during the continuance of a company. A call can also be made by a liquidator in the course of the winding up of the company (*Ramchandran vs. Manickam* [1941] A.I.R. Mad 565). If a part of the uncalled capital of the company is treated as a reserved capital, a call cannot be made in respect of such capital during the continuance of the company; it can be made only on liquidation (Section 99). From the time a call is made, the amount called up becomes a debt due to the company within the meaning of Section 36(2); as such the company is entitled to charge interest on it during the period of default. Furthermore, if any sums which are due on allotment or if calls are not paid, then the directors may, if so empowered by the articles, forfeit the shares. But they may do so only after giving a notice to the shareholders to this effect.

**(a) Rules for making calls :** The Board of Directors alone is empowered to make a call. The power cannot be delegated to a director or to a committee of directors or to any other officer of the company (Section 292). A call on the shares falling under the same class must be made on a uniform basis. Shares of the same nominal value, on which different amounts have been paid up, are not deemed to fall under the 'same class' (Section 91). The Board's resolution making the call must specify the amount of call per share and the time allowed for its payment. The calls are made and are payable according to the conditions prescribed by the articles of the company. A call must not exceed 1/4th of the nominal value of the shares or be payable at less than one month from the date fixed for the payment of the last preceding call.



**(b) Payment of calls in advance:** But before we conclude our discussion on calls we have also to know how payment in advance of calls is treated by a company. A company may, if so authorised by the articles, accept from any member the whole or a part of the amount remaining unpaid of any shares by him although no part of that amount has been called up [Section 92(1)]. The amount so received or accepted is described as payment in advance of calls. When a company receives payment in advance of calls, the consequences will be as follows:

- (i) The shareholder is not entitled to voting rights in respect of the moneys so paid by him until the same would, but for such payment, become presently payable [Section 92(2)].
- (ii) The shareholder's liability to the company in respect of the call for which the amount is paid is extinguished.
- (iii) The shareholder is entitled to claim interest on the amount of the call to the extent payable according to articles of association. If there are no profits, it must be paid out of capital, because shareholder becomes the creditor of the company in respect of this amount.
- (iv) The amount received in advance of calls is not refundable.
- (v) In the event of winding up the shareholder ranks after the creditors, but must be paid his amount with interest, if any before the other shareholders are paid off.
- (vi) The power to receive the payment in advance of calls must be exercised in the general interest and for the benefit of the company (*Syke's case (1872) L.R. 13 Eq. 255*).

### 3.18 TRANSFER OF SHARES

Transfer of shares means the voluntary conveyance of the rights and possibly, the duties of a member (as represented in a share in the company) from a shareholder who wishes to cease to be a member to a person desirous of becoming a member. Subject to the provisions of the articles of the company and to any statutory restrictions, a shareholder has an unrestricted right to transfer his shares (Section 82). Thus, shares in a company are transferable like any other moveable property in the absence of express restrictions under the articles.

#### **(a) Procedure for effecting transfer**

An application for the registration of a transfer of the shares in a company may be made either by the transferor or by the transferee [Section 110(1)]. In addition to comply with the provisions of the Articles the following procedure must be followed before a company can lawfully register a transfer:

- (1) The instrument of transfer must be executed in a prescribed form *i.e.*, Form No. 7B and before it is signed by the transferor and before any entry is made therein, it should be



presented to the prescribed authority who shall stamp or otherwise endorse thereon the date on which it is so presented.

- (2) After this has been done, the instrument must be executed by or on behalf of the transferor and the transferee and completed in all other respects (must specify the name, address and occupation, if any, of the transferee).
- (3) After that, the instrument of transfer completed in all respects (*i.e.*, along with the share certificate or if no such certificate is in existence, along with the letter of allotment of the shares) should be delivered to the company :
  - (i) in the case of shares dealt in or quoted on a recognised stock exchange, at any time before the date on which the register of members is closed, in accordance with the law, for the first time after the date of the presentment to the prescribed authority or within twelve months from the date of such presentation, whichever is later [Section 108(1A)(b)(i)].
  - (ii) in any other case, within two months from the date of such presentation [Section 108(1A)(b)(i)].

These time-limits are intended to do away with the evil of blank transfers. Blank transfers created problems of evasion of taxes, priority between transferees, etc., since there is no entry on the instrument, *i.e.*, it is signed in blank. As a result of these limits, the currency of blank transfers has been restricted.

*Exemptions:* The above mentioned provisions are however, not applicable to transfer of shares held : (a) by a company in any other body corporate in the name of director or nominee pursuant to Section 49(2) or (3); (b) by a corporation owned or controlled by the Central Government or a State Government in any other body corporate; or (c) in respect of which a declaration has been made to the Public Trustee under Section 153B.

These exemptions are operative only if the following two conditions are complied with, namely; (i) if the company or corporation referred to in (a) & (b) above stamps or otherwise endorses on the form of transfer the date on which it decides that such shares shall not be held in the name of the said director or nominee and Public Trustee mentioned in (c) above stamps or otherwise endorses on the form under his seal, the date on which the form is presented to him (ii) if the instrument of transfer, complete in itself, is delivered to the body corporate in whose share capital, such company or corporation has made the investment in the name of its director or nominee, or the company in which such share is held in trust; this completed instrument of transfer is to be delivered as aforesaid within two months of the date, so stamped or otherwise endorsed.

\*The prescribed authority apart from the Registrar, that may from time to time, be



appointed by the Central Government, be a person already in the service of the Government.

Another exemption has been made in respect of shares deposited by way of security for the repayment of any loan advanced to, or for the performance of any obligation undertaken by such a person when these are deposited with (i) the State Bank of India; or (ii) any scheduled bank; (iii) any banking company other than a scheduled bank or financial institution as may have been approved by the Central Government; or (iv) the Central Government or a State Government. This exemption can be availed of, if the following conditions are complied with, namely; (i) that the bank, institution, Government or Corporation stamps or otherwise endorses in the form of transfers: (a) the date on which such shares are returned to the depositor; or (b) the date of release of such shares for sale, when the depositor has defaulted in the discharge of his obligation; or (c) the date on which the instrument of transfer relating to such shares is executed where the bank, institution, etc., intends to get such share registered in its own name; (ii) that the instrument is delivered to the company within two months from the date so stamped or endorsed.

Still another exemption has been made in respect of any share, which is held in any company by the Central Government or State Government in the name of its nominee, except that every instrument of transfer which is executed on or after 1-10-1966 in respect of any such share should be in the prescribed form.

*Extension of time:* The Central Government has been given power to extend the period within which the instrument of transfer is to be deposited with the company. This has been done to avoid any hardship. An application may be made either before or after the expiry of the period to be extended. The Central Government has, however, to show in the Annual Report laid before the Parliament the number and length of extensions so granted [Section 108(1D)].

- (4) *Transfer of partly paid shares:* Where the application is made by the transferor and relates to partly paid shares, the transfer must not be registered unless the company gives notice of the application to the transferee and the transferee makes no objection to the transfer within two weeks from the receipt of the notice [Section 110(2)]. Notice to the transferee shall be deemed to have been duly given if it is despatched by prepaid registered post to the transferee at the address given in the instrument of transfer, and shall be deemed to have been duly delivered at the time at which it would have been delivered in the ordinary course of post [Section 110(3)].
- (5) After the above formalities have been observed, the Board of Directors considers the application and if found alright in all respects registers the transfer. An endorsement is made on the back of the share certificate recognising the transferee as the new holder.



**(b) Acquisition and transfer of shares:** Sections 108A to 108H were originally introduced in the Companies Act, 1956 by the Amendment Act, 1974 to regulate the acquisition and transfer of shares of a body-corporate owning any undertaking to which the provisions of Part A of Chapter III of the MRTP Act, apply. They were intended to prevent acquisition or take-over of companies leading to further concentration of economic power.

The Sachar Committee recommended that provisions of Sections 108A to 108H in the Companies Act be transferred to the MRTP Act, and stated that “the provisions of these Sections are apparently applicable, by virtue of the specific provisions in Section 108H to shares of companies to which the provisions of Part A of Chapter III of the MRTP Act, apply; therefore, they should be transferred to the MRTP Act. Consequently the provisions of Sections 108A to 108H of the Companies Act, were omitted and incorporated in Chapter IIIA (Sections 30A to 30G) of MRTP Act, by the MRTP (Amendment) Act, 1984.

The MRTP Act, has been reconstructed by the MRTP Amendment Act, 1991 and the concept of MRTP undertakings has been re-moved by omitting Sections 20 to 26 of Part A of Chapter III. The provisions of Chapter IIIA (Sections 30A to 30G) have been re-transferred to Companies Act, as Sections 108A to 108I. On transfer to the Companies Act, these provisions now apply where the acquirer or transferee of shares is (or would be) the owner of a dominant undertaking as defined in Section 2(d) of the MRTP Act, 1969, or as result of acquisition of shares the dominance of the acquirer increases *vide* Section 108G.

The provisions of Sections 108A to 108I are summarised as under :

(i) Section 108A provides that no individual, firm or group, constituent of a group, body corporate or bodies corporate under the same management, shall acquire or agree to acquire more than 25 per cent of the paid-up equity share capital of a public company or a private company which is a subsidiary of a public company, without the previous approval of the Central Government. Also the following shall not transfer or agree to transfer any shares to such acquirer unless the acquirer has obtained the previous approval of Central Government:

- (a) company in which not less than 51 per cent of the share capital is held by the Central Government; or
- (b) corporation (not being a company) established by or under any Central Act; or
- (c) financial institution.

(ii) Section 108B provides that every body corporate or bodies corporate under the same management holding whether singly or in the aggregate 10 per cent or more of the subscribed equity share capital of any company and which proposes to transfer any of such shares, shall inform the Central Government regarding the particulars of the shares proposed to be transferred, the name and address of the proposed transferee and his existing shareholdings in that company etc. Where the Central Government is of the view that such transfer would result in a change in the composition of Board of Directors of the company and that such



change would be prejudicial to the interests of the company or to public interest, it may by order director either not to give effect to such transfer or in case of share held by a company engaged in an industry specified in Schedule XV, to transfer such shares to the Central Government itself or any specified corporation owned or controlled by that Government. The Central Government or the specified corporation shall pay in cash, the market value of these shares.

(iii) Section 108C provides that a body corporate or bodies corporate under the same management, which hold in aggregate, 10 per cent or more of the nominal value of equity share capital of a foreign company having an established place of business in India, shall not transfer any share in such foreign company to any citizen of India or any body corporate incorporated in India except with the previous approval of Central Government. The Central Government shall not refuse such approval unless it is of the opinion that such transfer would be prejudicial to public interest.

(iv) Section 108D empowers the Central Government to direct companies not to give effect to any transfer of shares if as a result of such transfer, a change in the controlling interest of the company is likely to take place and such change would be prejudicial to interests of the company or public interest.

Where the Central Government refuses the transfer, the shares shall stand transferred back to the transferor and the amount paid by the transferee shall be refunded.

If the refund is not made within 30 days from the date of the order, the Central Government shall, on the application of the person entitled to get the refund, direct, by order, the refund of such amount and such order, shall be enforced as if it were a decree made by a Civil Court.

The person to whom such shares are re-transferred, shall on making the refund, be eligible to exercise voting or other rights attaching to such share or block of shares.

(v) Section 108E provides for the time limit of 60 days of receipt of the request within which the Central Government must communicate its decision for any refusal on the proposal for an acquisition of shares under Section 108A or transfer of shares under Section 108C otherwise the approval shall be presumed to have been granted.

(vi) Section 108F provides that Sections 108A to 108D shall not apply to the following except that these entities shall not transfer or agree to transfer any share to the acquirer covered under Sections 108A to 108E, unless such acquirer has obtained the previous approval of the Central Government for acquisition or such shares :

- (i) Any company in which not less than 51 per cent of shares capital is held by the Central Government.
- (ii) Any corporation not being a company established by or under any Central Act, *i.e.*, a Statutory Corporation.





- (iii) Any financial institution.
- (vii) Section 108H defines the various expressions such as 'group', 'same management', financial institutions; 'dominant undertaking' etc., used in Sections 108A to 108G. Section 108(l) lays down the final provisions for acquisition and transfer of shares in contravention of Sections 108A to 108D.

### **3.19 NOMINATION FACILITY IN RESPECT OF SHARES**

A new Section (109A) has been inserted by the Companies (Amendment) Act, 1999. Sub-section (1) of Section 109A provides that every holder of shares in, or holder of debentures of, a company may, at any time nominate, in the prescribed manner, a person to whom his shares in, or debentures of, the company shall vest in the event of his death.

Where the shares in, or debentures of, a company are held by more than one person jointly, the joint-holders may together nominate, in the prescribed manner, a person to whom all the rights in the shares or debentures of the company shall vest in the event of death of all the joint holders. (Sub-section 2)

Notwithstanding anything contained in any other law for the time being in force or in any disposition, whether testamentary or otherwise, in respect of such shares in, or debentures of, the company, where a nomination made in the prescribed manner purports to confer on any person the right to vest the shares in debentures of, the company, the nominee shall, on the death of the shareholder or holder of debentures of, the company or, as the case may be, on the death of the joint holders become entitled to all the rights in the shares or debentures of the company or, as the case may be, all the joint holders, in relation to such shares in, or debentures of the company to the exclusion of all other persons, unless the nomination is varied or cancelled in the prescribed manner. (Sub-section 3)

Where the nominee is a minor, it shall be lawful for the holder of the shares, or holder of debentures, to make the nomination to appoint in the prescribed manner any person to become entitled to shares in or debentures of, the company, in the event of his death, during the minority. (Sub-section 4)

### **3.20 HOW NOMINATION FACILITY SHALL OPERATE IN CASE OF TRANSMISSION OF SHARES? (SECTION 109B)**

Any person who becomes a nominee by virtue of the provisions of Section 109A, upon the production of such evidence as may be required by the Board and subject as hereinafter provided, elect, either-

- (a) to a registered himself as holder of the share or debenture, as the case may be; or
- (b) to make such transfer of the share or debenture, as the case may be as the deceased shareholder or debenture holder, as the case may be, could have made.



If the person being a nominee, so becoming entitled, elects to be registered as holder of the share or debenture, himself as the case may be, he shall deliver or send to the company a notice in writing signed by him stating that he so elects and such notice shall be accompanied with the death certificate of the deceased shareholder or debenture -holder, as the case may be. (Sub-section 2)

All the limitations, restrictions and provisions of this Act relating to the right to transfer and the registration of transfers of shares or debentures shall be applicable to any such notice or transfer as aforesaid as if the death of the member had not occurred and the notice or transfer were a transfer signed by that shareholder or debenture holder, as the case may be. (Sub-section 3)

A person, being a nominee, becoming entitled to a share or debenture by reason of the death of the holder shall be entitled to the same dividends and other advantages to which he would be entitled if he were the registered holder of the share or debenture except that he shall not, before being registered a member in respect of his share or debenture, be entitled in respect of it to exercise any right conferred by membership in relation to meetings of the company:

**Provided** that the Board may at, any time, give notice requiring any such person to elect either to be registered himself or to transfer the share or debenture, and if the notice is not complied within ninety days, the Board may thereafter withhold payment of all dividends, bonuses or other moneys payable in respect of the share or debenture, until the requirements of the notice have been complied with. (Sub-section 4).

### **3.21 REFUSAL TO REGISTER TRANSFER AND APPEAL AGAINST REFUSAL [SECTION 111]**

For the purpose of Section 111, "Company" means a private company and includes a private company which had become public by virtue of Section 43A of this Act (Sub-section 14) inserted by Depositories Act, 1996. A company, when it refuses to register a transfer or transmission by operation of law, of the right to any shares in, or debentures thereof, is required to send notice of refusal giving reasons to the transferee and the transferor or the person giving intimation of transmission, within 2 months from the date on which the transfer deed or the intimation of transmission, is delivered to the company. An aggrieved person being a transferor or transferee or any other person may apply to the Company Law Board under Sub-section (2) or (4) against refusal or for rectification of the register of members, if his name is entered in the register without sufficient cause, or for omission of his name from the register or default in making an entry of his name in the register. An appeal may be filed within 2 months of the receipt of notice of refusal or within 4 months from the date of lodgement of transfer application in case no notice has been sent by the company. There is no limitation period provided for making an application for rectification of register of members, under Sub-section (4). For default in registration of transfer within 2 months or for not giving reasons for



refusal, as provided in Sub-section (1) offence is punishable under Sub-section (12) with a fine upto Rs. 500 per day.

Earlier, the appellate power was vested with the Central Government and now, the power has been statutorily conferred on the Company Law Board. The Board can now decide any question relating to the title of any person, under Sub-section (7); this power was earlier vested with the court under Section 155. Since the Board is now exercising judicial and *quasi-judicial* functions, the proceedings are no more confidential as earlier provided in Sub-section (3), now omitted by the Amendment Act of 1988. Now, the parties cannot claim confidentiality in these proceedings. The board was earlier required to give notice to the transferor and the transferee, under the then Sub-section (5). Sub-section (5) now provides for hearing the parties and the Board is not obliged to issue notice of hearing also to the transferor, unless the petition has been filed by him; the Board is required to give hearing to the company and the aggrieved party, who may be either the transferor or the transferee. It may, however, be noted that rule 5 of the Companies (Appeal to the Central Government) rules, 1975 provide for notice to the transferor also. These rule will continue to apply so long as the Company Law Board does not frame its own rules or procedures to regulate the proceedings under Section 111.

Under Sub-section (6), the Board has been empowered to pass interim orders, including any order of injunction or stay and other interlocutory order, regarding payment of dividend or allotment of bonus or rights shares during the pendency of the appeal. It may be noted that under Section 206A, inserted by Amendment Act of 1988, provision has been made for transfer of dividend to a special account and for keeping in abeyance any offer of rights shares and any issue of bonus shares, in respect of any instrument of transfer lodged with the company.

In the matter of private company, it may be stated that though by its very definition under Section 3(1)(iii) a private company restricts transfer of its shares, under Section 111 the power of a private company to refuse transfer of shares has been iterated under Sub-section 13. However, the right conferred is only to the extent of enforcing restrictions contained in the articles of association and not on any other grounds. Also, Sub-section 11 of Section 111 provides that petition will lie for non-transmission of shares in or debentures of a private company which is not a subsidiary of a public company, if such transmission is by way of sale thereof held by a court or other public authority.

### **3.22 TRANSFER OF SECURITIES OF A PUBLIC COMPANY [SECTION 111A]**

The newly Section 111A provides that the securities of a company other than a private company or a deemed public company are freely transferable. The Board of Directors of a Company or the concerned depository has no discretion to refuse or withhold transfer of any security. The transfer has to be effected by the company/depository automatically and immediately.



Where, however, the transfer of shares or debentures is effected in contravention of the provisions of the Securities and Exchange Board of India Act, 1992, or regulations made there under or the Sick Industrial Companies (Special Provisions) Act, 1985, an application can be made to the Company Law Board by a depository, company, participant or investor or the Securities and Exchange Board of India within two months from the date of transfer of the shares or debentures held by the depository or from the date on which the instrument of transfer or the intimation of transmission was delivered to the company, as the case may be, to rectify the register or records of the company or depository. If the Company Law Board, after making such inquiry as it thinks fit, is satisfied that the contravention has taken place, it may direct the company or the depository to rectify the register or the records of ownership.

The Company Law Board may, pending completion of the inquiry, at its discretion suspend the voting rights in respect of the securities which are subject matter of inquiry. During the pendency of the application before the Company Law Board, the transferee can transfer the security and such further transfer would entitle the transferee to voting rights also unless the voting rights in case of transferee to voting rights also unless the voting rights in case of transferee have also been suspended by Company Law Board.

**Omission of Section 22A of the Securities Contracts (Regulation) Act, 1956**

Section 22A of the Securities Contracts (Regulation) Act, 1956 which was inserted by the 1985 Amendment Act, (effective from 17-1-1986) and the provisions of which have been discussed above, has been deleted from the Act by the Depository Act, 1996. Consequently, the grounds for refusal to register the transfer of share by the Companies no longer exist and the securities have now become freely transferable.

**3.23 CERTIFICATION OF TRANSFER (SECTION 112)**

Where a shareholder wishes to transfer only part of his shareholding or wishes to sell them to two or more persons, he is required to lodge the share certificate with the company. Where he has already lodged with the company the relevant share certificate, together with an instrument of transfer for part of the shares, he may request the company to certify on the instrument of the transfer that the share certificate for the shares covered by the instrument of transfer has been lodged with the company. This is known as certification and may be in the following form:

Certificate for..... equity/preference shares lodged at the Company's Registered office.

Dated the..... day of.....

Sd/-  
Secretary



An instrument of transfer shall be deemed to be certificated if it bears the words “certificate lodged” or the words to the like effect. Certification is, therefore, the act of noting by the secretary etc., stating that the share certificate has been lodged with the company.

When only a portion of shares is transferred, the company usually issues him a ticket for the balance of shares which have not been transferred. Such a ticket is called a ‘balance ticket’.

The certification by a company of a transfer as above is to be taken as a representation by the company to any person acting on the faith of the certification that there has been produced to the company such documents as, on the face of them, show a *prima facie* title to the shares in the transfer. It is, however, not a representation that the transferor has any title to the shares [Section 112(1)].

The company will be responsible for the certification only if :

- (a) the person issuing the instrument is authorised to issue such instrument on the company’s behalf; and
- (b) the certificate is signed by any officer or servant of the company or any other person authorised to certify transfer on the company’s behalf. In case a body corporate has been so authorised by any officer or servant of the body corporate.

*Liability in case of wrong certification:* With regard to liability, Section 112(2) provides that where any person acts on the faith of a false certification by a company made negligently, the company shall be under the same liability to him as if the certification had been made fraudulently. In other words, the company shall be liable to pay damages which the person might have suffered.

If, however, by negligence, the secretary, after certifying the transfer, returns the original certificate to the transferor who pledges the same, the company shall not be liable to the pledgee as (i) it owes no duty to the pledgee, (ii) the immediate cause of his loss was not the issue of the certificate [*Longman vs. Bath Electric Tramways* (1905) 1 Ch. 646].

However it may be noted that the company is under no obligation to certify any instrument of transfer of shares at all.

*Effect of transfer:* A transfer is not complete until registered. The transferee does not acquire a legal title to the shares until his name has been entered in the Register of Members. Thus, the transferor continues to be the legal owner of the shares but on the principle of equity he holds them in trust for the transferee.

The position during the period, between the date when a contract to transfer shares is made and the placing of the transferee’s name on the Register of Members, may be summed up as follows :

- (1) The transferor must pay the calls, if any. He may, however, recover the amount from the transferee.



- (2) If dividends are declared and paid before transfer is registered, the company must pay it to the transferor. As between the seller and the buyer, it is the buyer who has a *prima facie* right to all dividends declared, after the date of transfer [*Black vs. Homersham*], unless otherwise agreed. Thus, where shares have been sold 'ex-dividend' the seller shall be entitled to retain dividends.
- (3) The voting power rests with the transferor but he must vote as the transferee directs [*Musselwhite vs. Musselwhite & Sons Ltd.* (1962) Ch. 964]. However, if the transferee has not paid the price, the transferor may vote as he pleases.

### 3.24 BLANK TRANSFERS

A blank transfer is an instrument of transfer signed by the transferor in which the name of the transferee and the date of the transfer are not filled. But why blank transfer at all? You know that the ownership of shares in a company is generally transferred from one person to another by the execution of a document by the seller and the buyer. This document is variously described as a 'transfer instrument' or 'transfer deed' or simply 'transfer'. But in a blank transfer, the seller only fills in his name and sign it. Neither the buyer's name and signature nor the date of sale is filled in the transfer form. This will enable the buyer to sell the shares again to a subsequent buyer without filling his name and signature. The process of purchase and sale can be repeated any number of times with the blank deed and any transferee can fill in his name and date and get it registered in the company's book. For such ultimate transfer and registration, the first seller will be treated as the transferor.

The widespread practice of blank transfers which was prevalent before the Companies Act, 1956, lent itself to certain abuses, the most important of which were: (1) avoidance of transfer stamps; (2) concealment of the identity of the real beneficial owners behind their nominees; (3) evasion of tax by suppression of 'secret' profit invested in holdings on blank transfers.

### 3.25 FORGED TRANSFERS

A forged transfer is a nullity. It does not give the transferee concerned any title to the shares. If the company acts on a forged transfer and removes the name of the real owner from the register of Members then the company is bound to restore the name of the real owner on the register as the holder of the shares and to pay him any dividends which he ought to have received [*Barton vs. North Staffordshire Railway Co.* 38 Ch. D. 456. *People Insurance Co. Ltd. vs. Wood & Co. Ltd.* (1961) 31 Comp. Case. 63].

Thus, if by forgery, a obtains a certificate of transfer of shares from a company and transfers the shares to a purchaser for value acting in good faith *i.e.* without the knowledge of the forgery, such purchaser does not get a good title to the shares so transferred, because a forged transfer is a nullity and cannot be a source of a valid transfer of title. But the company



shall be liable to compensate the purchaser in so far as the company had issued a certificate to transfer and was therefore estopped from denying the liability accruing from its own act. The innocent purchaser for value acting upon the faith of the certificate issued by the company could validly and reasonably assume that the person named in the certificate as the owner of shares was really the owner of the shares represented by the certificate [*Balkis Consolidated Co. vs. Tamkinson* (1982) A.C. 1961]. If as a result of the forged transfer, the name of the true owner of shares is taken off the Register of Members he can compel the company to restore his name to the register. He can also claim any dividend which may not have been paid to him during the intervening period [*Barton vs. North Staffordshire Supra*]. Likewise the transferee must take care that he is not getting a certificate from the company on a forged transfer, because in that case the transferee shall be liable to indemnify the company against the consequences of the damages which may have to be paid by the company to the true owner of the shares [*Sheffield Corporation vs. Barclay* (1905) B.C. 393]. The person who even without any negligence brings about a transfer is liable to indemnify the company against its liability to the owner of shares whose name was taken off from the register as a result of the forged transfer [*Sheffield Corporation vs. Barclay (supra)*; *Starkey vs. Bank of England* (1903) A.C. 104].

### **3.26 TRANSMISSION OF SHARES**

It takes place when shares are transferred under the operation of law, either on the death of the registered shareholder or on his being adjudged as insolvent. It also takes place where the holder is a company if it goes into liquidation. Upon the death, the shares of the deceased vest in his executors or administrators and the estate becomes liable for calls if the shares are not fully paid up. In the like manner the official assignee or the receiver, as the case may be, is also entitled to be registered as a member in the place of shareholder who has been adjusted in insolvent [*R.W. Key and Sons* (1902) 1 C, 467]. However, the executors or administrators may decline to be registered as members for various reasons. In that event the legal representatives, by virtue of Section 109, shall be entitled to transfer the shares of the deceased irrespective of whether they are partly paid or fully paid. Similarly, the official assignee has the statutory power to transfer the shares under Section 58(1) of the Presidency Towns Insolvency Act.

The distinction between transfer and transmission, thus, is that the former is the effect of deliberate act of a member whereas the latter is the result of operation of law on the death or insolvency of a member. Again unlike a transfer in the case of the transmission of shares, an execution of any instrument of transfer is not required. Transmission is recorded by the company on the basis of evidence showing the entitlement of the transferee the shares. No stamp duty is payable on transmission of shares.



### 3.27 FORFEITURE AND SURRENDER OF SHARES

Forfeiture is the remedy for non-payment of calls or instalments of call or other sums as premiums due in respect of shares. Such a power can be exercised only if the articles expressly so provide and the procedure laid down there under is strictly adhered to. The effect of the forfeiture of a member's share is that he ceases to be a member. If the shares are partly paid, then he is discharged from the liability as shareholder to pay the balance of the amount due on the shares. (But the articles may reserve the liability in respect of sums already called up but not yet paid by him, in which case this creates new liability and he will be liable to these sums as an ordinary debtor and not as a shareholder). Limitation begins to run from the date of forfeiture.

You have already noted that a company can forfeit shares for non-payment of calls only if it has taken power (most companies do so take) in the articles for the purpose. Further, in *Naresh Chandra Sanyal v. Calcutta Stock Exchange Association Ltd.* [1971] *Comp. case 51 (S.C.)*, it has been held that forfeiture of shares of non-compliance with any other engagement than to pay calls is also valid, provided the articles stipulate so. Nonetheless directors should exercise this power carefully, for in the case of any irregularity, the dispossessed shareholder may have the forfeiture annulled. The power of forfeiture is required to be exercised *bona fide*, in the interest of the company; it must not be collusive or fraudulent.

The procedure to be followed in this regard is laid down in Regulations 29, 30, 31 and 34 of Table A of Schedule I to the Companies Act, 1956. These are outlined below :

- (i) If a member fails to pay call (or instalment of a call) on the day appointed for payment thereof, the board may, at any time thereafter, during such time as any part of the call for instalment remains unpaid, serve a notice on him requiring payment of so much of the call (or instalment) as is unpaid together with any interest which may have accrued (Regulation 29). It may be noted that an improper notice will invalidate the procedure [*Public Passenger Services Ltd. vs. M.A. Khadar* (1965) 1 *Comp. L.J.* (S.C.)]. The notice must disclose sufficient information as to the amount due.
- (ii) The aforesaid notice must: (a) mention a further day (not being earlier than expiry of 14 days from the date of service of the notice) on or before which the payment required by the notice is to be made; and (b) state that if the payment is not made on or before the date so mentioned, the shares in respect of which the call was made would be liable to be forfeited.

Usually, along with the above-mentioned notice an extract is sent from the articles of association, showing the directors' power to forfeit shares. If the requirements of the notice are complied with, any share in respect of which notice has been given, may at any time thereafter, before the payment required by the notice has been made, be forfeited by a resolution of the board to that effect.





A duly verified declaration in writing that the declarant is a director, the manager or the secretary of the company and that a share in the company has been duly forfeited on a date stated in the declaration shall be conclusive evidence of the facts therein stated as against all persons claiming to be entitled to the shares.

As regards surrender of shares both the Act and Table A are silent. The articles of companies, however, often empower the directors to accept the surrender of shares. Courts too recognise in on the principle that it relieves the directors of the necessity to go through the formality relating to forfeiture. Although surrender and forfeiture have almost the same effect, yet they differ from each other. Surrender is effected with the assent of the shareholder, whereas forfeiture is a proceeding in invitum (*i.e.*, against a reluctant shareholder) [*Trevor vs. White-work* (1887) 12 App. Case. 417]. But a surrender of shares are not fully paid can only be accepted where forfeiture would be justified [*Bellerly and Rawland and Marwoods Steamship Co.* (1902) 2 Ch. 14].

Where the company pays any consideration for the surrender of partly paid up shares, the surrender will be invalid, in as much as it will amount to purchase by the company of its own shares. Unless there are special circumstances, *e.g.*, where the surrender is a part of compromise. Every surrender of shares, whether or not fully paid up, involves reduction of capital, which is unlawful without the sanction of the Court. But if it does not result in the reduction of capital *e.g.*, if the surrender is in exchange of other shares of the same nominal value, it has been held in a leading case that it can be accepted without leave of the Court but doubts have been cast on this decision by leading text-book writers like Palmer.

Thus, it may be right to say that surrender of shares in a company is a shortcut to forfeiture.

### **3.28 CAPITALISATION OF PROFIT**

It can only be done if the articles of the company contain provisions in regard thereto (Regulations 96 and 97 to Table A of Schedule I). It means that profits which otherwise are available for distribution among the members, are not divided among them in cash, but the shareholders are allotted further shares (bonus shares). Capital profits, shares premium and capital redemption reserve account can also be used for the purpose of issuing fully paid bonus shares.

According to the proviso to Section 205(3), it is permissible for a company to capitalise its profits or reserves for the purpose of issuing fully paid up bonus shares or paying up any amount for the time being unpaid on any shares held by the members of the company.

The procedure as regard the issue of bonus shares has been laid down in (Regulation 96 of Table A to Schedule I.) This is as follows:

A resolution is to be passed by the Board recording its decision to issue bonus shares. On the recommendation of the Board, the company is to resolve in the general meeting that: (a) it is



desirable to capitalise a part of the amount for the time being standing to the credit of any of the company's reserve accounts, or to the credit of the profit and loss account, or otherwise available for distribution and (b) such sum be accordingly set free for distribution in the specified manner amongst the members who have been entitled thereto if distribution by way of dividend and in the same proportions would have made.

The sum mentioned in the preceding paragraph must not be paid in cash. It must be applied (subject to the provision stated in paragraph immediately following) either in or towards, *inter alia* (a) paying up any amounts for the time being unpaid on any shares held by such members respectively, (b) paying up in full unissued shares of the company to be allotted and distributed, credited as fully paid up, among such members in the proportions aforesaid.

A share premium account and a capital redemption reserve may only be applied in paying up unissued shares to be issued to the members of the company as fully paid bonus shares.

*Conceptual framework as regards to capitalisation of profits:* There are a number of considerations which will weigh with the Board of Directors of a company in issuing bonus shares by capitalisation of accumulated profits. The principal objects are: (i) the company's cash resources may not be sufficient to pay dividend in cash; (ii) the company intends to building-up cash resources for expansion or for repayment of a liability; (iii) in order to bring the paid-up capital more in line with the capital employed in the business. For instance, if the company has a share capital of Rs. 2 crores, reserves and surplus of Rs. 6 crores and capital employed in the business (*i.e.*, net fixed assets plus working capital) of Rs. 12 crores, it is more realistic to state that the paid-up capital of the capital of the company is Rs. 8 crores. To achieve this mode of disclosure, a part of the reserves are converted into share capital by issuing bonus shares, this depicts a more rational capital base; (iv) a company which has built up large reserves, when it earns profit, gives a superficial view of its current earning capacity. For example, if a company with a share capital of Rs. 5 crores and a general reserve of Rs. 10 crores earns an annual profit of Rs. 1.5 crores, it works out at 30 per cent on share capital of five crores. The real rate of return is 10 per cent (150 lakhs on 15 crores). To depict this realistic picture the company may convert a part of its reserves into capital by issuing bonus shares. This saves the company from accusation of profiteering and demand from labour for higher reward having regard to higher earning capacity which is in fact deceptive; (v) bonus issue is also resorted to with a view to bringing down the rate of dividend though not the quantum of dividend on the issued capital. When the capital base is small and the earnings are large, even a small portion of profits distributed by way of dividend would yield quite a high percentage and may give the impression of profiteering. For instance if paid up capital is Rs. 10 lakhs on which profit of Rs. 1 lakh is distributed, it yield 10 per cent return. If, however, Rs. 5 lakhs of the reserves is capitalised to issue bonus shares, a profit of Rs. 1 lakh will give a return of bare 6.7 per cent. It will be observed that the proposal of bonus issue may have been influenced as a result of any of these considerations.



**(a) Guidelines on Bonus Issue (Issued by SEBI) - Disclosure and Invertors' Protection Guidelines, 2000).**

**A listed company proposing to issue bonus shares shall comply with the following**

**1 GUIDELINES FOR BONUS ISSUES**

15.0 A listed company proposing to issue bonus shares shall comply with the following:

- 15.1.1 (a) No company shall, pending conversion of FCDs/PCDs, issue any shares by way of bonus unless similar benefit is extended to the holders of such FCDs/PCDs, through reservation of shares in proportion to such convertible part of FCDs or PCDs.
- (b) The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.
- 15.1.2 The bonus issue shall be made out of free reserves built out of the genuine profits or share premium collected in cash only.
- 15.1.3 Reserves created by revaluation of fixed assets are not capitalised.
- 15.1.4 The declaration of bonus issue, in lieu of dividend, is not made.
- 15.1.5 The bonus issue is not made unless the partly-paid shares, if any existing, are made fully paid-up.
- 15.1.6 The Company –
- (a) has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption thereof and
- (b) has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.
- 15.1.7 A company which announces its bonus issue after the approval of the Board of Directors must implement the proposal within a period of six months from the date of such approval and shall not have the option of changing the decision.
- 15.1.8 (i) The Articles of Association of the company shall contain a provision for capitalisation of reserves, etc.
- (ii) If there is no such provision in the Articles the company shall pass a Resolution at its general body meeting making provisions in the Articles of Associations for capitalisation.



**Return of Bonus Issue** : Under Section 75(1)(c) when a company having a share capital makes any allotment of bonus shares, it must within 30 days thereafter file with the Registrar a return stating the number and nominal amount of such shares comprised in the allotment and the names, addresses and occupations of the allottees and a copy of the resolution authorising the issue of such shares.

### **3.29 DEBENTURES**

Under Section 2(12) debenture includes debenture stock, bonds and other securities of the company whether constituting a charge on the assets of the company or not. Debentures are bonds issued in acknowledgement of any indebtedness. Generally, however, they are issued under the company's seal and contain a provision for the repayment of principal sum at the appointed date and the payment of interest at fixed rate. Debentures are usually secured upon the company's property or undertaking.

Thus, a debenture is an instrument which is drawn under the seal of the company; it binds the company to pay a sum of money at a fixed time with interest but the debenture stock is a debt which carries interest at a fixed rate; it is constituted generally by a deed of covenant with trustees and the stockholder obtains a certificate of title. A stock is called perpetual if the principal amount of debt is not payable at any fixed time but only in the case of winding up or in case of default in paying interest.

Let us once again recapitulate the distinction between a debenture and debenture stock. The former is the description of an instrument while the latter is the description of debt or sum secured by an instrument. Lord Lindley has described debenture stock as the borrowed capital consolidated into one mass for the sake of convenience.

#### **(a) Type of Debentures**

Debentures may be of the following types:

1. Naked or unsecured debentures.
2. Secured debentures.
3. Redeemable debentures.
4. Perpetual debentures.
5. Bearer debentures.
6. Registered debentures.

1. *Naked or unsecured debentures*: Debentures that do not carry any charge on the assets of the company are known as naked or unsecured debentures. The holders of these debentures do not have any security as to repayment of principal or interest thereon.



2. *Secured debentures*: Debentures that are secured by a mortgage of the whole or part of the assets of the company are known as mortgage debentures or secured debentures.
3. *Redeemable debentures*: Debentures that are redeemable at the expiry of a certain period are known as redeemable debentures. Debentures once redeemed can be reissued in accordance with the provisions of Section 121 of the Companies Act.
4. *Perpetual debentures*: Where the debentures are redeemable on the happening of specified events which may not happen for an indefinite period, for example, winding up, they are known as perpetual debentures.
5. *Bearer debentures*: These debentures are payable to a bearer and are transferred by delivery and no stamp duty is payable on the transfer. The debenture holder is not registered in the books of the company but is entitled to claim interest and repayment of principle. A *bona fide* transferee for value is not affected by the defect in the title of the transferor.
6. *Registered debentures*: These debentures are payable to registered holders. A registered holder is one whose name appears on the debenture certificate/letter of allotment and is registered on the company's register of debenture holders maintained under Section 152 of the Companies Act, 1956.

**(b) Classification of debentures according to convertibility**

According to convertibility, debentures are further classified into three categories:

1. Fully convertible debentures (FCDs).
  2. Non-convertible debentures (NCDs).
  3. Partly convertible debentures (PCDs).
1. *Fully convertible debentures*: Convertible debentures are those debentures that are converted into equity shares of the company on the expiry of specified period or periods. Where the conversion is to be made at or after 18 months from the date of allotment but before 36 months, the conversion is optional on the part of the debenture holders in terms of S.E.B.I. guidelines. Convertible debentures may or may not carry any interest.
  2. *Non-convertible debentures*: Non-convertible debentures are those debentures that do not confer any option on the holder to convert the debentures into equity shares and are redeemed at the expiry of a specified period(s).
  3. *Partly convertible debentures*: Partly convertible debentures consist of two parts—convertible and non-convertible. The convertible portion(s) is/are convertible into equity shares at the expiry of specified period(s), whereas the non-convertible portion is redeemed at the expiry of a certain period(s). Where the conversion takes place at or after 18 months, the



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conversion is optional at the discretion of the debenture holder.

### (c) Distinction between fully convertible and partly convertible debentures:

Convertible debentures can be fully or partly convertible. The major points of distinction between fully and partly convertible debentures are highlighted below:

<i>Features debentures</i>	<i>Fully convertible debentures</i>	<i>Partly convertible</i>
(i) Classification for debt equity ratio computation	Classified as equity for debt equity for computation.	Convertible portion classified as 'equity' and non-convertible portion as 'debt'.
(ii) Flexibility in financing	Highly favourable debt equity ratio.	Favourable debt equity ratio.
(iii) Capital base	Higher equity capital on conversion of debentures.	Relatively lower equity capital on conversion of debentures.
(iv) Suitability	Better suited for companies without established track record.	Better suited for companies with established track record.
(v) Servicing of equity	Higher burden of servicing of equity.	Relatively lesser burden of equity servicing.
(vi) Debenture redemption reserve	Not required.	Required to be created for 50% of the face value of the non-convertible portion.
(vii) Buyback arrangements	Not required.	Arrangement may be made buyback of the non-convertible portion of the debentures.
(viii) Popularity	Highly popular with investors.	Not so popular with investors.

### (d) Debenture Certificate

Section 113 of the Companies Act, 1956 provides that every company shall, within three months of allotment of any of its shares, debentures or debenture stock and within two months after the application for registration of the transfer of any such debentures or debenture stock, deliver the certificates of all debentures and debenture stock allotted or transferred in accordance with the procedure laid down in Section 53 of the Companies Act, 1956. However, the C.L.B. may extend the period within which the debenture certificate may be delivered to a



further period not exceeding nine months, if it is satisfied that it is not possible for the company to deliver the certificates within the said period.

If default is made in complying with the above provisions, every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years and the company and every officer of the company who is in default shall be punishable with fine which may extend to Rs. 5,000 per day of default.

If a company on which a notice has been served requiring it to make good the default fails to do so within 10 days of the service of the notice, the CLB may on an application made by the aggrieved person, make an order directing the company and any officer of the company to deliver the securities within the period mentioned in the order. The order may provide that all costs incidental to the application shall be borne by the company or by the officer of the company responsible for the default.

*Transfer of debentures:* Bearer debentures are negotiable instruments and hence are transferable by delivery, free from any equities. A *bona fide* transferee for value gets a good title notwithstanding any defect in the title of the transferor. Transfer of registered debentures takes place exactly in the same way as the transfer of shares.

*Fixed and floating charges:* Debentures may be secured by a fixed charge or by a floating charge or by a combination of both. A floating charge is an equitable charge which is not a specific charge on any property of the company. Thus, the company may, despite the charge deal with any of the assets in the ordinary course of business. "It is of the essence of a floating charge that it remains dormant until the undertaking charged ceases to be a going concern or until the person in whose favour the charge is created, intervenes. His right to intervene may, of course, be suspended by agreement. But if there is no agreement of suspension, he may exercise his right whenever he pleases after default."

On the other hand, a specific (fixed) charge is a charge which is expressed to cover specific property like land, building, etc. Although the company usually remains in possession of the property, it can only deal with it subject to the prior rights created by the charge.

It is thus evident that a floating charge is characteristically ambulatory and shifting; it flows "with the property which is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp." But specific charge is a charge which fastens on to the property which is ascertained and definite or capable of being ascertained and made definite.

The main characteristics of a floating charge as described in [*Re. Yorkshire Woolcombers's Association* (1903) 2. Ch. 284 and 285] are as follows:

- (a) It is a charge on a class of the company's assets, present and future, that class being one which, in the ordinary course of the business is changing from time to time.



- (b) Generally, it is contemplated that the company carry on its business in an ordinary way with such a class of assets till some event occurs on which the charge is to settle down on the property as then existing and the charge becomes fixed. The moment the charge crystallises, it becomes a fixed charge. It takes place when some event contemplated in the agreement creating the charge occurs, e.g. debenture holders enforcing their securities on a default being made by company either in payment of interest or capital on the company being wound up.

There are two major statutory limitations to the rights arising out of floating charge. Firstly, a floating charge created within 12 months preceding the commencement of the winding up (whether compulsory or voluntary or subject to supervision), shall unless it is proved that the company immediately after the creation of the charge was solvent, be invalid except up to the amount of any cash paid to the company at the time of, or subsequent to the creation of and in consideration for the charge together with the interest on that amount at 5 per cent per annum or at any other prescribed rate (Section 534).

**[Note:** You should note that although these provisions of Section 534 are excluded from your syllabus nonetheless you should read them by way of passing reference]. Secondly, floating charge crystallises, i.e. becomes fixed and consequently the security ceases to be a floating security (i) in the charge, i.e. failure of the company to pay interest or to redeem the debentures as agreed; cessation of businesses by the company, (ii) if a receiver is appointed for the debenture holders either by the Court or by the debenture holders or their trustees under power given by terms of issue of debentures and (iii) if the company is wound up even if it is a voluntary winding up for the purpose of reconstruction [*Re Crompton & Co.* (1914) 1. Ch. 954.]

Under Section 123 of the Act, where a receiver is appointed on behalf of the debenture holders secured by a floating charge even though the company may not be in the course of winding up, the debts which in a winding up are to be paid in priority to all other debts under Section 530 shall be paid out of the assets available in the hands of the receiver, in priority to any claim in respect of the principal or interest to which the debenture holders with floating charge are entitled. In other words, preferential debts have priority over a debenture holder's floating charge not only in a winding up but also when a receiver is appointed in a debenture holder's action. Where the debentures are secured both by a floating charge and a fixed charge, such priority is applicable to the assets subject to the floating charge; the fixed charge remains unaffected [*Anthony Ulysses John vs. Suraj Bhan* (1938) All 896]. The preferential payments referred to in Section 123 are to be made forthwith out of the assets that come to the hands of the receiver. If the receiver fails to do so, he thereby renders himself liable in tort. But if his failure to make the preferential payment is the result of misguidance or inducement given by the debenture holder, he can claim indemnity from debenture holders [*West Minister City Counsel vs. Treby* (1936) 2. A.N.R. (21)].





**(e) 'Pari Passu' clause** in a debenture means that all the debentures of the series are to be paid rateably. If therefore, security is insufficient to satisfy the whole debts secured by the series of debentures, the amounts of debentures will abate proportionally. If the clause is not made use of then the debentures rank in accordance with the date of issue and if they are all issued on the same date they will be payable according to their numerical order. A company, however, cannot issue a new series of debentures so as to rank *pari passu* with prior series unless the power to do so is expressly reserved and contained in the debenture deed of the previous series.

In the event of the *pari passu* clause being included in the debentures, it is enough if the following particulars are filed with the Registrar within 30 days after the execution of the deed containing the charges or where there is no deed after the execution of any debentures of the series: (i) the total amount secured by the whole series, (ii) the dates of the resolutions authorising the issue of the series, (iii) The date of deed if any, by which security is created and (iv) a general description of the property charged and the name of the trustees for debenture holders, if any, together with the deed containing the charges or a certified copy of the deed or, if there is no deed, one of debentures of the series (Section 128).

Where more than one issue is made of debentures in the series, particulars of the date and the amount of each issue filed with the Registrar. An omission to do so will not affect the validity of the debentures issued.

**(f) Debentures with voting rights not permissible**

No company can issue any debentures carrying voting rights at any meeting of the company, whether generally or in respect of any particular classes of business. This provision applies to debentures issued after the commencement of the Companies Act [Section 117 of 1956 Act]. The idea behind prohibition of issue of debentures with voting rights is to ensure that debenture holders are not placed in a much more advantageous position than the holders of equity shares and are not in a position to influence the policy of the company in a manner detrimental to the interest of the general body of shareholders.

**(g) Right to obtain copies of trust deed**

A copy of the trust deed for securing any issue of debentures should be forwarded to the holder of any such debentures or any member of the company within seven days of the receipt of request for the same upon payment of the prescribed sum. If a copy is refused or is not forwarded within the specified period, the company and every officer of the company who is in default shall be punishable for each offence with fine which may extend to fifty rupees and with a further fine which may extend to twenty rupees for every day of default. The aggrieved debenture holder may apply to the Company Law Board (CLB) which may by order, direct that the copy required be sent forthwith.



The trust deed shall be open to inspection by any member or debenture holder in the same manner as the register of members of the company, as provided for in Section 163. [Sections 118 of 1956 Act].

**Special provisions as to debentures: (Sections 117A, 117B and 117C) Companies (Amendment) Act, 2000**

(i) New Section 117A—deals with execution of trust deed in the prescribed form. Any member/debenture holder shall be entitled to obtain copy of the trust deed on payment of prescribed fees. The trust deed will be available for inspection by a member/debenture holder. If default is made in giving such inspection penalty of Rs. 500 for every day during which the default continues can be levied by the court.

(ii) New Section 117B—deals with appointment and duties of debenture trustees. It is now provided that before issue of prospectus or letter of offer for the debentures, the company should appoint one or more debenture trustees and disclose their names and also state that they have given their consent. It is now specifically provided that (i) a shareholder who has beneficial interest in shares (ii) creditor or (iii) a person who has given guarantee for repayment of principal and interest in respect of the debentures cannot be appointed as a debenture trustee. The section gives the list of duties of a debenture trustee who has to protect the interest of debenture holders.

It will therefore, now be mandatory for companies making a public issue of debentures to issue only secured debentures. However, SEBI Guidelines provide that in case of issue of debentures with a maturity of 18 months or less, there is no requirement for securitisation of debentures. These guidelines may now have to be aligned in tune with the new provision.

(iii) New Section 117C— provides that the company should create debenture redemption through credit of adequate amounts out of its profits every year until the debentures are redeemed. The word 'adequate' is not defined. It is also provided that such reserve shall not be used for any purpose, except for redemption of debentures. The company has to pay interest as provided in the terms of issue and redeem the debentures on maturity. If default is made CLB can pass such orders as it deems fit. There is also a provision for prosecution of officers and imprisonment upto 3 years and fine of Rs. 500 per day during which default continues.

Heading of Section 117C reads as 'Liability of company to create security and debenture redemption reserve'. However there is no mention as regards creation of security. These three sections are being introduced to protect the interests of debenture holders. As regards a listed company the provisions must be synchronised with SEBI Guidelines/Regulations.



**(h) Liability of trustees for debenture holders**

Any provision in the debenture trust deed for securing as issue of debentures, or in any contract with the holders of the debentures secured by a trust deed is void to the extent it has the effect of exempting a trustee thereof from or indemnifying him against, liability for breach of trust or negligence, having regard to the provisions of the trust deed.

However, the above provisions will not invalidate any release otherwise validly given in respect of anything done or omitted to be done by a trustee before the giving of the release or deprive any person of any exemption in respect of any thing done or omitted to be done by him when the exemption was in force.

The benefit of the above provision may be given by a resolution passed by a three fourth majority in value of the debenture holders present and voting at a meeting held for the purpose.

As trustees receive remuneration for their services, they should not be allowed to escape liability for failure to do their duty properly. A general provision for exempting trustees from liability is prohibited but enabling clauses limit for liability is permitted. [Section 119 of 1956 Act].

**(i) Power to reissue redeemed debentures**

Where a company has redeemed any debentures previously issued, unless there is any contrary provision in the articles, the conditions of the issue or a resolution has been passed by the company for cancelling the debentures, the company shall have and shall be deemed always to have had, the right to keep the debentures alive for the purpose of reissue. In exercising such a right, the company shall have and shall be deemed always to have had the power to reissue the debentures either by reissuing the same debentures or by issuing other debentures in their place [Section 121(1)].

Upon such reissue, the holders of the debentures shall have and shall be deemed always to have had the same rights and priorities as if the debentures had never been redeemed. [Section 121(2)].

Where with the object of keeping the debentures alive for the purpose of reissue, they have been transferred to a nominee, a transfer from that nominee shall be deemed to be a reissue for the purpose of Section 121 [Section 121(3)].

The object of keeping debentures that have been issued alive is that the formalities for issue of debentures need not be complied with again and the issue can be made without delay.

The power to reissue debentures does not authorise the issue in the place of the redeemed debentures, of debentures different in their terms from those which have been redeemed [Anot Eagasta (Chilean) & Bolivia Railway Co., 5 Trust Deed vs. Schroder, (1939) 2 All E.R. 461 (Chd. D)].



**(j) Remedies available to a debenture holder**

If the debenture is not secured by any mortgage or charge, then its holder has alternative remedies either (i) to sue the company for the recovery of the money secured by the debenture and execute the decree against the company's property; or (ii) to present a petition for the winding up of the company under Section 433(e) on the ground of company's inability to pay its debts, but if the winding up is already in progress, to prove in such winding up the amount due to him like any other unsecured creditor.

Where however the debenture is secured by a mortgage or a charge, the holder thereof who wishes to realise his security and recover the money due to him, may resort to all or any of the following remedies:

- (i) He may sue on his own behalf and on behalf of other debenture holders of the same class to obtain payment or enforce his security by sale.
- (ii) He may appoint a receiver if the conditions of the issue so permit.
- (iii) He may apply to the Court for closure of the company's rights to redeem the debentures. But, in such an action all debenture holders of the company in contradistinction to those of a class, as well as the company should be jointed as parties.
- (iv) He may, in the capacity of a creditor present an application for winding up for the principal and interest thereon.
- (v) He may have the property sold by the trustee if the debenture-trust deed permits the sale.
- (vi) In case of company's insolvency, he may realise value of his security and prove for the balance of his debt, if the security is insufficient or give up the security and prove for the whole debt. But he is prohibited from proving for interest which became due after winding up; also he cannot get such interest out of his security when arriving at a balance for which he can prove in the winding up.

**(k) Distinction between debenture and share**

- (i) Shares are a part of the capital of a company whereas debentures constitute a loan.
- (ii) The shareholders are the owners of the company whereas debenture holders are creditors.
- (iii) Shareholders generally enjoy voting right whereas debenture holders do not have any voting right.
- (iv) Interest on debenture is payable even if there are no profits. But dividends can be paid to shareholders only out of the profits of the company.



- (v) Debentures generally have a charge on the assets of the company but shares do not carry any such charge.
- (vi) The rate of interest is fixed in the case of debentures whereas on equity shares the dividend may vary from year to year.
- (vii) Fixed amount of interest on debentures gets priority over dividend on shares.

**(I) SEBI GUIDELINES FOR ISSUE OF DEBT INSTRUMENTS (Updated till May 8, 2006)**

**10.0** A company offering Convertible/ Non Convertible debt instruments through an offer document, shall comply with the following provisions in addition to the relevant provisions contained in other chapter of these guidelines.

**10.1 Requirement of credit rating**

- 10.1.1** (No company shall make a public issue or rights issue of debt instruments (whether convertible or not), unless credit rating of not less than investment grade is obtained from not less than two registered credit rating agencies and disclosed in the offer document.)
- 10.1.2** (Deleted)
- 10.1.3** (Where credit ratings are obtained from more than two credit rating agencies, all the credit rating/s, including the unaccepted credit ratings, shall be disclosed.)
- 10.1.4** All the credit ratings obtained during the three (3) years preceding the public or rights issue of debt instrument (including convertible instruments) for any listed security of the issuer company shall be disclosed in the offer document.

**10.2 Requirement in respect of Debenture Trustee**

- 10.2.1** (No company shall issue a prospectus or a letter of offer to the public for subscription of its debentures, unless the company has appointed one or more debenture trustees for such debentures in accordance with the provisions ns of the Companies Act, 1956.)
- 10.2.2** (The names of the debenture trustees shall be stated in the Offer Documents and also in all the subsequent periodical communications sent to the debenture holders).
- 10.2.3** (A trust deed shall be executed by the issuer company in favour of the debenture trustees within three months of the closure of the issue.)
- 10.2.4** Trustees to the debenture issue shall be vested with the requisite powers for protecting the interest of debenture holders including a right to appoint a nominee director on the Board of the company in consultation with institutional debenture holders.



10.2.5 (The merchant banker shall, along with the draft offer document, file with the Board, certificates from the bankers of the Company that the assets on which the security is to be created are free from any encumbrances and the necessary permissions to mortgage the assets have been obtained or No-objection Certificate from the Financial Institutions or Banks for a second or pari passu charged in cases where assets are encumbered.

The merchant banker shall also ensure that the security created is adequate to ensure 100% asset cover for the debentures.)

10.2.6 The debenture trustee shall ensure compliance of the following:

- a) (It shall obtain reports from the lead bank, regarding monitoring progress of the project.)
- b) (It shall monitor utilization of funds raised in the debenture issue.)
- c) Trustees shall obtain a certificate from the company's auditors:
  - (i) in respect of utilisation of funds during the implementation period of projects .
  - (ii) in the case of debentures for working capital, certificate shall be obtained at the end of each accounting year.
- d) Debenture issues by companies belonging to the groups for financing replenishing funds or acquiring share holding in other companies shall not be permitted.

**Explanation:**

The expression 'replenishing of funds or acquiring shares in other companies' shall mean replenishment of funds or acquiring share holdings of other companies in the same group. In other words, the company shall not issue debentures for acquisition of shares / providing loan to any company belonging to the same group. However, the company may issue equity shares for purposes of repayment of loan to or investment in companies belonging to the same group.

- e) The debenture trustees shall supervise the implementation of the conditions regarding creation of security for the debentures and debenture redemption reserve.

**10.3 Creation of Debenture Redemption Reserve (DRR)**

(10.3.1 For the redemption of the debentures issued, the company shall create debenture redemption reserve in accordance with the provisions of the Companies Act, 1956.)

**10.4 Distribution of Dividends**

- (a) (In case of the companies which have defaulted in payment of interest on debentures or redemption of debentures or in creation of security as per the terms of issue of the



debentures, any distribution of dividend shall require approval of the Debenture Trustees and the Lead Institution, if any.)

- (b) In the case of existing companies prior permission of the lead institution for declaring dividend exceeding 20% or as per the loan covenants is necessary if the company does not comply with institutional condition regarding interest and debt service coverage ratio.
- (c) (i) Dividends may be distributed out of profit of particular years only after transfer of requisite amount in DRR.  
(ii) If residual profits after transfer to DRR are inadequate to distribute reasonable dividends, company may distribute dividend out of general reserve.

### **10.5 Redemption**

10.5.1 The issuer company shall redeem the debentures as per the offer document.

### **10.6 Disclosure and Creation of Charge**

- (10.6.1) The offer document shall specifically state the assets on which security shall be created and shall also state the ranking of the charge/s. In case of second or residual charge or subordinated obligation, the offer document shall clearly state the risks associated with such subsequent charge. The relevant consent for creation of security such as pari passu letter, consent of the lessor of the land in case of leasehold land etc. shall be obtained and submitted to the debenture trustee before opening of issue of debenture.)
- (10.6.2) The offer document shall state the security / asset cover to be maintained. The basis for computation of the security / asset cover, the valuation methods and periodicity of such valuation shall also be disclosed. The security / asset cover shall be arrived at after reduction of the liabilities having a first / prior charge, in case the debentures are secured by a second or subsequent charge.)
- 10.6.3 (Deleted).
- (10.6.4) The issue proceeds shall be kept in an escrow account until the documents for creation of security as stated in the offer document, are executed.)
- (10.6.5) If the issuing company proposes to create a charge for debentures of maturity of less than 18 months, it shall file with Registrar of Companies particulars of charge under the Companies Act.

**Provided that**, where no charge is to be created on such debentures, the issuer company shall ensure compliance with the provisions of the Companies (Acceptance of Deposits) Rules, 1975, as, unsecured debentures / bonds are treated as "deposits" for purposes of these rules.



(10.6.6) The proposal to create a charge or otherwise in respect of such debentures, may be disclosed in the offer document along with its implications.

### 10.7 Requirement of letter of option

10.7.1 (Where the company desires to rollover the debentures issued by it, it shall file with SEBI a copy of the notice of the resolution to be sent to the debenture-holders for the purpose, through a merchant banker prior to dispatching the same to the debenture-holders. The notice shall contain disclosures with regard to credit rating, necessity for debenture -holders resolution and such other terms which SEBI may specify. Where the company desires to convert the debentures into equity shares in accordance with clause 10.7.2, it shall file with SEBI a copy of the letter of option to be sent to debenture-holders with the Board, through a merchant banker, prior to dispatching the same to the debenture -holders. The letter of option shall contain disclosures with regard to option for conversion, justification for conversion price and such other terms which SEBI may specify.)

#### 10.7.1.1 (Roll over of Non Convertible Portions of Partly Convertible Debentures (PCDs)/ Non Convertible Debentures (NCDs), by company not being in default.

The non-convertible portions of PCDs or the NCDs issued by a listed company, the value of which exceeds Rs.50 lacs, can be rolled over without change in the interest rate subject to section 121 of the Companies Act, 1956 and subject to the following conditions, if the company is not in default:

- (a) A resolution to this effect is passed by postal ballot, having the assent from not less than 75% of the debenture-holders.
- (b) The company shall redeem the debentures of all the dissenting debenture holders, who have not assented to the resolution.
- (c) Before roll over of any NCDs or non-convertible portion of the PCDs, at least two credit ratings of not less than investment grade, shall be obtained within a period of six months prior to the due date of redemption and communicated to debenture holders before roll over.
- (d) Fresh trust deed shall be executed at the time of such roll over.
- (e) Fresh security shall be created in respect of such debentures to be rolled over.

**Provided** that if the existing trust deed or the security documents provide for continuance of the security till redemption of debentures, fresh trust deed or fresh security need not be created.)





(10.7.1.1 A Roll over of Non Convertible portions of Partly Convertible Debentures (PCDs)/ Non Convertible Debentures (NCDs), by the company being in default.

The non-convertible portions of PCDs and the NCDs issued by a listed company, the value of which exceeds Rs.50 lacs, can be rolled over without change in the interest rate subject to section 121 of the Companies Act, 1956 and subject to the following conditions, where the company is in default:

- (a) A resolution to this effect is passed by postal ballot, having the assent from not less than 75% of the debenture-holders.
- (b) The company shall send an Auditors' certificate on the cash flow of the company with comments on the liquidity position of the company to all debenture holders, along with the notice for passing the said resolution.
- (c) The company shall redeem the debentures of all the dissenting debenture holders, who have not assented to the resolution.
- (d) The debenture trustee shall decide on whether the company is required to create fresh security and execute fresh trust deed in respect of such debentures to be rolled over

**Provided that** if the existing trust deed or the security documents provide for continuance of the security till redemption of debentures, fresh security and fresh trust deed need not be created.

**10.7.1.2 In case of conversion of instruments (PCDs/FCDs,etc.) into equity capital**

- i) In case, the convertible portion of any instrument such as PCDs, FCDs etc. issued by a listed company, value of which exceeds Rs.50 Lacs and whose conversion price was not fixed at the time of issue, holders of such instruments shall be given a compulsory option of not converting into equity capital.
- ii) Conversion shall be done only in cases where instrument holders have sent their positive consent and not on the basis of the non-receipt of their negative reply. **Provided that** where issues are made and cap price with justification thereon, is fixed beforehand in respect of any instruments by the issuer and disclosed to the investors before issue, it will not be necessary to give option to the instrument holder for converting the instruments into equity capital within the cap price.
- iii) In cases where an option is to be given to such instrument holders and if any instrument holder does not exercise the option to convert the debentures into equity at a price determined in the general meeting of the shareholders, the company shall redeem that part of debenture at a price which shall not be less than its face value, within one month from the last date by which option is to be exercised.



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iv) The provision of sub-clause (iii) above shall not apply if such redemption is to be made in accordance with the terms of the issue originally stated.

10.7.1.3 (The debenture trustee shall submit a certificate of compliance with clauses 10.7.1.1, 10.7.1.1A or 10.7.1.2, as the case may be, to the merchant banker which shall be filed with the Board within 15 days of the closure of the rollover or conversion.)

(10.7.2 Companies may issue unsecured/ subordinated debt instruments/ obligations (which are not 'public deposits' as per the provisions of Section 58 A of the Companies Act, 1956 or such other notifications, guidelines, Circular etc. issued by RBI, DCA or other authorities).

**Provided that** such issue shall be subscribed by Qualified Institutional Buyers or other investor who has given positive consent for subscribing to such unsecured /sub-ordinated debt instruments/ obligation.)

### 10.8 Other requirements

10.8.1 No company shall issue of FCDs having a conversion period of more than 36 months, unless conversion is made optional with "put" and "call" option.

10.8.2 If the conversion takes place at or after 18 months from the date of allotment, but before 36 months, any conversion in part or whole of the debenture shall be optional at the hands of the debenture holder.

10.8.3

(a) No issue of debentures by an issuer company shall be made for acquisition of shares or providing loan to any company belonging to the same group.

Sub-clause (a) shall not apply to the issue of fully convertible debentures providing conversion within a period of eighteen months.

10.8.4 Premium amount and time of conversion shall be determined by the issuer company and disclosed.

10.8.5 The interest rate for debentures can be freely determined by the issuer company.

### 10.9 Additional Disclosures in respect of debentures

The offer document shall contain:

(a) Premium amount on conversion, time of conversion.

(b) In case of PCDs/ NCDs, redemption amount, period of maturity, yield on redemption of the PCDs/ NCDs.

(c) Full information relating to the terms of offer or purchase including the name(s) of the party offering to purchase the khokhas (non-convertible portion of PCDs).



- (d) The discount at which such offer is made and the effective price for the investor as a result of such discount.
- (e) The existing and future equity and long term debt ratio.
- (f) Servicing behaviour on existing debentures, payment of due interest on due dates on term loans and debentures.
- (g) That the certificate from a financial institution or bankers about their no objection for a second or pari passu charge being created in favour of the trustees to the proposed debenture issues has been obtained.

### **3.30 REGISTRATION OF A CHARGE**

The word 'charge' has not been adequately defined in the Companies Act, 1956 except that Section 124 provides that the expression charge shall include a mortgage. However, it can be understood that where in transaction for value, both parties' evidence the intention that property existing or future shall be made available as security for the payment of a debt and that the creditor/mortgagee shall have a present right to have it made available, there is a charge.

The conditions of borrowing, as they normally do, confer charge on the company's assets (movables as well as immovables). It is thus important for those dealing with the company to know how much of its assets are subjected to charges or actually charged. To this end, Section 125 of the Act contain provisions whereby particulars of charges which encumber company's property(ies) without actually delivering possession thereof to be filed and registered on the company's file at the office of the registry *i.e.* the Registrar of the companies concerned.

The following is a list of such charges :

- (a) A charge to secure any issue of debentures.
- (b) A charge on an uncalled share capital of the company.
- (c) A charge on an immovable property, wherever situated or any interest therein.
- (d) A charge on book debts of the company.
- (e) A charge, not being a pledge on any movable property of the company.
- (f) A floating charge on the undertaking or any property of the company including stock-in-trade.
- (g) A charge on calls made but not paid.
- (h) A charge on a ship or any share in ship.
- (i) A charge on goodwill or a patent or a copyright.



Where a company raised a loan from a bank by pledging its fixed deposit receipts without registering the pledge with Registrar of Companies, it was held that since fixed deposit receipts were movable property and since the charge was in the nature of a pledge of movables, it was exempted from registration [*Meenakshi Mills v. Registrar of Companies* A.I.R. (1966) May 24]. If moneys are advanced on 'open credit' system and the goods of the company are pledged with the bank in consideration of loan by the bank to the company and if the bank consents to the borrower withdrawing any goods, so pledged with the bank, the transaction would amount to a pledge of the goods, and not a mere hypothecation. Even if the constructive possession of the pledgee bank is maintained, a subsequent pledge of the same goods even without notice of pledge to the company gets no preference over the bank. The rule of estoppel does not affect the property of the pledgee bank [*Nadar Bank Ltd. v. Canara Bank Ltd.* (1961) 21 Comp Cas. 12].

*Effect of non-registration* - If any of the above-mentioned mortgages or charges is not registered, then the unregistered mortgage or charge shall be void against the liquidators and creditors of the company [*Monolithic Building Co.* 1915. 1. Ch. 643. 669]. Another effect of non-registration of a charge is that the money secured thereby becomes immediately payable [Sec. 125(3)]. Beside the company and every officer of the company may be subjected to a penalty upto Rs. 5000 for everyday during which the default continues [Sec. 142(1)]. The prescribed particulars of the mortgage or charge together with the instrument, if any, creating the mortgage or evidencing it or a verified copy [Rule 6 of the Companies (Central Government's) General Rules and Forms] of such instrument must be filed with the Registrar within 30 days after the creation of the charge or mortgage. It is however, open to the Registrar to allow the particulars and instrument or copy to be filed within 30 days next following the expiry of the period of 30 days if the company satisfies the Registrar that it had sufficient cause for not filing the particulars and instrument or copy within 30 days. Where there is a document, the time runs not from the date of agreement to advance money or the date at which the money is actually advanced, but the date at which a document is executed [*Columbia Fire Proofing Co. Ltd.* 19 2 Ch. 11], *Capital Counties Bank* 1913. 2. Ch. 336). According to the view of the Company Law Board, if the instrument or copy of it is not filed with the Registrar within 30 days or the extended period of 7 days [as per the proviso to Section 125(1)] then the Registrar should not take the document on record even on payment of additional fees provided in Section 611(2) unless the sanction of the Company Law Board is obtained under Section 141].

Section 141(1) provides for the remedies available to the company for the failure on its part to register with the Registrar within prescribed time limit the particulars of the charge created by it on its immovable property together with documents creating it. The company may apply to the Company Law Board and seek extension of time for filling of the particulars for registration. But before passing any order, the Company Law Board must be satisfied (a) that the aforesaid omission was accidental or due to inadvertence or due to some other sufficient



cause or was not of the nature to prejudice the position of creditors or shareholders of the company; or (b) that it is just and equitable to grant relief on other grounds. Being thus satisfied, the Company Law Board may and on such terms and conditions as it may deem just and convenient, direct that the time for the filing of the particulars of the charge for registration shall be extended, or as the case may require, that the omission shall be rectified.

If the particulars of mortgage or charge are filed with the Registrar of Companies within the time allowed under the Companies Act, it is immaterial as to when the same are actually registered by the Registrar. The mortgage or charge cannot be invalidated merely because of the delay by the Registrar in registering the particulars which were filed with him on time [*Banaras Bank Limited v. Bank of Bihar* I.L.R. 1646 All 867]. Though for want of registration required by Section 125 by the mortgage or charge shall become void against the liquidator and creditor, the moneys payable by the company shall become immediately payable and contract or obligation to pay the debt shall remain unaffected. The effect of non-registration is that the charge becomes void against liquidator and creditor, but the debt is good as a simple debt; though the security for the debt may not be valid the debt itself remains good as a simple debt [*C. Padumji Company v. Moose 2 Bomb.* L.R. 1288]. Further, in the event of the charge being void for non-registration, no right of lien can be claimed on the documents of title, as they are only ancillary to the charge and were delivered pursuant to the charge [*In Re Moltan Ltd.* (1868) Ch. 325 (1968), 53 Cp.[Cas. 833].

Though floating charge on stock-in trade requires registration, if it is not registered, the creditor who lawfully takes possession of the goods before the winding up of company is not affected by the absence of the registration [*Mercantile Bank of India v. Chartered Bank of India* (1937) All E.R. 2311]. The company whose properties or goods are charged cannot seek to repudiate the charge consider it good as a simple debt only because the only consequence or non-registration under Section 125 is that the charge fails as such and is void against the liquidator and creditor. Section 125 does not provide that the charge shall be void against the company [*also Monolithic Building Co.'s Case 1975 1. Ch. 643, Aungzapa v. Chettiar 5 Rang 535, Thyagarajan v. Official Liquidator 1915, 2 Mad L.J. 295; Mayappaya Chettiar v. Jayanti Films Madura Private Ltd.* A.I.R. 1964 Mad 134.

An equitable mortgage by deposit of the title deeds requires to be registered [*Maneklal v. Saraspur Mfg. Co. 29 Bocm. C.R. 253*].

A simple debenture does not require any registration under Section 125 because such debenture is neither secured by a mortgage nor by a charge, fixed or floating but it is a simple (unsecured) debt. A mere lien does not require registration [*Ashby Warner Co. v. Simmons* (1936) All E.R. 697]. So also a negative lien does not require registration which applies to a charge which is created by an act of the parties (an act in the law) and not to a charge which comes in by operation of the law (an act of the law). A charge by operation of the law also does not require registration [*Humkumchand v. Pioneer Mills, A.I.R. (1927) Oudh 55*].



In the case of mortgage or charge created outside India, the property charged being outside India, the particulars of the mortgage or a copy of such instrument shall be filed with the Registrar for registration. The filing must be completed within 30 days after the date at which the instrument or copy would, in due course of post, and if despatched with due diligence be received in India. If the mortgage or charge is created in India but the property is outside India can then the instrument creating the charge or mortgage or a copy thereof in prescribed manner must be filed in with the Registrar within 30 days after the creation of the mortgage or charge even though further formalities or steps are required to complete the mortgage of the property which is outside India according to law of the land in which the property is situated.

(a) *Modification of charge* - Section 135 of the Act provides that “whenever the terms or conditions or the extent or operation of any charge registered under this part are or is modified, it shall be the duty of company to send to the Registrar the particulars of such modifications and the provisions of this part as to registration of a charge shall apply to modification of the charge.”

The term ‘modification’ includes variation of any of the terms of the agreement including variation of rate of interest which may be by mutual agreement or by operation of law. Even if the rights of a charge holder are assigned to a third party, it will be regarded as a modification.

*What constitutes modification?*

1. where the charge is modified by varying any terms and conditions of the existing charge by agreement;
2. where the modification is in pursuance of an agreement for enhancing or decreasing the limits;
3. where the modification is by ceding a *pari passu* charge;
4. change in rate of interest (other than bank rate);
5. change in repayment schedule of loan; (this is not applicable in working capital loans which are repayable on demand) and
6. partial release of the charge on a particular asset or property.

(b) *Registration and satisfaction of charge* - Registration of charges under Section 125 constitutes a notice to whosoever acquires a future interest on the charged assets. The Registrar has to maintain in respect of each company a register of charges with a proper chronological index [Sections 130 and 131]. The certificate of registration which must be given by Registrar under his hand is conclusive evidence of proper registration [Section 132].

In case the appointment of a receiver or manager is made, the person who obtains the order for such an appointment is bound to notify the Registrar about it, within 30 days of the



passage of the order of such appointment and the Registrar on payment of the prescribed fee, must enter in his register this appointment.

(c) *Satisfaction of charge* - Whenever any charge is created by a company and registered with the Registrar at the instance of the company or the charge holder and is satisfied in full, the company shall give an intimation thereof to the Registrar as to the payment and satisfaction in full of the said charge within 30 days from the date of such payment or satisfaction, upon which the Registrar will send a notice to the holder of the charge to show cause why payment or satisfaction, as notified by the company should not be recorded. Notice by the Registrar will be issued as early as possible so that unnecessary delay in recording particulars of satisfaction of the charge is avoided. The best procedure for notifying satisfaction of the charge to the Registrar by the company (in Form No. 17) is to attach with the form a certified copy of the chargeholder's letter confirming the date of the satisfaction of the charge. In some cases, the financial institutions and the banks take considerable time in conforming the satisfaction of the charge to the company. In this context, the Department is of the view that the period of thirty days under Section 138 of the Act for reporting satisfaction of the charge, in cases where banks are involved, will be counted from the date of issue of the bank's letter to companies intimating them about satisfaction of the charge under Section 138.

Part payment or satisfaction of charge need not be intimated to the Registrar; only satisfaction in full has to be reported within 30 days from the date of such payment or satisfaction [Section 138]. The Registrar is empowered to make entries of satisfaction, even though not intimated by the company [Section 139]. If the entry turns out to be incorrect, it cannot affect the charge holder's rights unless he was a consenting party to the making of the entry. According to Section 140 the company will have to be furnished with a copy of memorandum of satisfaction.

A rectification of the register of charges can also be made under the orders of a Court on the application of the company or any person interested [Section 141].

(d) *Register of charges* [Section 143] - Every company is under an obligation to keep at its registered office a register of charges and enter therein all charges specifically affecting property of the company and all floating charges on the undertaking or any property of the company. In each such case, the following particulars must be entered namely (i) a short description of the property charged, (ii) the amount of the charges and (iii) except in the case of securities to bear, the names of the persons entitled to charges. Any officer of the company who knowingly omits or wilfully authorises or permits the omission of any entry renders himself punishable with fine extending up to Rs. 5000.

(e) *Rights of inspection of instrument and company's register of charge* - During office hours, inspection by any creditor or member of the company is allowed without charging any fee therefore. An inspection of the register of charges is permitted to an outsider on payment of a fee of one rupee for each inspection at the registered office of the company. Default in



allowing inspection is liable to a penalty or fine which may extend up to Rs. 500 and with further fine extending up to Rs. 20 for every day during which the default continues. The Court may also compel an immediate inspection of the copies of the register, as the case may be [Section 144].

### **3.31 SELF-EXAMINATION QUESTIONS**

#### **Choose the Correct Alternative**

1. An extraordinary general meeting may be convened:
  - (a) By the Board of Directors on its own or on the requisition of members.
  - (b) By the requisition of members on the failure of the Board to call the meeting.
  - (c) By the Company Law Board.
  - (d) Any of the above.
2. Which one of the following is not true about shares
  - (a) It is a right to participate in the profits made by a company.
  - (b) Share is not a negotiable instrument.
  - (c) Share is small unit in the share capital.
  - (d) Share is not considered as goods.
3. A depositor who has invested in a financial year a sum not exceeding Rs. 20, 000/- in a company and includes his successors, nominees and legal representatives is known as
  - (a) Medium depositor.
  - (b) Small depositor.
  - (c) Conservative depositor.
  - (d) Liberal depositor.
4. A company may issue shares
  - (a) At discount.
  - (b) At premium.
  - (c) At par
  - (d) Any of the above.
5. An instrument of transfer signed by the transferor in which the name of the transferee and date of transfer are not filled is called as





- (a) Blank transfer.
  - (b) Bank transfer.
  - (c) Certification of transfer.
  - (d) Forged transfer.
6. A share can be transferred
- (a) In fractions.
  - (b) As a whole.
  - (c) Both (a) & (b).
  - (d) None of the above.
7. Debentures may be
- (a) Secured or unsecured debentures.
  - (b) Perpetual debentures.
  - (c) Registered debentures.
  - (d) Any of the above.
8. A prima facie evidence of document of title stating the holder is entitled to specified number of shares is called
- (a) Share warrant.
  - (b) Share certificate.
  - (c) Share document.
  - (d) None of the above.
9. Debentures may be
- (a) Secured or unsecured debentures.
  - (b) Perpetual debentures.
  - (c) Registered debentures.
  - (d) Any of the above.
10. An index of members must be maintained by a company when its membership exceeds
- (a) 20
  - (b) 50
  - (c) 75
  - (d) 100



11. A share warrant is
  - (a) A bearer document.
  - (b) A Negotiable Instrument.
  - (c) Can be issued in respect of fully paid up shares
  - (d) All of the above.
12. The power to make calls can be exercised by
  - (a) The Board
  - (b) The shareholders
  - (c) The Company Secretary
  - (d) The Company Law Board.
13. Pari Pasu clause in a debenture means
  - (a) All debentures of the series are to be paid fully.
  - (b) All debentures of the series are to be paid rateably.
  - (c) Any one of the above two methods.
  - (d) None of the above.
14. Buy-back of shares may be made from
  - (a) Existing shareholders.
  - (b) Open market or odd lots.
  - (c) Employees
  - (d) Any of the above.
15. A small depositor means a depositor who has deposited in a financial year a sum not exceeding
  - (a) A prescribed sum.
  - (b) Rs. 20,000/-
  - (c) Rs. 2 Lakhs.
  - (d) None of the above.
16. A prima facie evidence of document of title stating the holder is entitled to specified number of shares is called



- (a) Share warrant.
  - (b) Share certificate
  - (c) Share document
  - (d) None of the above.
17. The implication of issuance of a share certificates creates an estoppels as to
- (a) Title
  - (b) Payment
  - (c) Title and Payment
  - (d) None of the above.
18. Share warrants can be issued by
- (a) Private companies only.
  - (b) Public companies only.
  - (c) Both private and public companies.
  - (d) Companies limited by guarantee.
19. The particulars of a registerable charge must be find with the Registrar within
- (a) 14 days
  - (b) 21 days
  - (c) 30 days
  - (d) 45 days.
20. Reduction of share capital means
- (a) Reducing or distinguishing the liability for uncalled capital
  - (b) By paying of or returning capital which is an excess
  - (c) Pay off paid up capital
  - (d) A combination of the above methods.
21. Which one of the following is not true about shares?
- (a) It is a right to participate in the profits made by a company.
  - (b) Share is not a negotiable instrument.



- (c) Share is small unit in the share capital.
  - (d) Share is not considered as goods.
22. A company may close its register of members in a year not exceeding
- (a) 30 days
  - (b) 45 days
  - (c) 60 days
  - (d) 90 days.

**State Yes or No & Short Questions**

- 23. What is the significance of 'preference shares' to their holders?
- 24. X Ltd. wants to issue redeemable preference shares. The articles of the company are silent on this point. Can it do so?
- 25. The option to redeem the redeemable preference shares lies with holders thereof. Do you agree with this statement?
- 26. Can partly paid preference shares be redeemed?
- 27. Shares cannot be redeemed (i) out of company's profits which would otherwise be available for dividends and (ii) out of the proceeds of fresh issue of shares. Which is correct?
- 28. (a) what is the technical name for the reserve to be created on redemption of preference shares? and (b) what is the amount involved ?
- 29. Is reduction of capital lawful?
- 30. Conservation of capital is one of the fundamental principles of the Company Law. Why is it so?
- 31. "The forfeiture of shares for non-payment of call amounts to reduction of the share capital of a company without the consent of the Court."
- 32. What category of resolution is necessary for authorising the contemplated reduction of share capital?
- 33. How should the company proceed next to the passage of the requisite resolution for reduction?
- 34. Can the creditors object to reduction even if they are not hit by reduction?
- 35. Who are the creditors likely to be hit by the company's contemplated reduction?



36. When does the resolution for the reduction of share capital take effect?
37. What is the member's liability in respect of reduced shares?
38. Section 79 specifies circumstances in which shares can be lawfully issued at a discount.  
Is it necessary that all these specified circumstances must exist for the validity of such an issue?
39. In case of improper issue of shares at a discount, are the directors bound to compensate the company ?
40. Can shares be issued at different premiums?
41. Can shares at a premium be issued for consideration other than cash?
42. What is the significance of a share certificate in so far as the company is concerned?
43. Section 94 allows a company to increase its capital by issuing new shares. Can such new shares be offered to the public?
44. The soundness of A & Co. Ltd. promoted B to buy the majority of the shares of the company from the open market. Immediately after the purchase of the shares by B, the directors of the company offered rights shares in conformity with the law and duly allotted them to the existing members. Two shareholders who had sold shares to B filed a suit against the scheme on two grounds : (i) that company not being in need of further capital, its allotment was not *bona fide* in the interest of the company; and (ii) that about 275 shares of the new issue were not in fact offered to the shareholders. It was established that the company in fact needed the funds. In the circumstances, could the second contention of the shareholders be upheld ? [*Nandalal Zaveri v. The Bombay Life Assurance Co. AIR [1950] SC 172*].
45. (a) Can new shares be offered to outsiders in total disregard of the existing shareholders ? and (b) How ?
46. Has the Central Government any power to convert into shares any debentures issued to or loan taken from the Government by a company?
47. Is variation of shareholder's right permissible where memorandum or articles contain no provision in respect to such variation?
48. The holders of 3/5th of the issued shares of a particular class have consented to the variation in writing. Will the variation be permissible?
49. If a special resolution sanctioning the variation has been passed at a separate meeting of the shareholders of a particular class, can the rights attaching the class be varied?



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## The Companies Act, 1956

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50. Suppose, the holders of at least 10% of the shares of concerned class do not consent to or vote in favour of the resolution. Then what should they do?
51. Is there any time limit for the action as conceived by Question 28?
52. A public company has the right to convert (i) its fully paid-up shares; and (ii) its partly paid-up share warrants. Which is true ?
53. For the purpose of share warrants, which of the two things are necessary: authority of the articles or the approval of Central Government?
54. How may be bearer of a share warrant transfer the shares comprised therein?
55. Is registration of transfer optional with the company?
56. Can a private company assume power in its articles to issue share warrants?
57. Will it be sufficient legal compliance if only the transferor executes the instrument of transfer of shares?
58. Is it necessary to specify the name, address and occupation of the transferee in the transfer-deed?
59. Does instrument of transfer need stamping?
60. The law requires the instrument of transfer to be delivered to the company along with the certificate relating to the shares transferred. But if no such certificate is in existence, then what should the parties do?
61. Can the instrument of transfer be in any form?
62. Can the instrument be signed by the transferor or can any entry be made in the instrument before it is presented to the prescribed authority?
63. What is the prescribed authority required to do with the instrument?
64. What is the next step to be taken in this regard and by whom?
65. When is the instrument to be presented to the company (a) when share are quoted on a recognised stock exchange and (b) where it is not be quoted?
66. When all the requirements relating to transfer are complied with what should the company do ?
67. Can registration of transfer of shares be refused by the company on any ground ?
68. State the period within which the notice of refusal must be communicated to both the transferor and the transferee ?
69. What is the remedy of the parties in case of refusal ?



70. Can the Company Law Board compel the company to register the transfer ?
71. Can a company create a charge on the security of its reserve capital ?

**Essay / Practical Questions**

72. How far can a minor become a member of a company under the Companies Act, 1956?
73. Explain the meaning and significance of the 'Pari Passu' clause in a debenture. State the particulars to be filed with the Registrar of Companies in case of such debentures secured by a charge on certain assets of the company.
74. What do you understand by the term 'Charge'? State the list of charges which are required to be filed for Registration with the Registrar of Companies.
75. When can a Public Company offer the new shares (further issue of shares) to persons other than the existing shareholders of the Company? Can these shares be offered to the Preference Shareholders?
76. With reference to the provisions of the Companies Act, 1956 explain the circumstances under which a subsidiary company can become a member of its holding company- Examine the position of the following with regard to membership in a company:
- (i) An Insolvent
  - (ii) Partnership Firm.
77. Explain the following with reference to transfer of shares in a company registered under the Companies Act 1956:
- (i) Blank Transfers
  - (ii) Forged Transfers.
78. ABC Limited realised on 2nd May, 2001 that particulars of charge created on 12th March, 2001 in favour of a Bank were not filed with the Register of Companies for Registration, What procedure should the Company follow to get the charge registered with the Registrar of Companies? Would the procedure be different if the charge was created on 12<sup>th</sup> February, 2001 instead of 12th March, 2001? Explain with reference to the relevant provisions of the Companies Act, 1956.
79. What is a Debenture Certificate? When and within what time it should be issued' Is there any penalty for the delay or default in the issue of such certificate?



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80. Explain the meaning of 'Sweat Equity Shares' and state the conditions a company has to fulfill for issuing such shares.
81. Explain the term 'Share Warrant'. How does it differ from 'Share Certificate'?
82. Name any five charges which are required to be registered under the Companies Act, 1956. What is the effect of non-registration of a charge under Companies Act, 1956?
83. State the types of debentures which may be issued by a public company.
84. Define the term 'Small Depositors'. State the legal provisions relating to acceptance, repayment and further deposits of such small depositors under the Companies Amendment Act, 2000. (Nov. 2002)
85. 'A' commits forgery and thereby obtains a certificate of transfer of shares from a company and transfers the shares to 'B' for value acting in good faith. Company refuses to transfer the shares to 'B'. Whether the company can refuse? Decide the liability of 'A' and of the company towards 'B'.
86. What are the conditions and procedure whereunder shares may be forfeited under the Companies Act, 1956?
87. After receiving 80% of the minimum subscription as stated in the prospectus, a company allotted 100 equity shares in favour of 'X'. The company deposited the said amount in the bank but withdrew 50% of the amount, before finalisation of the allotment, for the purchase of certain assets. X refuses to accept the allotment of shares on the ground that the allotment is violative of the provisions of the Companies Act, 1956. Comment.
88. A who holds one share certificate of 1000 Equity shares in a company, wants to transfer 300 shares in favour of B. Explain the procedure to be followed for executing the partial transfer under the provisions of the Companies Act, 1956.
89. What are the provisions of the Companies Act, 1956 relating to the appointment of 'Debenture Trustee' by a company? Whether the following can be appointed as 'Debenture Trustee':
  - (i) A shareholder who has no beneficial interest.
  - (ii) A creditor whom the company owes Rs. 499 only.
  - (iii) A person who has given a guarantee for repayment of amount of debentures issued by the company.





90. Examine the provisions of the Companies Act, 1956 regarding 'nomination' in case of transmission of shares.
91. What is the concept of "charge" under the provisions of the Companies Act, 1956? Point out the circumstances where under a floating charge becomes a fixed charge.
92. Explain briefly the distinction between shares and debentures and state whether a company can issue debentures with voting rights.
93. The Board of Directors of M/s Reckless Investments Ltd. have allotted shares to the investors of the company without issuing a prospectus or filing a statement in lieu of prospectus with the Registrar of Companies, Mumbai. Explain the remedies available to the investors in this regard.

**3.32 Answers**

1. (d); 2. (d); 3. (b); 4. (d); 5. (a); 6. (b); 7. (d); 8. (b); 9. (d); 10. (b); 11. (d); 12. (a); 13. (b); 14. (d); 15. (b); 16. (b); 17. (c); 18. (b); 19. (c); 20. (d); 21. (d); 22. (b);
23. First entitlement to the receipt of dividends in preference to equity shareholders when the company is a going concern and to the payment of the amount paid up on preference shares when it is in liquidation,
24. No;
25. No;
26. No;
27. Both incorrect;
28. (a) Capital Redemption Reserve Account;
28. (b) Amount paid on redemption;
29. No, except when sanctioned by the Court;
30. Capital being the only security on which the creditors rely, must not be allowed to be depleted except under genuine necessity,
31. True;
32. Special resolution;
33. Apply to the court by petition for its confirmation order;
34. No
35. When reduction diminishes shareholder's liability to pay uncalled capital or involves



payment of any unpaid share capital to any shareholder;

36. On registration of the order and minutes of reduction;

37. To pay the difference between the amount deemed to have been paid on his share and the nominal value of the reduced shares;

38. Yes;

39. Yes, to the extent of the amount of discount

40. Yes;

41. Yes, against transfer of property;

42. Creates estoppel as to the title and payment;

43. No, to the existing equity shareholders;

44. No;

45. (a) Yes;

45. (b) Either by a special resolution or by an ordinary resolution coupled with the Central Government approval ;

46. Yes, if necessary in public interest;

47. Yes, if such variation is not prohibited by terms of issue of shares;

48. No;

49. Yes;

50. Apply to the Court;

51. Yes, within 21 days from the date of consent or resolution;

52. (i);

53. Both;

54. By simple delivery;

55. No;

56. No;

57. No;

58. Yes;

59. Yes;

60. Letter of allotment to be sent;



## **Business Laws, Ethics and Communication**

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- 61. No;
- 62. No;
- 63. To stamp or otherwise endorse on the instrument of the date of presentation;
- 64. Execution; completion and presentment to the company for registration by the transferor and the transferee
- 65. (a) Either before the closure of register of members or within 12 months whichever is later;
- 65. (b) Within 2 months from the date of presentation to the prescribed authority;
- 66. Register the transfer and replace transferor's name by that of transferee in the Register of members;
- 67. Yes;
- 68. Within 2 months;
- 69. To appeal to the Company Law Board;
- 70. Yes, if the refusal is found to be unjustifiable;
- 71. No;



## UNIT - 4 : MEETINGS & PROCEEDINGS

### Learning objectives

Meetings constitute an integral and important portion in the Companies Act, 1956. It gives an opportunity for the shareholders to know about the state of affairs of the company and also deliberate on various issues. There are different kinds of meetings that have to be called upon by the company and statutory requirements have to be complied with in calling, convening and conduct of the meetings. In this unit the students are exposed to the working knowledge on the following aspects:

Procedure in conduct of statutory, annual general and extraordinary general meeting.

- ◆ General requirements to be complied with in convening and conduct of general meetings
- ◆ Meetings of debenture holders
- ◆ Divisible profits and dividends.

### 4.0 INTRODUCTION

Since a company is an artificial legal entity distinct from that of its members, the affairs of the company are practically done by the Board of Directors. The Board of Directors in carrying out the day-to-day affairs of the company have to perform the role within their limited powers and the powers, which are granted to them. Certain powers can be exercised by the board of their own and with the consent of the company at the general meeting. The shareholders as owners of the company ratify the actions of the board at the meetings of the company. The meetings of the shareholders serve as the focal point for the shareholders to converge and give their decisions on the actions taken by the directors.

#### 4.1 Classification of meetings

Meetings held under the Companies Act, 1956 may be classified as follows:

1. *Meetings of shareholders or members:*
  - (a) Statutory meeting.
  - (b) Annual general meeting.
  - (c) Extraordinary general meeting.
  - (d) Class meetings.
2. *Meeting of debenture holders.*
3. *Meetings of creditors and contributories in winding up.*



4. *Meeting of creditors otherwise than in winding up.*
5. *Meeting of directors:*
  - (a) Board meeting.
  - (b) Committee meeting.

## **4.2 MEETING OF SHAREHOLDERS**

**4.2.1 Statutory Meeting (Section 165):** This meeting is held once during the lifetime of a company and it is the first meeting generally held after incorporation. The purpose of the meeting is to enable and apprise the members of the company regarding the financial affairs of the company immediately after the date of incorporation. Every public company limited by shares or limited by guarantee and having a share capital must hold a general meeting of the members of the company, which may be called the statutory meeting. It is to be convened after not less than one month but within six months from the date, which the company is entitled to commence business (sub-section 1). A meeting held prior to statutory period of one month is not a statutory meeting. The notice for such a meeting must say that it is intended to be statutory meeting [*Gardner Vs. Iredel (1912) I Ch.700*]. Student may note that the statutory meeting is to be held once in the life time of the company and that private companies and Government companies are not required to hold such a meeting. Therefore only public limited company with a share capital must hold the statutory meeting within the prescribed time limit.

### **4.2.3 Procedure at the statutory meeting:**

**4.2.3.1 Statutory Report:** The board of directors shall, at least 21 days before the day on which the meeting is to be held, forward a report called the Statutory Report, to every member of the company. Members present may discuss any matter relating to the formation of the company or arising out of the statutory report whether previous notice has been given or not but no resolution can be passed of which notice has not been given as required by the Act. [Section 165(7)]. The object of the statutory meeting is to acquaint the members with matters arising out of the promotion and formation of the company. After the receipt of particulars relating to shares taken up, moneys received, contracts entered into, preliminary expenses incurred etc., the shareholders have an opportunity of discussing and getting proper appraisal of the management and their methods and the prospects for the company.

At general meetings only such business is to be transacted and resolutions passed as have been notified to the members in the notice convening the meeting. At an adjourned meeting also which is deemed to be merely a continuance of the previous meeting only such matters as have been left over from the previous meeting may be transacted. In a statutory meeting the business to be transacted is laid down in the Act itself and provision is also made for transaction of business at adjourned meetings as set up above.



Default in filing the statutory report or in holding the statutory meeting is one of the grounds on which the company may be wound up by the Court (Section 433). The Court may instead of making a winding up order, direct the report to be delivered or the meeting to be held and order the costs to be paid by the persons in default. [Section 433(3)].

**4.2.3.2 Adjournment of statutory meeting:** Section 165(8) provides that the statutory meeting may be adjourned from time to time, and at any adjourned meeting, any resolution of which notice has been given in accordance with the provisions of the Act, whether before or after the former meeting, may be passed; and the adjourned meeting shall have the same power as an original meeting.

The power to adjourn rests with the decision of the meeting, that is to say, the chairman may not adjourn without the consent of the meeting, and must adjourn if so directed by the meeting, notwithstanding any discretionary power given to the chairman by the articles. Normally, where the chairman is given a discretion he is not bound to adjourn the meeting even if the majority desires it [*Salisbury Gold Mining Co. Vs. Hathorn (1897) AC 268; Parashuram Vs. Tata Industrial Bank Ltd. (1924) ILR 47 Bom. 915*].

The statutory meeting also provides an exception to the normal rule that only business left unfinished at the original meeting can be transacted at the adjourned meeting [Reg. 53(2), Table A]. Members have a right to introduce new business at the adjourned meeting, for the Act provides that any resolution of which notice has been given in accordance with the provisions of the Act, either *before or after* the former meeting, may be passed, and the adjourned meeting has the same power as an original meeting. If the meeting wishes to pass a resolution on any matter which it is entitled to discuss it may adjourn so that in accordance with the provisions of the Act may be given in the interval.

**4.2.3.3 Default:** If any default is made in filing the statutory report or in holding the statutory meeting, those in default are liable to a fine, which may extend to five thousand rupees [Section 165(9)]. Another consequence of not holding the statutory meeting in time is that the court can under Section 433(b) order the compulsory winding up of the defaulting company.

**4.2.3.4 Statutory Report:** The Directors are required to send a report to the members of the company at least 21 days before the meeting. Even if the report is forwarded later than required, it shall be deemed to have been duly forwarded, if all the members entitled to attend and vote agree to it (sub-section 2). The eight particulars to be set out in the statutory report are contained in sub-section (3) of Section 165. These are:

- (a) the number of shares allotted, distinguishing fully or partly paid up, otherwise than for cash and stating the extent to which the partly paid up shares have been paid and the consideration for which they have been allotted;
- (b) the total amount of cash received on account of shares allotted;



- (c) an abstract of receipts and payments up to the date within 7 days of the date of report, exhibiting under distinctive headings the receipts of the company from shares and debentures and other sources, the payment made thereout and particulars concerning the balance remaining in hand and an account or estimate of the preliminary expenses of the company, showing separately any commission or discount paid or to be paid on the issue or sale of shares or debentures;
- (d) the names addresses and occupations of the directors and auditors, manager and secretary, if any, and any changes therein, if occurred, since the date of the company's incorporation;
- (e) the particulars of any contract or modifications thereof to be submitted to the meeting for its approval;
- (f) the extent of non-carrying of each underwriting contract together with the reason therefore;
- (g) the arrears due on calls from every director and manager; and
- (h) particulars of commission or brokerage paid or to be paid to any director for manager in connection with the issue or sale of shares or debentures.

The report aforesaid must be certified as correct by at least two directors, one of whom should be the managing director, if there be any. The auditors should also certify it to be correct insofar as the report relates to shares allotted by the company, cash received in respect thereof and receipts and payments on revenue as well as on capital account of the company.

A copy of the above report should be sent to the Registrar also, after it has been sent to the members [Section 165(5)].

**4.3 Annual General Meeting:** Section 166 provides that every company must hold annual general meeting in addition to any other meetings at stipulated intervals specifying the meetings as such in the notice calling the meeting. The first annual general meeting of a company may, however, be held within 18 months of incorporation, and so long as the company hold its first annual general meeting within that period, the company need not hold any general meeting in the year of incorporation or in the following year [first proviso to Section 166 (1)]. This provision is intended to enable the company to make its first set up financial reports covering a longer period than what it wishes to be its financial year on cases where the first date of such year does not correspond with the date of its incorporation and present then in time for the first annual general meeting.

The second proviso to Section 166(1) states that the Registrar of Companies may, for any special reason, extend the time within which any annual general meeting (not being the first



annual general meeting) shall be held, by a period not exceeding three months. If the Registrar grants such extension of time, a company may not, in some cases, hold the annual general meeting in a particular year. For example, if the company was to hold its annual general meeting by the latest on 31st December of a particular year and the company had obtained an extension of time for holding the annual general meeting, the meeting could be held only in the following year. According to the clarification given by the Company Law Board/Tribunal, the Registrar and grant extension of time for special reasons up to the maximum limit of 3 months, even if such extension allows the company to hold its annual general meeting beyond the calendar year.

**4.3.1 Interval between two annual general meetings:** According to Section 166(1), there must not be more than 15 months between two consecutive annual general meetings. Section 210 requires the directors of a company to lay at every annual general meeting of the company a profit and loss account, or in the case of a company not trading for profit, income and expenditure account. The first account must cover the period since incorporation, and must be made up to a date not earlier than the date of meeting by more than nine months. Subsequent accounts must cover the period since the preceding account, and must be made up to a date not earlier than the date of meeting by more than six months. The account is required to be accompanied by a balance sheet as at the date to which the profit and loss account or income and expenditure account is made up.

It will therefore be appreciated that while a company may hold its annual general meeting in a year within the time limit of 15 months as provided by Section 166(1) it may still contravene Section 210. The date on which the annual general meeting is to be held is apart from the first annual general meeting, which is subject to different rules determined by three factors of time:

- (1) The meeting must be held in each year;
- (2) It must not held later than 15 months from the date of previous annual meeting; and
- (3) It must not held later than six months of date of balance sheet.

These three requirements are cumulative and separate: failure to comply with any of them constitutes an offence unless the Registrar of Companies has granted an extension of time for holding the meeting. The period of such extension is limited to three months [Second proviso to [Section 166 (6)]

**The following example will explain the position:** The financial year of a company ends on 31st December each year. The annual general meeting to adopt the accounts, etc. of the year ending 31st December, 1991 was held on 29th June, 1992. Under Section 166(1) the next annual general meeting need not be held until 29th September, 1993, but the accounts would be those, up to 31st December, 1991 which is more than six months before the date of the meeting. Therefore the last for holding that meeting would be 30th June, 1993.





Thus in fixing the date of the annual general meeting, Section 166 as well as Section 210 must be considered. A company and its directors may thus commit three different offences: that of not holding the annual general meeting in a calendar year, that of not holding the meeting within 15 months after the last meeting, and that of not holding the meeting within six months of the date to which the accounts are made up. [*B.N. Viswanathan Vs. Assistant Registrar of Joint Stock Companies, Madras (1953) 23 Comp. Cas. 63; AIR 1953 Mad 558; Sevaram Pansari Vs. Registrar of Companies (1964) 34 Comp.Cas.31*]

**4.3.2 Date, time and place:** An annual general meeting must be called for at any time during business hours, on a day that is not a public holiday, and must be held either at the registered office of the company or at some other place within the city, town or village in which the registered office of the company is situated, unless the company belongs to a class of companies exempted by Central Government from these requirements [Section 166(2)].

A public company or private company which is a subsidiary of public company, may by its articles fix the time for its annual general meeting and may also by resolution passed in one general meeting fix the time for its subsequent annual general meetings [Second proviso (a) to Section 166(2)].

A private company which is not a subsidiary of public company, may in like manner and also by a resolution agreed to by all the members thereof, fix the time as well as the place for its annual general meeting [Second proviso (6) of Section 166(2)]. Such a place need not be within the city, town or village in which the registered office of the company is situated.

**Can an annual general meeting be held on a public holiday?** An annual general meeting cannot be held on a public holiday. A public holiday has been defined in Section 2(38) as a public holiday within the meaning of the Negotiable Instruments Act 1881. Explanation to Section 25 of Negotiable Instruments Act states that the expression “public holiday” includes Sundays and any other day declared by the Central Government, by notification in the official Gazette, to be a public holiday. A day may be declared to be a public holiday after the notices calling the meeting for the day have already been issued. To avoid the difficulties that may be caused from such a situation, Section 2(38) provides that no day declared by the Central Government to be a public holiday shall be deemed to be such a holiday in relation to any meeting, unless the declaration was notified before the issue of the notice convening such meeting.

**4.3.3 Default in holding annual general meeting:** If an offence is committed by a company by not holding an annual general meeting in accordance with Section 166, it will render the company and every officer of the company who is in default, punishable with fine which may extend to Rs. 50,000 and in the case of a continuing default with further fine which may extend to Rs. 2,500 for every day after the first day which such default continued, (Section 168).



The company Law Board may, notwithstanding any thing in this Act, or in the Articles of the company, on the application of any member of the company, call or direct the calling of a general meeting of the company and gives such ancillary or consequential directions as the Company Law Board thinks expedient in relation to the calling, holding and conducting of the meeting. The directions, which the Company Law Board may give, include a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting. A general meeting so held is deemed, subject to any directions of Company Law Board, to be an annual general meeting of the company. (Section 167).

#### 4.3.3 Relevant case laws:

1. The annual general meeting must be called, whether or not the annual accounts are ready for consideration at the meeting [*Re El Sombrero Ltd. (1958)*].
2. An annual general meeting held beyond time can not be said to be void or illegal if the Registrar's permission is obtained, because the meeting must be held; it is not true to say that once the time for holding the meeting has expired the meeting can never be held as Sections 166, 167 and 168 make the failure to hold an annual general meeting within time punishable with penalty and do not say that the annual general meeting held after the prescribed time is void. Therefore, the meeting can be held and it will be valid even after the time fixed for holding it has expired. [*Hungerford Investment Trust Ltd. Vs. Towner Morrison & Co. Ltd. ILR(1972) 1 Cal 186*].
3. If because of circumstances beyond their control (for example, pandemonium in the hall) the directors decided not to hold the meeting, it can not be said to have been held by mere fact that before the directors' announcement, printed copies of balance sheet and agenda had been distributed to shareholders. [*Selvaraj Vs. Mylapore Hindu Permanent Fund Ltd. (1968) 38 Comp. Cas 153 (Mad)*].
4. It may be noted that directors could not be allowed to escape performance of duties regarding the meeting by a mere plea that they had no real control over the affairs of the company and they did not wilfully permit default; if directors were mere passive spectators and did not have the statutory requirements carried out, they may be considered as having wilfully permitted default [*Sarasvati Printers Limited Vs. State (1968) 30 Comp. Cas 523 (Raj)*].
5. An annual general meeting can not be held at a place other than the town, city etc. in which registered office is situated. [*Dineker Rai D. Desai .Vs. R.P. Bhasin (1986)*].



6. If the registered office is not available, moving to a nearby place and holding meeting there is not a violation of law; it is only an irregularity. [*M.R.S. Rathnavelusami Chettiar Vs. M.R.S. Manickavelu Chettiar (1951) 21 Comp. Cas. 93 (Mad.)*].
7. Where all members of the company were also members of the board of directors, a meeting of the board could well be treated as a general meeting of the company. [*P.VS. Damodara Reddi Vs. Indian National Agencies Ltd. (1945) 15 Comp. Cas 148(Mad.)*].
8. Holding of the AGM, whether or not the annual accounts are ready for consideration at the meeting, is a statutory requirement under Section 166 of the Companies Act, 1956. In fact consideration of accounts is only one of the matters to be dealt at an AGM (*Re. E1 Sumbbrero Ltd. It has also been held in Re, Brahambaria Loan Co. (1934)*) that if the annual accounts are not ready for being laid before the meeting as required by Section 210(1) the proper course to follow is to hold the meeting within the prescribed period and then adjourn it to a suitable date, say a month later for considering the accounts. Therefore, holding of the AGM even without getting the annual accounts ready is quite valid. However, in view of the decisions in the *Bejoy Kumar Karani V. Registrar of Companies (W.B) (1985)* and also in view of the 1988 an amendment to Section 220, care should be taken by the company to ensure that the adjourned AGM was held within the statutory period to avoid violation of Section 210 and 220 of the Companies Act, 1956.

**4.4 Extraordinary general meeting (Section 169):** An extraordinary general meeting is any general meeting of a company other than the statutory meeting or the annual general meeting or any adjournment thereof. Such a meeting may held subject to the terms of the Articles of Association at any time the directors think fit, and when they desire to transact the business of a special character.

There are, various matters in relation to administration of a company's affairs, which can be transacted only by resolutions of members in a general meeting. It is not always possible or expedient for consideration of such matters to wait until the next annual meeting. The Articles of Association of the company therefore make provisions for the convention of general meeting other than the annual general meeting. Such meetings are termed extraordinary general meetings'. (Regulation 47 of Table A).

An extraordinary general meeting may be convened:

1. by the Board of Directors on its own or on the requisition of members ; or
2. by the requisitionists themselves on the failure of the Board to call the meeting;
3. by the Company Law Board.



**1. By the Board of Directors:** (a) On its own: An extraordinary general meeting may be convened by the directors if some business of special importance requires an approval from the members. The articles invariably provide, as does Reg. 48 (1) *Table A* that the Board of directors may, whenever it thinks fit, call an extraordinary general meeting.

It is contended by some people that the term 'extraordinary general meeting' should be confined to a general meeting called on the requisition of members under *Section 169*, as not only this section is headed "calling of extraordinary general meeting on requisition" but the term is also so used in the body of section; however, *Reg. 47 of Table A* specifically provides that "all general meeting other than annual general meetings should be called extraordinary general meetings. It may therefore be noted that if the Articles of a company contain a clause in similar terms, every general meeting other than an annual general meeting, whether convened by the directors of their own or on requisition of members should be called an extraordinary general meeting.

*Exercise of directors' power to call extraordinary general meetings.* The directors' power to call general meeting including extraordinary general meeting must, like their other powers, be exercised at a properly convened Board meeting. It is not open to some of the directors to convene a general meeting of their own motion [*Harben Vs. Phillips (1883) Ch.D-14*].

If the Articles provide that a resolution in writing signed by all the members of the board without meeting is as effective as a resolution passed at a Board meeting as in normally the case, (*Reg. 81 of table A*), a general meeting may be convened on a resolution so signed.

The Articles also frequently provide for the contingency that there may be insufficient number of directors to call an extraordinary general meeting. Thus, *Reg 48(2) of Table A* provides that if at any time there are not within India sufficient directors capable of acting to form a quorum, any director or any two members of the company may call an extraordinary general meeting in the same manner (as nearly as possible) as meetings are convened by the Board of directors.

(b) *On requisition of members:* The members of a company may also ask for an extraordinary meeting to be held. The Rules in this regard may be noted as hereunder:

*Persons entitled to requisition (Section 169).* A requisition for convening an extraordinary general meeting may be made by members (i) holding 10% of the paid-up share capital of the company and having a right to vote at the date of deposit of requisition on the matter to be discussed at the meeting or (ii) if the company has no share capital, members having 10% of the voting power of all members having a right to vote at the date of the deposit of requisition on the matter to be discussed. Shares on which any call money is due or shares the holder of which has died will be excluded in counting 1/10th, as they have no power on the date of deposit of the requisition. Preference shareholders can join in the requisition only if their dividends are in arrears for the specified period or if the proposed resolution is likely to affect their interest, e.g., a resolution for winding up of the company. After requisition if any



requisition ceases to be a member or withdraws, it will not invalidate the requisitionists. Further, the right of a member to requisition or vote at a meetings not affected by pledge or attachment of his shares or by appointment of Receiver over his shares. Such rights are also not affected by taking over of management under the Industries (Development and Regulation) Act, of the shareholder company. [*Balkrishan Gupta Vs. Swadeshi Polytext Ltd.*(1985) 58 Comp. Cas 563 (SC)].

Where two or more persons hold any shares or interest in a company jointly, a requisition, or a notice calling a meeting, signed by one or some only of them shall, for the purposes of this Section, have the same course and effect as if it had been signed by all of them. [Section 169(8)].

*Contents of requisition.* The requisition should contain matters for consideration of which the meeting is to be called. If any special resolution is intended to be passed at the requisitioned meeting, the Board shall be deemed not to have duly convened the meeting if they do not give such notice thereof as is required by sub-section (2) of Section 189. For each item of the agenda explanatory statement must be given.

*Form and depositing of the requisition.* The requisition may be in the form of letter addressed to the Board of directors. There may be one letter signed by the requisite number of members or there may be several letters in the like form. Although, the letters need not be identical in language they should be to the same effect. The requisition should be deposited at the registered office of the company. The requisition sent by a registered post properly addressed and received by the company at its registered office will amount to deposit of the requisition at the registered office.

*Compliance of requisition:* The Board of Directors are under a legal obligation to proceed within 21 days of the deposit of the requisition to convene a meeting which should be held within 45 days of such deposit of the requisition with the company. (Section 169(6)). The Board shall send out notices within 21 days of the deposit of the requisition giving not less than 21 days notice for the meeting. Where the requisition specifies the requirements of Section 169, it can not be rejected on the ground that some of the resolutions referred to in the requisition can not refuse to proceed with a requisitioned meeting merely on the ground that be put to the requisitioned meeting for any reason. In other words, the Board of Directors the requisition does not disclose sufficient reasons for the resolution to be put to vote at the meeting, in the explanatory statement. [*Life Insurance Corporation of India Vs. Escorts Limited, 1986, 59 Comp. Cas 548 (SC)*].

Any reasonable expenses incurred by the requisitionists by reason of the failure of the Board to call a meeting duly shall be repaid to the requisitionists by the company; and any sum so repaid shall be retained by the company out of any sums due or to become due from the company by way fees or others remuneration for their services to such of the directors as were in default. [Section 169(9)].



**2. By the requisitionists themselves:** If the directors fail to issue the notice of the meeting within 21 days from the date of the deposit of requisition to convene the meeting on a day not later than 45 days from the date of deposit of the requisition, the meeting may be called:

- (a) in the case of company having a share capital, by the requisitionists representing either a majority in value of the paid up share capital held by all of them or not less than one-tenth of the paid up share capital of the company having the right of voting, whichever is less; or
- (b) in case of a company not having a share capital, by the requisitionists representing not less than one-tenth of the total voting power of all the members of the company [Section 169(6)].

Such a meeting must be held within a period of three months from the date of the deposit of requisition by the requisitionists or any of them. The meeting shall be called in the same manner as nearly as possible that in which Board meeting are called [Section 169(7)].

It may be noted that it is not necessary for the requisitionists to disclose reasons for resolution they propose to move at the meeting. Thus in *Life Insurance Corporation of India Vs. Escort Ltd. (1986) 59 Comp. Cas. 548 (S.C)*, certain financial institutions held 52 percent shares in company E. Company E had launched litigation in a case which the institutions did not approve of and suggested withdrawal of litigation and have further discussions. As the management did not agree to this course, one of the institutions (LIC) requisitioned an extraordinary general meeting for the purpose of removing the non-executive directors and electing new directors in their places. Company E sought an order restraining the LIC from requisitioning the meeting; the contention of E was the LIC being an instrumentality of the State, it was incumbent upon it to state reason for the resolution for removal of directors.

Held that every shareholder of a company has the right, subject to statutorily prescribed procedural and numerical requirements to call an extraordinary general meeting in accordance with the provision of the companies Act. He cannot be restrained from calling a meeting and he is not bound to disclose the reasons for the resolution proposed to be moved at the meeting. Nor are the reasons for the resolutions subject to judicial review. No doubt, under Section 173(2), there shall be annexed to the notice of the meeting a statement setting out all material facts concerning each item of business to be transacted at the meeting including in particular, the nature of concern and the interest, if any, there in, of every director, and of the manager, if any. This is a duty cast on the management to disclose, in an explanatory note, all material facts related to resolution coming up before the general meeting to enable the shareholders to form a judgement on the business before them. It does not require the shareholders calling meeting to disclose the reasons for the resolution which they propose to move at the meeting. Therefore, the LIC, in the present case, as a shareholders of E, had as the same right as every shareholder to call an extraordinary general meeting of the company



for the purpose of moving a resolution to remove some directors and appoint others in their place. Hence, the LIC could not be restrained from doing so, nor was it bound to disclose its reasons for moving the resolution.

When the State or an instrumentality of the State ventures into the corporate world and purchases the shares of a company, it assume to itself the ordinary role of a shareholder, and don the robes of a shareholder, with all the right available to such a shareholder. There is no reason why the State as a shareholder should be expected to state its reasons when it seeks to change the management by resolution of the company, like any other shareholder.

It may again be noted that where an amalgamation scheme has been approved in a statutory meeting under Section 391, shareholders cannot requisition a meeting to compel the company for withdrawing its petition pending before Court for its sanction under Section 392.

Thus in *Centron Industrial Alliance Ltd. Vs. Pravin Kantilal Vikil (1985)57 Comp. Cas. 12(Bom)*., after a scheme for the amalgamation of company C with company B had been approved by an overwhelming majority of shareholders and secured and unsecured creditors, it was filed with High Court for sanction. While it was pending with the High Court, some shareholders requisitioned an extraordinary general meeting of the company to consider a resolution to the effect that the company should examine alternate sanction of High Court to the proposed scheme. The meeting was conveyed but another shareholder sought an injunction to restrain the company from holding this extraordinary general meeting. The question was whether after the approval of the scheme in the meeting held under Section 391, and presentation of the scheme to the High Court for sanction, the shareholders could requisition a meeting for compelling the company to withdraw its petition from the High Court.

Held that under Section 391, read with rule 79 of the Companies (Court) Rules after a scheme is approved at the statutory meeting held for the purpose, the company is under an obligation to present a petition for confirmation of the scheme within 7 days of the filing of the report by the chairman of such meeting or meetings. Accordingly, company C was under a statutory obligation to present a petition for sanctioning the scheme. The requisitioned meeting clearly interfered with the company's obligation in this connection. In *Isle of Wight Railways Co. Vs. Tahaourdin (1884) 25 Ch. D 320 (CA)*, Lord Justice Lindley had in his guarded language, expressed a view that if the resolution proposed to be passed at the requisitioned meeting were wholly illegal, then the board of directors would be under no obligation to call meeting requisitioned for the purpose of passing such an illegal resolution. Thus, there could be no point in calling a meeting for passing a resolution, which would be wholly illegal. Even otherwise, in the instant case, the meeting had not been called to consider the internal management of the company. The resolution, which had been proposed, did not deal with matters, which concerned only the company and its shareholders. The purpose of the requisition was to compel the company to withdraw the petition for amalgamation which was pending before the Court. A scheme of amalgamation affects not merely the company and its



shareholders, but it also vitally concern an important body of outsiders, viz., the creditors of the company, both secured and unsecured. It is, therefore, important that any opposition to this scheme should be express and taken note of in the manner provided in Section 391 and not by the shareholders requisition a meeting in order to compel the company to withdraw the petition. In the present case, there appeared to be a clear attempt on the part of the opponent to interfere with the petition under Section 391 which was to pending in the Court .It seemed that the opponents, by calling a requisitioned meeting of the shareholders were seeking to undo the effect of the statutory meeting which had been already held to consider the scheme and seeking to postpone the sanctioning of the scheme by the Court as far as possible. The requisitioned meeting in the present case, therefore, was convened for a purpose, which was totally different from the purpose for which such meetings are ordinarily convened. Thus, the shareholders could not requisition such a meeting for compelling the company to withdraw its petition from the High Court.

It may further be noted that the Court cannot prevent shareholders from requisitioning a meeting, discussing and passing a resolution, proposing a modification to an amalgamation scheme, even when the scheme is pending for sanction before Court. Thus in *Pravin Kantilal Vakil Vs. Mrs. Rohini Ramesh Save(1985) Comp. Cas. 31 (Bom.)*, a scheme of amalgamation of company C with company B was approved at a statutory meeting convened under Section 391, after which the scheme was presented to the High Court for sanction. The scheme, *inter alia*, provided for exchange ratio of share of B for 5 shares of C. While the scheme was pending in the High Court, an extraordinary general meeting was requisitioned for the purpose of asking the company C to re-negotiate with B, as according to the requisitionists the ratio was not fair and equitable. The question was whether the Court could prevent the shareholders from discussing the modification on the ground that the scheme of amalgamation was already pending before the Court.

Held that Section 392 gives wide powers to the Court to give such directions in regard to any matter or make such modification in the compromise or arrangement as it may consider necessary for the proper working of the compromise or arrangement arrived at. Under the said Section 392 the Court even at the instance of any shareholder could consider any such modification in the scheme. In that event, a mere discussion by the shareholders at a properly requisitioned meeting about the proposed modification to the scheme pending before the Court for sanction and if approved passing a resolution to that effect would not by itself affect either the scheme or the Court's powers to consider the modification and sanction of the scheme with or without modification. Thus, the shareholders could requisition the meeting for proposing a modification to the scheme pending for sanction before the Court.

It may be mentioned here that once a final dividend is declared at an annual general meeting, no further dividend can be declared at an extraordinary general meeting. Sections 166,186,210,211,217 and provisions in Schedule VI, Part II, clause (3) (xiv) of the Act indicate





that the declaration of the dividend is a business of annual general meeting. Clause 3 (xiv) in Schedule VI states that the profit and loss account is to set out the aggregate amount of dividends paid and proposed. It, therefore, manifest that interim dividends and dividends proposed at the annual general meeting exhaust the dividends for the year. Further, Section 173 makes declaration of dividend a business of the ordinary general meeting. Therefore, there is no power to declare further dividend at an extraordinary meeting [*Biswanath Prasad Khaitan Vs. New Central Jute Mills Co. Ltd. (1961) 31 Comp. Cas. 125 (Cal)*].

The business to be transacted at the extraordinary general meeting will be special in all cases [See Section 173 (1) (b)]. It is to be noted that even at an extraordinary meeting both ordinary and special resolution can be passed.

Relevant judicial rulings (Extraordinary general meetings).

1. Every shareholder of a company has the right, subject to statutorily prescribed procedural and numerical requirements, to call an extraordinary general meeting in accordance with the provisions of the Companies Acts. He cannot be restrained from calling a meeting and he is not bound to disclose the reasons for the resolution proposed to be moved at the meeting. Nor are the reasons for the resolutions subject to judicial review. No doubt, under Section 173(2), there shall be annexed to the notice of the meeting a statement setting out all material facts concerning each item of business to be transacted at the meeting including, in particular, the nature of the concern or the interest, if any, therein, of every director and managers, if any. This is duty cast on the management to disclose, in an explanatory note, all material facts relating to the resolution coming up before the general meeting to enable the shareholders to form a judgement on the business before them. It does not require the shareholders calling a meeting to disclose the reasons for the resolution, which they propose to move at the meeting. [*Life Insurance Corpn. Of India Vs. Escorts Ltd. (1986)59 Comp. As. 548(SC)*].
2. Section 181, *inter alia*, states that notwithstanding anything contained in the Act, The articles of the company may provide that no member shall exercise any voting right in respect of any shares registered in his name on which any calls or other moneys presently payable by him have not been paid. From conjoint reading of Section 181 and the Articles of Association of the company, it is clear that any sum is due from a shareholder in respect of share, he is not entitled to vote at any general meeting.

Section 169 deals with calling of extraordinary general meeting on requisition. Sub-section (4) says that the number of members entitled to requisition a meeting in regard to any matter, in the case of a company having a share capital shall be such number of them holding at the date of the deposit of the requisition, not less than the one-tenth of such of the paid-up capital of the company as at that date carry the right of voting in



regard to that matter. From a reading of sub-section it is clear that only those shareholders who have a right of voting can requisition a meeting.

Where the articles of association of a company prohibited any defaulting shareholder from exercising his right to vote at any general meeting, and certain shareholders had not paid a call made on their shares it was held that they were not entitled to requisition an extraordinary general meeting under Section 169 [*Col. Kuldip Singh Dhillon Vs. Paragaon Utility Financiers (P) Ltd. (1986) 60 Comp. Cas 1075 (Punj.& Har)*].

3. Where an amalgamation scheme has been approved in a statutory meeting under Section 391, the shareholders cannot requisition a meeting to compel the company for withdrawing its petition pending before the Court for its sanction Under Section 392. [*Centron Industrial Alliance Ltd. Vs. Pravin Kantilal Vakil (1985) 57 Comp. Cas. 12 (Bom.)*].
4. All that is required to be seen before the provision of sub-section (6) of Section 169 become applicable would be to consider whether the requisition deposited was in accordance with the provisions of Section 169 as to its contents, the number of signatories and similar matters, and it would not be open to the board of directors of a company to refuse to act on a requisition on the grounds that, although such requisition was in accordance with the requirements of Section 169, it was otherwise invalid. This conclusion receives support when one peruses sub-section (5) of Section 169, where also the use of the word 'valid' is perceived. The word or the adjective 'valid' in Section 169 has no reference to the object of the requisition but rather to the requirements in that section itself. If these requirements indicated in the earlier part of section are satisfied, then the requisition deposited with the company must be regarded as a valid requisition on which the directors of the company must act. [*Cricket Club of India Ltd. v Madhav L. Apte (1975) 45 Comp. Cas. 574 (Bom)*]
3. **By the Company Law Board:** If for any reasons it is 'impracticable' to call a meeting of the company other than an annual general meeting in any manner in which the meeting of that company may be called or hold or to conduct it in any manner prescribed by the Act and the Articles, the Company Law Board, under Section 186, may, either on its own motion (*suo motu*) or on the application of any director of the company or any member thereof would be entitled to vote at the meeting, order a meeting to be called, held and conducted in such a manner as it thinks fit and give such directions as it thinks expedient (Section 186). Thus, where a petition was filed under Section 186 but in the petition there was no allegation that it was for any reason impracticable for the company to call, hold or conduct a meeting, such a petition would be incompetent. [*Siri Ram Vs. Edword Ganj Public Welfare Association Limited (1997) 47 Comp. Cas 283*].



The following connotations of the word 'impracticable' are worth noting:

- (a) The word impracticable must certainly be given a practical meaning. It must be understood to be impracticable from the business point of view. It must not be held impracticable on the slightest excuse that the directors cannot agree [*Bengal & Assam Investors Ltd. Vs. J.K. Eastern Industries (P) Ltd. (1957) 27 Comp. Cas 86(Cal)*]
- (b) The word 'impracticable' does not mean 'impossible'. Before a meeting can be ordered under Section 186, the Company Law Board must find that it has become 'impracticable' to call a meeting in ordinary manner [*Passari Floor Mills Ltd., In Re (1962) 32 Comp. Cas 896 (MP).*]
- (c) Impracticability of conducting a meeting also includes impracticability of holding a meeting. For example, holding of a meeting is impracticable where the registered office of the company is locked and is not available [*M.R.S. Rathnavelusami Chettiar Vs. M.R.S Manickavelu Chettiar (1951) 21 Comp. Cas 93 (Mad)*]
- (d) The expression "impracticable" is sufficient to include a case in which it is impracticable owing to the terms of the articles and the state of the share holding in the company to get a quorum present. Thus where one of the only two director - share holders who was holding 51 % shares wanted to remove his fellow director who did not attend the meeting to frustrate him because the articles required quorum of two, the Court [here it would have to be NCLT ] ordered a meeting to be called with the presence of one as sufficient quorum. [*Opera Photographic Ltd., Re., 1989 BCLC 763 (1989)*].

The Company Law Board / NCLT may direct for the modification of the provisions of the Act or the articles in relation to the calling, holding and conducting of the meeting or that one member of the company present in person or by proxy may be deemed to constitute a meeting. Any meeting called, held and conducted in accordance with the order of the Company Law Board will be deemed, for all purposes, to be a meeting of the company duly called, held and conducted.

#### **4.5 POWERS OF COMPANY LAW BOARD/TRIBUNAL:**

*Guidance of Judicial Rulings:* The main principles that should guide the Tribunal as regards ordering meeting to be called were indicated in *re, Ruttonjee & Co. Ltd.(1968) 2 Comp. LJ 155 (1970) 40 Com. Cases 491 (Cal.):*

- (i) The CLB/Tribunal would not ordinarily interfere with the domestic management of a company which should be conducted in accordance with the articles.



- (ii) The discretion granted under Section 186 should be used sparingly with caution so that the CLB/Tribunal does not become either a shareholder or director of the company trying to participate in the internecine squabbles of the company.
- (iii) The word 'impracticable' means impracticable from a reasonable point of view.
- (iv) The CLB/Tribunal should take a common sense view of the matter and must act as a prudent man of business.
- (v) A prudent man of business has not a sensitive officious view of intervention in case of every rivalry between two groups of directors; prudence demands that the CLB/Tribunal should ordinarily keep itself aloof from participating in quarrels of rival groups of directors or shareholders.
- (vi) But where the meeting can be called only by the directors and there are serious doubts and controversy as to who are directors or where there is a possibility that one or other or both the meetings called by the rival groups of directors may be invalid, the CLB/Tribunal ought not to expose the shareholders to uncertainties and should hold a position has arisen which makes it "impracticable: to convene a meeting in any manner in which meeting of the company may be called.
- (vii) "Before the CLB/Tribunal exercise its discretion under Section 186, the CLB/Tribunal must be satisfied when a director or a member moves an application, that it has been made *bona fide* in the larger interests of the company for removing a deadlock otherwise irremovable".

*In Smt. Jain Vs. Delhi Flour Mills Company Ltd. and others (1974) 44 Comp. Cas. 228 (Delhi)*, it was held that an application under Section 186 need not to be on behalf of the company for the very language of that Section even permits the Company Law Board *suo moto* to call meeting of the company if it has become impracticable to call a meeting other than an annual general meeting. An action need not be in the name of the company for actions concerning injuries personal to the petitioner.

Where a meeting can be called by recourse to Section 169 or 167, the Company Law Board will not grant an application under Section 186; for the petitioner would at least have to show that there is no other option but to apply under Section 186.

In a petition under Section 186 for an order directing the holding of general meeting the CLB/Tribunal will not go to the extent of rectifying the register of members for the purpose of giving directions as to who should vote at such a meeting.

*In B.R. Kundra Vs. Mohan Pictures Association (1976) 46 Comp. Cas. 339 (Delhi)* it was held that:



Directors can not continue in office by failing to call annual general meeting at which they are to retire; where directors no longer continued to hold office as such, the court (now CLB/Tribunal) can call a meeting to elect directors.

In re. Motion Pictures Association (1979) 46 Comp. Cas.298 (Delhi), it was held that :

A meeting which is not conducted in accordance with the directions of the Company Law Board in not a meeting of a company under sub-section (2) of Section 186 and any business conducted in that meeting must fail.

*In Indian Hardware Industries Ltd. Vs. S.K. Gupta (1981) 51 Comp. Cas. (Delhi)*, it was held that:

There is nothing in Section 186 which lays down that a Company Court which is supervising the scheme under Section 392 cannot call a meeting of the company if it feels that it is necessary to do so for the proper supervision and implementation of the scheme. So long as the meeting is to be called, because the Court feels it necessary for the proper working of the scheme, the power must be found to be implicit in the Court by virtue of Section 392(1) and it is not necessary to invoke Section 186 for this purpose. In other words, Section 186 is not applicable to cases covered by Section 392.

*In Bengal & Assam Inventors Ltd. Vs. J.K. Eastern Industries (P) Ltd. (1957) 27 Comp. Cas 86 (Cal)*, it was held that:

The Company Law Board's power under Section 186 is discretionary. It is not a power which it must exercise. It is not a mandatory obligation upon the Company Law Board. It is an alternative remedy to be applied only when the normal machinery of company management fails and the Company Law Board must find firstly that it is impracticable to call a meeting and secondly that to leave the parties to follow their own remedies and rights will put the company in jeopardy.

**4.6 Class meetings:** Meetings of members of a company fall into two broad divisions, namely, general meetings and class meetings. Class meetings are meeting of shareholders, holding a particular class of share which are held to pass resolution which will bind only the members of the class concerned. Only members of the class concerned may attend and vote at meeting. Usually the rules to voting apply to class meetings as they govern voting at general meetings. These class meetings must be convened whenever it is necessary to alter or change the rights or privileges of that class as provided by the articles. For effecting such changes, it is necessary that these are approved at a separate meeting of the holders of those shares and supported by a special resolution. Under Section 106, class meeting of the holders of different classes of shares shall be held if the rights attaching to these shares are to be varied. Similarly, under Section 394, where a scheme of arrangement is proposed, meeting of several classes of shareholders and creditors are required to be held.



#### 4.7 PROCEDURE FOR CONVENING AND CONDUCT OF GENERAL MEETINGS

The business at a meeting is said to have been “validly transacted” if the members of the organisation or body concerned, whether or not they were present, are bound by the decision made thereat. They cannot be so bound unless the meeting is validly held. The essentials of a valid meeting are that the meeting should be:

- (a) *Properly convened*;, i.e. a proper notice must be sent by the proper authority to every person entitled to attend.
- (b) *Properly constituted*, i.e. the proper person must be in the chair, the rules as to quorum must be observed, and the regulations governing the meeting must be complied with.
- (c) *Properly conducted*, i.e. the chairman must conduct the proceeding in accordance with the law relating to general meetings as per the Companies Act (Sections 171 to 185), the Company’s own Articles of Association or, where applicable, Table A (Regulations 47 to 63 ) or in the absence thereof in respect of any specific matter, by the common law relating to meetings.

**4.8 Notice of meeting:** The notice must be given by the proper summoning authority, which would normally be the Board of Directors. If however a notice has been issued without authority, the requisite authority may be given by ratification by the proper summoning authority before the meeting is held and notice may thus become good [*Hooper Vs. Kerr, Stuart & Co. (1900) 83 L.T. 729*].

**4.8.1 Persons entitled to notice:** Notice of the meeting shall be given:

- (a) to every member of the company;
- (b) to the persons entitled to a share in consequence of the death or insolvency of a member;
- (c) to a auditor or auditors [Section 172(2)]; and

The company cannot take notice of the beneficial owners of shares who are, therefore, not entitled to receive notice. Where, however, anyone is legally entitled to represent the member, such representative is entitled to receive the notice.

A private company, which is not, a subsidiary of a public company may prescribe, by its Articles, persons to whom the notice should be given.

It does not always follow that all the members of a company are entitled to receive notice of meetings of the company; the Articles frequently provide that preference shareholders shall not be entitled to receive notice of and vote at general meeting of the company, except in certain circumstances. There is a statutory obligation to send notice to preference



shareholders when their dividend is in arrears for more than a certain period [Section 87(2)(b)]. This obligation arises from the fact that preference shareholders whose dividends are in arrears are entitled to attend and vote at the meeting.

The non-receipt of notice or accidental omission to give notice to any member shall not invalidate the proceedings in the meeting [Section 172(3)]. However, omission to serve notice of meeting on a member on the mistaken ground that he is not a shareholder cannot be said to be an accidental omission [*Musselwhite Vs. C.H. Musselwhite & Sons Ltd.*(1962) 32 Comp. Cas 804]. 'Accidental omission' means that the omission must be not only designed but also not deliberate [*Maharaja Export Vs. Apparels Exports Promotion Council* (1986) 60 Comp. Cas 353].

**4.8.2 Length of notice:** A general meeting cannot ordinarily be called by giving less than 21 days' notice in writing excluding the day of service of notice and the day of the meeting [See Section 171(1)]. The Delhi High Court held in *Bharat Kumar Dilwale Vs. Bharat Carbon and Ribbon Manufacturing Co. Ltd. and other* (1973) 43 Comp. Cas 197 that the expression "not less than 21 days notice" appearing in Section 171 of the Act implies a notice of 21 whole or clear days i.e. a period of 21 days excluding the day from which it ran and the day on which the notice expired. Part of the day, after the notice would be deemed to have been served, could not be added up to part of the day immediately before the timing of the meeting so as to construe one day. Each of the 21 days must be full or a clear day. Following the Supreme Court's interpretation of the expression "not less than one month" that the first day and the last day of the month had to be excluded, the day of service of the notice and the day of the meeting were excluded from the computation of 21 days.

**Consider the following practical situation:**

ABC Ltd. called its annual general meeting on 7<sup>th</sup> September, 2005. The notice of AGM was posted on 16<sup>th</sup> August, 2005. One member holding 20 shares wishes to challenge the resolutions passed at the AGM on the ground that the notice was not valid. What advice would you give to him?

According to Section 171(1) a general meeting of a company may be called by giving not less than 21 days notice in writing. Not less than 21 days means 21 clear days i.e. excluding both the date on which the notice was served and the date of the meeting. In case the notice of the general meeting is sent by post, service notice of the meeting shall be deemed to have been effected at the expiry of 48 hours after it was posted. In the instant case, the notice was short of one day as per the section:

16 <sup>th</sup> August to 7 <sup>th</sup> September	23 days
Less date of service and date of meeting	2 days
	21 days



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## The Companies Act, 1956

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Less 48 hours of posting but 24 hours are common between date of service & 48 hours of posting 1 day

20 days

Therefore, the meeting was invalid and the resolutions passed were invalid. However in case AGM, where all members entitled to vote consent, the meeting may be held on shorter notice.

However, there are different High Court judgments relating to the question as to whether the requirement as to the period of notice is directory or mandatory.

In *Saliesh Harilal Shah v. Matushree Textiles Ltd.* (1994) 2CLJ, 291, the Bombay High Court [in contrast to the Madras High Court decision in *N. Chettair(v) the Madras Race Club* (1951)] held that the requirement of the section as length of notice is directly only and not mandatory. A couple of shareholders cannot be permitted to defeat the interest of the large body of shareholders by saying that the duration of the notice was not sufficient even if the short notice does not indicate any prejudice to the complaining shareholders.

In this problem, the member may be advised to explore whether he has suffered any prejudice by the short notice before proceeding to challenge the validity of the resolutions.

An Annual general meeting, however, may be called by giving a shorter notice with the consent of all the members entitled to vote at meeting and, in case of any other meeting with the consent of members holding not less than 95 percent of paid up capital or, if the company has no share capital, not less than 95 per cent of the total voting power [Section 171(2)]. Note that all members can similarly agree to the accounts being sent to them less than 21 days before the annual general meeting [Section 219(1) proviso(c)].

It may be noted that *consent means 'consent of members entitled to attend and vote' and 'not of members entitled to vote and present'*. Under the proviso to Section 171 (2), It would be seen that the requirement as to 21 days 'notice may be dispensed with by agreement of all the members, *entitled to attend and vote and not merely of all the members* entitled to vote and present in person or proxy at the meeting. It, therefore, requires an agreement of all the members of the company in order to dispense with the requirement of 21 days notice. The proviso, in other words, indicates the intention on the part of the Legislature that the provision in sub-section (2) is mandatory and that it can be dispensed with only by the agreement of all the members. It is not enough that the members present at the meeting indicated either expressly or impliedly that they consented to or acquiesced in shortening the period of notice [*N.O.R Nagappa Chettiar Vs. Madras Race Club* (1949) 19 Comp. Cas.].

Even though consent of shareholders to a shorter notice for meeting at which a special resolution is passed, is not obtained prior to meeting, consent obtained thereafter would validate the resolution. It has been held in various English decisions under the English Companies Act, the provisions of which are similar to the provisions of Section 171(2), that





even though consent of shareholders to shorter notice for the meeting at which a special resolution is passed is not obtained prior to the meeting, consent obtained thereafter would validate the resolution. The only Indian case, *Self Help Private Industrial Estate (P) Ltd. In re (1972) 42 Comp. Cas 6(Mad.)* is in favour of the view that a post-consent validates a special resolution passed without proper notice.

Where majority of the members of the company holding more than 95 percent of such part of the paid-up share capital which give them a right to vote at the meeting, had given their consent, subsequent to the meeting, to a shorter notice and had ratified and accepted the special resolutions passed at the meeting and the company had stated on affidavit that not a single objection was received from any of the other members, it was held that in view of the subsequent consent obtained by the company from its members who formed a majority and held more than 95 percent of the paid-up share capital which gave them a right to vote, the resolutions must be deemed to be valid [*Parikh Engg. & Body Building Co. Ltd. In re (1975) 45 Comp. Cas 157(Pat)*].

As regards shorter notice for general meeting, let us consider a practical problem. According to Section 171 read with Section 170 it boils down to this that a private company which is not a subsidiary of a public company can provide in its articles for holding the general meeting at a shorter notice than 21 days. Now, in view of this position of law, if the articles of the private company provide for 7 days' notice in lieu of 21 days, can a copy of the balance sheet, together with the profit and loss account, auditors's report, etc., be also sent to its members for consideration at the annual general meeting along with notice of such meeting? Does Section 219 need any amendment to bring it in conformity with Section 171 read with Section 170?

According to the proviso (c) to Section 219(1), statement of account, auditors's report together with all necessary annexures or attachments can be sent to members less than 21 days before the date of meeting only if so agreed to by all members entitled to attend and vote there at. Seemingly, this provision is in conflict with that of Section 171 read with Section 170. But this conflict is perhaps not unintentional and irrational. The formalities prescribed by Sections 171 and 219 are independent of one another, the copies of the documents referred to in Section 219 are to be despatched also to persons other than those entitled to receive the notice of the general meeting. Moreover, consideration of annual accounts, etc., cannot be treated as identical and hence at par with the consideration of other business coming before the shareholders. Therefore, the shareholders must be given sufficient time to peruse the documents mentioned in Section 219.

If a meeting is called without notice to a shareholder the omission not being accidental, it is invalid and all proceedings therein are also invalid. A meeting was convened for December, 1969 but deliberately notice of the meeting was not sent to S and his wife. At that meeting B and S were elected as directors, but were to hold office only till April, 1970. In the next



meeting, S was not elected and B and his wife were elected as directors. The contention of S was that since the meeting of December, 1969 was invalid, the meeting of 1970 was also invalid and so were the appointments of B and his wife. The omission to send the notice was not accidental.

Held that all the proceedings of April, 1970 meeting suffered from the infirmity of the December, 1969 meeting being invalid, and could not confer any legitimacy on the proceedings held at the alleged meeting of April, 1970. Any proceedings at this meeting of April, 1970 would be obviously unauthorised and illegal [*Eastern Linkers (P) Ltd. Vs. Dina Nath Sodhi (1984) 55 Comp. Cas 462 (Delhi)*].

**4.8.3 Service of notice:** The notice may be served personally or sent through post to the registered address of the members and in the absence of any registered office in India, to the address, if there be any, within India furnished by him to the company for the purpose of serving notice to him. Service through post shall be deemed to have effected by correctly addressing, preparing and posting the notice. If, however, a member wants the notice to be served on him under a certificate or by registered post with or without acknowledgment due and has deposited money with the company to defray the incidental expenditure therefore, the notice must be served accordingly; otherwise service will not be deemed have been effected. Service on the joint holder may made by serving it on the one whose name appears first in the register of members. Service of notice shall be deemed to have been effected in the case of notice of meeting on the expiry of 48 hours since the posting of the same. When a notice is advertised in a news paper circulating in the neighbourhood of the registered office of the company, it is regarded as having been served on day on which the advertisement appears, on every member having no registered address in India and who has not supplied to the company an address within India for giving notice to him. Note that Section 53 applies to all documents and not merely service of notice of meetings (Section 53).

Where a person refuses to accept notice served by registered post, under section 27 of the General Clauses Act, such tender of the registered cover and his refusal to accept the same is vaild service, in accordance with law [*Joginder Singh Palta Vs. Time Travel (.P) Ltd. (1984) 56 Comp, Cas. 103 (Cas)*].

Where the photocopy of the purported notice of two meetings, one of the board of directors and another an extraordinary general meeting of the company to consider the removal of a permanent director, was sent to the permanent director under certificate of posting despite protests by the said director by registered acknowledgment due post that he had not been receiving notices of meetings, it was held that such notice was not properly served and meetings either could not be held or if they were held there was no proper notice to the director and hence the meetings were invalid. [*Tarlok Chand Khanna Vs. Raj Kumar Kapoor (1983) 54 Comp. Cas 12 (Delhi)*].



It should be noted that an improper or insufficient notice, as well as absence of notice, may affect the validity of a meeting and render the resolutions passed at the meeting ineffective [See *Boschoek Proprietary Company Vs. Fuxe (1906)* I Ch.148; *Bailu Vs. Oriental # Company (1915)* I Ch.503]. But the accidental omission to give notice does not invalidate proceedings at meeting [Section 172(3)]. The requirement of 21 days notice is not mandatory and an accidental omission to give a notice of less than 21 days 'does not invalidate the meeting.

The annual general meeting for 1980-81 and 1981-82 were convened on 7-10-1983 belatedly and with great difficulty. The notice of the meeting was published in a newspaper of Calcutta on 12-9-1983. The shareholders received the notice 22-9-1983 which was shown to have been posted on 16-9-1983. The notice was dated 9-9-1983. D sought an injunction that the resolutions passed at the meetings are not given effect to, on the ground that the notice was received by him on 22-9-1983. D held only seven shares of Rs. 10 in the company and was a resident of Calcutta where the meeting was to be held. He was not prejudiced by the short notice in anyway. The question was whether the shortness of the notice invalidated the meeting.

Held that Section 172(3) makes it abundantly that it is not a condition precedent to the holding of the annual general meeting of a company that a clear 21 days' notice must be given to each and every member of the company. The accidental omission to give notice to any member or non-receipt of notice by any member shall not invalidate the proceedings at the meeting. If the contention of D was to be upheld it would mean that whereas if the notice to a shareholder was not accidentally posted at all, the proceedings at the annual general meeting of a company would be valid, but if the notice was posted accidentally less 21 days before the meeting, the proceedings at the meeting will be void even though the shareholder received the notice in good time before the meeting was held an actually attended the meeting. Hence, such a construction would lead to absurdity and should be avoided. The contention could not, therefore be accepted that a short notice served on member will invalidate meeting altogether but non-receipt of the notice by a member will not have the same effect. In view of the clear provisions of Section 172(3), it cannot be said that the requirements of Section 171 are mandatory and a short notice given to any member will render the entire meeting void and of no legal consequence even if that the member has not suffered any prejudice in any way. On the facts of the case that the notice of the meetings was published in a newspaper in good time, the shareholder was a resident of Calcutta; advertisement was given in a newspaper having circulation in Calcutta the two annual meetings were held at Calcutta; the shareholder had not been able to make out any case of any prejudice at all; and that two annual meetings were at last held after protracted litigations, there was no reason why the resolutions passed at the annual general meeting should not given effect to merely because one shareholder having 7 shares of Rs.10 actually each received the individual notices less than 21 days in advance. The balance of convenience did not required an order of injunction [*Calcutta Chemical Co. Ltd. Vs. Chandra Roy (1985)* 58 Comp. Cas 275 (Cal)]. Further if a notice of



meeting is published as a newspaper advertisement, the statement of material facts, referred to in Section 173, need not be annexed, but the fact that the statement shall be forwarded must be mentioned.

**4.8.4 Contents of notice:** Notice of a general meeting must be in writing [Section 171(1)] and signed by a director or the manager or the secretary or some other authorised officer of the company and specify following:

- (i) The company's full name and the address of its registered office in legible characters [Section 147(1)c].
- (ii) *Statutory requirements:* The date, place and hour of the meeting and the nature of the business to be transacted there at [Section 172(1)]:
  - Where special business is to be transacted, there must be appended to the notice an explanatory statement containing material facts concerning such business, particularly the nature of interest, if any, of directors and manager in the business [Section 173(2)].
  - If the business to be transacted relates to or affects any other company, the extent of the shareholding of the directors or manager in that other company (if it is not less than 20 percent of the paid-up capital of that other company) must also be stated in the explanatory statement [proviso to Section 173(2)].
  - If the meeting is to accord approval to a document, the explanatory statement must also state the time and place where that document can be inspected [Section 173(3)].
  - Where the resolution is to be passed 'as a special resolution', the intention to propose the resolution as such must also be stated in the notice [Section 189(2)](a).
  - In the case of companies having share capital, the notice should also state with reasonable prominence that 'a member entitled to attend and vote is entitled to appoint a proxy to attend and vote instead of himself and proxy need not be a member' [Section 176(2)]. This must appear in the body of the notice before the signature of authorised person.
  - If the notice is published in a newspaper mainly to satisfy the requirement of giving a deemed notice to those members who have no registered address in India and who have not supplied any address within India for the giving of notices to him, the statement of material facts need not be annexed to the notice, but it should be mentioned in the notice that the statement has been forwarded individually to the members [proviso to sub-section (2) of Section 172].



A notice must clearly specify the business, which is to be transacted at the meeting to which the notice relates; otherwise the notice would be bad. It should make a full and frank disclosure to the shareholders of the fact, on which they would be expected to vote. [*Tiessien Vs. Henderson (1889) 1 Ch. 861; Narayanlal Bansailal Vs. Manekji Patel Mfg. Company, 93, (Bom) L.R.556*].

Where the business to be transacted at the meeting is considered as special, an explanatory statement must be annexed to the notice convening the meeting setting out all material facts concerning each item of business, nature of the concern or interest, if any, of every director and the manager (Section 173). Where the special business relates to another company the extent of shareholding/ interest of every director, etc. is necessarily, to be disclosed only if the shareholding interest is not less than 20% of the paid-up capital of that other company (Student should not confuse 'special business' with 'special resolution'). Where the statement annexed to the notice of the meeting contains full and frank disclosure of the material facts concerning each item of business must essentially depend upon the facts of each case. A very minor defect arising out of strict non-conformity with the provisions contained in Section 173(2) might not render the resolution null and void [*Joseph Michael Vs. Tranvancore Rubber & Tea Co. Ltd. (1986) 59 Comp. Cas.898 (Ker.)*].

The explanatory statement must give all facts, which have a bearing on the question on which shareholders have to form their judgement. The explanatory statement, which is required to be annexed under Section 173, is for the purpose of ensuring that all facts that have a bearing on the question on which shareholders have to form their judgement are brought to their notice. Company C had, at a statutory meeting convened under Section 391, approved a scheme of amalgamation with company B. Later, some shareholders to consider alternative scheme in the interest of the company requisitioned an extraordinary general meeting. The explanatory statement did not mention any specific scheme, but it was contended by the requisition insist that in the two annual reports of the company there was a mention of proposal from M, for the lease of C's factory which had been sent for legal advice and, therefore, the shareholders must be deemed to be aware of the alternate scheme even though the explanatory statement did not specifically refer to this proposal of M. Further, the annual reports did not contain the scheme proposed by M. The question was whether the explanatory statement was insufficient and misleading.

Held that in the explanatory statement there was not even a reference to the proposal of M. If the purpose of calling the requisitioned meeting was to consider the scheme proposed by M, it should have been so stated. The explanatory statement was insufficient and misleading; The requirements of law were not complied with and all relevant facts in the present case, and the alternative schemes were not put before the shareholders fairly and, accordingly, the requisition for calling the impugned meeting was bad in law [*Centron Industrial Alliance Ltd. Vs. Pravin Kantilal Vakil (1985) 57 Comp. Cas.12 (Bom.)*].



Section 173 is designed to secure that facts having a bearing on the issue on which the shareholders have to form their judgement, are brought to the notice of the shareholders so that they can exercise intelligent judgement.

A combined reading of Sections 391 and 393 and their comparison with provisions of Section 173 shows that the former sections deal with a specific situation to the exclusion of general provisions made by Section 173. The provisions of Section 173 are general provisions pertaining to the meetings of a company, whether an annual general meeting or an extraordinary general meeting. As against the said provisions, Section 393 (1) deals with 'a meeting of creditors or any class of creditors or members or any class of members called under Section 391'. The provisions of Section 393 take their colour from Section 391 which contemplates convening of the meetings under the directions of a Court, 'of creditors or class of creditors, of the members or class of members, as the case may be.' Sections 391 and 393 are a code complete in themselves in respect of provisions or procedure relating to sponsoring of the scheme, the approval thereof by the creditors or the members, as the case may be, and the sanction thereof by the Court. A combined reading of Sections 391 and 393 and their comparison with the provision of Section 173 shows that the former sections deal with a specific situation to the exclusion of the general provision made by Section 173. Furthermore, Section 173 postulates a meeting of a company whereas Sections 391 and 393 contemplate convening of a meeting of members or a class of members. It is true that any meeting of a company is factually also a meeting of the members of that company but the thrust of the two set of sections clearly establishes a different legal identity of such meetings [*Khandelwal Udyog Ltd., In re. (1977) Comp. Cas 503 (Bom.)*].

**4.9. Special and ordinary business:** When we refer to the business of the company, it may be special business or ordinary business. The following discussion may be useful to understand the meaning and statutory requirements stipulated to transact these businesses by the Companies Act.

In the case of an *annual general meeting* the items of business relating to : (i) the consideration of the accounts, balance sheet and the reports of the Board of Directors and auditors; (ii) the declaration of a dividend; (iii) the appointment of directors in the place of those retiring; and (iv) appointment of and fixation of remuneration of auditors, are regarded as *ordinary business*. All businesses, other than those under (i) to (iv) transacted at the meeting are deemed to be special. In the case of any other meeting, all businesses shall be deemed special. By implication, Therefore, all businesses transacted at an extraordinary general meeting are special.

If the notice convening the meeting (where at special business will be transacted) does not state the nature of the special business, the meeting would be deemed to have been convened irregularly. Consequently, that special business cannot be dealt with at the meeting. Where the notice convening an extraordinary general meeting had furnished insufficient



particulars as to the special business to be transacted thereat, and the members passed a resolution at the meeting, the directors were restrained by the Court's injunction from acting on that resolution. This was because the insufficient particulars furnished prevented the members from preparing their mind prior to the meeting so that they could exercise their judgement at the meeting in proper manner [*Jain Vs. Kalinga Tubes, 1965 I.S.C.S 540; Pacific Coast Coal Mines Ltd. Vs. Arbuthnot 1917 A.C. 607*].

**4.10 Quorum:** Quorum means the minimum number of members that must be present in order to constitute a meeting and transact business thereat. Thus, quorum represents the number of members on whose presence the meeting of a company can commence its deliberations. Unless the articles provide for a larger number, five members, personally present in the case of a public company (Other than a public company which has become such by virtue of Section 43 (A) and two in the case of any other company form the quorum for a general meeting (Section 174). This provision is calculated to remove a practical difficulty in respect of Section 43 A public companies which may have less than 5 members. Therefore, two members in this case will be sufficient.

The words, personally present exclude proxies. However, the representative of a body corporate appointed under Section 187 or the representative of the President or a Governor of a State under Section 187-A is a member 'personally present' for purpose of counting a quorum [*Re. Kelantan Coconut Estate Ltd. , 1920 W.N. 274*]. In case two or more corporate bodies who are members of a company are represented by single individual , each of the bodies corporate will be treated as personally present by the individual representing it. If, for instance, he represents three corporate bodies, his presence will be counted as three members being present in person for purposes of quorum. It has been held in a Scottish case that one individual may count as more than one member if he attends the meeting in more than one capacity, e.g. as a member holding shares in his own right and as a member entitled to vote in person in respect of a trust holding (*Neil McLeod & Sons Ltd., Petitioners, 1976 SC 16*).

In the case of the meeting of a special class of shareholders, Annexure B to the Companies (Central Government's) Rules, 1956, applies and fixes the quorum at five members of that class present either in person or by proxy in the case of public companies, and two members in the case of a private company. In the case of a meeting of debenture holders, or any class of debenture holders , the quorum is uniform. i.e., five debenture holders, personally present.

**4.10.1 Joint holders and quorum:** In the case of joint holders it would seem *prima facie* that any one of them may be counted in a quorum. In an Australian case [*Re. Trans-Continental Hotel Ltd. (1947) SASR 49*], It has been held that two joint holders are each members and are to be counted towards a quorum as two members personally present.

It should be noted that Act specifically provides that for certain purposes where two or more persons hold any shares jointly, they shall be counted only as one member, e.g. under Section



3(1) (iii) for the purposes of counting the number of members in a private company, and under Section 399 for the purposes of right to apply for relief in cases of oppression or mismanagement. If the articles do not provide anything to the contrary, it appears that two or more joint holders when personally present can be counted as so many members for the purpose of forming a quorum.

**4.10.2 When quorum is immaterial:** If all the members are present, it is immaterial that the quorum required is more than the total number of members [*Re. Express Engineering Works Ltd. (1920) Ch 466; Re Oxted Motor Co. Ltd. (1921) 3 KB 32*]. If, for example, the articles of a private company provide that four members personally present shall be a quorum, and the number of members is reduced to three then the question of quorum will not arise when all the three members attend a meeting.

The *meeting* cannot proceed with business in the absence of quorum. Unless the articles of the company provide otherwise, if within half-an-hour from the time appointed for holding the meeting of the company, quorum is not present then the meeting shall be dissolved, if it has been called upon by the requisition to the same day in the next week, at the same time and place, or to such other day and such other time and place as the Board may determine. If at such an adjourned meeting a quorum is not present within half-an-hour from the time appointed for the meeting, the members present shall constitute the quorum (Section 174). A single member present shall not constitute quorum at an adjourned meeting.

**4.10.3 Effect of failure of a quorum:** If no quorum is present, then there is no meeting and the proceedings are invalid [*Re Romford Canal Co. (1883) 24 Ch D 85*]. However, acts done creating rights in favour of third parties at a meeting without a quorum being present would not affect the rights of such third parties, provided they had no notice of the irregularity e.g. debentures issued at a meeting of directors where there was an insufficient quorum-*Re. Romford Canal*.

In the context of Section 174, let us now grapple with some practical problems, Suppose, the articles of X & Co. Ltd provide thus, "In the event of the quorum being not present within half-an-hour- from the time scheduled for the annual general meeting, the meeting shall stand dissolved " and then quorum is not formed within half-an-hour from the time fixed therefor.

- (a) In the circumstance, what further steps are necessary to hold the annual general meeting? By implication of Section 174(2), if the articles of the company otherwise provide, the meeting cannot be adjourned to the same day at the next week at same time and place or to such other day and at such other time and place as the Board determines. To resolve this impasse, till any judicial ruling is given, the annual general meeting should be called a new in the circumstances of the above-mentioned case.
- (b) Now, if it is to be convened afresh as opined above, will a fresh resolution of the Board be needed? Since a resolution is taken at a Board meeting, fixing the date of the annual general meeting and since the annual general meeting will have to be convened afresh in





the circumstances of the case, it seems that a fresh resolution of the Board fixing the date of the new annual general meeting would be required.

- (c) What will be the position of retiring directors-will they cease to be directors from the date on which the general meeting could not be held for want of quorum and consequently stood dissolved as per the articles as aforesaid or will they remain directors till the date of the fresh annual general meeting which was convened subsequent to the first one? if the newly convened annual general meeting is held well within the statutory period, then the rotational directors may remain in office till the date of the second meeting so held. If, however, the meeting is called on the last day of the statutory prescribed period and the meeting could not be held for want of quorum and a fresh annual general meeting is convened as a result, then the rotational directors might be allowed to retain their office till the date of the second meeting with the prior permission of the registrar of Companies.

**Examples:**

1. A general meeting of a public company was adjourned by the chairman for want of quorum. Fresh notice was not served for the adjourned meeting. Do you feel that notice is required for the adjourned meeting? Referring to the provisions of the Companies Act, 1956 state the minimum number of members required to be present in the adjourned meeting.

As per section 174 of the companies Act, 1956, if within half an hour from the time appointed for holding a meeting for the company quorum is not present, the meeting, shall stand adjourned to the same day in the next week, at the same time and place unless the directors determine otherwise. No fresh notice is, therefore, required to hold the adjourned meeting. Besides, no quorum is necessary in the adjourned meeting. Thus, the adjourned meeting in question is valid.

2. Section 174 of the Companies Act, 1956 stipulates that unless the articles of associations provide for a larger number, two members personally presented shall constitute quorum in the case of a private company. Hence, the private company may provide a larger number for quorum. The general principle is that if no quorum is present the meeting and proceedings are void. However, there can be situations when quorum becomes immaterial. If all the members are present, it is immaterial that the quorum required is more than the total number of members. (Re. Express Engineering Works Ltd. (1920) CH466.
3. Whether the following persons can be counted for the purposes of quorum in a general meeting of a public company (a) a person representing three member companies; (b)



both the joint owners of shares or present at the meeting; (c) a single member present at the meeting.

**Answer**

- (i) Unless the articles of a company provide for a larger number, five members personally present in the case of a public company shall be the quorum for a meeting of the company (section 174). Personally present excludes proxies. But a representative of a body corporate appointed under Section 187 is a member personally 'present' for purposes of counting of quorum. If one individual represents three member companies, his presence will be counted as three members being present in person for purpose of quorum [*Mac-Leod (Neil) & Sons Ltd.*].
- (ii) For the purpose of quorum, joint shareholders will be collectively regarded as one shareholder. However in an Australian Case (*Re. Trans-Continental Hotel Ltd.*), it has been held that two joint holders are each members and are to be counted towards a quorum as two members personally present.

The Companies Act specifically provides for certain purposes e.g. under Section 3(i) (iii) and under section 399 where two or more persons hold shares jointly they shall be counted only as one member. If the articles do not provide anything to the contrary, it appears that two or more joint holders when personally present can be counted as so many members for the purpose of forming quorum.

- (iii) The word 'meeting' literally means a coming of together of two or more persons and generally more than one person will be necessary to constitute a meeting [*Mac-leod (Neil) & Sons Ltd.*]. But there may be cases where the constitution of a company may be such as, for instance, where one person holds all the equity shares of a class or all the preference shares so that there can be no meeting of more than one voting shareholder or one member of a particular class of shares. In such cases, it must be presumed that the Act contemplates positions where a meeting of two or more persons will not be possible in the strict sense and the word 'meeting' must be taken to have been used in the sense of a function which can be performed by one person also as effectively as by two or more (*East v. Bennet Bros. Ltd.*). Apart from these special circumstances, there is an express provision in the Companies Act where a single member will constitute a meeting. Section 167 empowers the CLB to call annual general meeting of a company. Section 186 empowers CLB to order a meeting of the company, other than an annual general meeting. In both these cases, the CLB may issue directions in relation to the calling, holding and conducting of the meeting. The directions may include a direction



that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

4. The Articles of Associations of X Ltd. require the personal presence of six members to constitute quorum of General Meeting. The following persons were present at the time of commencement of an Extraordinary General Meeting to consider the appointment of Managing Director:
- (i) Mr. G. the representative of Governor of Gujarat
  - (ii) Mr. A and Mr. B, shareholders of Preference Shares.
  - (iii) Mr. L. representing M Ltd., N Ltd. and X Ltd.
  - (iv) Mr. P, Mr. Q, Mr. R and Mr. S who were proxies of Shareholders.

Can be said that quorum was present? Discuss.

**Answer**

Quorum means the minimum number of members that must be personally present in order to constitute a meeting and transact business thereat. Thus, quorum represents the number of members on whose presence the meeting of a company can commence its deliberations. According to Section 174, of the Companies Act, 1956, unless the Articles provide for larger number, five members, personally present in the case of a public company and two in the case of any; other company form the quorum for a general meeting. In this case, the Articles provide for six.

The word 'personally present' exclude proxies. However, the representative of a body corporate appointed under Section 187 or the representative of the President or a Governor of State under Section 187A is a member 'personally present' for purpose of counting a quorum. In case two or more corporate bodies who are members of a company are represented by a single individual, each of the bodies corporate will be treated as personally present by the individual representing it. If, for instance, he represents three corporate bodies, his presence will be counted as three members being present in person for purposes of quorum.

The quorum of members, personally present means the presence of the members who are called to vote in the meeting. Preference shareholders can vote only in relation to the matters affecting the rights of preference shares. In the extra ordinary general meeting in question, only the appointment of the managing director has to be considered. It is not a matter affecting the right of preference shares and the preference shareholders are not entitled to vote and hence, they cannot be considered as "members personally present" for the purpose of quorum.

Thus, the number of persons being personally present would be as follows:



Present personally	Number
Mr. G	1
Mr. A and Mr. B	Nil
Mr. L	3
Proxies	Nil
Total	4

It can therefore be said that quorum was not present.

**4.11 Voting and the right to demand a poll:** Vote is taken in the first instance by a show of hands (Section 177); each member has one vote. The shareholders present at the meeting indicate their views by raising their hands. As voting by a show of hands may not always reflect the opinion of members upon a 'value' basis, Section 179 provides for the demand of a poll.

Before or on the declaration of the result of the voting on any resolution by a show of hands, the chairman may order *suo moto* that a poll be taken but when a demand for poll has been made, he must be do so. The demand to be valid must be made:

- (a) in the case of the public company having a share capital, by any member or members present in person or by proxy and holding shares in the company:
  - (i) which confer a power to vote on resolution not being less than 1/10th of the total voting power in respect of the resolution, or
  - (ii) on which an aggregate sum of not less than Rs.50,000 has been paid up;
- (b) in the case of a private company having a share capital, by one member having the right to vote on the resolution and present in person or by proxy if not more than seven persons are personally present and by two members, if more than seven persons are personally present.
- (c) in case of any other company, by any member or members present in person or by proxy and having not less than 1/10th of the total voting power in respect of the resolution. [Section 179].

**4.12 Proxies:** A proxy is an instrument in writing executed by a shareholder authorising another person to attend a meeting and to vote thereat on his behalf and in his absence. The term is also applied to the person so appointed.

Section 176 gives every shareholder, who is entitled to attend and vote, a statutory right to appoint another person as his proxy to attend and vote for him. But the proxy so appointed has no right of audience, i.e. he cannot speak. The proxy may demand or join in demanding a poll but (unless the articles otherwise provide) may vote only on a poll. In every notice



convening a meeting of a company which has a share capital or the articles of which provide for voting by proxy, there must be included with reasonable prominence a statement that a member is entitled to appoint a proxy and that a proxy need not be member. Any provision in the articles requiring the instrument appointing a proxy to be lodged with the company more than 48 hours before a meeting in case of public companies and their subsidiaries which are private companies shall have effect as if 48 hours had been specified therein. No invitation can be issued by the company at its expense to appoint specified persons as proxies. But the list of persons willing to act as proxies can be sent to all members.

It has already been observed that a proxy cannot speak at the meeting. But can he express his views in writing or through any other vehicle? The answer to this question is definitely in the negative. This is because if he is so allowed, a door might be open for the perpetration of the mischief that Section 176 has been designed to guard against, by denying him the right of audience. A proxy is not a member or a shareholder; he is simply an outsider. If proxies are allowed the right of audience or are otherwise allowed to interrupt a company meeting, many members may appoint and brief professional persons as proxies. In that event the proceedings at the meeting may be undesirably prolonged. To eschew such a situation a proxy cannot also express his views in writing because it would tantamount to speech.

You have noticed the impact of Section 176(3) is that a company is prohibited from providing in its articles a longer period than 48 hours from the of meeting for depositing proxies. By implication therefore, the company can provide for a shorter period than 48 hours without any restriction whatsoever. Now the question arises as to whether a proxy can be lodged before an adjourned meeting, if it was not lodged 48 hours before the original meeting. According to Article 61 of Table A, an instrument appointing a proxy may be deposited 48 hours before an "adjourned meeting at which the person named in the instrument proposes to vote." Therefore, if the articles of company include Article 61 or any other similar provision then the proxy may be lodged even before the adjourned meeting. But if they do not so include, then of course the ruling in [*Laren Vs. Thompson (1917) 2 Ch. 261*] will come to prevail. According to this ruling, a proxy cannot be deposited 48 hours before an adjourned meeting, since adjournment is just a continuation meeting ;it ought to be lodged within the stipulated time before the original meeting.

*Representations of corporations at meetings of companies and creditors:* According to Section 187, a company, it is member of another company, may by a resolution of its Board of Directors or other governing body, authorised such person as it thinks fit to act as its representative at any meeting of the company or at any meeting of any class of members of the company. The person so authorised is entitled to exercise the same rights and powers (including the right to vote by proxy) on behalf of the company which he represents as that company could exercise if it were an individual member of the company. These very rules will govern a case where the company is a creditor (including a holder of debenture) of another



company.

*Representation of the President and Governors in meeting of companies to which they are members:* The President of India or the Governor of a State, if he is member of a company, may or appoint such person as he thinks fit to sit as his representative at any meeting of the company or at any meeting of any class of members of the company. Such appointee shall be deemed to be a member of such a company and he shall be entitled to exercise the same rights and powers (including the rights to vote by proxy) as the President, or as the case may be, the Governor could exercise as a member of the company (Section 187A).

*Declaration by persons not holding beneficial interest in any share:* Despite anything contained in Section 150, Section 153-B or Section 187-B, a person, whose name is entered in the register of members of a company as the holders of a share in that company but who does not hold a beneficial interest in such share then he must within such time and in such form as may be prescribed, make a declaration to the company specifying the name and other particulars of the person who holds the beneficial interest in such share [Section 187-C(1), as introduced by the Companies (Amendment) Act, 1974].

A person who holds a beneficial interest in a share or class of shares of a company must make a declaration to the company. This declaration is to be made within 30 days after his becoming such beneficial owner. The declaration must specify 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 [Section 187-C(2)]. Whenever there is a change in the beneficial interest in such shares, the beneficial owner must, within 30 days from the date of such change, make a declaration to the company in such form containing such particulars as may be prescribed [Section 187-C(3)].

Within 30 days from the date of the receipt of any of the declarations mentioned above, the company must make a note of it in its register of members and file a return with the Registrar in the prescribed form in respect of such declaration. This requirement shall have to be complied with irrespective of anything contained in Section 153 [Section 187-C(4)].

If the person who is required to make the said declaration fails to do so without any reasonable excuse, he shall be punishable with fine extending to Rs. 1,000 for every day during which the failure continues. If the company fails to comply with the provisions of Section 187-C, then the company and every officer there of who is in default, shall be liable to the same punishment as aforesaid [Section 187-C(5)].

Any charge, promissory note or any other collateral agreement created, executed or entered into in relation to any share by the ostensible owner there of, or any hypothecation by the ostensible owner of any share, in respect of which a declaration is required to be made under the foregoing provisions of this section, but not so declared, shall not be enforceable by beneficial owner or any person claiming through him [Section 187-C(6)].



Nothing in Section 187-C shall be deemed to prejudice the obligation of a company to pay dividend in accordance with the provisions of Section 206 and the obligation shall, on such payment, stand discharged [Section 187-C(7)]

It will have been observed from the foregoing exposition of law that it has been made obligatory that all *benami* holdings of shares in existence at the commencement of the Companies (Amendment) Act of 1974 must be declared both by the *benamidar* and by the beneficial owner. Likewise, all beneficial interest in shares in future is also to be declared.

*Investigation of beneficial ownership of shares in certain cases:* The Central Government may appoint one or more inspectors to investigate and report as to whether the provisions of Section 187-C have been complied with. On such appointment, the provisions of Section 247 shall apply to such investigation as if it were an investigation ordered under that Section [Section 187-D as introduced by the Companies (Amendment) Act of 1974].

Consider the following practical situation and analyse:

M/s Happy Homes Ltd. had sent notices to all its members about the holding of the 5<sup>th</sup> Annual General Meeting to be held on 15<sup>th</sup> October, 2005 at 4.00 P.M. As per the notice the members who are unable to attend the meeting in person can appoint a proxy and the proxy forms duly filled should be sent so as to reach at least 48 hours before the meeting. Mr. A, a member of the company appoints Mr. P as his proxy and the proxy form dated 10.10.2005 was deposited by Mr. P with the company at its Registered Office on 11.10.2005. However, Mr. A changes his mind and on 12.10.2005 gives another proxy to Mr. Q and it was deposited on the same day with the company. Similarly another member Mr. B also gives to separate proxies to two individuals named Mr. R and Mr. S. IN the case of Mr. R, the proxy dated 12.10.2005 was deposited with the company on the same day and the proxy form in favour of Mr. S was deposited on 14.10.2005. All the proxies viz., P, Q, R and S were present before the meeting. In the light of the relevant provisions of the Companies Act, who would be the persons allowed to represent at proxies for members A and B respectively ?

**Answer**

A Proxy is an instrument in writing executed by a shareholder authorizing another person to attend a meeting and to vote thereat on his behalf and in his absence. As per, the provisions of Section 176 of the Companies Act, 1956 every shareholder who is entitled to attend and vote has a statutory right to appoint another person as his proxy and the proxy need not be a member of the company. Further, any provision in the articles of association of the company requiring instrument of proxy to be lodged with the company more than 48 hours before a meeting shall have effect as if 48 hours had been specified therein. The members has a right to revoke the proxy's authority by voting himself before the proxy has voted but once the proxy has voted the member cannot retract his authority. Where two proxy instruments by the same shareholder are lodged in respect of the same votes before the expiry of the time for lodging



proxies, the second in time will be counted and where one is lodged before and the other after the expiry of the date fixed for lodging proxies, the former will be counted. Thus in case of Member A, the proxy Q (and not Proxy P) will be permitted to vote on his behalf. However, in the case of Member B, the proxy R (and not Proxy S) will be permitted to vote as the proxy authorizing S to vote was deposited in less than 48 hours before the meeting.

**4.13 Resolution:** The purpose of a meeting is to arrive at decisions and the sense of a meeting is ascertained by voting upon proposals put to the meeting. A formal proposal put to the meeting is resolution. A company expresses its will by the mean of resolutions.

There are only two kinds of resolutions under the Act, ordinary and special, and they are defined in Section 189. Some writers classify resolutions into three types namely, ordinary, special and resolutions requiring special notice.

**4.13.1 Ordinary Resolution:** This is resolution passed by a simple majority of those present in person or by proxy where proxies are allowed and voting upon the resolution. Members not participating in voting are not taken into account. As distinguished from a simple majority, an absolute majority is a majority of all those entitled to vote whether they attend or not.

Section 189(1) defines an ordinary resolution as follows:

“A resolution shall be an ordinary resolution when at a general meeting of which the notice required under this Act has been duly given, the votes cast (whether on a show of hands, or on a poll, as the case may be) in favour of the resolution (including the casting vote, if any, of the chairman) by members who, being entitled so to do, vote in person, or where proxies are allowed, by proxy, exceed the votes, if any, cast against the resolution by members so entitled and voting.”

Subject to the articles, an ordinary resolution is sufficient, for *inter alia* any of the following matters:

- (a) To authorise an issue of shares at a discount (Section 79);
- (b) To increase the share capital if authorised by the articles, or otherwise alter the share capital apart from its reduction (Section 94,100);
- (c) To appoint auditors [Section 224(1)]; but in the case of a company in which not less than 25 percent of the subscribed share capital is held, whether singly or in any combination, by a public financial institution or a Government company or Central or any State Government, or a nationalised bank or an insurance company carrying a general insurance business, the appointment of auditors requires a special resolution (Section 224A);
- (d) To appoint directors;





- (e) To adopt annual accounts;
- (f) To declare dividends;
- (g) To wind up voluntarily when the period, if any, fixed for the duration of the company by the articles has expired, or the event, if any, has occurred, on the occurrence of which the articles provided that the company is to be dissolved [Section 484(1)];
- (h) To appoint liquidators in a members 'voluntary winding-up and to fix their remuneration (Section 490);
- (i) To register an unlimited company as a limited company (Section 32); and generally to do all things for which a special resolution is not specifically required either by the Act or the company's articles.

**4.13.2 Special Resolution:** Apart from ordinary resolutions, various sections of the Act provide that certain things can be done by a company with the authority of a special resolution passed at a duly constituted general meeting. A special resolution is an artificial conception of the Act, requiring a larger majority than an ordinary resolution. It has been defined by Section 189(2) as follows:

“A resolution shall be a special resolution when:

- (a) the intention to propose the resolution as a special resolution has been duly specified in the notice calling the general meeting or other intimation given to the members of the resolution;
- (b) the notice required under the Act has been duly given of the general meeting; and
- (c) the votes cast in favour of the resolution (whether on a show of hands, or on a poll as the case may be) by members who, being entitled so to do, vote in person or where proxies are allowed, by proxy, are not less than three times the number of the votes, if any, cast against the resolution by members so entitled and voting”;

It is doubtful whether a resolution can take effect as a special resolution when the formalities required by Section 189(2) have not been complied with even if it is agreed to by all the members of the company. There are no cases directly in point, and Section 189(2) should therefore be complied with;

The notice convening the meeting at which a special resolution is to be considered must set out the actual wording of the resolution, and also annex an explanatory statement as required under Section 173, in which the shareholders are informed of the material facts concerning the resolution and the nature of interest therein of the directors;

A printed or typewritten copy of the special resolution (together with a copy of the explanatory statement annexed under Section 173) duly certified under the signature of an officer of the



company must be filed with Registrar of Companies within thirty days of its being passed (Section 192).

*Acts for which special resolutions are required:* Some matters may be so important and outside the ordinary course of the company's business, such as any important constitutional changes, that safeguards should be imposed to ensure that a larger majority than a simple majority of the members approve of them before they are given effect to. The Act requires that the following matters, *inter alia*, have to be resolved by the company, by a special resolution:

- (1) To alter any provision contained in the memorandum, which could lawfully have been contained in the articles instead of the memorandum (Section 16);
- (2) To alter the objects or the place of registered office of a company (Section 17);
- (3) To change the name of the company (Section 21);
- (4) To alter the articles of association (Section 31);
- (5) To create a reserve liability, that is, to determine that a portion of the uncalled capital shall not be capable of being called up, except in the event of a winding up (Section 99);
- (6) To reduce the share capital (Section 100);
- (7) To move the company's registered office within the same State but outside the local limits of the city, town or village where such office is situated [Section 146(2)];
- (8) To commence any new business which is not germane to the business the company is carrying on currently, though covered by the objects clause of the memorandum [Section 149(2A)];
- (9) To pay interest on shares out of capital (Section 208);
- (10) To appoint auditors, if not less than 25 per cent of the company's subscribed capital is held, whether singly or in any combination, by the Central or any State Government, Government companies, financial institutions, nationalised banks, etc. (Section 224A);
- (11) To support an application to the Central Government to appoint inspectors to investigate the affairs of the company (Section 237);
- (12) To appoint sole selling agents, if the company's paid-up capital is Rs. 50 lakhs or more [Section 294 AA(3)];
- (13) To authorise the payment of remuneration to non-executive directors by way of commission on the basis of a percentage of the net profits, in the case of public company or a private company which is a subsidiary of a public company [Section 309(4)];



- (14) To authorise directors, etc. to hold office or place of profit under the company (Section 314);
- (15) To alter the memorandum where the articles permit, to make unlimited the liability of director (Section 323);
- (16) Investment exceeding the limits prescribed in Section 372A.
- (17) To have the company wound up by the court [Section 433(a)];
- (18) To wind up voluntarily for any reason not otherwise provided for by the section (Section 484).
- (19) To authorise the liquidator to transfer or sell the assets of the company, which is proposed to be, or is in the course of being wound up voluntarily, to another company in exchange for shares (Sections 494 and 507);
- (20) To authorise the liquidator in a members' voluntary winding up to exercise the powers given by clauses (a) to (d) Section 457(1) to a liquidator in a winding up by the Court [Section 512 (1) (a)].
- (21) To sanction the exercise by the liquidator in volunteer winding up of powers mention in Section 546;
- (22) To direct the disposal of books and papers of the company in a members, voluntary winding up (Section 550(3) (a));
- (23) To adopt *Table A* in Schedule I in the case of registration of a company under Part IX of the Act [Section 578(3) (a)];
- (24) To alter the form of constitution of a company registered under Part IX of the Act [Section 579(1)];

In addition to the requirements of the Act, a company's own articles may prescribe for special resolution where under the Act only an ordinary resolution is necessary. However, where the Act specifies for a special resolution, the articles cannot provide for the different kind of resolution.

**4.13.3 Resolution requiring special notice:** For certain purposes, the Act requires a special notice, i.e., 14 days notice, to be received by the company from a shareholder of his intention to move the resolution, either as an ordinary or as a special resolution. After the receipt of the notice, the company must immediately issue a notice to the shareholders in this regard, not less than 7 days before the meeting either by serving it on them or through an advertisement in the newspaper having an appropriate circulation or in any other mode allowed by the articles (Section 190).



The matters in respect of which special notice is required are: (1) for appointment a person as auditor at the annual general meeting other than the retiring auditor for providing expressly that the retiring auditor shall not be re-appointed [Section 225(1)]; (2) for removing a director before the expire of the period of his office and appointing some one in the place of the director so removed [Section 284(2)]; and for appointing certain person who cannot be appointed in the ordinary course as director provided for in Section 261 [Section 261(2)].

Now suppose, at the annual general meeting of a company a resolution is proposed to be moved to the effect that the retiring auditors shall not be re-appointed. What would be the duty of the company and the right of the auditor in the circumstances? From the law discussed above, the duty of the company may be summed up follows:

- (i) On the receipt of the 14 days' special notice, the company must forthwith send a copy thereof to the retiring auditor [Section 225(2)].
- (ii) Where the retiring auditor makes a written representation, not exceeding a reasonable length, to the company and requests the company to notify such representation to the members, the company is bound to state in any notice of the resolution given to the members, the fact of the representation having been made and send a copy of the representation to every member to whom notice of the meeting is sent-whether before or after a receipt of the representation by the company. Moreover, the company is bound by this duty if the representation has not been received too late. If the representation has been received too late, the company will be relieved of this duty. But in such a case, the auditor may (without prejudice to his right to be heard orally) require that the representation shall be read out at the meeting.

The auditor's right to get the copies of the presentation sent out to members or read out at the meeting is hedged in by the provision that if the Court is satisfied, on the application of the company or any other aggrieved person, that the right is being abused to secure needless publicity for a defamatory matter, the Court may order that the representation may not be circularised or read out. The Court may further order that the company's costs on such an application should be paid by the auditor, in whole or any part even though he is not a party to the application [Section 225(3)].

The rights of the auditor in this context are as follows:

- (1) It follows from paragraph (ii) above that the auditor has the right to make representation to the company and to request it to the members.
- (2) The auditor has also right to be heard orally at the meeting of the shareholders.
- (3) Where a copy of the representation has not been despatched as aforesaid because it was received too late or because of the company's default, the auditor may without



prejudice to his right to be heard orally, require that the representation be read out at the meeting.

**4.13.4 Circulation of members' resolution and statements:** Students should carefully note the circumstances in which the members can make use of the administrative machinery of a company for introducing resolutions for consideration at any annual general meeting or for circulation of statements in regard to any resolution to be proposed at an extraordinary general meeting or business to be dealt with at that meeting. Such circumstances are stated below:

The company on the receipt of the written requisition by: (i) such number of members as represents not less than 1/20th of the total voting power of all members having at the date of requisition, the right to vote on the resolution or business to which the requisition relates; or (ii) not less than 100 members holding shares on which there has been paid up as aggregate sum of not less than Rs. 1 lakh in all and having a right to vote, must (a) give to members entitled to have notice of meeting sent to them, the notice of any resolution which may properly be moved and which is intended to be moved at the meeting; and (b) circulate to members who are entitled to have notice of any general meeting with statement in not more than 100 words in regard to the proposed resolution at the business to be dealt with at the meeting.

The company is not bound to give notice of any resolution or to circulate any statement unless (a) a copy of the requisition by the requisitionists is deposited at the registered office of the company (i) in case of a requisition requiring a notice of a resolution, not less than 6 weeks before the meeting and (ii) in the case of any other requisition, not less than 2 weeks before the meeting; and (b) a sum reasonably sufficient to meet the company's expenses has been deposited along with the requisition.

It is also not binding upon the company to circulate any resolution or statement when, on its application or that of an aggrieved party, the Company Law Board decided that it contains defamatory matter.

In the case of a banking company, if the Board of Directors opines that the circulation of a statement will be detrimental to the interests of the company, it need not circulate the same.

Notwithstanding any provision to the contrary in the company's articles a resolution in respect of which notice has been given by a member as aforementioned, may be dealt with at an annual general meeting; also any incidental omission to serve notice upon one or other members will not invalidate the proceedings (Section 188).

**4.13.5 Registration of resolution and agreement (Section 192):** Printed or typewritten copies of all special resolutions as well as certain ordinary resolutions and agreements, some of which are described below, together with explanatory statement under Section 173 are required to be filed with the Registrar of Companies within 30 days after the passing or making thereof:



- (a) Special resolution.
- (b) Resolution agreed to by all the members of a company, which, if not so agreed to would have been ineffective unless they had been passed as special resolutions.
- (c) Any resolution of the Board of Directors or agreement executed by a company relating to appointment, re-appointment, renewal of appointment or variation of the terms of appointment of the managing director.
- (d) Resolutions or agreements agreed to by all the members of any class of shareholders but which, if not agreed to, would have been ineffective for their purpose unless those had been passed by some particular majority or otherwise in some particular manner, and all resolutions or agreements which effectively bind all the members of any class of shareholders though not agreed to by all of them.
- (e) Resolutions requiring a company to be wound up voluntarily, passed under Section 484(1).
- (f) Resolutions passed under Section 293 (1) (a), (d), (e).
- (g) Resolutions approving appointment of sole selling agents under Section 294 or 294AA on appointment of sole selling agent.
- (h) Copies of the term and conditions of appointment of a sole setting agent appointed under Section 294 or of a sole selling agent or other person appointed under Section 294AA.
- (i) Where articles have been registered, a copy of every resolution which alters the articles and of every agreement shall be embodied in the articles. Where articles have not been registered, a printed copy of every such resolution or agreement shall be forwarded on request of any member on payment of one rupee [Sections 92(2) and (3)].

It may be noted that Form No.23 of the Companies (Central Government's) General Rules and Forms, 1956 depicts the manner in which copies of any of the aforesaid resolutions and agreements are to be certified and filed with the Registrar.

**4.14 PASSING OF RESOLUTION BY POSTAL BALLOT: (COMING INTO FORCE W.E.F. 15TH JUNE, 2001) [SECTION 192A COMPANIES (AMENDMENT) ACT, 2000.]**

The Section provides for the procedure to be followed by the company for ascertaining the views of the members by postal ballot. A company shall read notice and draft resolution by registered post to all shareholders explaining the reasons and requesting there to communications within 30 days from the date of posting of letter.



“postal ballot” includes voting by shareholders by postal or electronic mode instead of voting personally by presenting for transacting businesses in a general meeting of the company.

“requisite majority” with regard to special resolution means votes cast in favour of the business is three times more than the votes cast against, with regard to ordinary resolution, votes cast in favour is more than the votes cast against.

List of businesses in which the resolutions may be passed through postal ballot :

- (a) alteration in the object clause of memorandum;
- (b) alteration of articles of associations in relation to deletion or insertion of provisions defining private company;
- (c) buy-back of own shares by the company under sub-section (1) of Section 77A;
- (d) issue of shares with differential voting rights as to voting or dividend or otherwise under sub-clause (ii) of clause (a) of Section 86;
- (e) change in place of registered office out side local limits of any city, town or village as specified in sub-section (2) of Section 146;
- (f) sale of whole or substantially the whole of undertaking of a company as specified under sub-clause (a) of sub-section (1) of Section 293;
- (g) giving loans or extending guarantee or providing security in excess of the limit prescribed under sub-section (1) of Section 372A;
- (h) election of a director under sub-section (1) of Section 252;
- (i) power to compromise or make arrangements with creditors and members as specified under sub-section (2) of Section 391;
- (j) variation in the rights attached to a class of shares or debentures or other securities as specified under Section 106.

#### **4.14.1 Procedure to be followed for conducting business through postal ballot**

- (a) The company may make a note below the notice of general meeting for understanding of members that the transaction(s) at serial number requires consent of shareholders through postal ballot;



- (b) the board of directors shall appoint one scrutinizer, who is not in employment of the company, may be a retired judge or any person of repute who, in the opinion of the board can conduct the postal ballot voting process in a fair and transparent manner;
- (c) The scrutinizer will be in position for 35 days (excluding holidays) from the date of issue of notice for annual general meeting. He is to submit his final report on or before the said period.
- (d) The scrutinizer will be willing to be appointed and he is available at the registered office of the company for the purpose of ascertaining the requisite majority;
- (e) The scrutinizer shall maintain a register to record the consent or otherwise received, including electronic media, mentioning the particulars of name, address, folio number, number of shares, nominal value of shares, whether the shares have voting, differential voting or non-voting rights and the scrutinizer shall also maintain record for postal ballot which are received in defaced or mutilated form. The postal ballot and all other papers relating to postal ballot will be under the safe custody of the scrutinizer till the chairman considers, approves and signs the minutes of the meeting. Thereafter, the scrutinizer shall return the ballot papers and other related papers/register to the company so as to preserve such ballot papers and other related papers/register safely till the resolution is given effect to;
- (f) Consent or otherwise relating to issue mentioned in notice for annual general meeting received after 35 days from the date of issue will be strictly treated as if the reply from the member has not been received. **[Companies (Passing of the Resolution by Postal Ballot) Rules, 2001 Notification No. G.S.R.337 (E), dated 10th May, 2001].**

If default is made in following this procedure, fine of Rs. 50,000 can be levied for each default.

**4.15 Minutes:** The minutes represent a record of business transacted at a meeting. It is obligatory for every company to cause minutes of all proceedings of the general meeting of the Board or committees of the Board to be entered in the Minute Book. The minutes of each meeting contain a fair and correct summary of the proceedings. The appointment of officers made at the meeting will have to be included in the minutes.

In the case of the meeting of the Board or of a committee thereof, the minutes must contain the names of directors present there at and the names of directors who dissent from or do not concur in, any resolution. It, therefore, follows that a director can insist upon his dissent being recorded in the minutes of the Board meeting. But the director cannot so insist in the case of a general meeting, as Section 193 makes no such provision.





The chairman of the meeting has, however, unfettered discretion on the matter of excluding from the minutes any matter which could reasonably be regarded as defamatory of any person, or is irrelevant or immaterial, or determined to be against the interests of the company (Section 193). The minutes of the meeting must contain a fair and correct summary of the proceedings thereat. But it is not necessary unless it affects fairness to *mention* the names of members who participated in such discussion.

Minutes must be entered within 30 days of the conclusion of the meeting concerned. They have to be written by hand and typed minutes cannot be pasted in the Minute Book. Ordinarily minutes cannot be kept in loose-leaf system. The Department of Company Affairs, however, has expressed that it would refrain from taking any action against a company which maintained its minutes in the loose-leaf form provided adequate safeguards are taken against falsification, and loose-leaves are bound in books at reasonable intervals, say six months. Every page of the book, with pages consecutively numbered, should be initialled or signed and the last page shall be dated and signed: (a) in the case of Board or Committee minutes, by the Chairman of the meeting or the Chairman of a succeeding meeting; (b) in the case of minutes of general meeting, by the Chairman of the meeting within the aforesaid period of 30 days of the conclusion of the meeting or in the event of death or inability of the Chairman, by the Director duly authorised for the purpose.

In this context let us consider a concrete case. The chairman of the Board, having presided over the company's annual general meeting, left India immediately thereafter. He is likely to come back only after a couple of months. Now how are the minutes to be signed and dated? By virtue of Section 193(1A) (b), minutes of proceedings of general meeting can be signed and dated within a period of 30 days, by a director duly authorised by the Board for the purpose. In the circumstances contemplated by the question, therefore, a Board meeting has to be convened and one of the directors present thereat be authorised to sign and date the minutes of the annual general meeting.

Any such minutes, when kept according to provisions mentioned above, are evidence of the proceedings (Section 194). It has been held in *Kerr Vs. Motiram (1940) 1CH 657* that should the articles provide that the minutes signed by the Chairman shall be conclusive evidence without any further proof of the facts therein stated, evidence cannot be led in to contradict the minutes.

A director, who is present at a meeting at which the minutes of a prior board meeting are confirmed, is not thereby made responsible for what was done at prior meeting [*Re land Allotment Co. 1894 1 Ch. 615*].



A member has the right to inspect, free of cost, during business hours at the registered office of the company, the books containing the minutes of general meeting of the company. Any member shall be entitled to be furnished within seven days after his request with a copy of any such minutes on payment of the prescribed fee. Penalties are imposed for defaults, and the Company Law Board has the power to order immediate inspection of the minutes or to direct that copies shall be furnished (Section 196) . These statutory rights of the members are exercisable only in respect of minutes of general meetings. Note that the fee for copies mentioned above , need not be prepaid unlike to obtain the copy of a document filed with the Registrar for which the fee must be prepaid [Section 610(1)(b)].

#### **4.16 MEETING OF DEBENTURE HOLDERS**

A company having power to borrow money may do so, subject to its memorandum and articles, in any way in which an individual can borrow. Where it wishes to operate with borrowed money forming part of its permanent capital structure, the borrowing, however, is usually effected by means of the issue of debentures or debenture stock.

The term of issue of debentures frequently and trust deeds invariably contain provisions for meetings of the debenture-holders or debenture stockholders. Such meetings are desirable not merely for the discussion of the debenture-holders' interests, and the ascertainment of their wishes at a time of crisis or when some modification or rearrangement is proposed by the company, but also to give effect to those wishes by means of resolutions binding on the whole body of debenture-holders.

One of the most common purpose for which the machinery of debenture-holders' meetings is employed is to effect a modification or compromise of rights between the company and the debenture-holders. From time to time occasions arises which call for some renunciation or modification by the debenture-holders of their strict rights. It may be desirable or expedient, for example, to release particular property from the specific charge (with or without the substitution of other property), or to reduce the amount of the debenture interest, or to defer its payment for a time, or to allow the creation of debentures ranking in priority to the existing debentures, or *pari passu* with them ,or to release the company for a limited period from all obligations to set apart profits towards a sinking fund, or to effect an exchange of debentures for equity or preference shares. To facilitate this, there is commonly inserted in trust deeds, and often in simple debenture, a clause enabling a specified majority of the debenture-holders or debenture stockholders, by resolution, to bind the whole body to a compromise with the company in respect of their rights, or in respect of the subject-matter of the security. The convenience of such a clause is obvious; it respect of the subjected-matter of the security. The convenience of such a clause is obvious; or in enables the company to deal with the debenture, holders as a class, and prevents a few perverse or adversely interested debenture holders from obstructing a necessary or desirable arrangement. The Power must be exercised



bona fide for the benefit of the whole class [*British America Nickel Crpn.Vs. O'Brien (1927) AC 369,PC*]

Section 170(2)(b) states that unless the articles of the company or a contract binding on the persons concerned otherwise provide, Sections 171 to 175 and Sections 177 to 186 with such adaptations and modifications, if any, as may be prescribed, shall apply with respect to meetings of debenture-holders or any class of debenture-holders of a company, in like manner as they apply to general meetings of the company.

#### **4.17 COMPANY LAW IN A COMPUTERIZED ENVIRONMENT**

##### **MCA 21 PROJECT**

This is an innovative project and initiative of the Ministry of Company Affairs carried out under the national e-governance Programme of the Government with a comprehensive online portal to enable e-filing. This project being cover all the services provided by the Registrar of Companies (ROC) starting from the incorporation of a new company. The project would provide e-services including names such, registration of new companies, filing of various returns and statutory documents under the Companies Act, 1956. The system would also enable on filing and access for statutory documents like memorandum of association, articles of association, certificate of incorporation etc.

The project serves the interest of all the key stake holders and the public at large. Also professionals need no longer to visit the officers of ROC and would be able to interact with the Ministry using MCA 21 portal from their offices or home or going to the facilitation centers which have been set up. The services of the Ministry of Company Affairs with the introduction of MCA 221 will be e-form driven. Form filing will be done using freely downloadable software and it can be done offline. The prerequisite for using the MCA 21 portal will be P-4 computer with printer, windows 2000 / XP, internet explorer 6.0 version, Adobe Acrobat Reader 7.05 version and digital signature certificate.

To know better about how MCA 21 will function, one need to know about the set up of the Ministry of Company Affairs

##### **Set up of MCA**

MCA has a three tier organizational set-up:

- ◆ Headquarters at New Delhi
- ◆ Regional Directors (RD) at Mumbai, Kolkata, Chennai and Noida
- ◆ Registrar of Companies (RoC) in States and Union Territories

MCA Headquarters handles cases that require approval of the Gol for citizen related functions. RD supervises the functioning of RoCs and handles the matters delegated by Gol while the RoC offices handle the bulk of citizen facing functions.



The Official Liquidators (OL) attached to various High Courts functioning in the country are also under the overall administrative control of the MCA. Its headquarters at Delhi also includes two Directors of Inspection and Investigation and Director of Research and Statistics.

### **MCA 21 Program**

Ministry of Company Affairs (MCA), Government of India (GoI) has initiated MCA 21 program, for easy and secure access to MCA services in a manner that best suits the businesses and citizens.

The program goals have been set as follows keeping in mind stakeholders' needs:

- ◆ **Business** enabled to register a company and file statutory documents quickly and easily
- ◆ **Public** to get easy access to relevant records and effective grievances redressal
- ◆ **Professionals** to be able to offer efficient services to their client companies
- ◆ **Financial Institutions** to easily find charges registration and verification
- ◆ **Employees** to ensure proactive and effective compliance of relevant laws and corporate governance

MCA 21 is envisioned to provide anytime and anywhere services to businesses. It is a pioneering program being the first mission mode e-governance project being undertaken in the country. This program builds on the GoI vision to introduce a Service Oriented Approach in the design and delivery of Government services, establish a healthy business ecosystem and make the country globally competitive.

### **Program Scope**

MCA 21 program will provide for anytime anywhere electronic services with speed and certainty to all the stakeholders. It will include:

- ◆ Design and development of application system
- ◆ Setting up of IT infrastructure
- ◆ Setting up the Digital Signature/PKI delivery mechanisms and associated security requirements
- ◆ Setting up of Physical Front Offices (PFOs)
- ◆ Setting up of temporary FOs for the peak periods to meet with the requirements and subsequent shutdown of temporary FOs at the end of such peak periods
- ◆ Migrating legacy data and digitization of paper documents to the new system
- ◆ Providing MCA services to all MCA 21 stakeholders in accordance with the Service Oriented Approach
- ◆ Providing user training at all levels and all offices (Front and Back Offices)



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The MCA 21 is designed to automate processes related to the proactive enforcement and compliance of the legal requirements under the Companies Act, 1956. However, it does not include processes related to OL.

### **Front Office**

The implementation of Front Offices (FO) is done in two ways. These can be called as Virtual Front Office (VFO) and Physical Front Office (PFO).

The VFO is what the citizen has in front while accessing the MCA 21 portal. The PFO will be a replacement to the existing RoC counters. The PFO will also accept paper documents. However, these will be converted into electronic documents by customer service agents manning PFO. Also, the authorised person(s) will have to sign these documents digitally. Consequently the authorised signatories for a given document will need to appear in person at the PFO for the purpose of digitally signing the document.

The user can avail the following services on MCA 21 portal

- ◆ eFiling
- ◆ Viewing public document
- ◆ Requesting certified copies
- ◆ Registering investor complaint
- ◆ Tracking transaction status

### **Back Office**

The back office is what MCA employee has in front which accessing back office portal. The back office process relates to:

- ◆ Dynamic routing of documents that have been electronically filed to the concerned official within MCA based on the type of service request.
- ◆ Electronic workflow systems to support speed and certainty in service delivery
- ◆ Supporting all routine tasks such as registrations and approvals
- ◆ Storing of all approved documents of companies as part of electronic records, including provision of access to electronic records for the stakeholders
- ◆ Enhancing identification of defaulters
- ◆ Increasing efficiency of Technical Scrutiny
- ◆ Ensuring close follow-up on matters related to compliance management including prosecutions
- ◆ Enabling quicker responses to investor grievances
- ◆ Providing alerts when the tasks are not carried out within stipulated period



### Key Benefits

MCA 21 seeks to fulfill the requirements of the various stakeholders. The key benefits of MCA 21 project are the back office process relates to:

- ◆ Expeditious incorporation of companies
- ◆ Simplified and ease of convenience in filing of Forms/ Returns
- ◆ Better compliance management
- ◆ Total transparency through e-Governance
- ◆ Customer centric approach
- ◆ Increased usage of professional certificate for ensuring authenticity and reliability of the Forms / Returns
- ◆ Building up a centralised database repository of corporate operating
- ◆ Enhanced service level fulfillment
- ◆ Inspection of public documents of companies anytime from anywhere
- ◆ Registration as well as verification of charges anytime from anywhere
- ◆ Timely redressal of investor grievances
- ◆ Availability of more time for MCA employees for monitoring and supervision

### SOME FAQ'S ON E-FILING

#### 1. What are the steps for offline eFiling?

1. Select a category to download an eForm from the MyMCA portal (with or with out the instruction kit).
2. At any time, you can read the related instruction kit to familiarise yourself with the procedures (you can download the instruction kit with eform or view it under **Help** menu).
3. You have to fill the downloaded e-Form.
4. You have to attach the necessary documents as attachments.
5. You can use the **Prefill** button in eForm to populate the greyed out portion by connecting to the Internet.
6. The applicant or a representative of the applicant needs to sign the document using a digital signature.



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7. You need to click the **Check Form** button available in the eForm. System will check the mandatory fields, mandatory attachment(s) and digital signature(s).
  8. You need to upload the eForm for pre-scrutiny. The pre-scrutiny service is available under the **Services** tab or under the **eForms** tab by clicking the **Upload eForm** button. The system will verify (pre-scrutinise) the documents. In case of any inadequacies, the user will be asked to rectify the mistakes before getting the document ready for execution (signature).
  9. The system will calculate the fee, including late payment fees based on the due date of filing, if applicable.
  10. Payments will have to be made through appropriate mechanisms - electronic (credit card, Internet banking) or traditional means (at the bank counter through challan).
    - (a) Electronic payments can be made at the Virtual Front Office (VFO) or at PFO
    - (b) If the user selects the traditional payment option, the system will generate 3 copies of pre-filled challan in the prescribed format. Traditional payments through cash, cheques can be done at the designated network of banks using the system generated challan. There will be five banks with estimated 200 branches authorised for accepting challan payments.
  11. The payment will be exclusively confirmed for all online (Internet) payment transactions using payment gateways.
  12. Acceptance or rejection of any transaction will be explicitly communicated to the applicant (including facility to print a receipt for successful transactions).
  13. MCA 21 will provide a unique transaction number, the Service Request Number (SRN) which can be used by the applicant for enquiring the status pertaining to that transaction.
  14. Filing will be complete only when the necessary payments are made.
  15. In case of a rejection, helpful remedial tips will be provided to the applicant.
  16. The applicants will be provided an acknowledgement through e-mail or alternatively they can check the MCA portal.
- 2. What are the steps for online eFiling?**
1. When the business or the registered users access the MyMCA portal, they enter their username and authentication details - Password/ Digital Certificate.
  2. The user will be shown a list of eForms category-wise under **eForms** tab .



3. At any time, the users can read the related instruction kit, available under **Help** menu, to familiarise themselves with the procedures.
4. The users can then fill the appropriate eForm for the service required. There is an option of pre-fill facility in the eForms, where the static details such as name and address of the company will be pre-filled by the system automatically on entering the Corporate Identity Number (CIN).
5. The users attach the necessary documents to the eForm.
6. The users may avail the pre-scrutiny service of the eForm. The documents will be verified (pre-scrutinised) by the system. In case of any inadequacies, for example, if a mandatory column in the eForm is not filled in, the user will be asked to rectify before the document is ready for execution (signature).
7. The applicant or a representative of the applicant will then submit the duly signed documents electronically.
8. The system will calculate the fee, including late payment fees, if applicable.
9. Payments will have to be made through appropriate mechanisms - electronic (credit card, Internet banking) or traditional means (at the bank counter).
  - (a) Electronic payments can be made at the Virtual Front Office (VFO).
  - (b) If the user selects the traditional payment option, the system will generate a pre-filled challan in the prescribed format. Traditional payments through cash, cheques can be done at the designated network of banks using the system generated challan. There will be five banks with estimated 200 branches authorised for accepting challan payments.
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13. Filing will be complete only when the necessary payments are made.
14. In case of a rejection, helpful remedial tips will be provided to the applicant.
15. The applicants will be provided an acknowledgement through e-mail or alternatively they can check the MCA portal.





**3. How can I apply for a Company Name?**

File eForm1 A by logging in the portal along with a payment of fees of Rs. 500/- and attaching the digital signature of the applicant proposing to incorporate the company. If proposed name is not available apply for a fresh name on the same application.

**4. Can I apply for a Company Name Online?**

Yes, You can avail this service at MCA portal.

**5. What is the validity period of the Name approved?**

The approved name is valid for a period of 6 months from the date of approval. The Applicant can renew the name within 6 months by submitting a fresh Name application (Form-1A) along with the fees of Rs. 500/-, by mentioning that the application is for renewal of the name already approved. Names inadvertently allowed or which are against the guidelines, which have subsequently come to the notice, may be withdrawn by the RoC before or after incorporation of the company.

**6. What is the minimum number of directors required to form a company?**

Minimum no. of directors for Private Limited Company: Two. For Public Limited Company: Three.

**7. What is the minimum number of subscribers required for registration of a company?**

Minimum no. of subscribers for Private Limited Company: Two. For Public Limited Company: Seven.

**8. What is the minimum Paid-up Capital at the time of registration of a company?**

The minimum paid up capital for Private Limited Company: Rs. 1,00,000/- For Public Limited Company: Rs. 5,00,000/- This limit is not applicable to company having licence under section 25.

**9. What are the documents to be filed with RoC every year?**

Invariably, the Balance Sheet and Annual Return have to be filed every year. Other documents such as, Return of Allotment (Form-2), Change of Registered office (Form-18), Change among the Directors (Form-32), Charges (Form-8, 10, 17, 13)etc., have to be filed within the due date from the events taking place in the company as per the Companies Act, 1956.



**10. How do I find SRN for form 1A filed before MCA 21 project?**

You may find SRN by entering NIC issued name approval reference number in the “**Name Approval Reference Number**” service available after logging into MyMCA portal.

**4.18 SELF-EXAMINATION QUESTIONS**

1. Resolution requiring special notices requires:
  - (a) 14 days notice
  - (b) 7 days notice
  - (c) 14 days notice to the company and thereafter 7 day to the shareholders
  - (d) 21 clear days notice.
2. Minutes should not include any matter which in the opinion of the Chairman of the meeting
  - (a) is, or could reasonable be regarded as, defamatory of any person.
  - (b) is irrelevant or immaterial to the proceedings
  - (c) is detrimental to the interest of the company
  - (d) All of the above.
3. Which of the following shall be credited to the Investor Education and Protection Fund as per Section 205C, the Companies Act, 1956:
  - (a) Matured deposits with companies
  - (b) Matured debentures with companies
  - (c) Amounts in the unpaid dividend accounts of companies.
  - (d) All of the above.
4. The Gap between two AGM’s must not be more than
  - (a) 12 months
  - (b) 15 Months
  - (c) 18 months
  - (d) 15 months as may be extended by ROC to 18 months.
5. Which one of the following requires ordinary resolution?
  - (a) to alter the articles of association
  - (b) to change the name of the company



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- (c) to reduce the share capital
  - (d) to declare dividends.
6. Which one of the following does not required special resolution
- (a) to adopt annual accounts
  - (b) to authorize an issue of shares at a discount
  - (c) to increase the share capital if authorized by the articles
  - (d) All of the above.
7. Statutory meeting should be held
- (a) Not less than one month from the date which the company is entitled to commence business.
  - (b) Not less than one month from the date which the company is incorporated.
  - (c) Not less than one month but within six months from the date which the company is entitled to commence business.
  - (d) Not less than one month but within six months from the date which the company is incorporated.
8. An extraordinary general meeting may be convened by
- (a) the board of directors
  - (b) the requisitionists
  - (c) the company law board/tribunal
  - (d) all the above.
9. Notice of the general meeting shall be given to
- (a) every member
  - (b) the persons entitled to a share in consequence of death or insolvency
  - (c) auditor or auditors
  - (d) all the above.
10. Dividends may be declared out of
- (a) Current year profits or past reserves
  - (b) Past reserves or monies provided by the Government
  - (c) Current year profits or Past reserves or monies provided by the Government
  - (d) None of the above.



11. Which one of the following is correct?
  - (a) Dividend can be paid out of short term loan
  - (b) Dividend can be paid out of long term loan
  - (c) Dividend can be paid only out of the profits of a company
  - (d) None of the above.
12. An annual return is to be filed with the Registrar by
  - (a) A public company limited by guarantee only
  - (b) A private company only
  - (c) A public company limited by shares only
  - (d) Every company.

**Essay/Practical Questions**

13. State the conditions, which are required to be fulfilled before declaration of "Interim Dividend" under the Companies Act, 1956.
14. Dinesh, a director in a company, gave in writing to the company that notice for any General Meeting and the Board of Directors' Meeting be sent to him at his address in India only by Registered Mail and for which he paid sufficient money. The company sent two notices to him, of such meetings, by ordinary mail, under certificate of posting. Dinesh did not receive the said notices and could not attend the meetings and the proceedings thereof on the ground of improper notice. Decide in the light of the provisions of the Companies Act, 1956:
  - (i) Whether the contention of Dinesh is valid?
  - (ii) Would your answer be still the same in case Dinesh remained outside India for two months (when such notices were given and meetings held)
15. Explain the provisions of the Companies Act, 1956 relating to holding of Annual General Meeting of the Company with regard to the following:
  - (i) Period within which the first and the subsequent Annual General Meetings must be held.
  - (ii) Business which may be transacted at an Annual General Meeting.
16. M/s Low Esteem Infotech Ltd. was incorporated on 1.4.2003. No General Meeting of the company has been held so far. Explain the provisions of the Companies Act, 1956 regarding the time limit for holding the first annual general meeting of the Company and



- the power of the Registrar to grant extension of time for the First Annual General Meeting.
17. The Board of Directors of M/s Optimistic Company Ltd. propose to pay interim dividend of Rs.2 per equity share of Rs. 10 each. Advise the Board regarding:
- (i) The time limit for payment of interim dividend to the shareholders, and
  - (ii) Steps to be taken in case any dividend amount remains unpaid in the books of the company.
18. In what way does the Companies Act, 1956 regulate the holding of an Annual General Meeting by a public limited company? Explain.
19. M/s Low Esteem Infotech Ltd. was incorporated on 1.4.2003. No General Meeting of the company has been held so far. Explain the provisions of the Companies Act, 1956 regarding the time limit for holding the first annual general meeting of the Company and the power of the Registrar to grant extension of time for the First Annual General Meeting.
20. Annual General Meeting of a Public Company was scheduled to be held on 15.12.2003. Mr. A, a shareholder, issued two Proxies in respect of the shares held by him in favour of Mr. 'X' and Mr. T. The proxy in favour of 'Y' was lodged on 12.12.2003 and the one in favour of Mr. X was lodged on 15.12.2003. The company rejected the proxy in favour of Mr. X as the proxy in favour of Mr. Y was of dated 12.12.2003 and thus in favour of Mr. X was of dated 13.12.2003. Is the rejection by the company in order?
21. The Board of Directors of M/s Optimistic Company Ltd. propose to pay interim dividend of Rs.2 per equity share of Rs. 10 each. Advise the Board regarding:
- (i) the time limit for payment of interim dividend to the shareholders, and
  - (ii) steps to be taken in case any dividend amount remains unpaid in the books of the company.

**4.19 Answer**

1. (c) 2. (d) 3. (d) 4. (d) 5. (d) 6. (a) 7. (c) 8. (d) 9. (c) 10. (d) 11. (c) 12. (d)

**PART II**

**ETHICS**

# CHAPTER 7

## PRINCIPLES OF BUSINESS ETHICS

### Learning Objectives

After reading this chapter, you will be able to

- ◆ Define business ethics
- ◆ Distinguish between Business Ethics and Morality
- ◆ Understand Ethical Dilemmas
- ◆ Explain how businesses can promote Ethical Behaviour
- ◆ List the benefit of Business Ethics

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*"Whether men understand it or not, they are impelled by that power behind to become unselfish. That is the foundation of morality. It is the quintessence of all ethics, preached in any language, or any religion, or by any prophet in the world. "Be thou unselfish", "Not 'I', but 'Thou'" - that is the background of ethical codes."*

**Swami Vivekananda**

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### 7.1 INTRODUCTION

Corporate scandals such as Enron are illustrative of the relationship between ethics and business. Investigation into the fraud committed by corporate senior executive officers as well as the stress on the employees, who have to follow the unreasonable and sometimes illegal orders of their superiors have also come to the fore in recent times. In a general sense, ethics is the concern for good behaviour - doing the right thing. Human beings have always been puzzled with moral questions of right and wrong behaviour; struggling to develop a system that produced the maximum good for the individual and for the group. They understood the importance of "right" behavior and realized that there was danger of extinction if violent acts and pilferage were not curtailed. Over time, codes of conduct were developed to ensure survival. These codes were for nurturing children, forming of family and tribal units, hunting rituals and so on. Thus, a system of acceptable behavior was formed. One example that comes to mind most readily is the Ten Commandments from the Bible. Other traditions and religions have comparable sacred or ancient texts that have guided people's actions in all areas, including business, for centuries, and still do.



At all times, wise men and religions all over the world have considered “value centred perfection” and not “material success” as the ultimate goal of every human being. Unfortunately with passage of time, we started witnessing a degradation of values-ethics, forgetting the wise teachings; associating material success and fame as highest achievement. According to *Vedanta* one of the world's most ancient religious philosophies based on the *Vedas*, the sacred Hindu scriptures of India, it is crucially important that our thoughts and actions be governed by ethical values and habits.

*Vedanta*, is in agreement with Socrates in holding the view that the practice of virtue should be preceded by a rational understanding of the implications and the nature of virtue. It says that *Viveka* (understanding) should precede *Vairagya* (dispassion) and the practice of *Shatsampat* (six ethical virtues – tranquility, training, withdrawal, forbearance, faith and focus), are cultivated to stabilize the mind and emotions. “The knowledge of the importance of virtue does not deter people from moving to the evil side of things. This is the inscrutable illusion covering the consciousness of man, says the *Vedanta*.”

Mahatma Gandhi, Father of India, promoted non-violence, justice and harmony between people of all faiths. Satyagraha, Gandhi's approach to conflict, was to “hold firmly to Truth.” He stressed that people follow ethical principles and listed following seven Social Sins:

- (i) Politics without Principles.
- (ii) Wealth without work.
- (iii) Commerce without Morality.
- (iv) Knowledge without Character.
- (v) Pleasure without Conscience.
- (vi) Science without humanity.
- (vii) Worship without sacrifice.

The first deals with the political field. The Kings in Indian tradition were only the guardian executors and servants of ‘Dharma’. For Gandhi Rama was the symbol of a king dedicated to Principles. The second and the third dicta deal with the sphere of Economics. Tolstoy and Ruskin inspired Gandhi on the idea of bread-labour. The Bhagavad Gita also declares that he who eats without offering sacrifice eats stolen food. Gandhi put this into practice at his community centers. The third maxim was developed into the idea of *Trusteeship* by Gandhiji. A business man has to act only as a trustee of the society for whatever he has gained from the Society. Everything finally belongs to the society. “Trusteeship provides a means of transforming the present capitalist order of society into an egalitarian one”. The fourth dictum deals with knowledge. Education stands for the all round development of the individual and his





character. Gandhi's system of basic education was the system for development of one's character. True knowledge leads to the development of one's character where one evolves his 'Rational self.' Gandhi held that Science without the thought of the welfare of humanity is a Sin. Science and humanity together pave the way for welfare of all. In religion, we worship, but if we are not ready to sacrifice for social service, worship has no value; it is sin to worship without sacrifice. Gandhiji's everyday prayer was a recitation of the virtues of an ideal person as depicted in the Bhagvad Gita. His prayer addressed to better one's own self, the conscience, the true self. There is little doubt that unethical behaviour results in unspeakable restlessness, tension, secret fear and loss of peace.

## **7.2 ETHICS AND MORALS**

The word 'Ethics' is derived from the Ancient Greek *ēthikos*- meaning character is the essence of values and habits of a person or group. It covers the analysis and employment of concepts such as right and wrong, good and evil, and acting with responsibility. It has many definitions. According to one "ethics are the principles of conduct governing an individual or a group". Another describes "ethics as relating to what is good or bad, and having to do with moral duty and obligation."

Let us draw a distinction between Ethics and Morals. The word "Moral" is defined as relating to principles of right and wrong. Although both words are broadly defined in contemporary English as having to do with right and wrong conduct, the root word for ethics is the Greek "ethos," meaning "character", while the root word for Moral is Latin "mos," meaning "custom." Character and custom, however, provide two very different standards for defining what is right and what is wrong. Character is a personal attribute, while custom is defined by a group over time. People have character. Societies have custom. To violate either can be said to be wrong, within its appropriate frame of reference.

Another way to look at the distinction is to say that morals are accepted from an authority (cultural, religious, etc.), while ethics are accepted because they follow from personally accepted principles. For example, if one accepts the authority of a religion, and that religion forbids stealing, then stealing would be immoral. An ethical view might be based on an idea of personal property that should not be taken without social consent (like a court order). Moral norms can usually be expressed as general rules and statements such as "always tell the truth." and are typically first absorbed as a child from family, friends, school, religious teachings and other associations. Morals work on a smaller scale than ethics, more reliably, but by addressing human needs for belonging and emulation, while ethics has a much wider scope.



### **7.3 NATURE OF ETHICS**

Simply stated, ethics refers to standards of behavior that tell us how human beings ought to act in the many situations in which they find themselves-as friends, parents, children, citizens, businesspeople, teachers, professionals, and so on. It is helpful to identify what ethics is NOT: Ethics is not the same as feelings. Feelings provide important information for our ethical choices. Some people have highly developed habits that make them feel bad when they do something wrong, but many people feel good even though they are doing something wrong. And often our feelings will tell us it is uncomfortable to do the right thing if it is hard.

Ethics is not religion. Many people are not religious, but ethics applies to everyone. Most religions do advocate high ethical standards but sometimes do not address all the types of problems we face. Ethics is not following the law. A good system of law does incorporate many ethical standards, but Law can deviate from what is ethical. Law can become ethically corrupt, as some totalitarian regimes have made it. Law can be made to be a function of power alone and designed to serve the interests of narrow groups. Law may have a difficult time designing or enforcing standards in some important areas, and may be slow to address new problems.

Ethics is not following culturally accepted norms. Some cultures are quite ethical, but others become corrupt -or blind to certain ethical concerns (as the United States was to slavery before the Civil War or to using atomic weapons on civilians in Hiroshima and Nagasaki). "When in Rome, do as the Romans do" is not a satisfactory ethical standard.

Ethics is not science. Social and natural science can provide important data to help us make better ethical choices. But science alone does not tell us what we ought to do. Science may provide an explanation for what humans are like. But ethics provides reasons for how humans ought to act. And just because something is scientifically or technologically possible, it may not be ethical to do it.

#### **Why Identifying Ethical Standards is Hard**

There are two fundamental problems in identifying the ethical standards we are to follow:

1. On what do we base our ethical standards?
2. How do those standards get applied to specific situations we face?

If our ethics are not based on feelings, religion, law, accepted social practice, or science, what are they based on? Many philosophers and ethicists have helped us answer this critical question. They have suggested at least five different sources of ethical standards we should use.



### **7.3.1 FIVE SOURCES OF ETHICAL STANDARDS**

#### **The Utilitarian Approach**

Some ethicists emphasize that the ethical action is the one that provides the most good or does the least harm, or, to put it another way, produces the greatest balance of good over harm. The ethical corporate action, then, is the one that produces the greatest good and does the least harm for all who are affected - customers, employees, shareholders, the community, and the environment. The utilitarian approach deals with consequences; it tries both to increase the good done and to reduce the harm done.

#### **The Rights Approach (The Deontological Approach)**

Other philosophers and ethicists suggest that the ethical action is the one that best protects and respects the moral rights of those affected. This approach starts from the belief that humans have a dignity based on their human nature per se or on their ability to choose freely what they do with their lives. On the basis of such dignity, they have a right to be treated as ends and not merely as means to other ends. The list of moral rights -including the rights to make one's own choices about what kind of life to lead, to be told the truth, not to be injured, to a degree of privacy, and so on-is widely debated; some now argue that non-humans have rights, too. Also, it is often said that rights imply duties-in particular, the duty to respect others' rights.

#### **The Fairness or Justice Approach**

Aristotle and other Greek philosophers have contributed the idea that all equals should be treated equally. Today we use this idea to say that ethical actions treat all human beings equally-or if unequally, then fairly based on some standard that is defensible. We pay people more based on their harder work or the greater amount that they contribute to an organization, and say that is fair. But there is a debate over CEO salaries that are hundreds of times larger than the pay of others; many ask whether the huge disparity is based on a defensible standard or whether it is the result of an imbalance of power and hence is unfair.

#### **The Common Good Approach**

The Greek philosophers have also contributed the notion that life in community is a good in itself and our actions should contribute to that life. This approach suggests that the interlocking relationships of society are the basis of ethical reasoning and that respect and compassion for all others-especially the vulnerable-are requirements of such reasoning. This approach also calls attention to the common conditions that are important to the welfare of everyone. This may be a system of Laws, effective police and fire departments, health care, a public educational system, or even public recreational areas.



### **The Virtue Approach**

A very ancient approach to ethics is that ethical actions ought to be consistent with certain ideal virtues that provide for the full development of our humanity. These virtues are dispositions and habits that enable us to act according to the highest potential of our character and on behalf of values like truth and beauty. Honesty, courage, compassion, generosity, tolerance, love, fidelity, integrity, fairness, self-control, and prudence are all examples of virtues. Virtue ethics asks of any action, "What kind of person will I become if I do this?" or "Is this action consistent with my acting at my best?"

### **Putting the Approaches Together**

Each of the approaches helps us determine what standards of behavior can be considered ethical. There are still problems to be solved, however.

The first problem is that we may not agree on the content of some of these specific approaches. We may not all agree to the same set of human and civil rights.

We may not agree on what constitutes the common good. We may not even agree on what is a good and what is a harm.

The second problem is that the different approaches may not all answer the question "What is ethical?" in the same way. Nonetheless, each approach gives us important information with which to determine what is ethical in a particular circumstance. And much more often than not, the different approaches do lead to similar answers.

### **Making Decisions**

Making good ethical decisions requires a trained sensitivity to ethical issues and a practiced method for exploring the ethical aspects of a decision and weighing the considerations that should impact our choice of a course of action. Having a method for ethical decision making is absolutely essential. When practiced regularly, the method becomes so familiar that we work through it automatically without consulting the specific steps.

The more novel and difficult the ethical choice we face, the more we need to rely on discussion and dialogue with others about the dilemma. Only by careful exploration of the problem, aided by the insights and different perspectives of others, can we make good ethical choices in such situations.

### **Business Ethics**

Should a business entity be ethical? Experts often retort that business ethics is a contradiction in terms because of the inherent inconsistency between ethics and the self-interested motive of profit. On the contrary it is now a well accepted fact that ethical behaviour creates a positive reputation that expands the opportunities for profit. An organisation is not only its buildings, assets, capital or even profit. It is living and creative, evolving over time



and having a vision about its future role in society, nation and the world. In the broad sense ethics in business is simply the application of everyday moral or ethical norms to business. Being ethical in business requires acting with an awareness of how the products and services of an organization, and the actions of its employees, can affect its stakeholders and society as a whole and developing codes of conduct for doing business in an ethical manner. While values and moral development are part of personal development, organizational factors can also affect ethical behaviour. The strength of an organization's culture influences ethical behaviour. An organizational culture most likely to encourage high ethical standards is one that is high in risk tolerance, control, and conflict tolerance. Managers in such cultures are encouraged to be aggressive and innovative, are aware that unethical practices will be discovered, and feel free to openly challenge expectations they consider to be unrealistic or personally undesirable. Amongst the thinkers of modern times, an invaluable contribution to practising business ethically is provided by Mahatma Gandhi, the father of our nation. He sought to unite mankind in common pursuit of justice and establishment of a moral order in world-society. He advised our countrymen to observe truthfulness in business and reminded them that their responsibility was greater since their conduct would be seen as a reflection of their country.

### 7.4 NEED FOR BUSINESS ETHICS

"Trusteeship provides a means of transforming the present capitalist order of society into an egalitarian one" said Mahatma Gandhi. According to him, "a business man has to act only as a trustee of the society for whatever he has gained from the society. Everything finally belongs to the society." Society bestows upon businesses the authority to own and use land and natural resources. In return, society has the right to expect that productive organizations will enhance the general interests of consumers, employees and community. Society may also expect that organisations to honour existing rights and limit their activities within the bounds of justice. So, under this 'social contract' between society and business, what rules should guide the behavior of business enterprises? What are the minimal duties of business professionals? Business ethics provides this guidance, including the consequences and complications of their actions. Thus business ethics is that set of principles or reasons which should govern the conduct of business – whether at the individual or collective level by the application of ethical reasoning to specific business situations and activities.

#### **Being ethical in business requires acting with an awareness of:**

- ◆ The need for complying with rules, such as the laws of the land, the customs and expectations of the community, the principles of morality, the policies of the organization and such general concerns as the needs of others and fairness.
- ◆ How the products and services of an organization, and the actions of its members, can affect its employees, the community and society as a whole.



Business ethics has come to be considered a management discipline, especially since the birth of the social responsibility movement in the 1960s. In that decade, social awareness movements raised expectations of businesses to use their massive financial and public influence to address social problems such as poverty, crime, environmental protection, equal rights, public health and improving education. An increasing number of people asserted that because businesses were making a profit from using the country's resources, they owed it to the country to work to improve society. Many researchers, business schools and managers have recognized this broader constituency, and in their planning and operations have replaced the word "stockholder" with "stakeholder," meaning to include employees, customers, suppliers and the wider community.

In the above framework we can define business ethics as "the principles and standards that determine acceptable conduct in business organizations." Learning to recognise ethical issues is the most important step in understanding business ethics. An ethical issue is an identifiable problem, situation or opportunity that requires a person to choose from among several actions that may be evaluated as right or wrong, ethical or unethical. In business such a choice often involves weighing monetary profit against what may be appropriate conduct .

### **7.5 ETHICAL DILEMMA**

Learning to recognize ethical issues is the most important step in understanding business ethics. An ethical issue is an identifiable problem, situation, or opportunity that requires a person to choose from among several actions that may be evaluated as ethical or unethical. This will often involve an apparent conflict between moral imperatives, in which to obey one would result in transgressing another. Many business issues may seem straight forward and easy to resolve by choosing the one option which appears to be the clear choice, but in reality, one is faced with having to make a choice from various alternatives in which more than one option seems "right" resulting in an ethical dilemma. In business, more than anywhere else, we are faced with moral and ethical decisions daily. Not only are we faced with questions between right and wrong, but between right and right. According to Joseph Badaracco, Professor at Harvard Business School, "We have all experienced situations in which our professional responsibilities unexpectedly come into conflict with our deepest values. We are caught in a conflict between right and right. And no matter which option we choose, we feel like we've come up short." Ethical dilemmas faced by managers are often highly complex with no clear guidelines. For example, if you are a salesperson, when does offering a gift to a customer become a bribe rather than sales promotion? Codes of ethics that seek to influence moral behaviour of a group have a long tradition. Codes of Ethics are the most widespread means by which companies communicate their ethical standards to the employees or professionals. These are formalised rules and standards that describe what is expected from them. The Hippocratic Oath, which still governs the ethical behaviour of medical practitioners was drawn up more than two thousand years ago.



***The Hippocratic Oath- Ethical Code For Physicians***

Medical ethics, a branch of ethics, deals with moral decisions in various aspects of medicine. The Hippocratic oath is the most enduring tradition in medicine that has been the guiding ethical code for physicians since ancient Greece, and has eventually become the basis of all medical ethics. In its most compelling portions, it emphasizes the profundity of the medical agreement, patient dignity, the confidentiality of the transaction, and the physician's responsibility to guard against abuse or corruption of his or her knowledge and art. It also exhorts the physicians to honor the rules of their profession and expose those who do not follow the high standards of conduct.

A slogan on an ethics poster for Boeing states the profound truth about ethical dilemma : "Between right and wrong is a troublesome grey area." Each person must weigh alternatives and make choices in light of personal values and goals, but also with consideration to organizational and professional success. Decisions have to be made that are optimal and that we can live with in the long run. An analysis of the relationship between ethical behavior and effective leadership reveals that it is a matter of choosing both the ends and the means. A business enterprise must be profitable in order to survive. At the same time, the means by which they achieve those ends are increasingly important. Placing value on short term gains at the detriment of long term results often ends in disaster .

Some guidelines<sup>1</sup> to address ethical dilemmas are given below:

1. Define the problem clearly.
2. How would you define the problem if you stood on the other side of the fence?
3. How did the situation arise?
4. To whom are you loyal as a person and as a member of the organisation?
5. What is your intention in making this decision?
6. How does this intention compare with the probable results?
7. Whom could your decision or action injure?
8. Can you discuss the problem with the affected parties before you make your decision?
9. Are you confident that your position will be as valid over a long period?

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<sup>1</sup> Excerpt from "Ethics Without The Sermon" by Laura L. Nash, Harvard Business review- November-December, 1981



10. Could you disclose without any doubt your decision or action to your boss, your CEO, the Board of Directors, your family, society as a whole ?
11. What is the symbolic potential of your action if understood? If misunderstood ?
12. Under what conditions would you allow exceptions to your stand ?

## **7.6 BENEFITS OF BUSINESS ETHICS**

There are many benefits of paying attention to business ethics :

### **1. *Improved society***

A few decades ago, children and workers were ruthlessly exploited. Trusts controlled some markets to the extent that prices were fixed and small businesses stifled. Influence was applied through intimidation and harassment. Then society reacted and demanded that businesses place high value on ethics, fairness and equal rights resulting in framing of anti-trust laws, establishment of Government agencies and recognition of labour unions

### **2. *Easier Change management***

Attention to business ethics is critical during times of fundamental change - times like those faced presently by businesses, whether non profit or for-profit. During times of change, there is often no clear moral compass to guide leaders through complex conflicts about what is right or wrong. Continuing attention to ethics in the workplace sensitizes leaders and staff for maintaining consistency in their actions.

### **3. *Strong teamwork and greater productivity***

Ongoing attention and dialogue regarding values in the workplace builds openness, integrity and community, all critical ingredients of strong teams in the workplace. Employees feel a strong alignment between their values and those of the organization resulting in strong motivation and better performance.

### **4. *Enhanced employee growth.***

Attention to ethics in the workplace helps employees face the reality, both good and bad in the organization and gain the confidence of dealing with complex work situations.

### **5. *Ethics programs help guarantee that personnel policies are legal.***

A major objective of personnel policies is to ensure ethical treatment of employees , For example, in matters of hiring, evaluating, disciplining, firing, etc., an employer can be sued for breach of contract for failure to comply with any promise it made, so the gap between stated corporate culture and actual practice has significant legal, as well as ethical implications. Attention to ethics ensures highly ethical policies and procedures in the workplace. Ethics management programs are also useful in managing diversity. Diversity programs require recognizing and applying diverse values and perspectives which are the basis of a sound





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## Principles of Business Ethics

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ethics management program. Most organisations feel that it is far better to incur the cost of mechanisms to ensure ethical practices than to incur costs of litigation later.

**6. Ethics programs help to avoid criminal acts “of omission” and can lower fines.**

Ethics programs help to detect ethical issues and violations early, so that they can be reported or addressed.

**7. Ethics programs help to manage values associated with quality management, strategic planning and diversity management .**

Ethics programs help identifying preferred values and ensuring that organizational behaviors are aligned with those values. This includes recording the values, developing policies and procedures to align behaviours with preferred values, and then training all personnel about the policies and procedures. This overall effort is very useful for several other programs in the workplace that require behaviors to be aligned with values, including quality management, strategic planning and diversity management. For example, Total Quality Management initiatives include high priority on certain operating values, e.g., trust among stakeholders, performance, reliability, measurement, and feedback.

**8. Ethics helps to promote a strong public image**

An organization that pays attention to its ethics can portray a strong and positive image to the public. People see such organizations as valuing people more than profit and striving to operate with the integrity and honor.

Thus managing ethical values in businesses besides optimizing profit generation in the long term, legitimizes managerial actions, strengthens the coherence and balance of the organization's culture, improves trust in relationships between individuals and groups, supports greater consistency in standards and qualities of products, and cultivates greater sensitivity to the impact of the enterprise's values and messages. Finally and most essentially, proper attention to business ethics is the right thing to do.

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Website: [www.managementhelp.org/ethics](http://www.managementhelp.org/ethics)

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### **7.7 SELF-EXAMINATION QUESTIONS**

1. Define business ethics and examine the importance of business ethics in the present corporate environment.
2. Distinguish between morals and ethics.
3. Write short notes on
  - (a) Ethical issues
  - (b) Morals and Ethics
  - (c) Ethical Dilemma
4. List the benefits of ethical business practices.
5. Do you think it's ethical to
  - (i) Lay off employees after telling them that there would be no layoffs?
  - (ii) Establish a community-relations department and begin fund-raising activities after receiving bad press
  - (iii) Operate a cancer-treatment centre with funding from tobacco companies?
  - (iv) To not reveal defects /accidents while selling your car
- 6 **Mini-case** : Answer the questions after reading and reflecting on the following situation  
*Rohan Sharma accepted a position of Manager (administration) at Pearl Vocational Training Institute, Delhi. He moved with his family from Jaipur to Delhi. Soon, he was promoted as Vice President (Administration), overseeing the purchase department of the Institute. His oldest son, Akshay also got a good job as sales executive at IB Computer Corporation in Delhi. As Vice President, Rohan quickly saw the need for 4 to 5 computers in his office. Although Pearl had a bidding policy, Rohan purchased IB Computer Corporation's computers for about Rs. 35,000 each, when another popular brand IBC was selling for around Rs. 28,000 and had more promising features than the IB computer. Akshay handled the sale and received a healthy commission on the sale. If the purchase had gone through the normal bidding process, the IB model would not have been selected.*

#### **Questions:**

- (a) Was Rohan Sharma's decision not to request bids an ethical choice?
- (b) Should Akshay have made the sale? Received a commission?
- (c) Draft a Code of ethics for the purchase section of Pearl Vocational Training Institute.

# CHAPTER 8

## CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY

### Learning Objectives

After reading this chapter , you will be able to-

- ◆ Define Corporate Governance and understand the term “stakeholder”
- ◆ Explain various corporate governance initiatives in India and abroad
- ◆ Understand Corporate Social responsibility and the need and importance of being a Corporate Citizen
- ◆ Explain the implementation and list the benefits of Corporate Social Responsibility

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*“What good did the creatures of the earth do to the clouds that pour the rain? So indeed should you serve society, seeking no return. Good men put forth industry and produce wealth, not for themselves but for the use of society. Wealth is not to be earned for the purpose of self indulgence or for satisfaction of greed. Wealth should be treated as the citizen's instrument for helpfulness. The word is not just helpfulness but helpfulness combined with a sense of duty. There is no pleasure in this or in the other world equal to the joy of being helpful to those around you. Do not lose the opportunity for this rare pleasure.”*

**C. Raja Gopalachari's translation of Thiruvalluvar's Kural (Social Cooperation)**

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### 8.1 INTRODUCTION

The importance of corporate social responsibility surfaced in the 1960s when the activist movement began questioning the singular economic objective of being maximization of profits. This has always been a source of contention. For example, were tobacco companies ignoring health risks associated with nicotine and its addictive properties? Times have changed and managers must regularly make decisions about issues that have a dimension of social responsibility. Karl Marx , commenting on business objectives said *“Business is all green, only philosophy is grey.”* What he meant was that business is all about profits and comfort for



its rich owners and discomforts for all other sections of the society who are at the receiving end of the business. Despite such socialist ideology been relegated to the background due to fact that capitalism is being gradually accepted; business is still painted as essentially exploitative in nature. But one has to accept that much of the progress in the world would not have been possible without entrepreneurship and business which involves risk. Corporate Governance is getting a focused attention particularly after market and public confidence became fragile after a series of high profile corporate failures in which the absence of effective governance was a major factor.

Business ethics if properly understood is neither anti business nor anti capitalist. It is simply articulating a cohesive set of values to guide decision making in running a business. Globalisation and liberalization of economies has brought corporate organizations to the center stage of social development. As a result in the process of corporate decision making, managers contribute, consciously or unconsciously to the shaping of human society. It is not a choice between profits and ethics, but profits in an ethical manner. This mantra has led to the evolution of Corporate Governance. Corporate Governance is getting attention for satisfying the divergent interests of the stakeholders of a business enterprise especially after the corporate scandals and loss of shareholder value at Enron and several other large companies in the recent past, which focused more attention on the issue of shareholder rights, calling for greater transparency and accountability and enhancing corporate reporting and disclosure. The scandals led to numerous corporate governance reforms, including passage of the Sarbanes - Oxley Act and the adoption of new listing requirements by the New York Stock Exchange in the United States. Other countries have introduced similar legal requirements. As a result, increasing number of companies are working proactively to address issues that concern shareholders and a range of other stakeholders.

### **Definition**

*“Corporate governance is about promoting corporate fairness, transparency and accountability”*.<sup>1</sup> It is concerned with structures and processes for decision making, accountability, control and behaviour at the top level of organisations. It influences how the objectives of an organisation are set and achieved, how risk is monitored and assessed and how performance is optimized.

The term Corporate Governance is not easy to define. The term governance relates to a process of decision making and implementing the decisions in the interest of all stakeholders. It basically relates to enhancement of corporate performance and ensures proper accountability for management in the interest of all stakeholders. It is a system through which an organisation is guided and directed. On the basis of this definition<sup>2</sup>, the core objectives of

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<sup>1</sup> J.Wolfensohn, President of the World Bank- Financial Times, June 21, 1999

<sup>2</sup> The Cadbury Report, 1992



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## Corporate Governance and Corporate Social Responsibility

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Corporate Governance are focus, predictability, transparency, participation, accountability, efficiency & effectiveness and stakeholder satisfaction

Corporate Governance can also be defined “as the formal system of accountability and control for ethical and socially responsible organisational decisions and use of resources.”

- ◆ Accountability relates to how well the content of workplace decisions is aligned with the organisation’s stated strategic direction.
- ◆ Control involves the process of auditing and improving organisational decisions and actions.

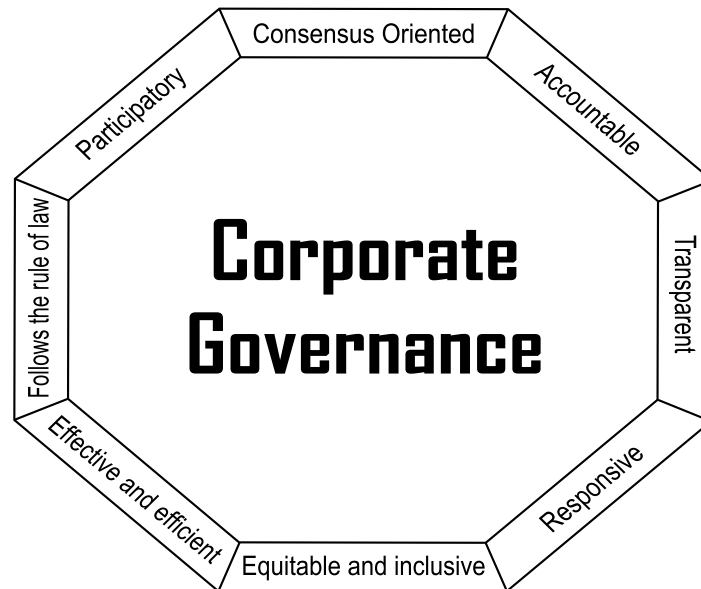
Corporate governance arrangements are key determinants of an organization’s relationship with the world and encompass:

1. The power given to management;
2. Control over management’s use of power (e.g. through institutions such as Boards of Directors);
3. Management’s accountability to stakeholders;
4. The formal and informal processes by which stakeholders influence management decisions.

### 8.2 STAKEHOLDERS

The traditional governance model positions management as accountable solely to investors (shareholders). But a growing number of corporations accept that constituents other than shareholders are affected by corporate activity, and that the corporation must therefore be answerable to them. Coined only in the late part of the 20th century, this word “stakeholders” describes such constituents of an organisation - the individuals, groups or other organizations which are affected by, or can affect the organisation in pursuit of its goals. A typical list of stakeholders of a company would be

- ◆ Employees
- ◆ Trade Unions
- ◆ Customers
- ◆ Shareholders and investors
- ◆ Suppliers
- ◆ Local communities
- ◆ Government
- ◆ Competitors.



**Characteristics of Corporate Governance**

**8.3 Corporate Governance – DEVELOPMENTS ABROAD**

The trend of developing corporate governance guidelines and codes of best practice began in the early 1990s in UK and Canada in response to problems in performance in some leading organizations, presumably due to lack of effective board oversight leading to pressure from institutional investors for change. The Cadbury Report, 1992 in UK became a pioneering reference code for stock markets. The 'Blue Ribbon Committee' set up in the U.S. in 1998 by New York Stock Exchange and National Association of Securities Dealers studied the effectiveness of audit committees and provided recommendations for improvement. In response to these recommendations, New York Stock Exchange and National Association of Securities Dealers as well as other exchanges revised their listing standards relating to audit committees. In 2002 the Sarbanes – Oxley Act, passed in response to major corporate scandals, is considered to be one of the most significant. The OECD (Organisation for Economic Co-operation and Development) Principles 1999 and 2004 reflect global consensus regarding the critical importance of corporate governance.

**8.4 CORPORATE GOVERNANCE MEASURES**

In general, corporate governance measures include appointing non-executive directors, placing constraints on management power and ownership concentration, as well as ensuring



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## Corporate Governance and Corporate Social Responsibility

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proper disclosure of financial information and executive compensation. Many companies have established ethics and /or social responsibility committees on their Boards to review strategic plans, assess progress and offer guidance on social responsibilities of their business. In addition to having committees and boards, some companies have adopted guidelines governing their own policies and practices around such issues like board diversity, independence, and compensation.

Indian Companies are required to comply with Clause 49 of the listing agreement primarily focusing on following areas:

- ◆ Board composition and procedure
- ◆ Audit Committee responsibilities
- ◆ Subsidiary companies
- ◆ Risk management
- ◆ CEO/CFO certification of financial statements and internal controls
- ◆ Legal compliance
- ◆ Other disclosures

### Developments in India

The Confederation of Indian Industry (CII) took the lead in framing a desirable code of corporate governance in April 1998. This was followed by the recommendations of the Kumar Mangalam Birla Committee on Corporate Governance. This Committee was appointed by the Securities and Exchange Board of India (SEBI). The recommendations were accepted by SEBI in December 1999, and enshrined in Clause 49 of the Listing Agreement of all Stock Exchanges in India.

In August 2002 , the Department of Company Affairs, Government of India, constituted a nine-member committee under the chairmanship of Mr. Naresh Chandra, to examine the Auditor- Company relationship, role of independent directors, disciplinary mechanism for auditors committing irregularities and the CEO/CFO certification introduced by SOX.

SEBI having analysed disclosures made by many companies under Clause 49 constituted a review committee under the chairmanship of Mr. N. R. Narayana Murthy. The Narayana Murthy Committee report, 2003, suggested further improvements and in alignment with these recommendations , the revised Clause 49 has been made effective.

## 8.5 Benefits of Good Corporate Governance

1. Protection of investor interests and strong capital markets



2. Studies show clear evidence that good governance is rewarded with a higher market valuation.
3. Ensures commitment of the board in managing the company in a transparent manner .

### **8.6 CORPORATE SOCIAL RESPONSIBILITY**

Corporate Social Responsibility (CSR) is a concept that organizations, have an obligation to consider the interests of customers, employees, shareholders, communities, and ecological considerations in all aspects of their operations. This obligation is seen to extend beyond their statutory obligation to comply with legislation. CSR is closely linked with the principles of Sustainable Development, which argues that enterprises should make decisions based not only on financial factors such as profits or dividends, but also based on the immediate and long-term social and environmental consequences of their activities, especially taking into consideration the needs of future generations. . It is an integrated combination of policies, programs, education, and practices which extend throughout a corporation's operations and into the communities in which they operate, about how companies voluntarily manage the business processes to produce an overall positive impact on society. CSR can mean different things to different people:

- ♣ for an employee it can mean fair wages, no discrimination, acceptable working conditions etc.
- ♣ for a shareholder it can mean making responsible and transparent decisions regarding the use of capital.
- ♣ for suppliers it can mean receiving payment on time.
- ♣ for customers it can mean delivery on time, etc.
- ♣ for local communities and authorities it can mean taking measures to protect the environment from pollution.
- ♣ for non-governmental organisations and pressure groups it can mean disclosing business practices and performance on issues ranging from energy conservation and global warming to human rights and animal rights, from protection of the rainforests and endangered species to child and forced labour, etc.

For a company, however, it can simply be seen as responding to the needs and concerns of people who can influence the success of the company and/or whom the company can impact through its business activities, processes and products.

The term **corporate citizenship** denotes the extent to which businesses meet the legal, ethical, economic and voluntary responsibilities placed on them by their stakeholders.





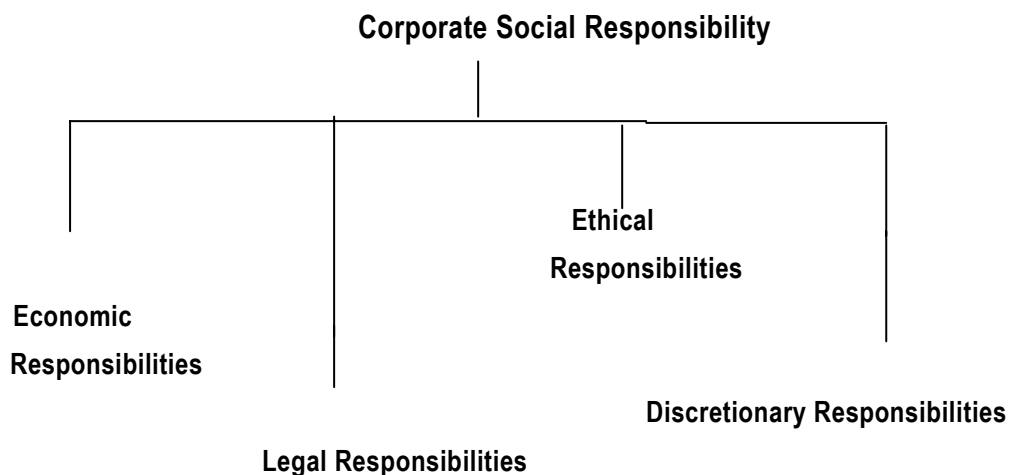
## Corporate Governance and Corporate Social Responsibility

Companies can best benefit their stakeholders by fulfilling their economic, legal, ethical and discretionary responsibilities. The benefits of “good corporate citizenship” include:

- ◆ A stable socio-political-legal environment for business as well as enhanced competitive advantage through better corporate reputation and brand image.
- ◆ improved employee recruitment, retention and motivation, improved stakeholder relations and a more secure environment in which to operate.

### 8.7 NEED FOR CSR

CSR is pursued by businesses to balance their economic, environmental and social objectives while at the same time addressing stakeholder expectations and enhancing shareholder value. Over the past decade, CSR has risen in global prominence and importance. More companies than ever before are engaged in serious efforts to define and integrate CSR into all aspects of their business, with their experiences being strengthened by a growing body of evidence that CSR has a positive impact on business economic performance.



New voluntary CSR standards and performance measurement tools continue to grow amidst the ongoing debate about whether and how to formalize legal CSR requirements for companies. Stakeholders, including shareholders, analysts, regulators, activists, labour unions, employees, community organizations, and the news media, are asking companies to be accountable not only for their own performance but for the performance of their entire supply chain. This is taking place against the backdrop of a complex global economy with continuing economic, social and environmental imbalance. Corporate governance scandals such as those at WorldCom, Enron, Daewoo etc. profoundly affected major capital markets worldwide, and placed issues such as ethics, accountability, and transparency firmly on the business, regulation and policy agenda. Additionally, issues such as peace, sustainable



development, security, poverty alleviation, environmental quality and human rights are having a profound effect on businesses and the business environment. While CSR does not have a universal definition, many see it as a way of integrating the economic, social, and environmental necessity of business activities. Social issues with which business corporations have been concerned since the 1960s may be divided into three categories:

- (a) Social problems external to the corporation that were not caused by any direct business action like poverty, drug abuse, decay of the cities and so on.
- (b) The external impact of regular economic activities. For example pollution caused by production; the quality, safety, reliability of goods and services; deception in marketing practices, the social impact of plant closures and plant location belong to this category.
- (c) Issues within the firm and tied up with regular economic activities, like equal employment opportunity, occupational health and safety, the quality of work life and industrial democracy .

The second and third categories are of increasing importance and are tied up with the regular economic operations of business. Improved social performance demands changes in these operations.

Corporate social responsibility ensures that corporations promote corporate citizenship as part of their culture. Corporate social responsibility is about businesses transforming their role from merely selling products and services with a view to making profits and increasing their revenue to the development of a society through their abilities of generating capital and investing it for social empowerment.

**Definition :**

"Corporate Social Responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large".<sup>3</sup>

"Corporate Social Responsibility is achieving commercial success in ways that honour ethical values and respect people, communities, and the natural environment."<sup>4</sup>

**CSR Policies**

Corporate Social Responsibility (CSR) refers to operating a business in a manner that accounts for the social and environmental impact created by the business. CSR means a

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<sup>3</sup> "Making Good Business Sense" by Lord Holme and Richard Watts -The World Business Council for Sustainable Development publication .

<sup>4</sup> Business Social Responsibility, a global non-profit organization.



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## Corporate Governance and Corporate Social Responsibility

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commitment to developing policies that integrate responsible practices into daily business operations, and to reporting on progress made toward implementing these practices.

### Common CSR policies include:

- Adoption of internal controls reform in the wake of Enron and other accounting scandals;
- Commitment to diversity in hiring employees and barring discrimination;
- Management teams that view employees as assets rather than costs;
- High performance workplaces that integrate the views of line employees into decision-making processes;
- Adoption of operating policies that exceed compliance with social and environmental laws;
- Advanced resource productivity, focused on the use of natural resources in a more productive, efficient and profitable fashion (such as recycled content and product recycling); and
- Taking responsibility for conditions under which goods are produced directly or by contract employees domestically or abroad.

### 8.8 KEY DEVELOPMENTS

Several factors have converged over the last decade to shape the direction of the CSR domain:

**Increased Stakeholder Activism:** Corporate accounting scandals have focused attention more than ever on companies' commitment to ethical and socially responsible behaviour. The public and various stakeholders are increasingly seeking assistance of the private sector to help with myriad complex and pressing social and economic issues. There is a growing ability and sophistication of activist groups to target corporations they perceive as not being socially responsible, through actions such as public demonstrations, public exposes, boycotts, shareholders' resolutions, and even "denial of service" attacks on company websites. Companies are therefore focusing on meaningfully engaging with their various stakeholders. Companies and stakeholders have, in many cases, progressed beyond "dialogue for dialogue's sake," and are looking to rationalize the process.

**Proliferation of Codes, Standards, Indicators and Guidelines:** The recent accounting scandals, such as, Enron, Worldcome, Parmalat, AIR, LLP and Author Andersen have created another surge of reforms and new voluntary CSR standards and performance measurement tools continue to proliferate.

**Accountability Throughout the Value Chain:** Over the past several years, the CSR agenda has been characterized by the expansion of boundaries of corporate accountability.



Stakeholders increasingly hold companies accountable for the practices of their business partners throughout the entire value chain with special focus on suppliers, environmental, labour, and human rights practices.

**Transparency and Reporting:** Companies are facing increased demands for transparency and growing expectations that they measure, report, and continuously improve their social, environmental and economic performance. Companies are expected to provide access to information on the impact of their operations, to engage stakeholders in meaningful dialogue about issues of concern that are relevant to either party and to be responsive to particular concerns not covered in standard reporting and communication practice. Many companies are also instituting various types of audit and verification as further means of increasing the credibility of their transparency and reporting efforts. Increasingly, demands for greater transparency also encompass public policy - stakeholders want to know that the way companies use their ability to influence public policy is consistent with stated social and environmental goals. As part of this move toward greater disclosure, many companies are displaying detailed information about their social and environmental performance on their publicly accessible websites - even when it may be negative.

**Convergence of CSR and Governance Agenda:** In the past several years, there has been a growing convergence of corporate governance and CSR agenda. In the 1990s, the overlap was seen most clearly on issues such as board diversity, director independence, and executive compensation. The need for having on the board of directors, directors who are non-executive and who are independent i.e., directors who are not involved in the day-to-day administration of the company but who would bring a non-partisan and unbiased approach to a company's policies is emphasized by both CSR and Corporate Governance dictates. Similarly, the need for putting a reasonable cap on executive compensation, such that, the CEO and the top level executives do not reward themselves with excessively high pay packages and unreasonable stock options at the cost of shareholders' and stakeholders' interest is stressed by CSR and Corporate Governance regimes. More recently, an increasing number of corporate governance advocates have begun to view companies' management of a broad range of CSR issues as a fiduciary responsibility alongside traditional risk management. In addition, more and more CSR activists have begun to stress the importance of board and management accountability, governance, and decision-making structures as imperative to the effective institutionalisation of CSR.

**Growing Investor Pressure and Market-Based Incentives:** CSR is now more and more part of the mainstream investment scene. The last few years have seen the launch of several high-profile socially and/or environmentally screened market instruments (e.g., indexes like the Dow Jones Sustainability Indexes), This activity is a testament to the fact that mainstream investors increasingly view CSR as a strategic business issue. Many socially responsible investors are using the shareholder resolution process to pressure companies to change



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## Corporate Governance and Corporate Social Responsibility

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policies and increase disclosure on a wide range of CSR issues, including environmental responsibility, workplace policies, community involvement, human rights practices, ethical decision-making and corporate governance. Activist groups are also buying shares in targeted companies to give them access to annual meetings and the shareholder resolution process.

**Advances in Information Technology:** The rapid growth of information technology has also served to sharpen the focus on the link between business and corporate social responsibility. Just as email, mobile phones and the Internet speed the pace of change and facilitate the growth of business, they also speed the flow of information about a company's CSR record.

**Pressure to Quantify CSR “Return on Investment”:** Ten years after companies began to think about CSR in its current form, companies, their employees and customers, NGOs, and public institutions increasingly expect returns on CSR investments, both for business and society. This is leading to questions about how meaningful present CSR practice is, and the answers to those questions would determine both the breadth and depth of CSR practice for the next decade. Companies want to determine what their CSR initiatives have accomplished so that they can focus on scarce resources more effectively.

### 8.9 CSR MECHANISM

Some companies have established committees that are specifically responsible for identifying and addressing social or environmental issues, or have broadened the scope of more traditional standing committees to include responsibility for CSR.; while others have strategically appointed directors on the board based on the unique expertise and experience they bring on specific issues, who then serve as advisors to others on the Board (see Corporate Governance at ITC). Moreover, companies are finding that a board that is diverse in terms of gender, ethnicity and professional experience is better equipped to grapple with emerging and complex challenges.

Companies implement CSR by putting in place internal management systems that generally promote :

- ◆ Adherence to labour standards by them as well their business partners;
- ◆ Respect for human rights;
- ◆ Protection of the local and global environment;
- ◆ Reducing the negative impacts of operating in conflict zones;
- ◆ Avoiding bribery and corruption and;
- ◆ Consumer protection.

Each company differs in how it implements CSR. The distinction depends on such factors as the company's size, sector, culture and the commitment of its leadership. Some companies



focus on a single area – the environment, for example, or community economic development while others aim to integrate a CSR vision into all aspects of their operations. Below are some key strategies companies can use when implementing CSR policies and practices-

**Mission, Vision and Values Statements:** If CSR is to be regarded as an integral part of business decision-making, it merits a prominent place in a company's core mission, vision and values documents. These are simple but important statements that succinctly state a company's goals and aspirations. They also provide insight into a company's values, culture and strategies for achieving its aims. The mission or vision of a socially responsible business frequently refers to a purpose beyond "making a profit" or "being the best," and specifies that it will engage in ethical and responsible business practices, and seek to make decisions that balance the needs of key stakeholders, including shareholders/owners, employees, customers, suppliers communities and the natural environment.

**Cultural Values:** Many companies now understand that corporate social responsibility cannot flourish in an environment where innovation and independent thinking are not welcome. In a similar vein, there must also be a commitment to close the gap between what the company says it stands for and the reality of its actual performance. Goals and aspirations should be ambitious, but care should be exercised so that the company says what it means and means what it says.

**Management Structures:** The goal of a CSR management system is to integrate corporate responsibility concerns into a company's values, culture, operations and business decisions at all levels of the organization. Although there is no single universally accepted method for designing a CSR management structure, many companies have taken steps to create such a system by assigning responsibility to a committee of the Board, an executive level committee or a single executive or group of executives who can identify key CSR issues and evaluate and develop a structure for long-term integration of social values throughout the organization. It is vital to design a structure that aligns the company's mission, size, sector, culture, business structure, geographic locations, risk areas and level of CSR commitment.

**Strategic Planning:** A number of companies are beginning to incorporate CSR into their long-term planning processes, identifying specific goals and measures of progress or requiring CSR impact statements for any major company proposals.

**General Accountability:** In some companies, in addition to the efforts to establish corporate and divisional social responsibility goals, there are attempts to address these issues in the job description and performance objectives of employees. This helps everyone understand how each person can contribute to the company's overall efforts to be socially responsible.

**Employee Recognition and Rewards:** Most companies understand that employees tend to engage in behaviour that is recognized and rewarded and avoid behaviour that is penalized.



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## Corporate Governance and Corporate Social Responsibility

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The system of recruiting, hiring, promoting, compensating and publicly honouring employees can be designed to promote corporate social responsibility.

**Communications, Education and Training:** Many companies now recognize that employees cannot be held accountable for irresponsible behaviour if they are not aware of its importance and provided with the information and tools they need to act appropriately in carrying out their job requirements. These companies are emphasising the importance of corporate social responsibility internally, have a code of conduct, provide managers and employees with adequate decision-making processes that help them achieve responsible outcomes.

**CSR Reporting:** Many companies have come to understand the value of assessing their social and environmental performance on a regular basis. Annual CSR reports can build trust among stakeholders and encourage internal efforts to comply with a company's CSR goals. The best reports demonstrate CEO and senior leadership support; provide verified performance data for social, environmental and economic performance indicators; share "good" and "bad" news; set goals for improvement; include stakeholder feedback; and many times are verified by outside auditors. According to Sustainability's Global Reporters 2002 Survey, the Global Reporting Initiative has made it easier to produce such reports.

### 8.10 EXTERNAL STANDARDS AND OTHER DEVELOPMENTS

The increased interest in CSR has been accompanied by substantial growth in the number of external standards produced for business by governmental, non-governmental, advocacy and other types of organizations. These various standards are designed to support, measure, assist in implementation and enhance accountability for corporate performance on CSR issues. While many of the standards produced are based on a single issue (e.g., focused on environmental performance or corporate governance), others like Social Accountability 8000 address a range of CSR issues.

Various performance and reporting standards have been introduced. Some are explained below

**The Global Reporting Initiative:** is a reporting standard established in 1997 with the mission of designing globally applicable guidelines for preparing enterprise-level sustainability reports including both social and environmental indicators. The GRI is convened by CERES (Coalition for Environmentally Responsible Economies) incorporates the active participation of corporations, non-governmental organizations, international organizations, United Nations agencies, consultants, accountancy organizations, business associations, universities, and other stakeholders from around the world. The GRI first released its Sustainability Reporting Guidelines in 1999 and is now a permanent, independent, international body with a multi-stakeholder governance structure. The Global Reporting Initiative's (GRI) vision is that reporting on economic, environmental, and social performance by all organizations becomes as routine and comparable as financial reporting. GRI accomplishes this vision by developing,



continually improving, and building capacity around the use of its Sustainability Reporting Framework. An international network of thousands from business, civil society, labor, and professional institutions create the content of the Reporting Framework in a consensus-seeking process

**AA1000:** Launched in 1999, AA1000, based on John Elkington's triple bottom line (3BL) reporting is an accountability standard designed to complement the Global Reporting Initiative's (GRI) Reporting Guidelines with the objective to improve accountability and performance by learning through stakeholder engagement. The AA1000 Stakeholder Engagement Standard (AA1000SES) is a generally applicable, open-source framework for improving the quality of the design, implementation, assessment, communication and assurance of stakeholder engagement. The AA1000 Assurance Standard was launched in 2003 as the world's first sustainability assurance standard and applies to the principles of Materiality, Completeness and Responsiveness.

#### **CSR initiatives in India**

Indian companies like Tata and Birla Groups have regularly maintained since several decades a certain level of expenditure for social and charitable causes. Some of the observations made by the Sachar Committee (1978), which was formed by Govt. of India to consider and report on the changes necessary in the form and structure of the Companies Act and MRTP Act, observed that, "the company must behave and function as a responsible member of the society just like any other individual. It cannot shun moral values nor can it ignore actual compulsion ---." Though there are no Govt. directives or legal compulsions, some progressive companies in India like SAIL, BHEL, MMTC, and ONGC, etc., in the public sector and TISCO, ITC, BATA, etc., in the private sector have ventured into the field of social responsibility reporting since 1980. Companies like Infosys, Wipro, Hero Honda and Bharti Enterprises have taken various initiatives to promote and support the environment, education, health, cultural harmony and welfare in the society. The Infosys Foundation in the past has provided Rs 38 lakh of financial assistance to war widows in various parts of India. It has also been involved with the construction of a super speciality hospital and reconstruction of schools in Andhra Pradesh and Karnataka. The Azim Premji Foundation run by the Wipro chairman in his personal capacity is working on the universalizing elementary education and to improve the quality of learning in schools.

**Social Accountability 8000 :** Globalisation of business, whilst providing significant benefits to organisations, has brought new challenges and risks. As supply chains become more complex, it is increasingly difficult to ensure transparent management practices in every market. Recently, many high profile multi-nationals like Nike have been implicated in scandals involving the use of child labour, discriminatory work practices or enforced labour within their supply chains. Consumer pressure, NGO scrutiny and the media, amongst others, are all placing business under the microscope. SA 8000 is a comprehensive, global, verifiable





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performance standard for auditing and certifying compliance with corporate responsibility. The heart of the standard is the belief that all workplaces should be managed in such a manner that basic human rights are supported and that management is prepared to accept accountability for this. SA8000 is an international standard for improving working conditions. This standard is based on the principles of the international human rights norms as described in International Labor Organisation conventions, the United Nations Convention on the Rights of the Child and the Universal Declaration of Human Rights. The requirements of this standard apply regardless of geographic location, industry sector, or company size.

**United Nations Global Compact:** The Global Compact is a voluntary international corporate citizenship network initiated to support the participation of both the private sector and other social actors to advance responsible corporate citizenship and universal social and environmental principles to meet the challenges of globalization. The UN Global Compact was formally launched in September 2000. UN Secretary-General Kofi Annan called on world business leaders to voluntarily “embrace and enact” a set of nine principles in their individual corporate practices .

**Organisation for Economic Cooperation and Development (OECD) Guidelines for Multinational Enterprises:** The guidelines were first published in 1976 and updated most recently in June 2004. The guidelines are recommendations addressed by governments to multinational enterprises and are voluntary principles and standards, not legally enforceable. Governments adhering to the Guidelines encourage the companies operating within the countries to observe the guidelines wherever they operate.

**Benchmarks for Measuring Business Performance:** The Interfaith Centre on Corporate Responsibility (ICCR) has published “Principles for Global Corporate Responsibility,” which is not a standard but a “collective distillation of the issues of concern” for institutional investors developed by groups in the U.S., Canada, and the U.K. The ICCR is comprised of more than 275 religious institutions that use their investments to promote social change. The principles cover the entire spectrum of CSR issues, including workplace, community, the environment, human rights, ethics, suppliers and consumers. The principles are published as a reference tool that companies (and investors) can use to benchmark or monitor their own policies, or those of the companies in which they invest.

**The Caux Round Table (CRT) :** promotes principled business leadership and the belief that business has a crucial role in identifying and promoting sustainable and equitable solutions to key global issues affecting the physical, social and economic environments. The CRT is comprised of senior business leaders from Europe, Japan and North America, and is based in Caux, Switzerland. The CRT has produced “Principles for Business,” a document which seeks to express a worldwide standard for ethical and responsible corporate behaviour for dialogue and action by business and leaders worldwide. The principles include the social impact of company operations on the local community, a respect for rules and ethics, support for



multilateral trade agreements that promote the “judicious liberation of trade,” respect for the environment and “avoidance of illicit operation,” including bribery, money laundering, and other corrupt practices.

**The Global Sullivan Principles:** Introduced in 1999, the Global Sullivan Principles expand upon the original Sullivan Principles, which were developed by the late Reverend Leon H. Sullivan in 1977 as a voluntary code of conduct for companies doing business in apartheid South Africa. According to Rev. Sullivan, “The objectives of the Global Sullivan Principles are to support economic, social and political justice by companies where they do business; to support human rights and to encourage equal opportunity at all levels of employment, including racial and gender diversity on decision-making committees and boards; to train and advance disadvantaged workers for technical, supervisory and management opportunities; and to assist with greater tolerance and understanding among peoples; thereby, helping to improve the quality of life for communities, workers and children with dignity and equality.”

**Asian-Pacific Economic Cooperation (APEC) Business Code of Conduct:** APEC is known as the primary international organization for promoting open trade and economic cooperation among 21 member countries. The Code, issued as a draft in 1999, is a standard that draws significantly on a variety of other internationally recognized codes and standards. The drafting of the Code was initiated by business leaders from companies operating in APEC countries and is designed to supplement and support companies’ existing codes of conduct. In addition to providing recommendations for specific “company action” on a range of issues, the Code addresses policy recommendations to APEC country governments.

### **8.11 BENEFITS OF CORPORATE SOCIAL RESPONSIBILITY**

Corporate social responsibility is the commitment of businesses to behave ethically and to contribute to sustainable economic development by working with all relevant stakeholders to improve their lives in ways that are good for business, the sustainable development agenda, and society at large. Social responsibility becomes an integral part of the wealth creation process - which if managed properly should enhance the competitiveness of business and maximize the value of wealth creation to society. There is a growing body of data, quantitative and qualitative, that demonstrates many benefits of socially responsible corporate performance.

#### **The Iron Law of Responsibility**

The institution of business exists only because it performs invaluable services for society. Society gives business its license to exist and this can be amended or revoked at any time if it fails to live up to society’s expectations. Therefore, if a business intends to retain its existing social role and power, it must respond to society’s needs constructively. This is known as the Iron Law of Responsibility. In the long-run those who do not use power in a manner that society considers responsible, will tend to lose it.



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## Corporate Governance and Corporate Social Responsibility

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### **Achievement of long term objectives**

Businesses have been delegated economic power and have access to productive resources of a community. They are obliged to use those resources for the common good of society which delegated these to them to generate more wealth for its betterment. Technical and creative resources of a business if applied to social problems can help in resolving them. A business organisation, sensitive to community needs would, in its own self-interest, like to have a better community in which to conduct its business. To achieve that, it would implement special programmes for social welfare. The resulting benefits would be:

- ◆ Decrease in crime
- ◆ Easier labour recruitment.
- ◆ Reduced employee turnover and absenteeism.
- ◆ Easier access to international capital, better conditions for loans on international money markets.
- ◆ Dependable and preferred as supplier, exporter/importer, retailer of responsibly manufactured components and products.

A better society would produce a better environment in which the business may gain long-term *profit maximisation*.

### **Enhanced Brand Image and Reputation:**

Customers are drawn to brands and companies with good reputations. A company considered socially responsible can benefit both from its enhanced reputation with the public as well as its reputation within the business community, increasing a company's ability to attract capital and trading partners. Proactive CSR practices would lead to a favourable public image resulting in various positive outcomes like consumer and retailer loyalty, easier acceptance of new products and services, niche market access and preferential allocation of investment funds.

### **Checks Government Regulation /Controls**

Regulation and control are costly to business, both in terms of energy and money and restrict its flexibility of decision-making as failure of businessmen to assume social responsibilities invites government to intervene and regulate or control their activities. Businessmen have learnt that once a government control is established, it is seldom removed even though the warranting conditions change. If these are the facts, then the prudent course for business is to understand the limit of its power and to use that power responsibly, giving government no opportunity to intervene. By their own socially responsible behaviour, they can prevent government intervention.



### **Helps minimise Ecological Damage**

The effluents of many businesses damage the surrounding environment. By their own socially responsible behaviour, they can prevent government intervention if they are proactive in recognising their ecological responsibility towards society. Companies recognize that a strategy for corporate responsibility can play a valuable role not only in meeting the challenges of globalization by mitigating risks domestically and internationally, but also in providing benefits beyond risk management.

### **Improved Financial Performance**

Business and investment communities have long debated whether there is a real connection between socially responsible business practices and positive financial performance. In the last decade an increasing number of studies have been conducted to examine this link. A DePaul University study in 2002 showed that overall financial performance of the 2001 Business Ethics Best Citizen companies was significantly better than that of the remaining companies in the Standard and Poor (S&P) 500 Index, based on the 2001 Business Week ranking of total financial performance. The ranking was based on eight statistical criteria, including total return, sales growth, and profit growth over the one-year and three-year periods, as well as net profit margins and return on equity.

### **Reduced Operating Costs**

Some CSR initiatives can reduce operating costs dramatically. For example, many initiatives aimed at improving environmental performance, such as reducing emissions of gases that contribute to global climate change or reducing use of agrochemicals also lower costs. Many recycling initiatives cut waste-disposal costs and generate income by selling recycled materials. In the human resources arena, flexible scheduling and other work-life programs that result in reduced absenteeism and increased retention of employees often save costs through increased productivity and reduction of hiring and training costs.

### **Increased Sales and Customer Loyalty**

A number of studies have suggested a large and growing market for the products and services of companies perceived to be socially responsible. While businesses must first satisfy customers' key buying criteria, such as price, quality, availability, safety and convenience; studies also show a growing desire to buy (or not buy) because of other values-based criteria, such as "sweatshop-free" and "child-labour-free" clothing, lower environmental impact, and absence of genetically-modified materials or ingredients.

### **Increased Productivity and Quality of Work life**

Efforts to improve working conditions, lessen environmental impacts or increase employee involvement in decision-making often lead to increased productivity and reduced error rate in a company. For example, companies that improve working conditions and labour practices



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## Corporate Governance and Corporate Social Responsibility

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among their suppliers often experience a decrease in merchandise that is defective or can't be sold.

### **Increased Ability to Attract and Retain Employees**

Companies perceived to have strong CSR commitments often find it easier to recruit and retain employees, resulting in a reduction in turnover and associated recruitment and training costs. Even in difficult labour markets, potential employees evaluate a company's CSR performance to determine whether it is the right "fit".

To further illustrate the points discussed above, as an example, the corporate governance structure of ONGC Ltd. is provided below. The Corporate Governance Structure of ONGC has been chosen to be included, as ONGC has received many awards for best Corporate Governance practices. The structure of this company also complies with Clause 49 requirements as provided in the SEBI's Listing Agreements.

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### **CORPORATE GOVERNANCE AT ONGC LTD. (as taken from their Website)**

#### **Purpose**

ONGC management continues to strive for excellence in good governance and responsible management practices, benchmarking with best of global companies.

ONGC has been practicing corporate governance principles much before it became mandatory. The company believes that for a company to be successful it must maintain global standards of corporate conduct towards its stakeholders. The company believes that it is rewarding to be better managed and governed and to identify its activities with national interest.

The company views corporate governance in its widest sense almost like a trusteeship, a philosophy to be progressed, a value to be imbibed and an ideology to be ingrained into the corporate culture. It is not merely compliance and simply a matter of creating checks and balances; it is an ongoing measure of superior delivery of company's objectives with a view to translate opportunities into reality. It involves leveraging its resources and aligning its activities to national need, shareholders benefit and employee growth, thereby delighting all its stakeholders, while minimizing the risks. The primary objective is to create and adhere to a corporate culture of conscience and consciousness, transparency and openness, fairness, accountability, propriety, equity, sustainable value creation, ethical practices and to develop capabilities and identify opportunities that best serve the goal of value creation, thereby creating an outperforming organization.



### **Corporate Governance Recognized**

In recognition of excellence in Corporate Governance, the following awards have been conferred on ONGC:

- 'Golden Peacock Award for Excellence in Corporate Governance - 2002' by the Institute of Directors;
- 'ICSI National Award for Excellence in Corporate Governance' - 2003 by the Institute of Company Secretaries of India; and
- 'Golden Peacock Global Award' for Corporate Governance in Emerging Economies -2005 by World Council for Corporate Governance, U.K.
- 'Golden Peacock Award for Excellence in Corporate Governance - 2005' by the Institute of Directors;
- 'Golden Peacock Award for Excellence in Corporate Social Responsibility in Emerging Economies' 2006 - by World Council for Corporate Governance, UK.

'Golden Peacock Award for Excellence in Corporate Governance - 2006' by Institute of Directors.

### **Composition, Meeting And Attendance**

The Company is managed by the Board of Directors, which formulates strategies, policies and reviews its performance periodically. The Chairman & Managing Director (CMD) and six whole-time Directors manage the business of the Company under the overall supervision, control and guidance of the Board.

#### **Composition**

The Board of Directors has an adequate combination of Executive (Functional) and Non-executive Directors. The Board has 14 members, comprising of 7 Functional Directors including the Chairman & Managing Director. Besides, the Board comprises of 6 non-executive Directors comprising of: 2 part-time official Directors and 4 part-time non-official Directors, all nominated by Government of India.

Decisions and deliberations of the Board are supported by various committees of the Board.



## **Board Procedures**

### **(A) Institutionalised decision making process:**

With a view to institutionalize all corporate affairs and setting up systems and procedures for advance planning for matters requiring discussion/ decisions by the Board , the Company has defined guidelines for the meetings of the Board of Directors and Committees thereof. These Guidelines seek to systematize the decision making process at the meetings of Board/Committees, in an informed and efficient manner.

### **(B) Recording minutes of proceedings at the Board Meeting:**

Minutes of the proceedings of each Board/Committee meeting are recorded. Draft minutes are circulated amongst all members of the Board/ Committee for their critical appreciations and comments. The comments are incorporated in the minutes, which are finally approved by the Chairman of the Board/Committee. These minutes are confirmed in the next Board/Committee Meeting. The finalized minutes of the proceedings of the meetings are entered in the Minutes Book.

### **(C) Follow-up mechanism:**

The guidelines for the Board/Committee Meetings facilitate an effective post meeting follow-up, review and reporting process for the action taken on decisions of the Board and Committee. Functional Directors submit follow-up Action Taken Report (ATR) on the areas of their responsibilities, at least once in a quarter, on the decisions/ instructions/directions of the Board.

### **(D) Compliance:**

Every functional Director while preparing the agenda notes is responsible for and is required to ensure adherence to all the applicable provisions of law, rules, guidelines etc. The Company Secretary has to ensure compliance to all the applicable provisions of the Companies Act, 1956, Secretarial Standards issued by ICSI, SEBI Guidelines, Listing Agreement, and other statutory requirements pertaining to capital market. A Quarterly Compliance Report (collected from all work centers) confirming adherence to all the applicable laws, rules, guidelines and internal instructions/manuals including on Corporate Governance is reviewed by the Audit & Ethics Committee and the Board.



**The Company has the following Committees of the Board:**

**Audit & ethics committee**

The terms of reference of the Audit & Ethics Committee are in accordance with Section 292 of the Companies Act, 1956 and the guidelines set out in Clause 49 of the Listing Agreement.

The Committee is headed under the stewardship of Shri P.K.Choudhury, *an Independent non-executive Director* w.e.f. 11<sup>th</sup> September, 2006. Shri Choudhury has multifarious and enriched experience of more than 35 years in Finance and Banking. Prior to above, the Committee was headed by Shri M.M.Chitale, a Fellow Member and past president of the Institute of Chartered Accountants of India. All members of the Committee have requisite financial and management experience and have held or hold senior positions in other reputed organisations.

Company Secretary acts as the Secretary to the Committee.

**The role of the Audit & Ethics Committee includes the following:**

- a) Overseeing financial reporting processes and the disclosure of financial information, to ensure that the financial statements are correct, sufficient and credible;
- b) Recommending to the Board, audit fees payable to Statutory Auditors appointed by C&AG and approving payments for any other services;
- c) Reviewing with management the periodic financial statements/results before submission to the Board, focusing primarily on:
  - o matters required to be included in the Directors' Responsibility Statement ;
  - o any changes in accounting policies and practices;
  - o major accounting entries based on exercise of judgement by the management;
  - o qualifications in draft audit report;
  - o significant adjustments arising out of the audit;
  - o the going concern assumption;
  - o compliance with accounting standards;
  - o compliance with listing agreement and legal requirements concerning financial statements;
  - o any related party transactions i.e. transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives etc. that may have potential conflict with the interest of the company at large;





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- d) Reviewing with the management, Statutory Auditors, Govt. Audit and Internal audit reports, adequacy of internal control systems and recommending improvements to the management;
- e) Reviewing the adequacy of internal audit function, approving internal audit plans and efficacy of the functions including the structure of the internal audit department, staffing, reporting structure, coverage and frequency of internal audits;
- f) Discussion with internal auditors any significant findings and follow-up thereon;
- g) Reviewing the findings of any internal investigations by the internal auditors into the matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the Board;
- h) Discussion with the Statutory Auditors before the audit commences, the nature and scope of audit, as well as post-audit discussion including their observations to ascertain any area of concern;
- i) Reviewing the Company's financial and risk management policies;
- j) Reviewing Quarterly Compliance Report confirming adherence to all the applicable laws, rules, guidelines, instructions and internal instructions/manuals including on Corporate Governance principles;
- k) Reviewing the management discussion and analysis of financial condition and results of operations, statement of significant related party transactions, management letters/letter of internal control weaknesses issued by the statutory auditors, internal audit reports; and
- l) Reviewing the financial statements and in particular the investments made by the unlisted subsidiaries of the Company.
- m) Matters relating to Corporate Governance including Ethics in business.

Minutes of the meetings of the Audit & Ethics Committee are approved by the Chairman of the Committee and are noted and confirmed by the Board in its next meeting.

### **Remuneration committee**

ONGC being a Government Company, appointment and terms and conditions of remuneration of Executive (whole-time functional) Directors are determined by the Government through administrative ministry, the Ministry of Petroleum & Natural Gas. Non-executive part-time official Directors (ex-officio) do not draw any remuneration. The Part-time non-official Directors receive sitting fees of Rs. 10,000/- for each Board/Committee meeting attended by them.



### **Shareholders' / Investors' grievance committee**

The Shareholders' / Investors' Grievances Committee specifically looks into redressing of shareholders' and investors' complaints/grievances pertaining to share transfers, non receipt of annual reports, dividend payments, issue of duplicate certificates, transmission (with or without legal representation) of shares and other miscellaneous complaints. The Committee oversees and reviews performance of the Registrar and Transfer Agent and recommends measures for overall improvement in the quality of investor services. The Committee also monitors implementation and compliance of Company's Code of Conduct for Prevention of Insider Trading in ONGC securities.

The Company Secretary acts as Secretary to the Committee.

Minutes of the meetings of the Shareholders' / Investors' Grievance Committee are approved by the Chairman of the Committee and are noted and confirmed by the Board in its next meeting.

### **Human Resource Management committee**

The terms of reference include consideration of all issues / areas concerning Human Resource Planning & Management, HR policies & Initiatives and Promotions from E6 to E7 and above level.

Minutes of the meetings of the Human Resource Management Committee are approved by the Chairman of the Committee and are noted and confirmed by the Board in the ensuing Board Meeting.

### **Project Appraisal committee**

The Project Appraisal Committee examines and makes recommendations to the Board on projects/capital investment exceeding Rs.150 Crore. Proposals exceeding Rs.150 Crore are appraised in-house, while the proposals exceeding Rs.250 Crore are first appraised by outside technical and financial consultants. It monitors IOR / EOR Schemes.

Minutes of the meetings of the Project Appraisal Committee are approved by the Chairman of the Committee and are noted and confirmed by the Board in the ensuing Board Meeting.

### **Share Transfer committee**

In order to expedite the process of share transfers and other related activities, the Share Transfer Committee has been empowered to approve the requests received for share transfer/ transmission/ transposition, issue of duplicate share certificates, sub-division, consolidation, re-materialization, change of status etc. These requests are processed through the Registrar & Share Transfer Agent, M/s Karvy Computershare Private Ltd. generally once in a fortnight. The details of transfers are reported to the Board of Directors at the ensuing meeting.

Minutes of the meetings of the Share Transfer Committee are circulated to the members of the Committee and the Board is kept apprised.



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### **Health, Safety & Environment committee**

The terms of reference includes review of policy, processes and systems on Safety, Health, Environment and Ecology aspects.

### **Financial Management Committee**

The mandate includes to look into the matters pertaining to Budget , Delegation of powers (Empowerment) Commercial Issues, Forex and Treasury Management, Investments, Risk Management, Capital Structure, Issue of Securities, Short & Long Term Loans, periodical Performance Review of subsidiaries.

Minutes of the meetings of the Financial Management Committee are circulated to the members of the Committee and the Board is kept apprised.

### **Business Development Committee**

In order to oversee new areas of business, proposals for collaborations, Joint Ventures, amalgamation, mergers and acquisitions; commercial matters including marketing etc. a Committee has been constituted. Director (Human Resource) is the Convener-Member of the Committee.

### **Other Functional committee**

Apart from the above, the Board also from time to time, constitute Functional Committees with specific terms of reference as it may deem fit. Meetings of such Committees are held as and when need for discussing the matter concerning the purpose arises.

Time schedule for holding the meetings of such functional committee(s) are finalized in consultation with the Committee Members. Minutes of the meetings of all such functional Committees are circulated to the members of the Committee and the Board is kept apprised.

### **Code of conduct for members of the board and senior management**

The Company is committed to conducting business in accordance with the highest standards of business ethics and complying with applicable laws, rules and regulations. A code of conduct, evolved in line with the industry practices was adopted by the Board on the recommendations of Audit and Ethics Committee and all Members of the Board and Senior Management i.e. 'Key Executives' have confirmed compliance with the Code of Conduct for the year under review. A copy of the Code has been placed on the Company's website [www.ongcindia.com](http://www.ongcindia.com).

### **ONGC Code On Insider Trading**

In pursuance of the Securities and Exchange Board of India ((Prohibition of Insider Trading) Regulations, 1992 (duly amended), the Board has approved the "Code of Conduct for Prevention of Insider Trading". The objective of the Code is to prevent purchase and/or sale of shares of the Company by an Insider on the basis of unpublished price sensitive information. Under this Code, insiders (Directors, Advisors, Key Executives, Designated Employees and other concerned persons) are prohibited to deal in the Company's shares during the closure of



Trading Window. To deal securities, beyond specified limit permission of Compliance Officer is also required. All Directors/Advisors/Officers/designated employees are also required to disclose related information periodically as defined in the code, which in turn is being forwarded to the stock exchanges. Company Secretary has been designated as the Compliance Officer.

#### **CEO/CFO Certification**

In terms of revised Clause 49 of the Listing Agreement, the certification by the CEO/CFO on the financial statements and internal controls relating to financial reporting has been obtained.

#### **Subsidiary Monitoring Framework**

All subsidiaries of the Company are Board managed with their Boards having the rights and obligations to manage such companies in the best interest of their stakeholders. As a majority shareholder, the Company nominates its representatives on the Boards of subsidiary companies and monitors the performance of such companies periodically.

The Company has wholly-owned unlisted non-material subsidiary companies. In terms of Clause 49.III (ii) and (iii) of the Listing Agreement, their performance has been reviewed by the Audit and Ethics Committee and the Board by the following means:

a) Financial Statements for the year/period ended 31st March, 2007, in particular the investments made by the unlisted subsidiary companies, are reviewed by the Audit and Ethics Committee;

*(source: website:[www.ongcindia.com](http://www.ongcindia.com))*

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#### **References:**

*website:[www.ongcindia.com](http://www.ongcindia.com)*

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#### **8.12 SELF-EXAMINATION QUESTIONS**

1. Explain the principles of Corporate Governance.
2. Trace the key developments of Corporate Governance in India and abroad.
3. Write Short notes on
  - (a) Responsibilities of an organisation
  - (b) Benefits of CSR
  - (c) Global Reporting Initiative
4. Explain the major developments shaping the exponential growth of CSR.
5. List the various ways in which a business could integrate corporate social responsibility in to its business strategy and decision making framework.

# CHAPTER 9

## WORKPLACE ETHICS

### Learning Objectives

After reading this chapter , you will be able to understand -

- ◆ The role and importance of ethical behaviour at the workplace
- ◆ Ethical dilemmas of the individual
- ◆ Discriminatory practices and harassment in organisations
- ◆ Measures to ensure ethics in the workplace

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*It's the action, not the fruit of the action, that's important. You have to do the right thing. It may not be in your power, may not be in your time, that there'll be any fruit. But that doesn't mean you stop doing the right thing. You may never know what results come from your action. But if you do nothing, there will be no result."*

**MAHATMA GANDHI**

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### 9.1 INTRODUCTION

Gandhi's ethics of *khadi* (homespun cloth) is closely linked with *swadeshi*. To him it meant a specific form of home-industry to counter the exploitation inherent in the more imperialistic forms of capitalism. Today industrialisation is an irreversible fact; but in our context *khadi* may certainly be interpreted to mean the intimate relation between a man and his work - the demand that a man should bear responsibility for his work in order to lend it dignity; and that he should share in the fruits of his labour. In other words - no man should be exploited in his work or alienated through his work.

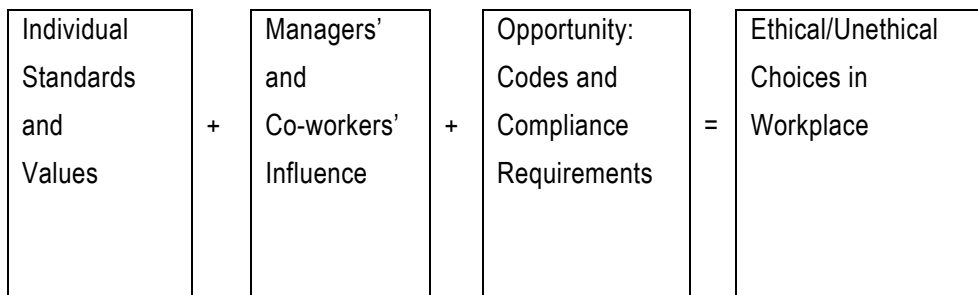
Public concerns about ethical practices in business usually relate to issues like fraud and embezzlement, accepting bribes or lying. Well publicized incidents of unethical activities ranging from financial scams to deceptive advertising of food and beverages to unfair competitive practices strengthen the public perception that ethical standards in business need to be improved. Ensuring the presence of sound values and ethics is a vital and ongoing part



of good governance in organizations and an integral part of good management practices. “Workplace ethics” is how one applies values to work in actual decision making - a set of right and wrong actions that directly impact the workplace. They are an extension of the personal standards or lack of them that is intrinsic in the people who comprise the workplace. It is about making choices that may not always feel good or seem beneficial but are the “right” choices to make.

## **9.2 FACTORS INFLUENCING ETHICAL BEHAVIOUR AT WORK**

Ethical decisions in an organization are influenced by three key factors: individual moral standards, the influence of managers and co-workers, and the opportunity to engage in misconduct. While one may have great control over personal ethics outside the workplace, co-workers and management through authority for example, exerts significant control on ones choices at work. In fact, the activities and examples set by co-workers, along with rules and policies established by the firm, are critical in gaining consistent ethical compliance in an organization. If a company fails to provide good examples and direction for appropriate conduct; confusion and conflict will develop and result in the opportunity for unethical behaviour. For example if the boss or co-workers leave work early, one may be tempted to do so as well. If one sees co-workers making personal long-distance phone calls at work and charging them to the company, then one may be more likely to do so also. In addition, having sound personal values contributes to an ethical workplace.



**Factors Influencing Workplace Ethics**

### **THE INDIVIDUAL**

An ethical issue is an identifiable problem, situation or opportunity that requires a person to choose from several actions which could be evaluated as right or wrong. For example, should a salesperson omit the fact of frequent replacement of the filter while selling a kitchen chimney to a prospective customer? When does offering a gift to a customer become a bribe rather than a sales promotion? There are no easy answers. An individual's ethical behaviour affects not only his or her reputation within the company, but may also contribute to the way in which



the company is perceived by others. Values reflect enduring beliefs that one holds that influences attitudes, actions, and the choices one makes. As individuals, our values are shaped by our personal beliefs. Values developed in childhood and youth are constantly tested and on-the-job decisions reflect the employee's understanding of ethical responsibility. Various socio-psychological factors could be responsible why individuals could develop negative attitudes or lose personal motivation.

- ◆ Negative work or life experiences.
- ◆ Employees failing to respect each others unique personalities.
- ◆ Overly aggressive financial or business targets.
- ◆ Pressures to perform and take quick decisions

Some examples of ethical issues faced by an individual in the workplace are:

- (1) *Relationships with suppliers and business partners:*
  - (a) Bribery and immoral entertainment
  - (b) Discrimination between suppliers
  - (c) Dishonesty in making and keeping contracts
- (2) *Relationship with customers*
  - (a) Unfair pricing
  - (b) Cheating customers
  - (c) Dishonest advertising
  - (d) Research confidentiality
- (3) *Relationship with employees*
  - (a) Discrimination in hiring and treatment of employees
- (4) *Management of resources*
  - (a) Misuse of organisational funds
  - (b) Tax evasion

### 9.3 ETHICAL ISSUES

As discussed earlier, an ethical dilemma exists when one is faced with having to make a choice among perplexing alternatives. Very often, business ethics is depicted as a matter of resolving conflicts in which one option appears to be the clear choice. However, ethical dilemmas faced by managers are highly complex with no clear guidelines due to alternatives that are equally justifiable, and involves significant interest of many "stakeholders" in given situation.



An individual's ethical concerns are about relationships and responsibilities at the workplace where correct decisions are not perfectly clear, and there are no hard and fast rules to follow. One set of relationships and responsibilities is directly related to employees, and include such areas as discipline, performance appraisal, safety, and the administration of reward systems. Another set is concerned with customers and suppliers, and include the intricate aspects of such elements as timing, quality, and price. Ethical dilemmas also arise when there are conflicts in values with superiors or peers over such things as strategy, goals, policy, and administration. Mainly ethical issues can be categorized in the framework of their relation with business associates, conflicts of interest, fairness and honesty, and communications.

### **Business Relationships**

The behaviour of businesspersons toward customers, suppliers, and others in their workplace may also generate ethical concerns. Ethical behaviour within a business involves keeping company secrets, meeting obligations and responsibilities, and avoiding undue pressure that may force others to act unethically.

Managers, in particular, because of the authority of their position, have the opportunity to influence employees' actions. For example, a manager can influence employees to use pirated computer software to save costs. The use of illegal software puts the employee and the company at legal risk, but employees may feel pressured to do so by their superior's authority. Customer's need should be considered most when it comes to ethical business practices. In the long run, a company will reap great profits from a customer base that feels it is being treated fairly and truthfully. Organizational pressures may encourage a person to engage in activities that he or she might otherwise view as unethical, such as invading others' privacy or stealing a competitor's secrets.

### **Conflicts Of Interest**

A conflict of interest exists when a person must choose whether to advance his or her own personal interests or those of the organisation. Seven former executives of Daewoo, a South Korean conglomerate were arrested on charges of fraud and embezzlement. Prosecutors charged that the executives raised \$20 billion by taking out illegal foreign exchange loans and pooling funds from company subsidiaries through falsified import/export documents. A bribe is a conflict of interest because it benefits an individual at the expense of an organization or society. Wal-Mart Stores, Inc., may have the toughest policy against conflict of interest in the retail industry. Sam Walton, the late founder of Wal-Mart, prohibited company buyers from accepting so much as a cup of coffee from suppliers. To avoid conflicts of interest, employees must be able to separate their personal financial interests from their business dealings.

Conflicts of interest need not be financial. For example, "if my son is working in a company that manufactures the type of tools that my organisation purchases, I have an interest in seeing him succeed and may be motivated to give him my company's business even although other firms may offer better terms.





### **Fairness and honesty**

Fairness and honesty are at the heart of business ethics and relate to the general values of decision makers. At a minimum, businesspersons are expected to follow all applicable laws and regulations. But beyond obeying the law, they are expected not to harm customers, employees, clients, or competitors knowingly through deception, misrepresentation, coercion, or discrimination. One aspect of fairness and honesty is related to disclosure of potential harm caused by product use. For example, Mitsubishi Motors, a Japanese automaker, faced criminal charges and negative publicity after executives admitted that the company had systematically covered up customer complaints about tens of thousands of defective automobiles over a 20-year period in order to avoid expensive and embarrassing product recalls. Another aspect of fairness relates to competition. Although numerous laws have been passed to foster competition and make monopolistic practices illegal, companies sometimes gain control over markets by using questionable practices that harm competition. Rivals of Microsoft, for example, accused the software giant of using unfair and monopolistic practices to maintain market dominance with its Internet Explorer browser.

### **Communications**

Communications is another area in which ethical concerns may arise. False and misleading advertising, as well as deceptive personal-selling tactics, anger consumers and can lead to the failure of a business. Truthfulness about product safety and quality are also important to consumers. The Food and Drug Regulatory authorities need to ensure that customers are told the truth about product safety, quality, and effectiveness claims. Some manufacturers fail to provide enough information to consumers about differences or similarities between products. For example, a lawsuit filed by consumers against Johnson claimed that the company's Acuvue and 1-Day Acuvue contact lenses were actually the same product. Consumers were directed by the company to dispose of the 1-Day Acuvue lenses after one day's use. The suit claims that because the two products were identical, the lenses could have been worn up to two weeks. It is estimated that six million people who used contact lenses spent \$1.1 billion on unnecessary replacements because of the company's misleading advertising. Johnson & Johnson agreed to pay up to \$860 million to settle the complaints. Another important aspect of communications that may raise ethical concerns relates to product labelling. It is mandatory for cigarette manufacturers to indicate clearly on cigarette packing that smoking cigarettes is harmful to the smoker's health.

### **9.4 DISCRIMINATION**

The root meaning of the term discriminate is "to distinguish one object from another." Discrimination is treating people differently. It is usually intended to refer to the wrongful act of making a difference in treatment or favor on a basis other than individual merit. Employment discrimination is treating one person better than another because of their age, gender, race, religion or other protected class status. Another approach to the morality of discrimination that



also views it as a form of injustice is based on the formal "principle of equality": Individuals who are equal in all respects relevant to the kind of treatment in question should be treated equally even if they are dissimilar in other non relevant respects. Although many more women, minorities and physically challenged are entering formerly male-dominated jobs, they still face problems that they would characterize as forms of discrimination.

**Discrimination in employment involves three basic elements.**

- ◆ First, it is a decision against one or more employees (or prospective employees) that is not based on individual merit, such as the ability to perform a given job, seniority, or other morally legitimate qualifications.
- ◆ Second, the decision derives solely or in part from racial or sexual prejudice, false stereotypes, or some other kind of morally unjustified attitude against members of the class to which the employee/s belongs.
- ◆ Third, the decision (or set of decisions) has a harmful or negative impact on the interests of the employees, perhaps costing them jobs, promotions, or better pay.

Arbitrarily giving some individuals less of an opportunity, to compete for jobs than others is unjust. Discrimination in employment is wrong because it violates the basic principle of justice by differentiating between people on the basis of characteristics (race or sex) that are not relevant to the tasks they must perform.

It is consequently understandable that the law has gradually been changed to conform to these moral requirements, and that there has been a growing recognition of the various ways in which discrimination in employment occurs. Among the practices now widely recognized as discriminatory are the following:

**Recruitment Practices** Firms that rely solely on the word-of-mouth referrals of present employees to recruit new workers tend to recruit only from those racial and sexual groups that are already represented in their labor force. Also, when desirable job positions are only advertised in media that are not used by minorities or women or are classified as for men only, recruitment would also tend to be discriminatory.

**Screening Practices** Job qualifications are discriminatory when they are not relevant to the job to be performed (e.g., requiring a high school diploma or a credential for an essentially manual task.). Job interviews are discriminatory if the interviewer routinely disqualifies certain class of people - for example assumptions about occupations "suitable for women" or the propriety of putting women in "male "environments.

**Promotion Practices:** Promotion, job progression, and transfer practices are discriminatory when employers place males on job tracks separate from those open to women and minorities.. When promotions rely on the subjective recommendations of immediate supervisors.

**Conditions of Employment :** Many times wages and salaries are discriminatory to the extent that equal wages and salaries are not given to people who are doing essentially the same



work. Another issue is related to fair wages and treatment to workers. Companies subcontracting manufacturing operations abroad are now aware of the ethical issues associated with supporting facilities like child labour that abuse and/or underpay their work forces. Such facilities have been termed "sweatshops." Maximizing profits is often the motivation behind a company's decision to utilize sweatshops. Nike was accused in 2001 of not only failing to fulfil many of its promises but also of intimidating sweatshop workers from speaking out about abuses. Three years ago, Nike chief executive Phil Knight promised sweatshop reform, including ending child labour and paying factory workers a living wage.

**Dismissal** : Firing an employee on the basis of his or her race or sex is a clear form of discrimination. Less blatant but still discriminatory are layoff policies that rely on a seniority system, in which women and minorities have the lowest seniority because of past discrimination.

### 9.5 HARASSMENT

Harassment is "tormenting by subjecting to constant interference or intimidation." Law prohibits harassing acts and conduct that "creates an "intimidating, hostile or offensive working environment" which could be a term or condition of an individual's employment, either explicitly or implicitly or such conduct which has the purpose or effect of unreasonably interfering with an individual's work performance or creating an intimidating, hostile or offensive working environment.

Another type of harassment is sexual harassment - situations in which an employee is coerced into giving into another employee's sexual demands by the threat of losing some significant job benefit, such as a promotion, raise, or even the job. This kind of degrading coercion exerted on employees who are vulnerable and defenseless inflicts great psychological harm on the employee, violates the employee's most basic right to freedom and dignity and is an unjust misuse of the unequal power that an employer can exercise over the employee. Sexual harassment is prohibited, and an employer is held responsible for all sexual harassment engaged in by employees, "regardless of whether the employer knew or should have known" the harassment was occurring and regardless of whether it was "forbidden by the employer."

According to The Supreme Court definition, in Vishaka Vs. State of Rajasthan & Others, sexual harassment is any unwelcome sexually determined behaviour, such as - physical contact, a demand or request for sexual favours, sexually coloured remarks, showing pornography and any other physical, verbal or non-verbal conduct of a sexual nature. In this judgment, the Supreme Court also held that employers/institutions employing women employees must mandatorily constitute a Sexual Harassment Redressal Committee.

The Members of the Committee should have the desired qualities viz., Subjectivity and Empathy.



## **9.6 IMPORTANCE OF ETHICAL BEHAVIOUR AT THE WORKPLACE**

An organization, whether a business or a government agency, is first and foremost a human society. If an employer does not take steps to create a work environment where the employees have a clear, common understanding of what is right and wrong, and feel free to discuss and ask questions about ethical issues and report violations, significant problems could arise, including:

- ◆ Increased risk of employees making unethical decisions
- ◆ Increased tendency of employees to report violations to outside regulatory authorities (whistle blowing) because they lack an adequate internal forum
- ◆ Inability to recruit and retain top people
- ◆ Diminished reputation in the industry and the community
- ◆ Significant legal exposure and loss of competitive advantage in the marketplace.

### **The Tata Group & Business Ethics**

The ethos of the Tata Group can be captured in their Founder's, Jamshetji Tata's words, "We think we started with sound and straightforward business principles, considering the interests of the shareholders, our own and the health and welfare of the employees the sure foundation of our success." JRD Tata always said that his model in whatever he did in business was Jamshetji Tata and that whenever he needed inspiration, he would read about his life. Tata Steel paid homage to them by no better means than reinforcing and institutionalising the values and beliefs so strongly cultivated and nurtured by them. July 2004 was celebrated as Ethics Month which began with reinforcing the values by each employee taking Ethics Pledge. Realising the usefulness of Ethics education among students, the Company encouraged the school students of the city to pay homage to JRD Tata by taking Ethics Oath. Continuous endeavours were made to reinforce these values among all stakeholders. Knowledge Manthan on Business Ethics with employees and vendors was conducted for greater involvement of employees and vendors in Company's Management of Business Ethics (MBE) Programme. The values and Code of Conduct were further strengthened by developing policies like Gift Policy, Whistleblower Policy, Vendor Action Policy etc. The Company provided more channels for reporting to facilitate whistleblowers to raise their concerns. The stakeholders are encouraged to voice their concerns through web-based channels e.g. e-Procurement site for vendors, e-Sales for customers etc. The senior citizens (ex. employees) of the Company are also given access to Company's website with a facility for them to send their views to Ethics Counsellor. Senior Leadership team demonstrates ethical behaviour by 'walking the talk' or by being the role model themselves. They discuss ethical issues in forums like General Dialogues, Senior Dialogues, etc. where Company's Executives are invited to share their view on various subjects. The effectiveness of communication and development measures is evaluated by analysis of the concerns received and also by various surveys conducted by internal and external agencies. These measures show that MBE system is fully in place in the Company.



## 9.7 GUIDELINES FOR MANAGING ETHICS IN THE WORKPLACE

The focus on core values and sound ethics, the hallmark of ethical management, is being recognized as an important way to ensure the long-term effectiveness of governance structures and procedures, and avoid the need for whistle-blowing. Whistle blowing is the public/private exposure of corrupt, illegal or unethical PRACTICES operating in an ORGANIZATION, usually on the part of an individual member, though sometimes by a body responsible for overseeing the organization which lacks the AUTHORITY or POWER to impose penalties for wrongdoing.

Employers who understands the importance of workplace ethics, provide their workforce with an effective framework and guiding principles to identify and address ethical issues as they arise.

- (1) Codes of Conduct and Ethics : A code of ethics specifies the ethical rules of operation in an organization. Codes of conduct specify actions in the workplace and codes of ethics are general guides to decisions about those actions, Examples of topics typically addressed by codes of conduct include: preferred style of dress, avoiding illegal drugs, following instructions of superiors, being reliable and prompt, maintaining confidentiality, not accepting personal gifts and so on Codes are insufficient if intended only to ensure that policies are legal. All staff must see the ethics program being driven by top management.
- (2) Establish Open Communication : Instead of just creating and distributing an ethics policy, it is important that take the time to explain the reasons for the policy and review the guidelines and conduct formal or informal training to further sensitise employees to potential ethical issues. Many of the ethical problems arising in a business are not clear-cut, but involve "grey areas," where the proper course of action may be ambiguous and uncertain. It is necessary to create a work environment where employees understand that it is acceptable to have an ethical dilemma, and give workers the resources to help resolve such situations.
- (3) Make ethics decisions in groups, and make these decisions public. This usually produces better quality decisions by including diverse interests and perspectives, and increases the credibility of the decision process and outcome by reducing suspicion of unfair bias.
- (4) Integrate ethics management with other management practices. When developing the values statement during strategic planning, include ethical values preferred in the workplace. When developing personnel policies, reflect on what ethical values you'd like to be most prominent in the organization's culture and then design policies to produce these behaviours.
- (5) Use of cross-functional teams when developing and implementing the ethics management program. It's vital that the organization's employees feel a sense of participation and ownership in the program if they are to adhere to its ethical values. Therefore, include employees in developing and operating the program.
- (6) Appointing an ombudsperson: The ombudsperson is responsible to help coordinate development of the policies and procedures to institutionalise moral values in the workplace. This establishes a point of contact where employees can go to ask questions



in confidence about the work situations they confront and seek advice.

- (7) Creating an atmosphere of trust is also critical in encouraging employees to report ethical violations they observe. This function might best be provided by an outside consultant, e.g., lawyer, clergy person, counsellor etc. Or, provide a “tip” box in which personnel can report suspected unethical activities, and do so safely on an anonymous basis.
- (8) Regularly update policies and procedures to produce behaviours preferred from the code of conduct, job descriptions, performance appraisal forms, management-by-objectives expectations, standard forms, checklists, budget report formats, and other relevant control instruments to ensure conformance to the code of conduct. There are numerous examples of how organizations manage values through use of policies and procedures. For example, we are most familiar with the value of social responsibility. To instil behaviours aligned with this value, organizations often institute policies such as recycling waste, donating to charities or paying employees to participate in community events. In another example, a high value on responsiveness to customers might be implemented by instituting policies to return phone calls or to repair defective equipment within a certain period of time.
- (9) Include a grievance policy for employees to use to resolve disagreements with supervisors and staff.
- (10) Set an example from the top: Executives and managers not only need to endorse strict standards of conduct, but should also ensure that they follow it themselves. They must stress to employees that dishonest or unethical conduct will not be tolerated, and that they are expected to report any wrongdoing they encounter; showing through actions as well as words that the company relies on, rather than discriminates against, those who come forward concerning ethical breaches.

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**9.10 SELF-EXAMINATION QUESTIONS**

1. What are the various factors that influence ethical behaviour of an employee?
2. Describe various ethical issues encountered in a workplace.
3. Write short notes on:
  - (i) Harassment
  - (ii) Discriminatory practices
3. The employee’s main moral duty is to work toward the goals of the organisation and avoid any activities that might harm those goals. Elaborate.

# CHAPTER 10

## ENVIRONMENT & ETHICS

### Learning Objectives

After reading this chapter, you will be able to-

- ◆ Explain the Concept of Sustainable Development
- ◆ Understand the Effects of Pollution and Resource Deletion
- ◆ Understand the importance of Conservation of Natural Resources
- ◆ Explain Eco friendly Business Practices

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*"Once the last tree is cut and the last river poisoned, you will find you cannot eat your money."*

**(Proverb)**

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### 10.1 INTRODUCTION

The Prayer "*Sarvatra Sukhinah Santu Sarve Santu Niramayah;*" 'Let all be happy here and let all enjoy full health' of Vedic Sages echoed universal welfare. The earthly life constituted the central concern for the Vedic Aryans. The sacrificial fire-rites which were evolved during Vedic period had social welfare as its motto, the motive was to prepare the land for agriculture for abundance and welfare of human race. Gandhiji said "There's enough on this planet for everyone's needs but not for everyone's greed."

Industrial and technological development has provided us with material prosperity but has also created unique environmental threats to us and to future generations. As the twenty-first century begins, several well-established environmental trends are shaping the future of civilization - rising pollution, global warming, falling water tables, shrinking forests, and the loss of plant and animal species. The extent of the environmental damage produced by present and projected industrial technology makes one wonder how long this kind of development would be sustainable.



## **10.2 SUSTAINABLE DEVELOPMENT**

The Concept of sustainable development was brought into focus by <sup>1</sup>Brundtland Report, which stated that economic growth has to be environmentally sustainable. There is no economic growth without ecological costs. One must realize that increased development and higher GNP are related to environmental damage and resource depletion. Therefore, an element of resource regeneration and positive approach to environment have to be incorporated in developmental programmes. Literally sustainable development refers to maintaining development over time. Most widely cited definition of sustainable development is <sup>2</sup>"Development that meets the needs of the present without compromising the ability of future generations to meet their own needs." A nation or society should satisfy its requirements – social, economic and others – without jeopardizing the interest of future generations.

High economic growth means high rate of extraction, transformation and utilization of non-renewable resources. There is no doubt that twenty first century markets shall be driven by the requirements of sustainable environments.

## **10.3 POLLUTION AND RESOURCE DEPLETION**

*Pollution* refers to the undesirable and unintended contamination of the environment by the manufacture or use of commodities. *Resource depletion* refers to the consumption of finite or scarce resources. In a certain sense, pollution is also a type of resource depletion because contamination of air, water, or land diminishes their beneficial qualities.

**Air Pollution:** Air pollution has increased exponentially as industrialization expanded. The most prevalent forms of air pollution are the gases and particulates spewed out by autos and industrial processes, which affect the quality of the air we breathe. One of the worst industrial disasters of all time occurred in Union Carbide's plant in Bhopal on the night of December 3, 1984. The accidental release of methyl-isocyanate in the congested, low-income district of Old Bhopal killed 3,000 people and left many thousand more with chronic disabilities leading to premature deaths.

Air pollutants also affect vegetation decreasing agricultural yields, deteriorate exposed construction materials through corrosion, discoloration, and rot, are hazardous to health and life and threaten disastrous global damage in the form of global warming, destruction of the stratospheric ozone layer and acid rains.

*Global Warming:* Greenhouse gases - carbon dioxide, nitrous oxide, methane, and chlorofluorocarbons, occur naturally in the atmosphere to absorb and hold heat from the sun, preventing it from escaping back into space, to keep the earth's temperature about 33°C

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<sup>1</sup> Report of Brundtland Commission – 'Our Common future', 1987

<sup>2</sup> World Commission on Environment and Development, 1987





warmer than it would otherwise be, so that life can evolve and flourish. However, industrial, and other human activities during the last 50 years have released substantially more greenhouse gases into the atmosphere, particularly by the burning of fossil fuels such as oil and coal rising the levels of greenhouse gases and resulting in increasing amounts of heat, raising temperatures around the globe. Average global temperatures are now at least 1°C higher than in 1900 and are expected to rise by upto 4.5°C during this century. This rising heat will expand the world's deserts; melt the polar ice caps, causing sea levels to rise; make several species of plants and animals extinct; disrupt farming; and increase the distribution and severity of diseases. Bodies of water such as lakes and oceans will warm, and this will dramatically shift the geographical distribution of fish and other marine species and increase the frequency and magnitude of droughts. The increase in levels of greenhouse gases would require reducing current emissions of greenhouse gases by 60 to 70 percent-an amount that would seriously damage the economies of both developed and developing nations.

To restrict current rates of emission of greenhouse gases, the international community signed two agreements namely, The United Nations Framework Convention on Climate Change in the year 1992 and a follow-up agreement called Kyoto Protocol in the year 1996. Under the Kyoto Protocol industrial countries (developed countries) have committed to cut their combined emission to 5% below the 1990 levels between the year 2008 to 2012.

In August, 2008 over 1600 participants representing Governments, Businesses and civil society undertook the United Nations Accra Climate Change Talks to identify targets for the period beyond Kyoto Protocol target dates, that is for the period beyond 2008 – 2012.

*Ozone Depletion* : A layer of ozone in the lower stratosphere screens all life on earth from harmful ultraviolet radiation. This ozone layer, however, is destroyed by CFC gases, which have been used in aerosol cans, refrigerators, air conditioners, industrial solvents, and industrial foam blowers. When released into the air, CFC gases rise; in 7 to 10 years, they reach the stratosphere, where they destroy ozone molecules and remain for 75 to 130 years, continuing all the while to break down additional ozone molecules. Shrinking of the ozone layer. This results in the subsequent increase of ultraviolet rays which could cause several hundred thousand new cases of skin cancer and could also lead to considerable destruction of the 75 percent of the world's major crops that are sensitive to ultraviolet light.

But ozone depletion has been minimized with adoption of the Vienna Convention on ozone depletion in the year 1985 and Montreal Protocol on substances that deplete the ozone layer in the year 1989. Under these two international agreements various Governments had restricted the use of CFC gases by the business houses within their national borders. It is believed that if the international agreement is adhered to, the ozone layer is expected to recover by 2050. Due to its widespread adoption and implementation it has been hailed as an examples of exceptional international cooperation with Kofi Annan (former U.N. Secretary General) quoted as saying of the Montreal Protocol that is perhaps the single most successful international agreement to date.



*Acid Rain* : Like global warming, acid rain is a threat to the environment that is closely related to the combustion of fossil fuels (oil, coal, and natural gas), which are heavily used by utilities to produce electricity. Burning fossil fuels, particularly coal containing high levels of sulphur, releases large quantities of sulphur oxides and nitrogen oxides into the atmosphere. When these gases are carried into the air, they combine with water vapour in clouds to form nitric acid and sulphuric acid. These acids are then carried down in rain, which often falls hundreds of miles away from the original sources of the oxides raising the acidity of the water sources. It also soaks into soils and falls directly on trees and other vegetation. Numerous studies have shown that many fish populations and other aquatic organisms are unable to survive in lakes and rivers that have become highly acidic due to acid rain. Other studies have shown that acid rain directly damages forests and indirectly destroys the wildlife and species that depend on forests for food and breeding. Acidic rainwater can also contaminate drinking water. Acid rain can corrode and damage buildings, statues, and other objects, particularly those made of iron, limestone, and marble.

**Water Pollution** : In 1985, about 11,000 oil spills, involving about 24 million gallons of oil, were recorded in and around U.S. In the past, the oceans have been used as disposal sites for intermediate and low-level radioactive wastes. Oceanographers have found traces of plutonium, cesium, and other radioactive materials in seawater that have apparently leaked from the sealed drums in which radioactive wastes are disposed.

Although water is essential to human life as well as to industrial growth and development, the world's per capita supplies of water are shrinking and are now 30 percent smaller than 25 years ago. A number of factors have contributed to this. An increase in population and economic activity particularly in urban areas, has resulted in increased demands for water. To meet these demands, water is being increasingly diverted from agricultural irrigation to provide water for cities.

**Land Pollution:**

*Solid Wastes*: Each year people living in cities produce tons of solid wastes every year. City garbage dumps are significant sources of pollution, containing toxic substances such as cadmium (from rechargeable batteries), mercury, lead (from car batteries and TV picture tubes), vanadium, copper, zinc.

*Hazardous or toxic substances*: are those that can cause increase in mortality rates or irreversible or incapacitating illness or those that have other seriously adverse health or environmental effects. Benzene is a common industrial toxic chemical used in plastics, dyes, nylon, food additives, detergents, drugs, fungicides, and gasoline. Benzene workers are several times more likely than the general population to get leukemia. Vinyl chloride is another common industrial chemical used in the production of plastics, which is released in small



amounts when plastic products deteriorate, causes liver damage; birth anomalies; liver, respiratory, brain, and lymph cancers, and bone damage Basel Convention 1992.

### **DEPLETION OF FOSSIL FUELS**

Fossil fuels depletion at an exponentially rising rate results in the loss of forest habitats. Combined with the effects of pollution it has led to the extinction of a phenomenal number of species and the danger of many existing species disappearing forever.

### **10.4 ECOLOGICAL ETHICS**

The problem of pollution and other environmental issues can best be framed in terms of our duty to recognize and preserve the ecological systems within which we live. An ecological system is an interrelated and interdependent set of organisms and environments, such as a lake, in which the fish depend on small aquatic organisms, which in turn live off decaying plant and fish waste products. Since the various parts of an ecological system are interrelated, the activities of one of its parts will affect all the other parts. Business firms (and all other social institutions) are parts of a larger ecological system. Business firms depend on the natural environment for their energy, material resources, and waste disposal, and that environment in turn is affected by the commercial activities of business firms. For example, the activities of 18<sup>th</sup> century European manufacturers of beaver hats led to the wholesale destruction of beavers (a semi aquatic large furry rodent) in the United States, which in turn led to the drying up of the innumerable swamp lands that had been created by beavers. Unless businesses recognize the interrelationships and interdependencies of the ecological systems within which they operate and unless they ensure that their activities will not seriously injure these systems one cannot hope to deal with the problem of pollution.

Ecological ethics is based on the idea that the environment should be protected not only for the sake of human beings but also for its own sake. The issue of environmental ethics goes beyond the problems relating to protection of environment or nature in terms of pollution, resource utilization or waste disposal. It is the issues of exploitive human nature and attitudes that should be addressed in a rational way. Problems like Global warming, Ozone depletion and disposal of hazardous wastes that concern the entire world. They require International cooperation and have to be tackled at the global level.

### **10.5 CONSERVATION OF NATURAL RESOURCES**

*Conservation* refers to the saving or rationing of natural resources for later uses. Conservation, therefore, looks primarily to the future: to the need to limit consumption now to have resources available for tomorrow. In a sense, pollution control is a form of conservation. Pollution "consumes" pure air and water, and pollution control "conserves" them for the future. Consequently, our concern over the depletion of resources is primarily a concern for future generations. Conservation, therefore, is the only way of ensuring a supply for tomorrow's generations.



### **Business and Environmental Ethics**

Few decades ago, the corporate world, the industry or others engaged in the use of natural resources or environmental services were mainly concerned with good business in economic sense. Concern for environment and resource depletion was not on their agenda; if conservation of resources was required it was with a motive of mere economic gains or profits.

Not only in India but all over the world, there is now a growing concern for Social responsibility and ethical norms in all spheres of human activities; be it public behaviour, business or environment and there are ethical concerns to look after not only the interest of stakeholders but also that of community; as the regulatory / mandatory requirements have also become more stringent. This translates into providing safety for the workers at workplace, concern for their health, reducing pollution and incorporating environmental values in governance.

Environmental ethics is a larger issue that concerns ethical behaviour of all types of organisations ranging from International bodies, national governments, opinion makers, media, intelligentsia, public and private enterprises and NGOs. In India many companies have come to realize that ethical practices make good business sense especially the organisations engaged in exports as these organisations have to satisfy the importer in regard to the quality, ethics and environmental standards.

#### **10.6 DEVELOPMENTS IN INDIA**

The Chipko movement in India is a proof of people's concern about balance in ecosystem when in 1973 they embraced the trees to prevent their felling by the government. In India especially the big cities are having the problem of air pollution on account of concentration of industries and power plants. Also the automobiles are proving to be the greatest challenge for abatement of air pollution.

In pursuant to the Stockholm Conference, India passed the Air (Control and Prevention of Pollution) Act 1981. The Factories Act, 1948 as amended by the Act of 1987 contains provisions for preventing pollution.

Under the Motor Vehicles Act and Rules framed there under stringent measures are stipulated to prevent air pollution Earlier also air-pollution measures were enacted through:

1. The Factories Act, 1948.
2. The Industries (Development and Regulation) Act, 1951.
3. Mines and Minerals (Regulation and Development) Act, 1957.

#### **10.7 ECO FRIENDLY BUSINESS PRACTICES**

Business and Industry are closely linked with environment and resource utilization. Production process and strategy for eco-friendly technologies throughout the product life cycle and



minimization of waste play major role in protection the environment and conservation of resources. Business, Industry and multinational corporations have to recognize environmental management as the priority area and a key determinant to sustainable development. Sound management of wastes is among the major environmental issues for maintaining the quality of Earth's environment and achieving sustainable development. Accordingly, waste management is to be done through following systems.

- (i) Minimum production of waste.
- (ii) Maximizing reuse of waste and recycling.
- (iii) Promoting environmentally sound waste disposal practices.

Economic progress and environmental protection is not a conflicting proposition. If companies redesign products and adopt latest technologies available; they can achieve the goals of reduction in wastage and resources depletion. This requires a new thinking and strategies in respect of environment-business relationship. A change is needed at all levels starting from organisational structure, finance, manufacturing, marketing, operations, accounting and other related disciplines. Some enlightened leaders of industry and trans national corporations are implementing certain policies that show environmental concern- viz. Environment Impact Assessment (EIA) and Environmental Audits. Some businesses have realized that implementation of environmental standards like ISO 14001 can provide competitive advantage like TQM did in 1980's and 1990's. Environmental consideration have become a part of corporate strategy, which means incorporating environmental issues in the process of developing a product, in new investments and in the organisational set up. A good environmental practice improves corporate performance. In many industries it has been found that environmental friendly practices have resulted in more savings; for example the process of recycling the waste. Thus environmental considerations play a key role in corporate strategy. Markets of new millennium will be able to create wealth if they respond to the challenges of sustainable development as unsustainable products will become obsolete.

Business must therefore make environmental ethic an integral part of their corporate goal, taking care that their practices, processes, and products conserve energy and resources and have a minimum impact on ecosystems.

Industries that are based on natural resources, like minerals, timber, fibre, and foodstuffs, etc. have a special responsibility for:

1. adopting practices that have built-in environmental consideration.
2. introducing processes that minimize the use of natural resources and energy, reduce waste, and prevent pollution;
3. making products that are "environment-friendly", with minimum impact on people and ecosystem.



4. Green accounting systems: Conventional accounts may result in policy decisions which are non-sustainable for the country. Green accounting on the other hand is, focused on addressing such deficiencies in conventional accounts with respect to the environment. If the environmental costs are properly reflected in the prices paid for goods and services then companies and ultimately the consumer would adjust market behaviour in a way that would reduce damage to environment, pollution and waste production. Price signal will also influence behaviour to avoid exploitation or excessive utilization of natural resources. Such measures would facilitate the approach of "Polluter Pay Principle". Removing subsidies that encourage environmental damage is another measure.

There is no doubt, that with the public opinion moving towards accountable socio-economic structures, ethical and eco-friendly business practices would be standard corporate norms.

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**10.8 SELF-EXAMINATION QUESTIONS**

1. Economic growth should be environmentally sustainable. Elaborate
2. Describe the main forms of pollution and resource depletion and their detrimental effects.
3. Business is a part of the ecological System. Elaborate.
4. What are the benefits of environmentally friendly business practices?
5. Write short notes on
  - (i) Sustainable development
  - (ii) Impact of climate change
  - (iii) Green accounting systems

# CHAPTER 11

## ETHICS IN MARKETING AND CONSUMER PROTECTION

### Learning Objectives

- ◆ To know the ethical dilemmas in marketing
- ◆ To understand the reasons for marketing ethical behaviour
- ◆ To learn the initiatives taken in India towards promoting healthy competition
- ◆ To know the distinction between protecting consumers interest and public interest
- ◆ To know the initiatives taken by the United Nations towards Consumers Welfare

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*Next to doing the right thing, the most important thing is to let people know you are doing the right thing.*

**JOHN D. ROCKEFELLER**

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### 11.1 ETHICS AND MARKETING

The task of marketers is to influence the behaviour of customers. To accomplish this goal, marketers have a variety of tools at their disposal. Broadly speaking, these tools include the design of a product, the price at which it is offered, the message used to describe it, and the place in which it is made available.

Ethics are standards of moral conduct. To act in an ethical fashion is to conform to an accepted standard of moral behavior. Undoubtedly, virtually all people prefer to act ethically. It is easy to be ethical when no hardship is involved – when a person is winning and life is going well. The test comes when things are not going well – when pressures build. These pressures arise in all walks of life, and marketing is no exception.

Marketing executives face the challenge of balancing their own best interests in the form of recognition, pay, and promotion, with the best interests of consumers, their organizations, and society into a workable guide for their daily activities. In any situation they must be able to distinguish what is ethical from what is unethical and act accordingly, regardless of the possible consequences.



## **11.2 ETHICAL GUIDELINES**

Many organizations have formed codes of ethics that identify specific acts (bribery, accepting gifts) as unethical and describe the standards employees are expected to live up to. Over 90 per cent of the Fortune 1,000 companies have ethics codes, as do many smaller businesses. These guidelines lessen the chance that an employee will knowingly or unknowingly violate a company's standards. In addition, ethics codes strengthen a company's hand in dealing with customers or prospects that encourage unethical behavior. For young or inexperienced executives, these codes can be valuable guides, helping them to resist pressure to compromise personal ethics in order to move up in the firm.

However, every decision cannot be taken out of the hands of the manager. Furthermore, determining what is right and what is wrong can be extremely difficult. It is not realistic for an organization to construct a two-column list of all possible practices, on headed "ethical" and the other "unethical." Rather, a marketer must be able to evaluate a situation and formulate a response.

## **11.3 BEHAVING ETHICALLY IN MARKETING**

Marketing executives should practice ethical behavior because it is morally correct. While this is simple and beautiful in concept, it is not sufficient motivation for everyone. So let's consider four pragmatic reasons for ethical behavior:

- ◆ **To reverse declining public confidence in marketing.** Periodically we hear about misleading package labels, false claims in ads, phony list prices, and infringements of well established trademarks. Though such practices are limited to only a small proportion of all marketing, the reputations of all marketers are damaged. To reverse this situation, business leaders must demonstrate convincingly that they are aware of their ethical responsibility and will fulfill it. Companies must set high ethical standards and enforce them. Moreover, it is in management's interest to be concerned with the well-being of consumers, since they are the lifeblood of a business.
- ◆ **To avoid increases in government regulation.** Our economic freedoms sometimes have a high price, just as our political freedoms, do. Business apathy, resistance, or token responses to unethical behavior simply increase the probability of more government regulation. Indeed, most of the governmental limitations on marketing are the result of management's failure to live up to its ethical responsibilities at one time or other. Moreover, once some form of government control has been introduced, it is rarely removed.
- ◆ **To regain the power granted by society.** Marketing executives wield a great deal of social power as they influence markets and speak out on economic issues. However,





there is responsibility tied to that power. If marketers do not use their power in a socially acceptable manner, that power will be lost in the long run.

- ◆ **To protect the image of the organization.** Buyers often form an impression of an entire organization based on their contact with one person. More often than not, that person represents the marketing function. You may base your opinion of a retail store on the behavior of a single sales clerk. As Procter & Gamble put it in an annual report: "When a Procter & Gamble sales person walks into a customer's place of business that sales person not only represents Procter & Gamble, but in a very real sense, that person is Procter & Gamble."

#### 11.4 HEALTHY COMPETITION AND PROTECTING CONSUMER'S INTEREST

##### Competition – Challenges and Changes

Globalisation and progressive liberalization of trade during the last decade opened a widening atmosphere giving rise to certain inevitable tasks and challenges for every country around the globe. It therefore became imperative for many countries to have a new line of rethinking on the existing pattern of policies on trade, customs and usages. The World Trade Organisation's (WTO) treaties and agreements, their implications on trade and commerce have already compelled many countries to review their competitiveness of trade and economic policies not only within their economy but across the frontiers of other countries also. In India, in the recent years, the corporate and economic reforms and policies had pervasive effects on the structure of domestic trade and competition. The law which was originally enacted to deal with market and competition (i.e., the Monopolies and Restrictive Trade Practices Act, 1969) addressed the problems concerning Monopolistic, Restrictive and Unfair Trade Practices only. There was no genesis to a comprehensive competition policy since then. Given the fact that the structure of world economy and trade has taken rapid strides and undergone vast changes, India has been taking adequate steps for integrating itself with the new changes and challenges thereby market functioning, positioning becomes effective and competitive. In this regard, Government constituted a High Level Committee on Competition Policy and Law on 15.10.1999 under the Chairmanship of Mr. S.V.S. Raghavan, to recommend a legislative framework relating to Competition Law including mergers and demergers. The Committee submitted its report on 22<sup>nd</sup> May 2000. The Government, after considering the report and suggestions from various organizations, institutions and general public, introduced the Competition Bill in the Parliament. This Bill became an Act after receiving assent from the President on 13<sup>th</sup> January 2003 and a few sections of the Act have already come into force by virtue of two separate Government notifications [i.e., S.O.340 (E) dated 31<sup>st</sup> March, 2003 and S.O.715 (E) dated 19<sup>th</sup> June, 2003]. This Act extends to the whole of India except the State of Jammu and Kashmir.



### **What is Competition?**

A broad definition of Competition is “a situation in a market in which firms or sellers independently strike for the buyers’ patronage in order to achieve a particular business objective, for example profit, sales or market share” (World Bank, 1999). A pre-requisite for a good competition is trade, trade is the unrestricted liberty of every man to buy, sell and barter, when, where and how, of whom and to whom he pleases. For a free market to be in existence the handicap is that for a given distribution of income of those who can pay the highest price will most be able to purchase the goods regardless their relative needs. However, the real culprit is income distribution system and not the competitive system. In an unregulated free market, in certain circumstances it could be of greater benefit to the owner to withhold goods from market in order to extract a higher price. Despite the efforts to regulate prices which have been unsuccessful, the caution in a free market as compared to the problems in an unregulated market can be overcome by posturing competition by which the ultimate *raison de’ etre* of competition, namely the, interest of the consumer can be protected.

### **Competition Policy and Law**

The Competition Policy is regarded as genus, of which, the Competition Law is specie. Competition Law provides necessary powers to the commission to enforce and implement the Competition Policy. The central economic goal of the Competition Policy is the preservation and promotion of the competitive process. It is a symbolic process, which encourages efficiency in the production and allocation of goods and services over a period of time through its effects on innovation and adjustment to technological change. In conditions of effective competition, competitors will be having equal opportunities to compete for their own economic interest and therefore the quality of their outputs and resource deployment will be given top priority in order to sustain and succeed in the market by meeting consumers’ demand at the lowest possible cost.

### **Competition Laws in UK and US**

There are three major federal anti-trust laws in United States namely the Sherman Anti-trust Act, the Clayton Act and the Federal Trade Commission Act.

The Sherman Act passed in 1890 was the first Federal Anti-Trust Laws. The Act aimed at restraint of trade and monopolisation of Inter-State and Foreign Commerce.

The Clayton Act is a civil statute (carrying no criminal penalties, was passed in 1914 and significantly amended in 1950). The Act is the result of failure of the Sherman Act to stop the trend towards concentration in the American economy. It attempts to nip monopolise in the bud by specifying practices that monopolists used to gain monopoly power.

The Federal Trade Commission Act, 1914 prohibits unfair methods of competition in Inter-State Commerce but carries no criminal penalties. However, there was Federal Trade



Commission to monitor violations of the Act. Thus, in US basically anti-trust laws protect competition by ensuring free and open competition, which bring benefits to consumers by way of lower prices, new and better products.

The UK Competition Act, 1988 which came into force in March 1, 2000 is based upon the Competition Law of the European Commission. The Act prohibited agreements, which have the object of preventing, restricting or distorting competition which directly or indirectly fix prices, trading conditions, limit or control production, markets or sources of supply.

The Enterprise Act introduced the next major reform of UK Competition Law, 2002 which concentrated on a new regime for the assessment of mergers and markets in the UK. The third and final stage of reform process in the UK Competition Law will be the implementation of European Commission, which is a radical modernisation of UK's Competition Policy. To regulate the competition and its practices, most of the countries have the competition authority commonly known as the Competition Commission.

#### **Competition Act, 2002**

The Competition Act, 2002 intends to provide, keeping in view of the economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto. The renewed efforts of the Government in implementing a Competition Act, 2002 is a laudable step in the right direction and a new beginning in the frontiers of India's Competition Policy towards harmonizing international trade and policy.

#### **Parameters of Competition Law**

- ◆ **Prohibition of certain agreements**, which are considered to be anti-competitive in nature. Such agreements [namely tie in arrangements, exclusive dealings (supply and distribution), refusal to deal and resale price maintenance] shall be presumed as anti-competitive if they cause or likely to cause an appreciable adverse effect on competition within India.
- ◆ **Abuse of dominant position** by imposing unfair or discriminatory conditions or limiting and restricting production of goods or services or indulging in practices resulting in denial of market excess or through in any other mode are prohibited.
- ◆ **Regulation of combinations** which cause or likely to cause an appreciable adverse affect on competition within the relevant market in India is also considered to be void.

#### **Consumer - [Section 2(f). Competition Act, 2002]**

"Consumer" means any person who—



- (i) buys any goods for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any user of such goods other than the person who buys such goods for consideration paid or promised or partly paid or partly promised, or under any system of deferred payment when such use is made with the approval of such person, whether such purchase of goods is for resale or for any commercial purpose or for personal use;
- (ii) hires or avails of any services for a consideration which has been paid or promised or partly paid and partly promised, or under any system of deferred payment and includes any beneficiary of such services other than the person who hires or avails of the services for consideration paid or promised, or partly paid and partly promised, or under any system of deferred payment, when such services are availed of with the approval of the first-mentioned person whether such hiring or availing of services is for any commercial purpose or for personal use;

It is noteworthy that the definition of consumer is substantially the same has given to the expression under Section 2(d) of the consumer protection Act, 1986. The difference is that under clause (i), in the Competition Act, it uses the words “whether such purchase of goods is for the resale of for any commercial purpose or for personal use” in places of the words “but does not include a person who obtains such goods for resale of for any commercial purpose”, as in the Consumer Protection Act. Likewise, in clause (ii), the words used in the Competition Act are “whether such hiring or availing of services is for any commercial purpose or for personal use” in place of the words “but does not include a person who avails of such services for any commercial purpose” as in the Consumer Protection Act. Thus, the interpretation of “consumer” in the Consumer Protection Act will be the same as in Competition Act. In the latter, “consumer” will also include a person who purchases goods for resale or for any commercial purpose or for personal use.

#### **CONSUMER INTEREST AND PUBLIC INTEREST**

1. Often, consumer interest and public interest are considered synonymous. But they are not and need to be distinguished. In the name of public interest, many Governmental policies are formulated which are either anti-competitive in nature or which manifest themselves in anti-competitive behaviour. If the consumer is at the fulcrum, consumer interest and consumer welfare should have primacy in all Governmental policy formulations.
2. Consumer is a member of a broad class of people who purchase, use, maintain and dispose of products and services. Consumers are affected by pricing policies, financing practices, quality of goods and services and various trade practices. They are clearly distinguishable from manufacturers, who produce goods and wholesalers or retailers, who sell goods.



3. Public interest, on the other hand, is something in which society as a whole has some interest, not fully captured, by a competitive market. It is an externality. However, there is a justifiable apprehension that in the name of “public interest”, Governmental policies may be fashioned and introduced which may not be in the ultimate interest of the consumers. The asymmetry arises from the fact that all producers are consumers but most are producers as well. What is desirable for them in one capacity may be inimical in the other capacity. A simple example will make the point clear. A farmer wants the price of goods he consumes to be as cheap as possible but wants the highest price for his produce. A Government wishing to encourage agriculture for self-sufficiency in food as a national security measure faces the conflict: should it support high prices to encourage production or low prices to protect the consumer? This is a characteristic public interest-consumer interest conflict. In general, it can be stated that buyers want competition and sellers monopoly. The economists’ answer is that there are in a society too many such divergent interests and therefore the resolution is best left to markets without Government intervention. They are all too conscious of the possibility of abuse of the expression “public interest” by vested interests.

### **Competition and Consumer Welfare**

Competition means rivalry in the marketplace, which is regulated by a set of policies and laws to achieve the goals of economic efficiency and consumer welfare, and to check on the concentration of economic power. All these goals have an interactive relationship and, when in harmony, deliver total welfare. Indeed, it is the consumers who are supposedly the biggest beneficiaries of competition. On the other hand, it is the consumers who are the main losers due to anti-competitive activities in a market. The consumers are worse off because of their lack of capacity to deal with such problems.

It is sometimes believed that competition policy and law are tools for the rich, the urban, and industries alone. However, at the macro level, the design and implementation of a competition policy promotes the advancement and increased welfare of the poor. At the micro level, an effective competition regime or consumer law (covering competition distortions) can prevent consumer abuses, both at industry level as well as in a village or locality where one shopkeeper can cheat the whole community. An appropriate and dynamic competition policy and law are imperative to buttress economic development, curb corruption, reduce wastage and arbitrariness, improve competitiveness and provide succour to the poor.

Before we embark on assessing the consumer welfare implications, it is important to understand the notion of consumer welfare. Unfortunately, there is no agreed definition of consumer welfare. Even so, one can have a fair understanding of the notions surrounding consumer welfare by looking at the United Nations Guidelines for Consumer Protection, adopted by the UN General Assembly in 1985, and amended in 1999. These guidelines



represent an international regulatory framework for governments to use, for the development and strengthening of consumer protection policy and legislation, aimed at promoting consumer welfare.

The UN Guidelines call upon governments to develop, strengthen and maintain a strong consumer policy, and provide for enhanced protection of consumers by enunciating various steps and measures around eight themes (UNCTAD, 2001). These eight themes are:

1. Physical safety
2. Economic interests,
3. Standards
4. Essential Goods and services
5. Redress
6. Education and information
7. Specific areas concerning health
8. Sustainable consumption

The Guidelines have implicitly recognized eight consumer rights, which were made explicit in the Charter of Consumers International as follows:

- ◆ Right to basic needs
- ◆ Right to safety
- ◆ Right to choice
- ◆ Right to redress
- ◆ Right to information
- ◆ Right to information
- ◆ Right to consumer education
- ◆ Right to representation
- ◆ Right to healthy environment

These eight consumer rights can be used as the touchstones for assessing the consumer welfare implications of competition policy and law, and to see how they help or hinder the promotion of these rights.



### 11.5 CONSUMER PROTECTION COUNCILS IN INDIA

- ◆ **The Central Consumer Protection Council:** The objects of the Central Council shall be to promote and protect the rights of the consumers such as,-
  - (a) the right to be protected against the marketing of goods and services which are hazardous to life and property;
  - (b) the right to be informed about the quality, quantity, potency, purity, standard and price of goods{or services, as the case may be} so as to protect the consumer against unfair trade practices;
  - (c) the right to be assured, wherever possible, access to a variety of goods, and services at competitive prices;
  - (d) the right to be heard and to be assured that consumer's interest will receive due consideration at appropriate terms;
  - (e) the right to seek redressal against unfair trade practices {or restrictive trade practices} or unscrupulous exploitation of consumers; and}
  - (f) the right to consumer education.
- ◆ **The State Consumer Protection Council:** The objects of every State shall be to promote within the State the rights of the consumers laid down in point (a) to (f) mentioned above.
- ◆ **The District Consumer Protection Council:** The objects of every District Council shall be to promote within the State the rights of the consumers laid down in point (a) to (f) mentioned above.

### 11.6 SELF-EXAMINATION QUESTIONS

#### Choose the Correct alternative

1. Consumer includes a person who purchases goods or avails services for
  - (a) Personal purposes only
  - (b) Commercial purposes only
  - (c) Personal or Commercial purposes
  - (d) None of the above
2. A consumer was aggrieved by the goods that he purchased from an enterprise covered under the Competition Act, 2002. He can seek remedy under the
  - (a) The Competition Act, 2002
  - (b) The Consumer Protection Act, 1996



- (c) (a) & (b)
- (d) Approach the civil court
- 3. Ethics are necessary in marketing because
  - (a) To avoid intervention by the Government
  - (b) To get recognition from the society
  - (c) To build brand image
  - (d) (a) & (b) only
- 4. Competition Act, 2002 covers the following parameters
  - (a) Regulation of combinations
  - (b) Prohibition of abuse of dominant position
  - (c) Prohibition of certain agreements
  - (d) All the above
- 5. Consumer Interest and Public Interest
  - (a) Synonymous
  - (b) Different
  - (c) Depends on facts and circumstances
  - (d) That talks about interest of the society as a whole

**Short/Essay type Questions**

- 6. What are the ethical dilemmas in today's marketing scenario?
- 7. What are the initiatives that have been taken in the Indian context towards maintaining and promoting healthy competition?
- 8. Distinguish between Public Interest and Consumer Interest.
- 9. Who is a Consumer? Is there any distinction between consumer for personal use and consumer for commercial use?

**Practical Problem**

- 10. A retailer was purchasing goods regularly from Government of India Enterprise for the purpose of re-sale. There were defects in the goods in one of the purchase lot and as a result the retailer suffered loss of his share in the competition. The retailer sued the said enterprise for the purpose and the enterprise contended that goods were purchased for the purpose of re-sale and also enterprise of the government cannot be treated as enterprise for the purpose. Examine the contention and its validity.

**Answers**

- 1. (c); 2. (b); 3. (d); 4. (d); 5. (b).



# CHAPTER 12

## ETHICS IN ACCOUNTING AND FINANCE

### Learning Objectives

After reading this chapter you should be able to understand,

- ◆ the importance of ethics for a finance and accounting professional;
- ◆ the various principles which need to be adhered to by finance and accounting professionals;
- ◆ the concept of ethical dilemma and conflict resolution;
- ◆ the various threats which can be faced by a finance and accounting professional while working as an auditor, consultant or an employee in an organisation;
- ◆ the various safeguards which need to be adopted to counter threats.

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*“A business that makes nothing but money is a poor kind of business.”*

**HENRY FORD**

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### 12.1 INTRODUCTION

Finance and Accounts is perhaps the only business function which accepts responsibility to act in public interest. Hence, a finance and accounting professional's responsibility is not restricted to satisfy the needs of any particular individual or organisation. While acting in public interest, it becomes imperative that the finance and accounting professional adheres to certain basic ethics in order to achieve his objective.

Until recently, various surveys conducted globally had ranked finance and accounting professionals very high in terms of professional ethics. However, various accounting scandals witnessed during the past few years have put a serious question mark on the role of the finance and accounting professional in providing the right information for decision making, both within and outside their respective organisations. In companies such as Enron, World Com, Tyco, Global Crossing, Adelphia, Quest, Xerox and most of the late dotcoms, the accounting information used by the Finance Department was false and manipulative.

What was the role of finance and accounting professionals in all these high profile failures? Of course there were a few professionals who were directly involved in fraudulent activities,



however, the majority, at most of the times, refused to challenge what they had already known.

Enron is a classic example of such behaviour. Months before Enron Corp declared bankruptcy, an employee of the name of Sherron Watkins sent the company's top executive (Kenneth Lay) a message which had detailed information of the accounting hoax in the form of the now famous 'off the book liabilities'. However, instead of taking note of what was mentioned in the message, the management of the company demoted Sherron. It is well known now, that, like Sherron, hundreds of finance and accounting employees at Enron knew about the happenings but preferred to remain silent. Hence, most of them did not lie, but neither did they disclose the truth nor did they attempt to correct the misleading and confusing information. Shouldn't they have blown the whistle the way Sherron did? Was the behaviour of these employees un ethical? Cases like Enron exist in plenty e.g. World Com, Global Crossing, Xerox, Qwest and many other companies have been known to have created accounting entries with the sole purpose of making their financial statements look attractive thereby inviting further investments from unsuspecting individuals and organisations.

## **12.2 ETHICS AND ETHICAL DILEMMA**

*The word Éthikos (Ethics) imbibes within itself both individual behaviour and community culture. Various individuals would be having different opinions on the same subject because of which what is perceived as right by one may be considered wrong by the other. Hence, doing what one thinks is right, may not always be the right thing to do! This is the essence of the term 'Ethics' which may be defined as 'those moral principles which guide the conduct of individuals' Irrespective of the differences of opinions amongst individuals, Ethical behavior implies such course of actions which are taken after giving due thought to their impact on the society and other stake holders. Hence when accounting and finance professionals at Enron did not report of the wrongs which they believed were being done at the top, their behaviour amounted to being unethical in spite of the fact that they were not directly involved in any of the fraudulent or manipulative activities. In contrast, when Cynthia Cooper, Vice President – Internal Audit of World Com found wrong accounting entries resulting in inflated profits, she immediately reported the matter to the Board of Directors, this, in spite of the fact that she was reporting against seniors whom she had come to admire over the past so many years of working together. These two examples mentioned above provide an insight into the meaning of Ethical dilemmas. Ethical Dilemmas exist when finance and accounting professionals need to choose from amongst alternatives and there are (1) significant value conflicts among differing interests, (2) actual alternatives which can all be justified and (3) significant consequences to all stakeholders. Let us consider an example of a finance and accounting professional who has been asked to provide a profit forecast which needs to be given to a banker for a much wanted loan to be utilised in launching a new product. The company has not been doing well for the past few years and without this loan there is a likelihood of its*



closing down. However, the loan can only be availed if the banker is convinced that the projected profitability shall be at least Rs 50,00,000 per annum. A optimistic projection of the profits shows that if everything goes extremely well the company may be able to make profits of Rs 50,00,000, however, a realistic assumption provides a much lower figure. In such a situation the concerned professional will need to resolve the dilemma of the type of profit forecast to be provided to the banker. In case he gives a realistic projection the company may not get the loan and perhaps may need to close down. On the other hand if he makes a optimistic projection, he may be misleading the banker. There is no right answer to such a situation. Both actions proposed have got there own risks.

### 12.3 POTENTIAL CONFLICTS

*For a finance and accounting professional working as consultant or auditor*

A finance and accounting professional in public practice should take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may give rise to threats to compliance with the fundamental principles. For example, a threat to objectivity may be created when a professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client. More examples of such threats are discussed later.

*For a finance and accounting professional working as an employee*

A finance and accounting professional has a professional obligation to comply with certain fundamental principles which have been detailed below. There may be times, however, when their responsibilities to an employing organization and the professional obligations to comply with the fundamental principles are in conflict. Ordinarily, a finance and accounting professional should support the legitimate and ethical objectives established by the employer and the rules and procedures drawn up in support of those objectives. Nevertheless, where compliance with the fundamental principles is threatened, a finance and accounting professional must consider a response to the circumstances. As a consequence of responsibilities to an employing organization, a finance and accounting professional may be under pressure to act or behave in ways that could directly or indirectly threaten compliance with the fundamental principles. Such pressure may be explicit or implicit; it may come from a supervisor, manager, director or another individual within the employing organization. A finance and accounting professional may face pressure to:

- ◆ Act contrary to law or regulation.
- ◆ Act contrary to technical or professional standards.
- ◆ Facilitate unethical or illegal earnings management strategies.



- ◆ Lie to, or otherwise intentionally mislead (including misleading by remaining silent) others, in particular:
- ◆ The auditors of the employing organization; or
- ◆ Regulators.
- ◆ Issue, or otherwise be associated with, a financial or non-financial report that materially misrepresents the facts, including statements in connection with, for example:
- ◆ The financial statements;
- ◆ Tax compliance;
- ◆ Legal compliance; or
- ◆ Reports required by securities regulators.

#### **12.4 CREATING AN ETHICAL ENVIRONMENT**

In light of the various corporate scandals mentioned above, the following three points need to be addressed for creating a sound ethical environment in any company. They are,

1. *Ensuring that employees are aware of their legal and ethical responsibilities.*

Ethical organisations would have policies to train and motivate employees toward ethical behaviour. This would require initiation from the top. A number of companies, both in the West and in India have been known for their quality and soundness of their Ethics programmes. Companies like Raytheon make ethics training compulsory for everyone. Similarly Texas Instruments has a well drafted Ethics programme from as long as 1961. In India Wipro was amongst the pioneers to establish an organised set of beliefs which would guide business conduct. This was done as early as 1970s. In the process the company has established an Integrity manual which helps employees take ethical decisions when faced with choices.

2. *Providing a communication system between the management and the employees so that any one in the company can report about fraud and mismanagement without the fear of being reprimanded*

Ethical organisations need to provide facilities for employees through which they could communicate with responsible positions for reporting frauds, mismanagement or any other form of non routine detrimental behaviour. In India Wipro has introduced a helpline comprising of senior members of the company who are available for guidance on any moral, legal or ethical issues that an employee of the company may face.

3. *Ensuring fair treatment to those who act as whistle blowers.*

This is perhaps the most important and sensitive issue. When Sherron had raised questions at Enron, she was demoted. Similar fate would have met all those who had followed Sherron.



Fair treatment to whistle blowers is a basic necessity to check fraud. It is reassuring that two of the three persons of the year, selected by the popular Time magazine were accountants from Enron and World Com who had dared to blow the whistle, however, needless to say that the appreciation is much more needed from within the company rather than outside.

### 12.5 REASONS FOR UNETHICAL BEHAVIOUR

A creation of a proper ethical environment requires a proper understanding of the reasons which lead to an ethical behaviour. Four such reasons are discussed below.,

1. **Emphasis on short term results** . This is one of the primary reasons which has led to the downfall of many companies like Enron and WorldCom. Manipulating accounting entries to depict good profitability can help companies raise further capital from the market
2. **Ignoring small unethical issues** : It is a known fact that most of the compromises we make start small however they lead us to large problems. Similarly, companies need to develop an environment where small ethical lapses are taken seriously so that they do not repeat in the future. Otherwise, toleration of such small lapses could lead to larger problems.
3. **Economic cycles** : When Enron was doing well , no one had bothered to understand its actual financial position. There were no question marks on its financial statements. However, when the economy took a downward turn, finance and accounting managers took decisions which were compromises over the established code of conduct. This was done to reflect a financial position which would keep the investors in the market satisfied. All this resulted in a huge crisis and the ultimate fall of this US Giant. Hence, to prevent disclosure of ethical problems in times of depression, company need to be extremely careful and vigilant during good times.
4. **Accounting rules** : In the era of globalisation and massive cross border flow of capital, accounting rules are changing faster than ever before. The rules have become more complex and it is difficult to identify deviations from these complex set of requirements. The complexity of these principles and rules and the difficulty associated with identifying abuse are reasons which may promote an ethical behaviour.

### 12.6 FUNDAMENTAL PRINCIPLES RELATING TO ETHICS

Certain fundamental principles need to be adhered with for behaving in an ethical manner. These principles have been summarised below;

1. *The principle of Integrity*

The dictionary meaning of integrity is veracity. Accordingly, the principle calls upon all accounting and finance professionals to adhere to honesty and straight forwardness while



discharging their respective professional duties. In addition the following acts of responsibility would help comply with the Integrity principle,

- ◆ Avoid being involved in activities which would impair the goodwill of the organisation
- ◆ Communicate adverse as well as favourable information with those concerned
- ◆ Refuse any gift or favour which could influence actions taken or to be taken
- ◆ Refuse to get involved in any activity which would adversely affect the achievement of an organisations objective.
- ◆ Avoid conflicts and advise related parties on apparent conflicts which could arise in the future.

2. *The principle of objectivity*

This principle requires accounting and finance professionals to stick to their professional and financial judgement. They should not allow bias, conflicting interests or undue influence of others to override their business judgements . They should communicate information fairly and objectively in such a way that the communication with the end user is complete and transparent.

3. *The principle of confidentiality*

This principle requires practitioners of accounting and financial management to refrain from disclosing confidential information related to their work. Such information may be however be disclosed to their subordinates and care should be taken that the latter maintains confidentiality. The only exception to this principle is when there are requirements to disclose information under a legal obligation or because of some statutory ruling.

4. *The principle of professional competence and due care*

Finance and accounting professionals have a need to update their professional skills from time to time. This has assumed a greater significance in the modern day competitive environment where updated knowledge and skill shall ensure that the client or employer receives competent professional services based upon current and contemporary developments in the related areas.

5. *The principle of professional behaviour*

This principle requires accounting and finance professionals to comply with relevant laws and regulations and avoid such actions which may result into discrediting the profession.

## **12.7 THREATS**

The dynamic environment in which businesses operate today may usher a broad range of circumstances because of which compliance with the abovementioned fundamental principles may potentially be threatened. Such threats may be classified as follows:



- (a) Self-interest threats, which may occur as a result of the financial or other interests of a finance and accounting professional or of an immediate or close family member;
- (b) Self-review threats, which may occur when a previous judgment needs to be reevaluated by the finance and accounting professional responsible for that judgment;
- (c) Advocacy threats occur when a professional promotes a position or opinion to the point that subsequent objectivity may be compromised;
- (d) Familiarity threats occur when a finance and accounting professional has close relationships in the work environment and such relationships impair his selfless attitude towards work.
- (e) Intimidation threats occur when a professional may be prohibited from acting objectively by threats, actual or perceived.

#### **12.8 EXAMPLES OF CIRCUMSTANCES CREATING ABOVE MENTIONED THREATS.**

Circumstances leading to the actual happening of the various threats are given below. Students may note that this is not an exhaustive list and has been provided to give a basic idea

*Self interest threat for finance and accounting professionals working as consultants or auditors*

- ◆ A financial interest in a client or jointly holding a financial interest with a client.
- ◆ Undue dependence on total fees from a client.
- ◆ Having a close business relationship with a client.
- ◆ Concern about the possibility of losing a client.
- ◆ Potential employment with a client.
- ◆ Contingent fees relating to an assurance engagement.

*Self interest threat for finance and accounting professionals working as an employee*

- ◆ Financial interests, loans and guarantees in the company the professional is working.
- ◆ Incentive compensation arrangements
- ◆ Inappropriate personal use of corporate assets.
- ◆ Concern over employment security
- ◆ Commercial pressure from outside the employing organisation

*Self review threat for finance and accounting professionals working as consultants or auditors*

- ◆ The discovery of a significant error during a re-evaluation of the work of the finance and accounting professional.



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- ◆ Reporting on the operation of financial systems after being involved in their design or implementation.
- ◆ Having prepared the original data used to generate records that are the subject matter of the engagement.
- ◆ A member of the assurance team being, or having recently been, a director or Officer of that client.
- ◆ A member of the assurance team being, or having recently been, employed by the Client in a position to exert direct and significant influence over the subject matter of the engagement.

### *Self review threat for finance and accounting professionals working as an employee*

Such threats occur when business decisions or data is subjected to review and justification is required to be given by the same professional who was responsible for taking such decisions or preparing that data.

### *Advocacy threat for finance and accounting professionals working as consultants or auditors*

- ◆ Promoting shares in a **listed entity\*** when that entity is a consultancy or a financial statement audit client.
- ◆ Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.

### *Advocacy threat for finance and accounting professionals working as an employee*

When furthering the legitimate goals and objectives of their employing organizations finance and accounting professionals may promote the organization's position, provided any statements made are neither false nor misleading. Such actions generally would not create an advocacy threat.

### *Familiarity threats for finance and accounting professionals working as consultants or auditors*

- ◆ A member of the engagement team having a close or immediate family relationship with a director or officer of the client.
- ◆ A member of the engagement team having a close or immediate family relationship with an employee of the client who is in a position to exert direct and significant influence over the subject matter of the engagement.
- ◆ A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement.





- ◆ Accepting gifts or preferential treatment from a client, unless the value is clearly insignificant.
- ◆ Long association of senior personnel with the assurance client.

*Familiarity threats for finance and accounting professionals working as an employee*

- ◆ A finance and accounting professional, in a position to influence financial or non financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.
- ◆ Long association with business contacts influencing business decisions.
- ◆ Acceptance of a gift or preferential treatment, unless the value is clearly insignificant.

*Intimidation threat for finance and accounting professionals working as consultants or auditors*

- ◆ Being threatened with dismissal or replacement.
- ◆ Being threatened with litigation.
- ◆ Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

*Intimidation threat for finance and accounting professionals working as employees*

- ◆ Threat of dismissal or replacement of the finance and accounting professional or a close or immediate family member over a disagreement about the application of an accounting principle or the way in which financial information is to be reported for external use as well as for decision making purposes.
- ◆ A dominant personality attempting to influence the decision making process, for example with regard to the exclusion of irrelevant costs from projected cost estimates.

## 12.9 SAFEGUARDS

It is important to have safeguards which may increase the likelihood of identifying or deterring unethical behavior. Such safeguards, which may be created by the finance and accounting profession, legislation, regulation or an employing organization, shall ensure an ethical environment. Safeguards that may eliminate or reduce the abovementioned threats to an acceptable level fall into two broad categories:

- (a) Safeguards created by the profession, legislation or regulation; and
  - (b) Safeguards in the work environment.
- (c) Some of the safeguards created by the profession, legislation or regulation are as follows
- ◆ Educational, training and experience requirements for entry into the profession.



- ◆ Continuing professional development requirements.
  - ◆ Corporate governance regulations.
  - ◆ Professional standards.
  - ◆ Professional or regulatory monitoring and disciplinary procedures.
  - ◆ External review by a legally empowered third party of the reports, returns, communications or information produced by concerned professionals.
- (d) Safeguards in the work environment are as follows.
- ◆ The employing organization's systems of corporate oversight or other oversight structures.
  - ◆ The employing organisation's ethics and conduct programs.
  - ◆ Recruitment procedures in the employing organisation emphasizing the importance of employing high caliber competent staff.
  - ◆ Strong internal controls.
  - ◆ Appropriate disciplinary processes.
  - ◆ Leadership that stresses the importance of ethical behavior and the expectation that employees will act in an ethical manner.
  - ◆ Policies and procedures to implement and monitor the quality of employee performance.
  - ◆ Timely communication of the employing organisation's policies and procedures, including any changes to them, to all employees and appropriate training and education on such policies and procedures.
  - ◆ Policies and procedures to empower and encourage employees to communicate to senior levels within the employing organization any ethical issues that concern them without fear of retribution.

#### **12.10 ETHICAL CONFLICT RESOLUTION**

While evaluating compliance with the fundamental principles, a finance and accounting professional may be required to resolve a conflict in the application of fundamental principles. The following needs to be considered, either individually or together with others, during a conflict resolution process,

- (a) Relevant facts;
- (b) Ethical issues involved;
- (c) Fundamental principles related to the matter in question;



- (d) Established internal procedures; and
- (e) Alternative courses of action.

Having considered these issues, a finance and accounting professional should determine the appropriate course of action that is consistent with the fundamental principles identified. The professional should also weigh the consequences of each possible course of action. If the matter remains unresolved, the professional should consult with other appropriate persons within the **firm** or employing organization for help in obtaining resolution. During times where a matter involves a conflict with, or within, an organization, finance and accounting professional should also consider consulting with those charged with governance of the organisation, such as the board of directors.

It may be in the best interests of the professional to document the substance of the issue and details of any discussions held or decisions taken, concerning that issue.

If a significant conflict cannot be resolved, a professional may wish to obtain professional advice from the relevant professional body or legal advisors, and thereby obtain guidance on ethical issues without breaching confidentiality. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant should consider obtaining legal advice to determine whether there is a requirement to report.

If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional should, where possible, refuse to remain associated with the matter creating the conflict. The professional may determine that, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

#### **12.11 SELF-EXAMINATION QUESTIONS**

1. What do you understand by Ethical Dilemma in context of an accounting and finance professional?
2. What are the various threats faced by an accounting and finance professional working as an employee of a company?
3. What are the various threats faced by an accounting and finance professional working as a consultant or an auditor of a company?
4. Discuss the various safeguards which should be adopted for overcoming threats.
5. Discuss briefly 'Ethical Conflict Resolution'

# **PART III**

# **COMMUNICATION**

# CHAPTER 13

## ESSENTIALS OF COMMUNICATION

### Learning Objectives

*After reading this chapter, you will be able to understand*

- ◆ Formal and Informal Communication
- ◆ Interdepartmental
- ◆ Verbal, Nonverbal and Written
- ◆ Communication Channels
- ◆ Barriers to Effective Communication
- ◆ Planning and composing Business messages

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*“Worthless words are doubly unprofitable: the listeners' enjoyment is lost, and the speaker's own virtues vanish”.*

**Kural (Verse 194)**

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### 13.1 INTRODUCTION

There is no doubt that Communication is so fundamental that without it no organisation can exist and function effectively towards achieving its objectives. Communication is the principal means by which members of an organisation work together. It helps to bind them together, enabling them to react to and influence each other. It flows in different directions within the organisation : downward, upward, horizontally and diagonally. No manager can be effective in his job unless he is able to communicate. It is, therefore, apt to call communication the “life-blood” of an organization. As Sir John Harvey-Jones says, “communication is the single most essential skill.” Professional and result-oriented organisations are always looking for managers who can communicate persuasively and competently. It has been pointed out that about nine tenths of a manager's time is spent in communicating, one way or the other. It lies at the very heart of management. Powerful concepts in management such as participation, empowerment and involvement revolve around communication. Given below are some of the factors responsible for the growing importance of communication :

**(a) Growth in the size and multiple locations of organisation:** Most of the organisations are growing larger and larger in size. The people working in these organisations may be



spread over different states of a country or over different countries. Keeping in touch, sending directions across and getting feedback is possible only when communication lines are kept working effectively.

**(b) Growth of trade unions** : Over the last so many decades trade unions have been growing strong. No management can be successful without taking the trade unions into confidence. Only through effective communication can a meaningful relationship be built between the management and the workers.

**(c) Growing importance of human relations** : Workers in an organisation are not like machines. They have their own hopes and aspirations. Management has to recognise them above all as sensitive human beings and work towards a spirit of integration with them which effective communication helps to achieve.

**(d) Public relations** : Every organisation has a social responsibility, towards customers, government, suppliers and the public at large. Communication with them is the only way an organisation can project a positive image of itself.

**(e) Advances in Behavioural Sciences** : Modern management is deeply influenced by exciting discoveries made in behavioural sciences like psychology, sociology, transactional analysis etc. All of them throw light on subtle aspects of human nature and help in developing a positive attitude towards life and building up meaningful relationships. And this is possible only through communication.

**(f) Technological advancement** : The world is changing very fast, owing to scientific and technological advancements. These advancements deeply affect not only methods of work but also the composition of groups. In such a situation proper communication between superiors and subordinates becomes very necessary.

### **13.2 THE PROCESS OF COMMUNICATION**

Communication is a dynamic, transactional (two-way process) in which there is an exchange of ideas linking the sender and receiver towards a mutually accepted direction or goal consisting of seven elements.

**1. Sender (Source)** : The process of communication begins with a sender, the person who has an idea and wants to share it. The Branch Manager explaining new product lines to the sales force, a computer programmer explaining a new program to a co-worker, accountant giving financial report to the superior are all examples of sender of communication.

**2. Encoding** : The sender must choose certain words or non-verbal methods to translate the idea into a message. This activity is called encoding. While encoding a message, one needs to consider what contents to include, how the receiver will interpret it and how it may affect one's relationship. A simple "thank-you" message will be relatively easy. In contrast, to inform



200 employees of a bad news about salary cut or bid on engineering plans to construct a 50 crore industrial building will be more complicated, requiring carefully planned messages.

**3. Message :** For communication to occur your receiver should first get the message. A message is any signal that triggers the response of a receiver. Messages could be verbal (written or spoken) or nonverbal (such as appearance, body language, silence, sounds, yawns, sighs etc.)

**4. Channel :** How will you send your message? Should it be sent via an electronic word processing system to be read on the receiver's screen or through the printed word or through graphic symbol on paper, or via the medium of sound? Briefly, should one write or speak?

The choice of channel or medium (written or oral) is influenced by the inter relationships between the sender and the receiver. It also depends upon the urgency of the message being sent. Besides, one may consider factors such as importance, number of receivers, costs and amount of information.

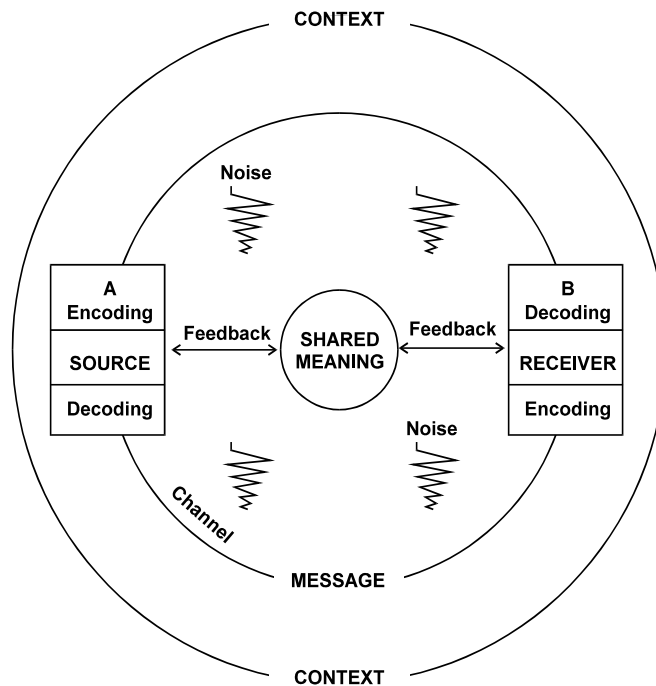
Generally, it has been observed that if the message requires an immediate answer, an oral channel may be a better choice. But if the message contains complicated details and figures or if its subject requires filing for future reference, a written communication is necessary. Further whether the receiver is inside or outside the organization also affects choice of the medium. For internal communication, written media may be memos, reports, bulletins, job descriptions, posters, employee manuals or even electronic bulletin boards or oral communication may be through staff meeting reports, face to face discussions, speeches, audio tapes, telephone chats, teleconferences or even video tapes. Another oral channel, though unplanned by the sender, is the 'grapevine' through which news and rumors often travel quickly.

External communication media may be, written - letters, reports, proposals, telegrams, faxes, electronic mails, telexes, postcards, contracts, ads, brochures, catalogues, news releases etc.; or oral – face to face, by telephone, or by speeches in solo or in panel situations personally before groups or via teleconferences, video-conferences or T.V.

**5. Receiver :** A receiver is any person who notices and attaches some meaning to a message. In the best circumstances, a message reaches its intended receiver with no problems. In the confusing and imperfect world of business, however, several problems can occur. The message may never get to the receiver. It might be sent but lie buried under a mountain of files on the recipient's desk. If the message is oral, the listener might forget it. Even worse, a message intended for one receiver might be intercepted by someone else, or your colleague may take your friendly joke in an offensive manner. For example, a competitor might see a copy of your correspondence to a customer. Similarly, your immediate boss's suggestion may be taken to be an order by you.



**Decoding** : Even if the message reaches intact to its intended receiver, there is no guarantee that it will be understood as the sender intended it to be. The receiver must still decode it - Attaching meaning to the words or symbols. It may be noted that decoding is not always accurate. It depends upon individual experiences. The problem is that all of us do not have identical experiences with the subject or symbols chosen by the sender. Even within India, attitudes, abilities, opinions, communication skills and cultural customs vary. And if the communication is between people of two different countries say India and Japan, the problems increase. There are greater chances of misinterpretation; personal biases may intervene, as each receiver tries to perceive the intended meaning of the sender's idea in his or her own receptor mechanism also called frame of reference.



### **Communication Process**

**Feedback** : Ultimately the receiver reacts or responds to the communication sent by the sender. The response could be based on clear interpretation of the symbols sent or it could be based on misunderstanding or misinterpretation of the symbols sent. Whatever the response





of a receiver to a sender is, it is known as feedback. Some feedback is non-verbal like smiles, sighs, nods and so on. Sometimes it is oral, as when you react to a colleague's ideas with questions or comments. Feedback can also be written, as when you respond to a co-worker's memo. In many cases, no message can also be a feedback. Failure to answer a letter or to return a phone call can suggest how non communicative the person feels about the sender. Feedback is an important component of the communication process, because ultimately the success or failure of the communication is decided by the feedback we get.

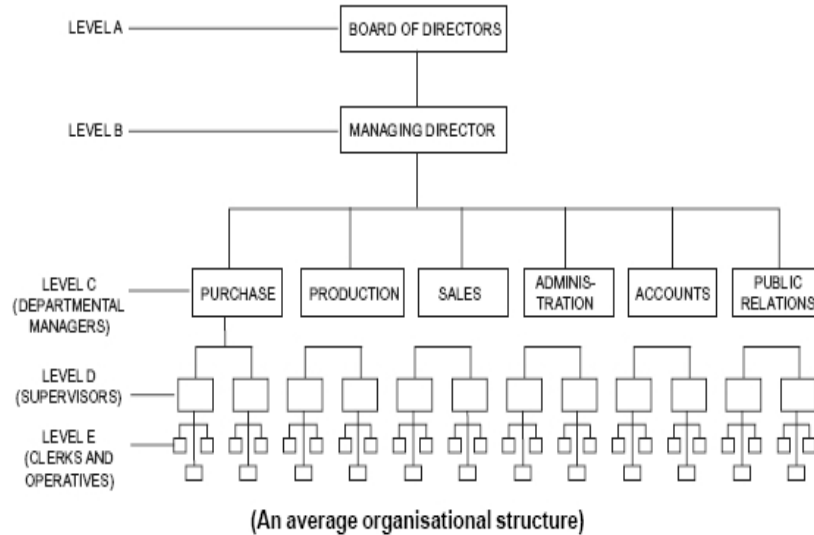
### **FORMS OF COMMUNICATION**

All communication passes through some well-defined stages or positions in the organisation. Everybody is familiar with the phrase 'through proper channel' which means that the sender of a written communication means to pass it on to the addressee through someone occupying an important position in the hierarchical system of the organisation. In this way the word 'channel' means the position or point through which the communication passes. These positions exist at different levels in the organisation. There is quite a large amount of communication that does not pass through these points or does not follow any protocol. So, we can divide the channels of communication into two categories:

- (a) Formal
- (b) Informal

### **13.3 FORMAL COMMUNICATION**

A formal communication flows along prescribed channels which all organizational members desirous of communicating with one another are obliged to follow. Every organisation has a built-in hierarchical system that can be compared to a pyramid. It can, therefore, be understood that communication normally flows from top downwards. But it is not always so. Communication in an organisation is multidimensional or multidirectional.



Given below are the directions in which communications are sent :

- (a) Downward
- (b) Upward
- (c) Horizontal or Lateral
- (d) Diagonal or Crosswise

Formally a clerk working in any section cannot directly communicate with a Managing Director but has to follow the reporting hierarchy. It has been called “the main line of the organisation’s operational communication”. In this are included the reports, records and other forms that supply working information to the various parts of the organisation, orders, instructions and messages that flow up and down in the hierarchical system and the letters, sales presentations, advertising and publicity material that go out to the public. These forms of communication just do not happen by themselves.

They are carefully thought out and well designed. Great care is taken in their design and movement.

**Advantages of formal communication :**

- (a) The formal channels account for most of the effectiveness of communication. As has been said earlier great care has to be taken in sending across any letter or report through the ‘proper’ formal channel.



- (b) Formal channels cover an ever – widening distance as organizations grow. Through them it is easier to reach out to the branches of an organisation spread far and wide.
- (c) The formal channels, because of their tendency to filter information, keep the higher level managers from getting bogged down.
- (d) Formal channels of communication consolidate the organisation and satisfy the people in managerial position

	<b>Downward Communication</b>	<b>Upward Communication</b>	<b>Horizontal (Lateral) Communication</b>
<i>Definition</i>	Superior to subordinate	Subordinate to superior	Between co-worker with different areas of responsibility
<i>Potential Benefits</i>	Prevention/correction of employee errors Greater job satisfaction Improved morale	Prevention of new problems and solution of old ones Increased acceptance of management decisions	Increased co-operation among employees with different duties Greater understanding of organisation's mission
<i>Potential Problems</i>	Insufficient or unclear messages Message overload Message distorted as it passes through one or more intermediaries	Superiors may discourage, disregard, or downplay importance of subordinates' messages Supervisors may unfairly blame subordinates for unpleasant news	Rivalry may occur between employees from different areas Specialisation makes understanding difficult Information overload discourages contacts Physical barriers discourage contact Lack of motivation

**Formal Communication in Organisations-Benefits & Problems**

### **13.4 INFORMAL COMMUNICATION**

Side by side with the formal communication there exists on a much larger scale, an informal channel of communication or a secondary network of information. Its source lies in man's compulsive instinct to communicate or talk out whatever he feels and thinks with his fellow beings and throw all norms to the winds. Man is essentially gregarious by nature i.e., he likes to move about and form groups. Whenever groups meet there is bound to be talks on different subjects, serious and not so serious. This tendency is more visible in the lower rung of the organisation. Here the people are rather fond of setting afloat rumours regarding all matters under the sun. The rumour mill is always working in any organisation. The larger the organization, the more active the rumour mill. It has come to be called the 'grapevine' in management literature. Quite often, it also contains some useful information. That is why, it cannot be altogether ignored.



**Factors leading to the grapevine phenomenon:**

The grapevine becomes active when the following factors are present :

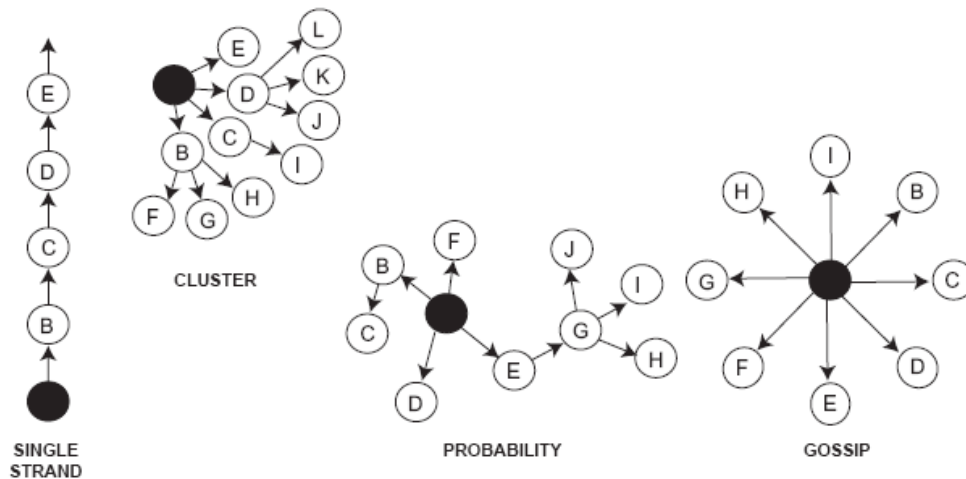
- (a) Feeling of uncertainty or lack of sense of direction when the organisation is passing through a difficult period.
- (b) Feeling of inadequacy or lack of self confidence on the part of the employee, leading to the formation of groups.
- (c) Formation of a coterie or favoured group by the manager, giving other employees a feeling of insecurity or isolation. People operating in such circumstances will be filled with all sorts of ideas and will share them with like minded companions, at whatever level they may be. Mostly they find them at their own level, but other levels are not barred. This type of communication is being seriously studied by psychologists and management experts.

**13.5 GRAPEVINE CHAINS**

Specialists in this field have identified four types of grapevine chains :

- (a) Single Strand Chain :** In this type of chain, 'A' tells something to 'B' who tells it to 'C' and so on. This type of chain is the least accurate in passing on the information or message.
- (b) Gossip Chain :** In it, a person seeks out and tells everyone the information he has obtained. This chain is often used when information or a message regarding a 'not-on-job' nature is being conveyed.
- (c) Probability Chain :** In it, individuals are indifferent to the persons to whom they are passing some information. This chain is found when the information is somewhat interesting but not really significant.
- (d) Cluster Chain :** In this type of chain, 'A' tells something to a few selected individuals and then some of these individuals inform a few other selected individuals.

It has been found out that the cluster chain is the dominant grapevine pattern in an organisation. Generally only a few individuals, called 'Liaison individuals' pass on the information they have obtained and then they are likely to share it with the people they trust. Most informal communication flows through this chain.



*Transmission Of Information Along Grapevine*

### Merits of the grapevine phenomenon

(a) **Speedy transmission** : The greatest merit of this phenomenon is that it transmits information very speedily. A rumour spreads like wild fire. The very moment a worker comes to know that something is 'top secret' or 'confidential' he tries to look into it or have some idea of it and pass it on to others. Thus it spreads within minutes. Managers have been known to distribute information through planned 'leaks' or carefully used 'just between you and me' remarks.

(b) **Feedback value:** It is primarily through the grapevine that the managers or top bosses of an organisation get the feedback regarding their policies, decisions, memos etc. The feedback reaches them much faster through the informal channel than through the formal channel.

(c) **Support to other channels** : The grapevine or informal channel functions as a supplementary or parallel channel of communication. The formal channels not only take more time but also impose certain constraints on the process of communication. So, whatever is deemed to be unsuitable for the formal channels can be successfully transmitted through the grapevine?

(d) **Psychological satisfaction** : The grapevine gives immense psychological satisfaction to the workers and strengthens their solidarity. It draws them nearer to each other and thus keeps the organisation intact as a social entity.

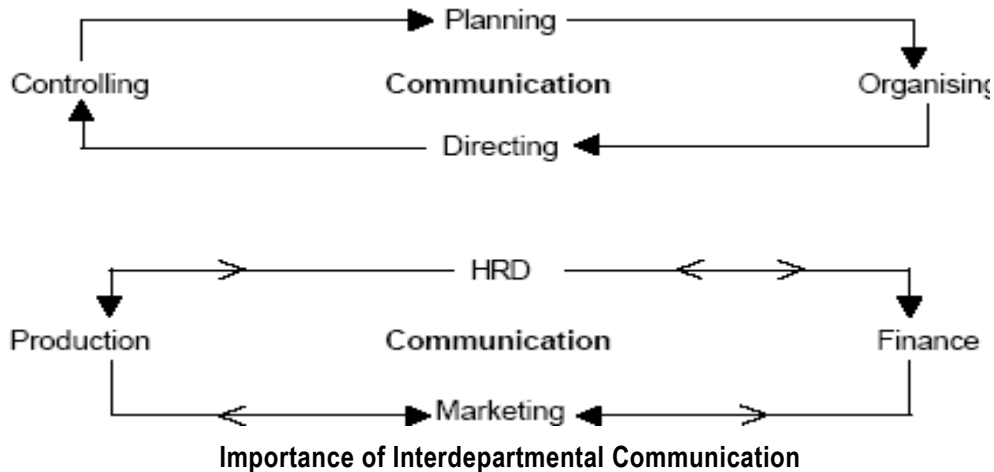


**Demerits of the grapevine phenomenon**

- (a) The information spread through the grapevine is less credible than the one given by the formal channel. Since the grapevine spreads information through the word of mouth it cannot always be taken seriously.
- (b) The grapevine does not always carry the complete information. Thus one may not get the complete picture on its basis.
- (c) The grapevine often distorts the picture or often misinforms. As its origin lies in the rumour mill it may spread any kind of stories about responsible people. In this way it may spoil the image of the organisation.

**13.6 INTERDEPARTMENTAL COMMUNICATION**

The word department comes from the French word *departir*, which means “to Separate.” Communication between departments is essential to collaborate and achieve the objectives of the organisation. Departments in an organization are like rooms in a house. Departments divide and create barriers.; but Without their cooperation it would be virtually impossible for an organisation to function.



Most organizations, to some degree, have difficulties with interdepartmental communication. Unfortunately, the problem is frequently overlooked and, even when recognized, often the symptoms are treated instead of the causes.



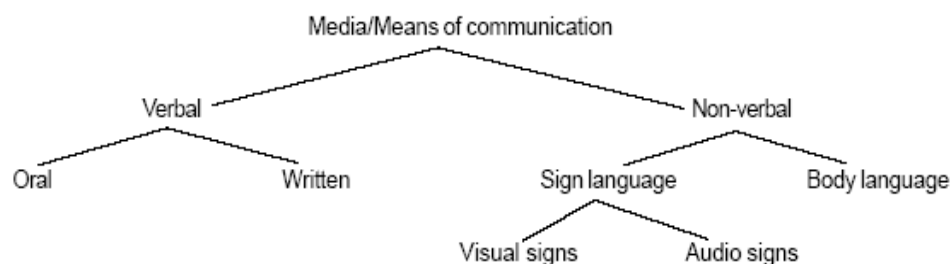
Avoiding unnecessary conflict, poor performance, time delays, and decisions that work at cross purposes are compelling reasons for taking active measures to improve interdepartmental communication. Major causes of interdepartmental communication problems are :

*Departments Are Physically Separated* : Office design may create barriers to effective interdepartmental relationships, because it subconsciously restricts natural communication impulses. To a great extent, office design determines who has access to whom by creating barriers to some departments and bridges to others. Because each office is unique, special factors have to be considered in each organization to make changes that will facilitate more effective communication between departments.

*Departments Perform Separate Functions* : Barriers are also caused by different priorities. What may be the first priority for department X may be the last priority for department Y. Ordinarily this may not be a problem, except when department X is dependent on department Y, a destructive sequence of impatience, tension, and distrust may prevail. Territory battles usually occur because departments fight over scarce resources, prestige, or such other factors. But who really wins? Who loses? Even though a particular department may "win," the customer usually loses. The competitor may even win. Customer service or a competitive threat should inspire and bridge the gaps between departments.

### 13.7 COMMUNICATION MEDIA

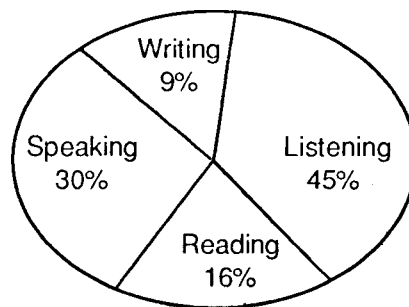
After the discussion of the meaning and importance, and dimensions of communication it is worthwhile to have a look at the means/media of communication. Specially after considering the directions/dimensions of communication we can understand that there may be various occasions requiring different types of communication. All communication cannot be of the same type and cannot flow through the same means. Much depends on who sends a message to whom and for what purpose. It must also be understood that a human being has at his command a number of means of communication.





### **Oral Communication**

According to a research, an average manager in general spends only 9% of his/her time in writing, 16% in reading, 30% in speaking and 45% in listening, as shown in the following figure



The most basic form of communication is **Intra personal** communication i.e. communication with the self. During intra personal communication one thinks and introspects. In contrast, when one engages in **Interpersonal** communication you interact with another, learn about him or her, and act in ways that help sustain or terminate your relationship. When you participate in **Group communication**, you interact with a limited number of others, work to share information, develop ideas, make decisions, solve problems or just have fun.

Through **Public Communication** you inform and persuade the members of an audience to hold certain attitudes, values or beliefs so that they think, believe or act in a certain way. On the other hand you can also function as a member of the audience. During **Mass communication** the media entertains or informs you and you in turn can influence the media through your viewing and buying habits.

Oral communication, which is face-to-face communication with others, has its own benefits. When people communicate orally they are able to interact, they can ask questions and even test their understanding of the message. In addition people can also relate and comprehend the non-verbal, which serves far more than words. By observing facial expressions, eye contact, tone of voice, gestures, postures, etc., one can understand the message better.

The only shortcoming of oral communication is that more often than not it is spontaneous and if one communicates incorrectly the message will not get understood. It is primarily due to this reason one needs to develop effective oral communication skills as a message, if not understood at appropriate time, can lead to disaster.

It is said that it does not matter what you say, what matters is how you say it. Your way of saying includes your choice of words, and your confidence and sincerity.





Oral communication is characterized by seven Cs – Candidness, Clarity, Completeness, Conciseness, Concreteness, Correctness, and Courtesy. These act as principles for choosing the form (style) and content (matter) of oral communication. Oral communication should provide a platform for fair and candid exchange of ideas.

In simple terms, the communicator should follow the following –

- Consider the objective.
- Think about the interest level of the receiver.
- Be sincere.
- Use simple language, familiar words.
- Be brief and precise.
- Avoid vagueness and generalities.
- Give full facts.
- Assume nothing.
- Use polite words and tone.
- Cut out insulting message.
- Say something interesting and pleasing to the recipient.
- Allow time to respond.

Unlike the printed word (of the written message), the spoken word (in oral communication) is ephemeral (short-lived). The listener cannot turn back to the spoken word as the reader can, in case he misses its meaning, while reading it. This is an inherent limitation of speech. To overcome this limitation, the listener has to listen closely and attentively. And the speaker should converse slowly, with proper semantic pauses, to enable the listener receive and register in the mind whatever is heard. There should be a due correlation between the pace of speaking and the rate of listening. Research has established that an individual speaks nearly 125 words a minute, and the brain of the listener processes nearly 4-5 times more rapidly. If the natural gap between the processes of receiving and registering is widened or too narrowly shortened by the speaker's pace of speaking, the act of comprehension will tend to be adversely affected.



<b>Oral Communication</b>	<b>Written Communication</b>
More personal and informal	Better for complex and difficult subjects, facts and opinions
Makes immediate impact	Better for keeping records of messages exchanged
Provides opportunity for interaction and feedback	Provides opportunity to refer back
Helps us to correct ourselves (our messages according to the feedback and non-verbal cues received from the listener)	Can be read at receiver's convenience or pleasure
Better for conveying feelings and emotions	Can be revised before transmitting
	Can be circulated
<b>Limitations</b>	
Demands ability to think coherently as you speak	Never know if the message is ever read
A word once uttered cannot be taken back	Impersonal and remote
Hard to control voice pitch and tone, especially under stress, excitement or anger	Immediate feedback is not available for correction on the spot
Very difficult to be conscious of our body language	Reader is not helped by non-verbal cues that contribute to the total message
	Many people do not like reading especially if it is an official or business message
	Time consuming

**Comparative Advantages of Oral and Written Communications**

**13.8 NON-VERBAL COMMUNICATION**

Words are not the only way we communicate. While we use language to communicate explicit information and message content, we use Non-verbal Communication to convey relational messages, our feelings about another person as well as status and power. While one can refuse to speak or write it is impossible to avoid behaving nonverbally.

One may continue to communicate nonverbally through:



**Kinesics or Body language:** It must be noted, though it is known to almost all, that all our bodily movements, gestures, postures etc., are guided by our feelings and thought processes. The nodding of our head, blinking of our eyes, waving of our hands, shrugging of our shoulders etc., are expressions of our thought and feelings. All these movements are the signals that our body sends out to communicate. That is why this area of study has been called 'body language'. Just as language uses sets of symbols to convey meaning, our body, consciously as well as unconsciously, conveys messages, attitudes, moods, status relationships etc. Nervousness, anger, fear, scorn, determination, horror, sympathy, pity, lack of understanding, disinterestedness, resentment can be much better expressed through the body language than through words. Mime is an old art in which ideas and emotions are communicated through facial expressions and gestures. It would be a serious mistake to overlook the contribution of the body language to the communication process. Nobody is known to have been pleased by words of praise uttered in a sarcastic tone, for he knows that it is the tone and not the words that matters. Would you believe a person who says glad to meet you unless his face glows with warmth and his voice quivers with a thrill of happiness. Successful communications make a very effective use of facial expressions and gestures. Any intelligent observer can understand this 'language'. Even if we try to hide the truth or anything that we want to suppress, our body, our eyes, our gestures speak out loud and clear. That is why it has been pointed out by psychologists that, by reading the signals sent out by one's body, we can tackle the "issues-at work and at home-before they become problems".

On careful observation, in a meeting, we can look around and see who occupies the highest position. Generally, those who are in control try to appear large, strong and fearless. A classic example of status consciousness expressed through body language is that of a senior army officer and a soldier standing before him. The soldier invariably stands at attention while the officer looks relaxed, at ease, with his arms and legs comfortably spread out. The soldier's body is tense and in perfect symmetry while that of the officer is relaxed, 'speaking' about his status. A tense, stiff body is a sign of subservience. The same situation prevails in any other organisation when a junior worker has to appear in the presence of a senior executive. In this way their body language shows their status and role relationship that is communication through body movement, facial expressions, gestures, posture etc.

**Paralanguage:** Very frequently *how* something is said is *what* is said. The term paralanguage is used to describe a wide range of vocal characteristics like tone, pitch, and speed etc – vocal cues that accompany spoken language which help to express and reflect the speaker's attitude. Adept communicators know how to use these cues effectively to help their listeners appreciate and understand content and mood. Through it one can convey enthusiasm, confidence, anxiety, and urgency. Paralanguage describes a wide range of vocal characteristics, which help to express and reflect the speaker's attitude.. On careful observation, we find that a speaker uses a vast range of vocal cues like:



**(a) Pitch Variation:** Most of us introduce wide variations in pitch while speaking. These variations are necessary to catch the listener's attention and to keep him interested in us. Speaking at length on the same level of pitch makes the speech 'monotonous' or boring.

**(b) Speaking speed :** One should not, always speak at a high speed. Speaking fast or at a high speed is not fluency. We speak at different speeds on different occasions and while conveying different parts of a message. As a general rule we should present the easy parts of a message at a brisk pace because it can be easily understood. On the other hand, the difficult, complicated, highly technical part of information should be conveyed at a slower pace. If we reverse the order the result will be counterproductive.

**(c) Pause :** The speaking speed is also accompanied by pauses. at the right moments. Incorrect use of pauses can create problems. A pause can be highly effective in emphasising the upcoming subject and in gaining the listener's attention. Too frequent pauses will, however, spoil the speech.

**(d) Volume variation :** Our speech should be loud enough to be audible to the audience, not too loud to put them off. The larger the audience, the higher the volume. But depending upon the different parts of the message we should monitor the volume of our speech so as to bring about a sense of contrast to generate interest of the audience

**(e) Non - fluencies :** Utterances like 'oh', 'ah', 'um', 'you know', 'ok' etc. are known as non-fluencies. They give the speaker breathing time (space fillers) and the audience time to think over what has been said (grasp-breaks). Carefully and judiciously used these utterances add to the fluency of the speaker. Frequent non-fluencies irritate the listener.

**(f) Word Stress :** Proper word stress is of crucial importance in communication. By putting stress or emphasis on a word here or a word there in the same sentence we can change the meaning. As an example let us look at the following sentences repeated with different words stressed :

Have you seen my new **book** ?

Have you seen my **new** book ?

**Artifactual Communication :** It is well known that we react to people on the basis of their appearance. The use of personal adornment like clothing , accessories, makeup, hairstyle etc. provides important non verbal cues about one's age, social and economic status, educational level, personality etc.

**Proxemics :** refers to the space that exists between us when we talk or relate to each other as well the way we organize space around us.. We can also call it 'space language" as the following four space zones indicate the type of communication and the relationship of the source and receiver:



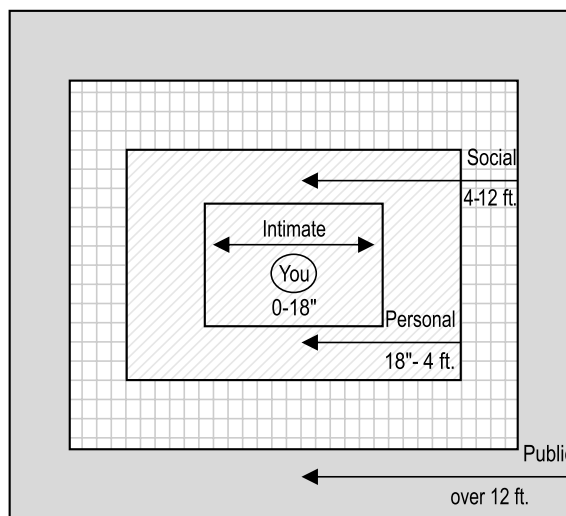
*Intimate* – Physical contact to 18 inches.

*Personal* – 18 inches to 4 feet.

*Social* – 4 to 12 feet

*Public*-12 feet to as far as we can see or hear.

Non-Verbal Communication



*Zones of Space Language*

**Chronemics or Time language:** is the study of how we use time to communicate. The meaning of time differs around the world. While some are preoccupied with time, others waste it regularly. While some people function better in the morning (early birds), others perform best at night. Punctuality is an important factor in time communication. Misunderstandings or disagreements involving time can create communication and relationship problems.

**Haptics :** is communication through touch. How we use touch sends important messages about us. It reveals our perceptions of status, our attitudes and even our needs. The amount of touching we do or find acceptable is at least in part culturally conditioned.

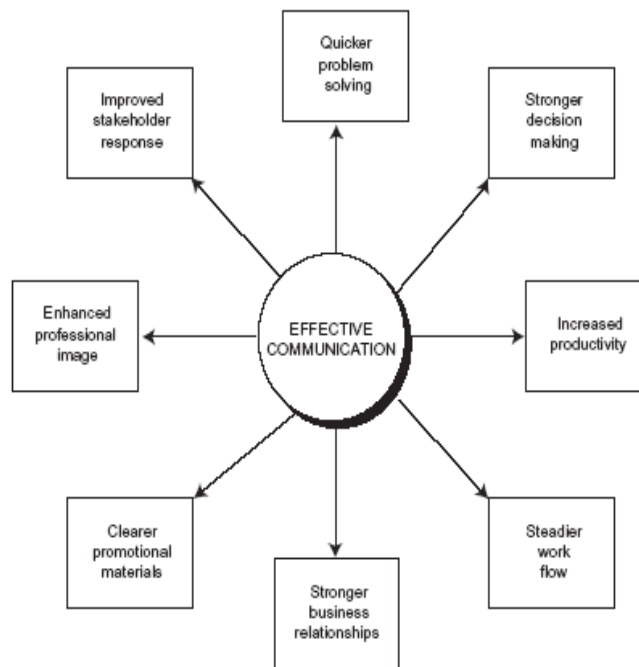
**Silence :** The absence of paralinguistic and verbal cues also serves important communicative functions. 'Silence is more eloquent than words' is not a meaningless adage, it contains in it the essence of generations of experience. Silence for example, can allow one to organize one's thoughts. It is not unusual to come across a situation in which nothing can express one's response so effectively as silence. Silence can effectively communicate a number of responses. - respect, fear, resentment, lack of interest are some responses that can be effectively communicated through silence. The most effective use of silence can be made by



giving a slight pause before or after making an important point during a speech. This is what the most successful orators usually do. A slight pause before an important point creates suspense, it raises a sense of anticipation and the audience listens to the next point more attentively. And a slight pause afterwards suggests that something very important has been said and the speaker desires his audience to assimilate it .

### **13.9 BENEFITS OF EFFECTIVE COMMUNICATION**

Only through effective communication both inside and outside, an organisation, becomes an open system interacting with its environment. Effective internal communication works towards establishing and disseminating of the goals of an enterprise, evolving plans for their achievement, organizing human and other resources in an efficient way, selecting, developing and appraising members of the organisation, leading, motivating and encouraging people to put in their best and controlling performance.



*The Benefits of Effective Communication*



External communication relates an organisation to the environment outside. No enterprise can thrive in a vacuum. It has to be aware of the needs of the customers, the availability of the suppliers, the regulations of the government and the concerns of a community.

### **13.10 BARRIERS TO EFFECTIVE COMMUNICATION**

The purpose of communication is to get your message across to others successfully. This is a process that involves both the sender of the message and the receiver. A message is successful only when both the sender and the receiver perceive it in the same way. This process leaves room for error, with messages often misinterpreted by one or more of the parties involved. This causes unnecessary confusion and counter productivity.

It is important to understand the causes of communication breakdown.

#### **NOISE**

Noise is the first and foremost barrier to communication. It means “interference that occurs in a signal and prevents you from hearing sounds properly.” In a factory, for example, the continuous noise made by machines makes oral communication difficult. In the same way some technical problem in a public address system or a static in a telephone or television cable will distort the sound signal and affect communication. Adverse weather conditions or some fault in the ultramodern telecommunication systems may also spoil the effect.

Noise does not mean only this. It also encompasses many other factors that may exist at the end of sender as well as that of the receiver. The sender may resort to ambiguous or confusing signals. The receiver may mess up the message owing to inattention or may spoil decoding because of wrong or unexpected interpretation. The receiver’s prejudices may also come in the way of his understanding the message in the right spirit. We must therefore keep in mind that communication is always likely to be spoiled by ‘noise’ that stands for so many things.

Some of the sources contributing towards noise factors are as follows.

**Poor Timing** - A last moment communication with deadline may put too much pressure on the receiver and may result in resentment.

**Inappropriate Channel** - Poor choice of channel of communication can also be contributory to them is understanding of the message.

**Network Breakdown** - Sometime staff may forget to forward a letter or there may be professional jealousy resulting in closed channel.

#### **LACK OF PLANNING**

Communication is not a casual affair. Unfortunately many people take it lightly. The result is that the message to be sent across may not be carefully planned. There are innumerable



examples of people who would give an ill-planned, long-winding lecture while a short presentation with tables or graphs would be sufficient. Such an event would turn into one of miscommunication. In the same way some people may not care to choose a suitable time and place that are so very necessary for effective communication.

Managers have to communicate individually with people at different levels – superiors, subordinates, peers, customers and public figures. The oral mode, of communication is easy, time saving, and of functionally helpful in resolving issues. But oral communication demands great control and communicative competence to be successful.

### **SEMANTIC PROBLEMS**

Semantics is the systematic study of meaning. That is why the problems arising from expression or transmission of meaning in communication are called semantic problems. Oral or written communication is based on words. And words, limited in number, may be used in unlimited ways. The meaning is in the mind of the sender and also in that of the receiver. But it is not always necessary for the meaning in the mind of the sender to be the same as in the mind of receiver. Much, therefore, depends on how the sender encodes his message.

The sender has to take care that the receiver does not misconstrue his message, and gets the intended meaning. Quite often it does not happen in this way. That leads to semantic problems. It can be ensured only if we aim at clarity, simplicity and brevity so that the receiver gets the intended meaning.

### **CULTURAL BARRIERS**

We live in a culturally diverse world ,and so could encounter individuals from different races, religions, and nationalities . There is often anxiety surrounding unfamiliar cultures. What manners are acceptable? What will offend a person from a very different background? It can be paralyzing to deal with other people if we do not know what to expect Cultural differences often come up as communication barriers. We have to be specially careful in this regard as now we have to operate in international environment. The same category of words, phrases, symbols, actions, colours mean different things to people of different countries or different cultural backgrounds. For example, in the United States people love to be called by their first names while in Britain, and to a large extent also in India, people like to be addressed by their last name. In the North American States a sign of 'O' made with the forefinger and thumb stands for 'OK' while in the Southern States it is construed as obscenity.

The desire to communicate is the first step in being effective. The desire to connect with another human being is the bond that will express itself clearly. A genuine effort to understand another person goes a long way in the path to communication. Knowing about other cultures and being proactive will help to develop these skills.





### **WRONG ASSUMPTIONS**

Quite often we act on assumptions, without caring to seek clarification for them. We should make all possible efforts to maintain our goodwill and not act impulsively on assumptions. If, for example, a customer writes to us that he would like to visit our office or factory without telling us that he would like to be picked up and we assume that he will manage to come on his own it may lead to loss of goodwill. So it is necessary to be circumspect in such matters.

### **SOCIO-PSYCHOLOGICAL BARRIERS**

The attitudes and opinions, place in society and status-consciousness arising from one's position in the hierarchical structure of the organization, one's relations with peers, seniors, juniors and family background -all these deeply affect one's ability to communicate both as a sender and receiver. Status consciousness is widely known to be a serious communication barrier in organisations. It leads to psychological distancing which further leads to breakdown of communication or miscommunication. Often it is seen that a man high up in an organisation builds up a wall around himself. This restricts participation of the less powerful in decision making. In the same way one's family background formulates one's attitude and communication skills.

Frame of Reference is another barrier to clear communication. Every individual has a unique frame of reference formed by a combination of his experiences, education, culture, attitude and many other elements, resulting in biases and different experiences in a communication situation.

### **EMOTIONS**

Emotions play a very important role in our life. Both encoding and decoding of messages are influenced by our emotions. A message received when we are emotionally worked up will have a different meaning for us than when we are calm and composed. Anger is the worst emotion and enemy of communication.

### **SELECTIVE PERCEPTION**

Perception provides each of us with a unique view of the world – a view some times related to, but not necessarily identical with that held by others. Selective perception means that the receivers selectively see and hear depending upon their needs, background, motivations, experience and other personal characteristics.

While decoding the messages, most protect their own interests and expectations into process of communication leading to a particular kind of feedback that may become a communication problem.



### **FILTERING**

Filtering means that the sender of a message manipulates information in such a way that it will be seen more favourably by the receiver. A manager, for example, likes to tell his boss what he feels his boss wants to hear. In this process he is filtering information. The net result is that the man at the top never gets objective information. In the same way, the people at the lower levels condense and synthesise information so as to get maximum benefits for themselves. They hold back or ignore some important part of information. The more vertical levels in the organisation, the more chances there are for filtering. This is a very frequently occurring communication problem.

### **INFORMATION OVERLOAD**

Unchecked inflow of information, very often becomes another barrier to communication. It may stifle the senior executive or bore and frustrate him. When people are bogged down with too much information they are likely to make errors, They may also delay processing or responding to information/message at least for sometime.

And delay may become a habit, causing serious communication problems. People may also become selective in their response, and selectivity is not communication-friendly. On the other hand, it is a communication problem.

### **POOR RETENTION**

As a corollary to the problem mentioned above, it is worth noting that people are also likely to forget messages reaching them. There from arises the necessity to repeat the message and use more than one medium to communicate the same message.

### **POOR LISTENING**

Poor listening may lead to serious communication problems. Too many people are interested in talking, and mostly talking about themselves. They are so much involved with themselves that they do not have patience to listen. The result is that they are not interested in the speaker whose words go waste. Everybody knows about the importance of listening, but very few actually practice patient, active and empathic listening. That I why, so many communication problems crop up. Poor listening accounts for incomplete information and also poor retention. One may simply not get the desired result if this keeps on happening.

### **GOAL CONFLICTS**

Very often clashes of the goals of various units and sub-units of an organisation lead to communication breakdowns. Communication should serve as a conflict-reduction exercise. But the goal conflicts act as communication reduction mechanisms. Different units internalise their own goals, and that leads to the splitting or bifurcation of interests in the organisation.



When people start competing for the fulfillment of their narrow interests, communication suffers.

### **OFFENSIVE STYLE OF COMMUNICATION**

It is quite obvious that offensive style of communication leads to communication breakdown. It is a rather sensitive point. If a manager sends a message in such a way that the workers/juniors become defensive their relations get strained and communication suffers. Hence it is absolutely necessary for the management to adopt a persuasive style of communication.

### **INSUFFICIENT PERIOD FOR ADJUSTMENT**

It is a fact well known to all that people respond to change in different ways. They take their own time to adjust to any news or proposal for change. While the purpose of communication is to effect change, it should be kept in mind that the employees whose duties, shifts etc., are going to be changed should be given sufficient time. Only then the communication will be effective.

### **LOSS BY TRANSMISSION**

Communication often suffers or gets diluted when messages pass on from person to person in a series of transmissions. They get diluted on the way. Special care has to be taken that the intended message reaches the person concerned.

### **FRAME OF REFERENCE**

Frame of reference is another barrier to clear communication. Every individual has a unique frame of reference formed by a combination of his experiences, education, culture, attitude and many other elements, resulting in biases and different experiences in a communication situation.

## **13.11 WRITTEN COMMUNICATION**

### **Planning and Composing Business Messages**

Effective writing in the workplace is an essential skill. The rules are basically the same for any type of writing, however, there are some special issues which arise in the business context. Knowing the elements of good business writing can make or break a career. Some of these basic elements are:

#### **Know Your Audience**

The key to effective business writing is knowing your audience. Before you sit down to compose your letter, memo or report, think about the recipient of your document. What are you trying to say to this person? Orderliness is crucial. Outlines are an invaluable aid to writing a lengthy report or memo. Remember, time is in short supply for most business professionals.



By organizing your thoughts beforehand, you can determine what exactly you are trying to say. Decide what details must be included in the report or memo. Look for graphic elements to add to your presentation, especially if your report contains many boring statistics. Statistics and research bolster your conclusions, especially if they are presented in a visually appealing manner. With the advent of modern word processing programs such as Microsoft Word and Corel WordPerfect, it is easy to include spread sheets, graphs and colorful clip art to your report, thereby making your work memorable and convincing.

After you have decided what the message is that you are trying to convey, work on saying it in concise language. Be brief, whenever possible. Avoid using vague words when a more precise word will do. Avoid wordiness and unnecessary jargon. Strive for clarity in your writing and avoid vagueness (unless there is good reason to be vague). For example:

*Wordy* - It is the responsibility of the recruiting committee to ensure that the goals of the hiring task force have been implemented.

*Precise* - Our recruiting committee must meet the hiring goals of the hiring task force.

### **Punctuation and Grammatical Errors**

Many grammatical and/or punctuation errors are due simply to insufficient proofreading of the document.

Some errors stem not from lack of proofreading, but from simple grammatical mistakes. The most common mistakes include misuse of apostrophes, misuse of commas, incomplete sentences, ending a sentence with a preposition and so on.

### **13.12 PARTS OF A BUSINESS LETTER**

Listed below are the parts of a business letter :

**1. Heading:** The heading, also called 'letterhead', contains the name of the organization and its address. It is usually given at the top centre or top right side of the paper. It is also usual to give the telephone, fax and telegraphic address in the heading as shown below :

**MEHTA CHEMICALS LIMITED**

**Regd. Office : 15, Okhla Estate, New Delhi - 110016**

**Phone : 6132757, Fax : 6132767**

**E-mail: mehtachem@rediffmail.com , website: www.mehtachem.org**

**2. Reference Number:** Every business letters usually carries a reference number to which the receiver may refer in all future correspondence. It serves the purpose of quick reference and linking up the chain of letters going out of the organization or identifying the memos issued by a department within the organization.



The reference number may be like this : Ref. No: 24/FD/65

In this Ref. No. 24 stands for the number given to the department, 'FD' is a code for the personnel department and '65' is the number allotted to the person addressed.

**3. Date:** The date of the letter is of crucial importance. It is usually written on the right hand side, parallel to the reference number as shown below :

Ref. No : **24/FD/65**

**December 16, 2005**

Abbreviated forms of the date such as 16.12.2005 should be avoided .

When the address of the organisation is combined with the date, the following format should be used :

15, Okhla Estate, New Delhi

December 16, 2005

#### **4. Inside Address**

It contains the name and address of the organisation or the individual to whom the letter is being sent. It should be written in either of the two ways as shown below :

**(a)** Mehta Chemicals Limited,  
15, Okhla Estate,  
New Delhi.

\* Closed punctuation

\* Indented lines (not applicable to PIN code).

**(b)** Mehta Chemicals Limited,  
15, Okhla Estate,  
New Delhi.

\* Open punctuation

\* Blocked lines (i.e. not indented)

\* If well written, it is a neat and on lettered address format.

#### **MODE OF ADDRESS**

(a) Addressing individuals

If the letter is being sent to an individual we have to be sure about the prefixing of the addressee.

(i) 'Mr' or 'Shri' is used for addressing a man.



- (ii) 'Miss' is used for an unmarried woman.
- (iii) 'Mrs' or 'Shrimati' is used for a married woman.
- (iv) 'Ms' is used for a woman whose marital status is not known. Most women now prefer the use of 'Ms'.
- (v) 'Messrs' is a plural for 'Mr' and is used while addressing a partnership firm. It can best be used when the name of the firm contains personal name or names as, for example.

Messrs Lal Bros.

Messrs Makhan Lal Sons

Messrs K. Lal & Co.

Messrs Verma and Verma

- (vi) Titles/ranks such as Colonel', 'Professor', 'Doctor', 'Reverend' etc., are used as follows.

Col. Y. P. Deva

Capt. R. N. Singh

Prof. B. L. Arora

Dr. R. N. Ghosh

Rev. T.L. Joseph

Padmashri R. S. Lugani (not Padmashri Mr. R.S. Lugani)

Maj. Gen. D. K. Palit

Flt. Lt. Manish Bansal

Maj. Gen. (Miss S. Rawat)

Dr. (Miss) S. Gupta

- (b) Addressing by designation

When a particular person is addressed by designation, 'Mr.' or 'Messrs.' (in case of a limited company) is not used:

The Personnel Manager,

Verma & Co.

The Secretary,

Youth Sports club.



**5. Attention Line:** When the writer sends his letter to a particular official in an organisation, he may use the phrase 'For the attention of' below the inside address and above the Salutation and underlines it. For example,

Mehta Chemicals Limited,  
15, Okhla Estate,  
New Delhi.

For the attention of Shri D. K. Singh

Other typical forms of this reference are as follows :

Attn. of D. K. Singh, General Manager

For Ms. R. Desai, Public Relations Officer

Attention : K. P. Verma, Vice President

Attention : B. K. Sood, Sales Manager

**6. Salutation:** Salutation is the greeting of the addressee. We may choose the salutation on the basis of our familiarity with the reader and the formality of the situation. The commonly used salutations are given below :

- (i) Sir
- (ii) Madam
- (iii) Dear Sir/Dear Madam
- (iv) Dear Mr. Verma
- (v) Dear Ms. Singh
- (vi) Dear Sirs
- (vii) Your Excellency (while addressing the Ambassador or High Commissioner of a foreign country)
- (viii) Gentlemen - used when a circular is sent to many addresses including an individual, firm, society, company etc. Now-a-days 'Dear Sir/Madam' is also freely used in circulars.

**Punctuation of Salutation:** When indented paragraphs are used in the letter, it is customary to end the salutation with a comma.

For example,

Dear Ms. Joseph,

Thank you for your letter.....



When the paragraphs are not indented, the comma at the end of the salutation is omitted.

Dear Ms. Joseph

Thank you for your letter.....

**7. Subject line:** Many writers use subject lines to enable the reader to quickly identify the subject of correspondence. It tells what the correspondence is about. In addition, it contains any specific identifying material that is supposed to be helpful date of previous letter, invoice number, order number or the central point of the letter. It is placed just below the line of salutation. It usually begins at the left margin, although it may be placed in the centre or indented (if the paragraphs are indented).

The subject line may be worded in a number of ways. Given below are a few representative samples :

Subject : Your December 16 inquiry about....

Reference : Your December 16 order for.....

About your Order No. 635 - A dated....

In reply, please refer to File K-304

Sub : Loan facilities for

Ref : Your enquiry of December 16

**8. Body of the letter:** The body of the letter carries its message or content. It is generally divided into three or four paragraphs, each having its own function. The first paragraph links up the correspondence and establishes rapport with the reader. The second paragraph may be called the main paragraph that contains the subject proper. If need be, the point of the second or main paragraph is elaborated or further developed upon in the third paragraph. The fourth or final paragraph brings the letter to a goodwill ending, leaving the door open for further business. Whatever the circumstances, the last paragraph brings the letter to a close on a positive note. It is generally followed by phrases like, 'with regards', 'with best wishes', 'with warm regards', 'Thanking you', etc.

Second page heading

When a letter goes beyond one page, we should mark the following page/pages for quick identification.

The following page/pages must always be typed on plain paper, not on the letterhead. Of the various forms used to identify these pages, the following are the most common :

- (i) Ms. T. Joseph                      December 16, 2005
- (ii) Ms. T. Joseph                     December 16, 2005 Page 2





(iii) Ms. T. Joseph                      December 16, 2005 Page 2

**9. Formal close:** The formal close of the letter must 'match' the salutation as shown below :

Dear Sir

Dear Madam                      Yours faithfully

Sir

Dear Mr. Joseph                      Yours sincerely

Dear Tina

If the salutation does not name the recipient, formal close is 'Yours faithfully'. If the salutation names the recipient the formal close is 'Yours sincerely'. 'Yours' begins with a capital 'Y', but 'faithfully' and 'sincerely' begin with small letters.

**10. Signature block/slot:** There is a fixed space for the signature of the writer. Just as the signature is important, so is its place in the layout of the letter. Conventionally the signature, that is handwritten and contains the writer's name, status, department, company etc., appears just below the complementary close. As far as possible it should be legible. But what is most important is that the name of the signatory should be written/typed/printed in parentheses below the signature.

*Given below are a few examples of the format :*

(i) ..... when the individual signs in his own right.

(P. C. Verma)

.....

(ii) ..... when the individual signs in his capacity as

(P. C. Verma)

Sales Manager

Sales Manager.

(iii) For the Verma Associates when the individual signs in his representative

.....

(P. C. Verma)

Partner

capacity.

(iv) For Verma Associates when the individual signs in his representative

.....

capacity.



(P. C. Verma)  
Managing Trustee

(v) For J. D. Singh  
.....

when the individual signs pursuant to a power of attorney.

(P. C. Verma)  
Attorney Holder

(vi) For Bunty (Minor)  
.....

when the individual indicates guardian responsibility.

(P. C. Verma)  
Local Guardian

(vii) Verma Associates  
.....

when the subordinate signs a routine letter.

For P. C. Verma

(viii) P. P. iw per Pro P.C. Verma  
..... Verma Associates  
Manager

When an individual signs with the authority of another individual.

(ix) For Verma Associates  
Sd/-  
P. C. Verma  
Partner

It is not necessary to sign in a format like this that is meant for executing a deed. However, there is nothing wrong in signing it.

### **11. Enclosures (Encl)**

Very often a letter carries along with it some important papers such as proof of date of death, copies of certificates and testimonials. Price list, invoice, receipts, Cheque/Draft bill/cash memo, copies of required pages of passport, photo identity card etc. The writer is well advised to make mention of these papers at

the bottom left margin as shown below :

(i) Enclosures : Three



- (ii) Encl : (i).....
- (ii).....
- (iii).....
- (ii) Enclosed.....etc.

**12. Postscript:** Postscript or P.S. is written if the writer has forgotten to mention something important in the letter.

Generally a writer is not supposed to forget any important item. But some important information may come in when the letter has been written. In such a case the writer is supposed to write the postscript very carefully and precisely or, in other words, to give the additional information in as few words as possible.

**13. 'CC' or Carbon copy Notation:** Often copies of a letter are supposed to be sent to some other people directly or indirectly concerned with the matter/subject. In such cases the names of the persons to whom copies are sent should be written/typed adjacent to the left margin like this :

- CC: Mr. P.K. Nangia
- Copies to Mr. P.K. Nangia and Mr. P.D. Paul
- Copy to Mr. P. K. Nangia

**14. Reference initials:** Many organisations continue to follow the practice of putting typed initials of the person who dictates the letter and those of the one who types it. These initials are useful for office checking. They can be typed adjacent to the left margin in the end like this:

- PKS/CB
- PKS : CB
- PKS - CB

PKS are the initials of the person who has dictated the letter and CB of the person who typed it.

### 13.13 LAYOUTS OF LETTERS

A letter is the most important form of written communication. It is, therefore, supposed to have an attractive or impressive layout. As has been well said, a letter's appearance is the part of its message. That is why, most reputed companies choose the best quality stationery and send out carefully drafted letters.





2. Modified Block

Date, closing and signature aligned at the right

<b>Company letterhead</b> (Printed Name, address, telephones, fax etc.)	
Ref. No.	Date
Name	
Inside Address	
Attention line	
Salutation:	
Subjectline (optional)	
XX	
xxxxxxx	
XX	
xxxxxxxxxxxxxxxx	
XX	
xxxxxxxxxxx	
XX.	
	Closing/Subscription
	Signature
Signatory's typed name	
Signatory's position in the Company	
Company name	
Encl	
P.S.	
C.C.	
Ref. Initials	



### 3. Semi-block or Indented Form

Each paragraph is indented five spaces as an added signal for a new paragraph.

<b>Company letterhead</b> <b>(Printed Name, address, telephones, fax etc.)</b>
Ref. No.
Date
Name and address of Receiver
Attention line
Salutation
Subject heading-not obligatory, but often used
XX XX
XX XX.
XX XX
Closing/Subscription
Signature
Signatory's typed name
Signatory's position in the Company
Company name
Encl
P.S.
C.C.
Ref. Initials

### 13.14 PLANNING BUSINESS MESSAGES

#### A. Purpose

- o Determine whether the purpose of your message is to inform, persuade, or collaborate.



- ⊖ Identify the specific behavior you hope to induce in the audience.
- ⊖ Make sure that your purpose is worthwhile and realistic.

**B. Audience**

- ⊖ Determine whether the purpose of your message is to inform, persuade, or collaborate.
- ⊖ Identify the specific behavior you hope to induce in the audience.
- ⊖ Make sure that your purpose is worthwhile and realistic.

**C. Main Idea**

- ⊖ Stimulate your creativity with brainstorming techniques .
- ⊖ Identify a “hook” that will motivate the audience to respond to your message in the way you intend.
- ⊖ Evaluate whether the main idea is realistic given the length limitations imposed on the message .
- ⊖ Collect any necessary information

**D. Channel and Medium**

1. If your purpose is to collaborate, give an informal, relatively unstructured oral presentation to a small group.
2. If you are celebrating an important public occasion, give a prepared speech to a large audience.
3. If you need a permanent record, if the message is complex, or if immediate feedback is unimportant, prepare a written message.
  - a. Send a letter if your message is relatively simple and the audience is outside the company.
  - b. Send a memo if your message is relatively simple and the audience is inside the company.
  - c. Write a report if your message is objective and complex.
4. If you need to communicate quickly, overcome time zone differences, or personally reach a widely dispersed audience, choose electronic communication.
  - a. Use voice mail if your message is short and clear.
  - b. Use teleconferencing for informational meetings.
  - c. Use videotape for sending motivational messages to a large number of people.
  - d. Use fax machines to overcome time-zone barriers.



- e. Use E-mail for speed lower cost, and increased access to other employees.
- f. Use computer conferencing to focus attention of ideas instead of status

### **13.15 CHECKLIST FOR COMPOSING BUSINESS MESSAGES**

#### **A. ORGANIZATION**

- 1. Recognize good organization.**
  - a. Subject and purpose are clear.
  - b. Information is directly related to subject and purpose.
  - c. Ideas are grouped and presented logically.
  - d. All necessary information is included.
- 2. Achieve good organization through outlining.**
  - a. Decide what to say.
    - i. Main idea
    - ii. Major points
    - iii. Evidence
  - b. Organize the message to respond to the audience's probable reaction.
    - i. Use the direct approach when your audience will be neutral, pleased, interested, or eager.
    - ii. Use the indirect approach when your audience will be displeased, uninterested, or unwilling.
- 3. Choose the appropriate organization plan.**
  - a. Short messages
    - i. Direct request
    - ii. Routine, good-news, and goodwill message
    - iii. Bad-news message
    - iv. Persuasive message
  - b. Longer messages
    - i. Informational pattern
    - ii. Analytical pattern





## B. FORMULATION

1. **Compose your first draft.**
  - a. Get ideas down as quickly as you can.
  - b. Rearrange, delete, and add ideas without losing sight of your purpose.
2. **Vary the style to create a tone that suits the occasion.**
  - a. Establish your relationship with your audience.
    - i. Use the appropriate level of formality.
    - ii. Avoid being overly familiar, using inappropriate humor, including obvious flattery, sounding preachy, bragging, and trying to be something you're not.
  - b. Extend your audience-centered approach by using the "you" attitude.
  - c. Emphasize the positive aspects of your message.
  - d. Establish your credibility to gain the audience's confidences.
  - e. Make your tone a polite one.
  - f. Use the style that your company prefers.

### 13.16 SELF-EXAMINATION QUESTIONS

#### I Questions (Short/Essay type answer)

1. Write a note on the statement, "You can't not communicate."
2. Discuss some of the principles of effective oral communication.
3. Give five reasons for choosing the oral mode of communication instead of the written form.
4. What do you mean by body language ? Discuss its various aspects in detail.
5. Write an essay on the paralinguistic aspects of effective oral communication.
6. "The face is the index of the mind". Elaborate.
7. Enlist and briefly outline the major components of a business letter .
8. Write short notes on (a) eye contact, (b) nodding, (c) stiff standing body position, (d) constant gaze.
9. What are the risks involved in depending on paralanguage
10. Explain the following :
  - (a) Speed variation in speech



- (b) Pause
  - (c) Non-fluencies
  - (d) Word stress
11. Write short notes on the following
- (a) Filtering
  - (b) Information overload
  - (c) Goal conflict
  - (d) Status consciousness
  - (e) Emotions and communication
12. Explain how offensive style is the greatest barrier to communication.
13. Which communication media would you use to ask employees to work overtime to meet an important deadline, a direct request or a persuasive message? Why?
14. Give five reasons for choosing the oral mode of communication instead of the written form.
15. Rewrite these sentences to reflect your audience's viewpoint:
- a. We request that you use the order form supplied in the back of our catalog.
  - b. We insist that you always bring your credit card to the store.
  - c. We want to get rid of all our manual typewriters in order to make room in our warehouse for the new electronic models. Thus we are offering a 25 percent discount on all sales this week.
16. Revise the following sentences, using, shorter, simpler words:
- a. The antiquated calculator is ineffectual for solving sophisticated problem.
  - b. It is imperative that the pay increments be terminated before an inordinate deficit is accumulated.

**II Choose the Correct Alternative**

- i) Hierarchy in a company means \_\_\_\_\_
- (a) a panel for promotion
  - (b) graded levels of employees
  - (c) formula for calculating bonus
  - (d) top level management



- ii) Diagonal communication is \_\_\_\_\_
  - (a) communication across boundaries
  - (b) communication between CEO and managers
  - (c) communication through body language
  - (d) communication using dialogue
- iii) An ombudsperson is
  - (a) a redressal forum
  - (b) a judicial forum
  - (c) a wing of a labour union
  - (d) a committee to study finance
- iv) In any communication, body movements and gestures constitute \_\_\_\_\_
  - (a) more than half
  - (b) less than 10%
  - (c) a negligible fraction
  - (d) 7 percent
- v) Paralanguage is \_\_\_\_\_
  - (a) a foreign language
  - (b) non-verbal
  - (c) a study of enclosed space
  - (d) musical and pleasant
- vi) Semantics is \_\_\_\_\_
  - (a) study of meanings
  - (b) study of employer psychology
  - (c) documentation of secret information
  - (d) the art of archiving data
- vii) An office order is an example of \_\_\_\_\_
  - (a) upward communication
  - (b) grapevine communication



- (c) downward communication
- (d) diagonal communication
- viii) Filtering is a phenomenon where \_\_\_\_\_
  - (a) useless workers are retired
  - (b) inefficient staff are made to pay penalties
  - (c) a message is manipulated so as to be pleasing to the receiver
  - (d) information is not allowed to flow at all
- ix) Feedback is necessary in effective communication because \_\_\_\_\_
  - (a) it provides continuity to dialogue
  - (b) it inspires the sender to speak more
  - (c) it tells the sender whether the receiver has understood the message
  - (d) it shows the receiver's intellectual capability
- x) The main limitation of oral communication is \_\_\_\_\_
  - (a) that it may degenerate into directionless conversation
  - (b) that it may take up too much time
  - (c) that it cannot be used as record for future reference
  - (d) that it needs people to come face to face with each other

**Answers (MCQs)**

- i) (b),    ii) (a),    iii) (a),    iv) (a),    v) (b),    vi) (a),    vii) (c),    viii) (c),  
ix) (c)    x) (c)

# CHAPTER 14

## INTERPERSONAL COMMUNICATION SKILLS

### Learning Objectives

*After reading this chapter, you will be able to understand:*

- ◆ Soft skills and the importance of Interpersonal Communication
- ◆ Active listening and Critical Thinking Skills
- ◆ Emotional Intelligence, Emotional Quotient
- ◆ The Role of leadership in organisation

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*The most powerful agent of growth and transformation is something much more basic than any technique: a change of heart.*

**John Welwood**

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### 14.1 INTRODUCTION

"People skills" or interpersonal skills are an essential ingredient for success in any career. These skills create a positive communication climate in which people feel valued. The key factors to building a positive environment in all areas of one's life are interpersonal communication, active listening, critical thinking and emotional intelligence- which convey respect for the other person and varied point of views; which during a conflict focus on solving problems- not imposing solutions; are honest, show concern for the other party, demonstrate an attitude of equality, and reflect the communicator's open-mindedness .

### 14.2 PRINCIPLES OF INTERPERSONAL COMMUNICATION

Interpersonal communication differs from other forms of communication discussed earlier, in that there are few participants involved; those interacting are in close physical proximity to each other; there are many sensory channels used, and feedback is immediate.

The following principles are basic to interpersonal communication:

**Interpersonal communication is inescapable:** We can't not communicate. The very attempt not to communicate communicates something. Through not only words, but through tone of voice and through gesture, posture, facial expression, etc., we constantly communicate to



those around us and through these channels, we constantly receive communication from others. Remember that: people judge you by your behaviour, not by your intent.

**Interpersonal communication is irreversible:** A Russian proverb says, "Once a word goes out of your mouth, you can never swallow it again." You cannot really take back something once it has been said. The effect will inevitably remain..

**Interpersonal communication is complicated:** No form of communication is simple. Because of the number of variables involved, even simple requests are extremely complex. .Actually we don't exchange ideas, BUT symbols that stand for ideas. This complicates communication. Words (symbols) do not have inherent meaning; we simply use them in certain ways, and no two people use the same word exactly alike.

**Interpersonal communication is contextual:** In other words, communication does not happen in isolation. There is: **psychological context**, which is who the communicators are and what they bring to the interaction. Their needs, desires, values, personality, etc., all form the psychological context.

**Relational context**, which concerns reactions to each other.

**Situational context** deals with the "psycho-social-where" one is communicating. For example, an interaction that takes place in a classroom will be very different from one that takes place in a Board room.

**Environmental context** deals with the "physical -where" one is communicating. Furniture, location, noise level, temperature, season, time of day, all are examples of factors in the environmental context.

**Cultural context** includes all the learned behaviours and rules that affect the interaction. If you come from a culture (foreign or within your own country) where it is considered rude to make long, direct eye contact, you will out of politeness avoid eye contact. If the other person comes from a culture where long, direct eye contact signals trustworthiness, then we have in the cultural context a basis for misunderstanding.

### **14.3 FUNCTIONS OF INTERPERSONAL COMMUNICATION**

Interpersonal communication is important because of the following functions its achieves:

**Gaining Information** : One reason we engage in interpersonal communication is to gain knowledge about another individual. We attempt to gain information about others so that we can interact with them more effectively. We can predict better how they will think, feel, and act if we know who they are. We gain this information passively, by observing them; actively, by having others engage them; or **interactively, by engaging them ourselves.**



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## Interpersonal Communication Skills

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**Building Understanding:** interpersonal communication helps us to understand better what someone says in a given context. Words can mean very different things depending on how they are said or in what context. **Content Messages** refer to the surface level meaning of a message. **Relationship Messages** refer to how a message is said. The two are sent simultaneously, but each affects the meaning assigned to the communication and helps us understand each other better.

**Establishing Identity:** We also engage in interpersonal communication to establish an identity based on our relationships and the image we present to others

**Interpersonal Needs:** we also engage in interpersonal communication to express interpersonal needs. William Schutz has identified three such needs: inclusion, control, and affection.

- Inclusion is the need to establish identity with others.
- Control is the need to exercise leadership and prove one's abilities. Groups provide outlets for this need. Some individuals do not want to be a leader. For them, groups provide the necessary control over aspects of their lives.
- Affection is the need to develop relationships with people. Groups are an excellent way to make friends and establish relationships.

### TIPS FOR IMPROVING INTERPERSONAL SKILLS

Lines of communications must be open between people who rely on one another to get work done. Poor interpersonal communications skills (which include active listening), result in low productivity simply because one does not have the tools needed to influence, persuade and negotiate – all necessary for workplace success.

**1) Congruency in communication elements:** If the words used are incongruent with the other interpersonal communication dynamics interpersonal communication is adversely affected. Since communication is shared meaning, words must send the same message as the other interpersonal communication dynamics.- body language, facial expression, posture, movement, and tone of voice to help emphasize the truth, sincerity, and reliability of the communication. A consistent message ensures effective communication.

**2) Listening Effectively:** Effective or active listening is a very important skill to enhance interpersonal communication. Listening helps to build strong personal relationships. The process of communication completes when the message as intended by the sender is understood by the receiver. Most assume that listening is natural trait, but practically very few of us listen properly. One needs to give the communicator of the message sufficient attention and make an effort to understand his viewpoint



#### **14.4 ACTIVE LISTENING & CRITICAL THINKING**

**Active Listening:** Most of us assume that listening is natural trait, but practically very few of us listen properly. What we regularly do is - we hear but don't listen. Hearing is through ears and listening is by mind. Listening happens when we understand and message as intended by the sender. Many managers, especially, are so used to helping people solve problems that their first course of action is to begin brainstorming solutions and giving advice instead of listening with full attention directed toward understanding what the co-worker or staff member needs. Maybe the employee just needs a listening ear.

If one does not learn how to listen, a great deal of what people are trying to tell you would be missed. In addition, appropriate response would not be possible. Active listening is important for several reasons. First, it aids the organization in carrying out its mission. In addition, it helps individuals to advance in their careers. It provides information that helps them to learn about important happenings in the organization, as well as assisting them in doing their own jobs well. It also helps build strong personal relationships. Despite these advantages, most workers are poor listeners for a variety of reasons, physiological, environmental, attitudinal, socio-cultural, and educational.



This Chinese symbol that is used for our English "to listen" is composed of four elements: ear, eyes, undivided attention, and heart.

#### **Guidelines for Active Listening**

- Look at the person and suspend other things you are doing. Otherwise, your brain will be distracted from its main goal - understanding the other person's concerns, intentions.
- Be interested in what the person is saying. Everybody is interesting in some way. If you just can't make yourself interested, you will lose important information, so try taking notes. Doing so will keep you body and mind active.
- Listen to the tone of voice and inflections; look at gestures and body language - these may carry an unspoken message.
- Restate what the person said. Restating their meaning is a way for you to make sure you understand the person clearly.





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- Ask questions once in a while to clarify meaning. Doing so will keep you alert, and let the other person know you have been listening and are interested in getting all the facts and ramifications.
- Be aware of your own feelings and opinions. They may cloud your perception of what is being said. Being aware of your own preconceptions is a type of critical thinking that prevents biasing your judgment about the other person.

### CRITICAL THINKING

Critical thinking is the discipline of rigorously and skillfully using information, experience, observation and reasoning to guide your decisions, actions and beliefs. Critical thinking means questioning every step of your thinking process: Have you considered all the facts? Have you tested your assumptions? Is your reasoning sound? Can you be sure your judgment is unbiased? Is your thinking process logical, rational and complete? This kind of rigorous, logical questioning is often known as Socratic questioning, after the Greek Socrates who is considered to be the founder of critical thinking. By developing the skills of critical thinking, and bringing rigour and discipline to your thinking processes, you stand a better chance of being "right", likely to make good judgments, choices and decisions in all areas of your life. This is an important part of "success" and "wisdom".

By thinking critically, you aim to ensure that the thinking processes you choose and follow are rigorous and complete. To do this effectively, you need to develop skills to:

*Analyze Cause and Effect:* You must be able to separate the motive or reason for an action or event (the cause) from the result or outcome (the effect).

*Classify and Sequence:* You must be able to group items or sort them according to similar characteristics.

*Compare and Contrast:* You must be able to determine how things are similar and how they are different.

*Infer:* You must be skilled in reasoning and extending logic to come up with plausible options or outcomes.

*Evaluate:* You must be able to determine sound criteria for making choices and decisions.

*Observe:* You must be skilled in attending to the details of what actually happened.

*Predict:* You must be able to find and analyze trends, and extend these to make sensible predictions about the future.

*Rationalize:* You must be able to apply the laws of reason (induction, deduction, analogy) in to judge an argument and determine its merits.



*Prioritize:* You must be able to determine the importance of an event or situation and put it in the correct perspective.

*Summarize:* You must be able to distill a brief report of what happened or what you have learned.

*Synthesize:* You must be able to identify new possible outcome by using pieces of information that you already know.

### **Qualities of a Critical Thinker**

By combining the skills of critical thinking with the appropriate mindset, you can make better decisions and adopt more effective courses of action. To develop as a critical thinker one must be motivated to develop the following attributes

1. *Open-minded* – is willing to accept and explore alternative approaches and ideas.
2. *Well-informed* – Knows the facts and what is happening on all fronts.
3. *Experimental* – Think through “what if” scenarios to create probable options and then test the theories to determine what will work and what won't.
4. *Contextual* – Keeps in mind the appropriate context when thinking things through. Apply factors of analysis that are relevant or appropriate.
5. *Reserved in Making Conclusions* – Know when a conclusion is “fact” and when it is not. Only true conclusions support decisions.

### **14.5 EMOTIONAL INTELLIGENCE**

Every day, emotions shape the path of our lives and influence our decision-making. Our emotional actions and reactions affect who we are and control whether or not we are able to achieve our goals. Each days news comes to us rife with emotional disquiet showing an increase in incidents of aggression - teens with guns in schools, freeway mishaps ending in shootings, disgruntled employees killing colleagues. Such reports of the collapse of civility and safety, reflects out of control emotions in our own lives and in those of the people around us. No one is insulated from this erratic tide of outburst and regret. Our passions, when well exercised, have wisdom; they guide our thinking, our values, our survival. But they can easily go awry, and do so all too often. As Aristotle saw, the problem is not with emotionality, but with the appropriateness of emotion and its expression. The question is, how can we bring intelligence to our emotions-and civility to our streets and caring to our communal life? The last decade, despite its bad news, has also seen an unparalleled burst of scientific studies of emotion. Most dramatic are the glimpses of the brain at work, made possible by innovative methods such as new brain-imaging technologies. This mapping offers a challenge to those who subscribe to a narrow view of intelligence, arguing that IQ is a genetic gift that cannot be



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changed by life experience, and that our destiny in life is largely fixed by these aptitudes. The difference quite often lies in the abilities called emotional intelligence, which include self-control, zeal and persistence, and the ability to motivate oneself.

“Emotional Intelligence” refers to the capacity to recognize your own feelings and those of others, for motivating yourself, and for managing emotions well in yourself and in your relationships. “It describes abilities distinct from, but complementary to, academic intelligence, the purely cognitive capabilities measured by IQ. Many people who are book smart but lack emotional intelligence end up working for people who have lower IQs than they but who excel in emotional intelligence skills.”<sup>1</sup> The basic flair for living called emotional intelligence is being able, for example, to rein in emotional impulse; to read another’s innermost feelings; to handle relationships smoothly as Aristotle put it, the rare skill “to be angry with the right person, in the right way.” “Intelligent” puts emotions at the centre of our abilities. These abilities can preserve our most prized relation-ships, or their lack corrode them; the market forces that are reshaping our work life are putting an unprecedented premium on emotional intelligence for on-the-job success; and toxic emotions put our physical health at as much risk as does chain-smoking, even as emotional balance can help protect our health and well-being. Our genetic heritage endows each of us with a series or emotional set points that determines our temperament. Drawing on groundbreaking brain and behavioural research, Daniel Goleman shows the factors at work when people of high IQ flounder and those of modest IQ do surprisingly well. These factors, which include self-awareness, self-discipline, and empathy, add up to a different way of being smart-one he terms “emotional intelligence.” While childhood is a critical time for its development, emotional intelligence is not fixed at birth. It can be nurtured and strengthened throughout adulthood-with immediate benefits to our health, our relationships, and our work. A view of human nature that ignores the power of emotions is sadly shortsighted. The very name Homo sapiens, the thinking species, is misleading in light of the new appreciation and vision of the place of emotions in our lives that science now offers. As we all know from experience, when it comes to shaping our decisions and our actions, feeling counts every bit as much-and often more-than thought. We have gone too far in emphasizing the value and import of the purely rational-of what IQ measures-in human life. For better or worse, intelligence can come to nothing when the emotions hold sway. Emotional Quotient Inventory is designed to measure a number of constructs related to emotional intelligence. A large part of our success in life is based on our EQ, our emotional quotient. How we manage our emotions and the way we relate to others determines how successful and satisfied we are at work, home, and with friends. Our EQ is the ability to make and deepen connections at three levels: with ourselves (personal mastery), with another

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<sup>1</sup> Emotional Intelligence, Daniel Goleman, 1995



person (one-to-one), and within groups/teams. Our EQ, or Emotional Intelligence, is the capacity for effectively recognizing and managing our own emotions and those of others. Emotions have the potential to get in the way of our most important business and personal relationships.

#### **14.6 COMPETENCIES ASSOCIATED WITH EMOTIONAL INTELLIGENCE<sup>2</sup>**

##### **I - Personal Competence – How You Manage Yourself**

###### **Self-Awareness**

- ⊖ *Emotional self-awareness*: Reading your own emotions and recognizing their impact; using 'gut sense' to guide decisions
- ⊖ *Accurate self-assessment*: Knowing your strengths and weaknesses
- ⊖ *Self-confidence*: A sound sense of your self-worth and capabilities
- ⊖ *Self-Management*
- ⊖ *Emotional self-control*: Keeping disruptive emotions and impulses under control
- ⊖ *Transparency*: Displaying honesty and integrity; trustworthiness
- ⊖ *Adaptability*: Flexibility in adapting to changing situations or overcoming obstacles
- ⊖ *Achievement*: The drive to improve performance to meet inner standards of excellence
- ⊖ *Initiative*: Readiness to act and seize opportunities
- ⊖ *Optimism*: Seeing the upside in events

##### **II – Social Competence – How You Manage Relationships**

###### **Social Awareness**

- ⊖ *Empathy*: Sensing other's emotions, understanding their perspective and taking active interest in their concerns
- ⊖ *Organizational awareness*: Reading the currents, decision networks, and politics at the organizational level
- ⊖ *Service*: Recognizing and meeting follower, client, or customer needs

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<sup>2</sup> "Working with Emotional Intelligence", Daniel Goleman, 1998



### Relationship Management

- ⊖ Inspirational leadership: Guiding and motivating with a compelling vision
- ⊖ Influence: Wielding a range of tactics for persuasion
- ⊖ Developing others: Bolstering others' abilities through coaching, feedback and guidance
- ⊖ Change catalyst: Initiating, managing, and leading in a new direction
- ⊖ Conflict management: resolving disagreements
- ⊖ Building bonds: Cultivating and maintaining a web of relationships
- ⊖ Teamwork and collaboration: Cooperation and team building

According to John Kotter of Harvard Business School, 'because of the furious pace of change in business today, difficult to manage relationships sabotage more business than anything else – it is not a question of strategy that gets us into trouble, it is a questions of emotions'. The wonderful thing about EQ , unlike IQ which stabilizes when a person is around 18 years of age, is that it can change. A person today with a low EQ score on “empathy” can have a higher “empathy” score in the future – if that person recognizes his/her limitation, changes attitude, adopts a learning strategy, and practices key listening and empathy skills.

Successful organizations nurture their people with outstanding EQ. The future will belong to those who have excellent relationship skills.

### 14.7 SELF-EXAMINATION QUESTIONS

#### I Questions (essay type answers)

1. Why are strong interpersonal relationships important to businesses? What are some obstacles to such relationships?
2. Discuss ways to improve relations with difficult co workers. What factors (personal or organizational) may stand in the way of improvement?

#### II Questions (short answers)

For any one of the situations given below choose the best method of communication from the following giving reasons (in about 30 words only) for your choice

- ⊖ face-to-face
- ⊖ telephone
- ⊖ personal written
- ⊖ formal written
- ⊖ visual



- o Any other
- 1. *As a result of a recent merger with another organization, a portion of the combined workforce will be laid off. As director of Human Resources, it's your job to communicate this difficult news to the affected employees. Although the organization is offering a substantial severance package, this news will be hard to deliver since it greatly impacts the lives of those being discharged. Your goal is to convey this information so that it causes the least amount of harm possible to employees' self-esteem while, if possible, maintaining a positive image of the organization. This is going to be a difficult challenge!*
- 2. *You are the manager of the local bookstore and supervise eight employees. It's time for annual performance appraisals. During the appraisal session you need to focus both on the past and toward the future. That is, you need to review each employee's performance record for the past year as well as set goals for the upcoming year. Additionally, the performance appraisal system requires you to rate each employee along five performance dimensions (initiative, productivity, quality, commitment, and overall effectiveness). You need to discuss these ratings with your employees. What communication medium should you use to conduct the performance reviews?*

### **III Activities**

- 1. Assume that you supervise five employees who range from five years younger to seven years older than you. What kinds of personal and work relationships do you believe you would develop with this group?
- 2. What do you usually do when you encounter a difficult person? Would you react any differently in a work setting?

### **IV Objective / Multiple Choice Questions**

- 1. Interpersonal communication involves the following :
  - (a) Those interacting are in close proximity to each other, large number of participants many sensory channels used, immediate feedback.
  - (b) Small number of participants, those interacting are in close proximity to each other,
  - (c) Small number of participants, those interacting are in close proximity to each other, few sensory channel immediate feedback.
  - (d) Small number of participants, those interacting are close to each other, many sensory channel used feedback in phases.



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## Interpersonal Communication Skills

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2. The Russian proverb “once a word goes out of your mouth, you can never swallow it again” point out.
  - (a) Interpersonal communication is irreversible
  - (b) Interpersonal communication has long lasting effect.
  - (c) Interpersonal communication is a one way process.
  - (d) (a) and (b) only
3. What makes interpersonal communication complicated :
  - (a) No of variables involved.
  - (b) Exchange of symbols that stand for ideas.
  - (c) Words do not have inherent meaning and no two people use the same word exactly alike.
  - (d) All of the above.
- 4.. Situational context deals with :
  - (a) ‘Psycho – physical – Relationship.
  - (b) ‘Psycho – dynamic where’ one is communicating.
  - (c) ‘Psycho – ethnic where’ one is communicating.
  - (d) ‘Psycho – Social where’ one is communicating
5. Psychological context includes :
  - (a) Needs
  - (b) Values
  - (c) Desires
  - (d) All of the above
6. The interpersonal needs identified by William Schutz are the following except :
  - (a) Control
  - (b) Authority
  - (c) Inclusion
  - (d) Affection
7. ‘Building Understanding includes :
  - (a) Content Messages



- (b) Relationship Messages
  - (c) Content relationship and contextual
  - (d) Both (a) and (b)
8. 'Inclusion' given by William Schultz means :
- (a) To exercise leadership and prove one's ability
  - (b) Need to establish identity with others.
  - (c) Need to develop relationships with people.
  - (d) All of the above.
9. Dynamics of interpersonal communication are :
- (a) Body language and facial expression
  - (b) Posture
  - (c) Movements
  - (d) All of the above.
10. Founder of critical thinking :
- (a) Einstein
  - (b) Karl Marx
  - (c) Socrates
  - (d) Aristotle

**Answers**

1. (b), 2. (d), 3. (d), 4. (d), 5. (d), 6. (b), 7. (d), 8. (b),  
9. (d), 10. (c).



# CHAPTER 15

## GROUP DYNAMICS

### Learning Objectives

*After reading this chapter, you will be able to understand*

- ◆ Groups : Importance and Characteristics
- ◆ Types of groups in organizations
- ◆ Characteristics of effective teams
- ◆ Handling Group Conflicts
- ◆ Negotiating and Bargaining
- ◆ Consensus Building, Influencing and Persuasion Skills

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*I have always loved the competitive forces in this business. You know I certainly have meetings where I spur people on by saying, "Hey, we can do better than this. How come we are not out ahead on that?" That's what keeps my job one of the most interesting in the world.*

**Bill Gates**

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### 15.1 WHAT IS A GROUP?

A group is a collection of people. The fact that a number of people are present in a particular space does not mean that a group exists. It is not a random collection of independent individuals – it is composed of individuals who interact verbally and non-verbally, occupy certain roles with respect to one another, and cooperate to accomplish a definite goal. Thus, a group is like a tune, it is not constituted of individual sounds but the resulting symphony. The importance of groups can not be over emphasised. There is an age old saying, "Two heads are better than one." All of us are simultaneously members of several groups. First and foremost comes our family. No family likes a decision arbitrarily imposed on it. Nor does a wise head of the family impose a decision on it. In the same way, an organisation is also a big family. A manager always keeps it in mind, and whenever a decision is to be taken, he refers it to a group within the organization. Most organisational decisions are group decisions.

A group can thus be defined as an **" aggregate of people, from two up to an unspecified but not too large a number, who associate together in face-to-face relationships over a**



**period of time.”** A viable number of members in the group can be anywhere between 15 and 20. More than that will become unwieldy or unmanageable. The members of a group recognize and have a certain attitude towards their group members and have some degree of satisfaction from belonging to and participating in the group. They set norms that specify and regulate the behaviour expected of members. Members of a group consistently influence and are influenced by each other.

Mainly two types of groups are present in organizations : **Formal Groups** created by deliberate sanction of management to meet certain official requirement and **Informal Groups** that are created because of the operation of the social and psychological factors at the work place.

### **15.2 CHARACTERISTICS OF GROUPS**

**Group goals** – every group establishes its own group goals, which provide motivation for their existence.

**Group structure** – is based on the roles to be performed and member positions.

**Group Patterns of communication** – is the pattern of message flow in a group.

**Group Norms** – are the informed rules of interaction in a group.

**Group climate** – is the emotional atmosphere of a group based on

- (1) Bonding and trust among members
- (2) Participative spirit
- (3) Openness
- (4) High performance goals.

### **15.3 GROUP DYNAMICS**

Groups are the basic building blocks of organizations. It is now very common for groups of employees to make decisions to solve difficult problems that were once the domain of authoritarian executives. Today workers and managers are experienced in participating in different kinds of groups. Members of any group get many opportunities for interaction. These interactions and processes take place in a team or Group. This is a direct manifestation of what is known as 'group dynamics'. The word dynamics has come from a Greek word meaning force so group dynamics refers basically to the study of forces operating within a group. Group dynamics deals with internal nature of groups, their formation, structure and processes and the way they affect individual members, other groups and the organization as a whole. "It implies", in the words of an expert, "continuously changing and adjusting relationships among members of the group." The core of group dynamics is interaction among members. Interaction, in the broad sense is any means of communication between people. Thus,



communication plays an extremely important role in group dynamics. "The means of communication can be both verbal and non-verbal. Without interaction the group will become static or defunct.

Just as an individual has personality, a group also develops what we may call its 'group personality.' Given below are the characteristics of group personality.

**(a) Spirit of Conformity :** Individual members soon come to realize that in order to gain recognition, admiration and respect from others they have to achieve a spirit of conformity. Our beliefs, opinions, and actions are influenced more by group opinion than by an individual's opinion, even if it is an expert's opinion. If the members conform to the accepted standards of their group relationships they feel happier and better adjusted.

**(b) Respect for group values :** Any working group is likely to maintain certain values and ideals which make it different from others. In order to deal effectively with a group, we must understand its values, which will guide us in foreseeing its programmes and actions.

**(c) Resistance to change :** It has been observed that a group generally does not take kindly to social changes. On the other hand, the group may bring about its own changes, whether by dictation of its leader or by consensus. The degree to which a group resists change serves as an important index of its personality. It helps us in dealing with it efficiently.

**(d) Group prejudice :** Just as hardly any individual is free from prejudice, groups have their own clearly evident prejudices. It is a different matter that the individual members may not admit their prejudiced attitude to other's race, religion, nationality etc. But the fact is that the individual's prejudices get further intensified while coming in contact with other members of the group holding similar prejudices.

**(e) Collective power :** It need not be said that groups are always more powerful than individuals, how so ever influential the individual may be. That is why individuals may find it difficult to speak out their minds in groups. There is always the risk of the one-against-many situation cropping up. All of us are in need of people who adopt a friendly attitude towards us, not really those who are out to challenge us in a group.

The group as a whole always rules. The odd man out is always at a disadvantage.

#### 15.4 TYPES OF GROUPS IN ORGANISATIONS

**1. Self directed teams** – autonomous and self regulated groups of employees empowered to make decisions.

**2. Quality Circles** – is a recent group dynamics technique representing a significant development in the fields of human relations and organizational behavior to improve productivity and work life in organizational settings. Quality Circle has been defined "as a



group of workers from the same area who usually meet for an hour each week to discuss their quality problems, investigate causes, recommend solutions and take corrective actions when authority is in their purview. In other words, Quality Circle is a small group to perform voluntarily quality control activities within their work area.

**3. Committees** – are of various types (a) Standing Committee which are permanent in nature and highly empowered. (b) An advisory Committee comprises of experts in particular fields (c) An adhoc committee is setup for a particular purpose and after the goal is achieved, it is dissolved

**4. Task Force** – Task force is like Committee but it is usually temporary. Task force has wide power to take action and properly fix responsibility for investigation, results and proper implementation of decisions. Task force groups are very important in govt. organization to tackle specific administrative problems.

### **15.5 TEAM ROLES**

Whether the task is to write reports, give oral presentations, produce a product, solve a problem, or investigate an opportunity, team members must communicate effectively among themselves and with people outside their team. Thus, companies are looking for people who can interact successfully in teams and make useful contributions while working together.

Teams encourage creativity in workers through participative management - involving employees in the company's decision making. At Kodak, for example, using teams has allowed the company to halve the amount of time it takes to move a new product from the drawing board to store shelves. Each member of a group play a role that affects the outcome of the group's activities. Some teams are more effective than others simply because the dynamics of the group facilitates optimum input from each member and quick resolution of differences. To keep things moving forward, productive teams also tend to develop rules that are conducive to business. Often these rules are unstated, they just become standard group practice, or norms – informal standards of conduct that members share and that guide member behavior. For example, members may have an unspoken agreement that it's okay to be 10 minutes late for meetings but not 15 minutes late, or that it's preferable to use e-mail to communicate with other team members rather than using the phone. When a team has a strong identity, the members observe team rules religiously. They are upset by any deviation and feel a great deal of pressure to conform. This loyalty can be positive, giving members a strong commitment to one another and highly motivating them to see that the team succeeds.



Self-Oriented Roles	Team-Maintenance Roles	Task-Facilitating Roles
Controlling: dominating others by exhibiting superiority or authority	Encouraging: drawing out other members by showing verbal and nonverbal support, praise, or agreement	Initiating: getting the team started on a line of inquiry
Withdrawing: retiring from the team refusing to deal with a particular aspect of the team's work	Harmonizing: reconciling differences among team members through mediation or by using humor to relieve tension	Information giving or seeking: offering (or seeking) information relevant to questions facing the team
Attention seeking: calling attention to oneself and demanding recognition from others	Compromising: offering to yield on a point in the interest of reaching a mutually acceptable decision	Coordinating: showing relationships among ideas, clarifying issues, summarizing what the team has done
Diverting: focusing the team's discussion on topics of interest to the individual rather than on those relevant to the task		Procedure setting: suggesting decision making procedures that will move the team toward a goal

### Team Roles

**Team Roles:** Members of a team can play various roles, which fall into three categories. Members who assume **self oriented roles** are motivated mainly to fulfill personal needs, so they tend to be less productive than other members. Far more likely to contribute to team goals are those members who recognize that each individual brings valuable assets, knowledge, and skills to the team. They are willing to exchange information, examine issues, and work through conflicts that arise and assume **team-maintenance roles**, to help everyone work well together, and those members who assume **task-facilitating roles**, to help solve problems or make decisions.

**Leadership:** Groups need effective leadership to achieve their goals. They help establish a cooperative climate that encourages group interaction, helps the discussion to follow smoothly and keep the planned agenda on track. In the absence of a leader, the whole activity may run haywire. If the group is large, it may also become chaotic. It is the role of the leader to steer the discussion like a ship through troubled waters. Hence a leader is indispensable for a group discussion.

Participation and leadership are interrelated. The degree to which group members make their own decisions affects the leadership style with which they will be most comfortable. There are many different descriptions of leadership. Some emphasize that a leader is a person who influences the actions of others. A communication-specific definition is that a leader is the



member of a group who speaks the most to the group as a whole, is spoken to the most, and directs communication in the group to productive levels.

A manager or supervisor is not necessarily a group leader. A person can be in charge of a group without exhibiting any leadership qualities. A member who leads a group could be its least experienced, lowest-ranking participant. Many training and development programs today attempt to teach managers or supervisors how to be leaders. The focus of these programs is on transforming managers from people with titles into people who exhibit true influence, direction, and motivation.

### **Groupthink**

Conformity, carried to its extreme, leads to groupthink. Groupthink is the tendency of group members to seek agreement solely for agreement's sake. A group gripped by groupthink fails to be creative, explore alternative solutions, problems, or concerns in an effort to present a united or cohesive front to outsiders. Group members must question themselves and their actions to ensure high-quality decision making. There are several ways to reduce the tendency toward groupthink. One technique that encourages open discussion is to have the group leader ask each member to assume the role of critical evaluator. It should be stressed that the role is that of constructive rather than destructive questioner. Another technique is to have the group from time to time divide into subgroups with similar tasks leading to fresh perspectives. A third technique conducive to warding off groupthink is to have each group member discuss the group's communications and actions with trusted outsiders to obtain an objective viewpoint. A fourth way to avoid groupthink is to have the group hold a special meeting where all misgivings, second-guessing, and objections are aired. At such a meeting, each member is encouraged to express any doubts she or he may have, about any phase of the group's deliberation.

A special method of minimizing groupthink is to have a measure of cultural diversity within a group leading to emergence of diverse ideas, opinions, and arguments which can counteract the effects of groupthink.

### **15.6 HANDLING GROUP CONFLICTS**

Conflict is a part of almost every interpersonal relationship. Managing conflict, then, is important if the relationship is to be long-lasting and rewarding. Conflict is a greatly misunderstood facet of group communication. Many group leaders avoid conflict because they think it detracts from a group's purpose and goals. Their attitude is that a group experiencing conflict is not running smoothly. Avoiding conflicts may be necessary when conforming to various rules, standards, and group goals during group decision making. However, Leaders can use conflict productively to test ideas or propositions generated by groups before they are implemented. Groups eventually must reach decisions, and conformity among group members



provides a basis for consensus. Members may be encouraged to disagree about the definition of the problem, the alternatives generated, and the criteria by which to evaluate alternatives. But certain fundamental issues-such as why the group exists and how it should operate-must be agreed on by everyone.

A conflict does not signal that a meeting is disorderly, raucous, or rude. It is a sign that people are actively discussing issues. If a group does not exhibit conflict by debating ideas or questioning others, there is very little reason for it to exist. The members may as well be working by themselves. Conflict, then, is part of the essence of group interaction. Leaders can use conflict as a means to determine what is and what is not an acceptable idea, solution, or problem; but it should be a debate about issues, not about personalities. A group will not be productive if arguments are centered on the participants rather than on what the participants are talking about. When conflicts arise, group members and especially leaders must be diligent in refocusing members' attention on the issues, not on personalities.

Conflict has been defined as "an expressed struggle between at least two interdependent parties who perceive incompatible goals, scarce resources, and interference from the other party in achieving their goals". Important concepts in this definition include "expressed struggle," which means the two sides must communicate about the problem for there to be conflict. Another important idea is that conflict often involves perceptions. The two sides may only perceive that their goals, resources, and interference is incompatible with each other's.

Researchers have identified several problems that typically arise in conflict situations. First, the parties will simply avoid the conflict. This can be damaging, because it can lead to greater problems in the future. It is usually best that the individuals discuss their differences. Second, individuals involved in conflict may blame the other individual. Often, individuals go beyond the specific behaviour in question and blame the character of the person. A final problem that is often encountered in conflict management is adopting a win-lose mentality. Focusing on each individual's goals / outcomes will help avoid using a win-lose strategy.

The climate in which conflict is managed is important. It is essential to plan communications to foster a supportive climate, marked by emphasis on

- Presenting ideas or opinions.
- Problem orientation- focusing attention on the task.
- Spontaneity-communicating openly and honestly.
- Empathy: understanding another person's thoughts.
- Equality- asking for opinions.
- A willingness to listen to the ideas of others.



If successfully managed conflict can be constructive and can strengthen relationships.

### **15.7 CONSENSUS BUILDING**

Consensus means overwhelming agreement. Most consensus building efforts set out to achieve unanimity. . The key indicator of whether or not a consensus has been reached is that everyone agrees with the final proposal And, it is important that consensus be the product of a good-faith effort to meet the interests of all stakeholders. Thus, consensus requires that someone frame a proposal after listening carefully to everyone's interests. Before the parties in a consensus building process come together, mediators (or facilitators) can play an important part in helping to identify the right participants, assist them in setting an agenda and clarifying the ground rules by which they will operate, and persuading noncompliant parties to participate. Once the process has begun, mediators (and facilitators) try to assist the parties in their efforts to generate a creative resolution of differences.

- *Problem-Solving Orientation-* It is important to be constructive and maintain a problem-solving orientation, even in the face of strong differences and personal antagonism. It is in every participant's best interest to behave in a fashion, they would like others to follow. Concerns or disagreement should be expressed in an unconditionally constructive manner.
- *Engage in Active Listening-*Participants in every consensus building process should be encouraged (indeed, instructed, if necessary) to engage in what is known as active listening -- a procedure for checking to be sure that communications are being heard as intended.
- *Disagree Without Being Disagreeable-*Participants in every consensus building process should be instructed to "disagree without being disagreeable." This dictum should probably be included in the group's written ground rules.
- *Strive For The Greatest Degree Of Transparency Possible-*To the greatest extent possible, consensus building processes should be transparent. That is, the group's mandate, its agenda and ground rules, the list of participants and the groups or interests they are representing, the proposals they are considering, the decision rules they have adopted, their finances, and their final report should, at an appropriate time, be open to scrutiny by anyone affected by the group's recommendations.
- *Strive to Invent Options for Mutual Gain-*The goals of a consensus building process ought to be to create as much value as possible and to ensure that whatever value is created be divided in ways that take account of all relevant considerations. The key to creating value is to invent options for mutual gain. This is best done by engaging in cooperative behaviors that "make the pie larger" before giving in to competitive pressures "to get the most for one's self."





## 15.8 NEGOTIATION AND BARGAINING

Negotiation occurs when two or more parties—either individuals or groups discuss specific proposals in order to find a mutually acceptable agreement. Whether it is with an employer, family member or business associate, we all negotiate for things each day like higher salary, better service or solving a dispute with a co worker or family member.. Negotiation is a common way of settling conflicts in business. When handled skilfully, negotiation can improve the position of one or even both but when poorly handled; it can leave a problem still unsolved and perhaps worse than before.

Negotiations can be approached in four ways. Each of these approaches produces a different outcome.

*Win-Lose Orientation* : This is the approach taken by competitive communicators. The win-lose orientation is based on the assumption that only one side can reach its goals and that any victory by that party will be matched by the other's loss. Despite the fact that it produces losers as well as winners, a win-lose orientation can sometimes be the best approach to negotiating. If one party is determined to take advantage and cannot be convinced that collaboration is possible, then you probably need to adopt a competitive stance out of self-defense. For example, in a one-time commercial transaction (the sale of a car, for instance), your concern for helping the other party may take a back seat to getting the best possible deal for yourself, without violating your ethical

*Lose-Lose Orientation*: With a lose-lose orientation, a conflict plays out in a way that damages both parties to such a degree that everyone feels like a loser. Nobody starts out seeking a lose-lose outcome, of course; but sometimes when people feel that a negotiating partner is blocking them, they wind up seeking revenge. For example, if customers feel cheated, they are likely to tell others about their dissatisfaction, costing the company future business.

*Compromise*: Sometimes it seems better to compromise than to fight battles in a competitive manner and risk a lose-lose outcome. There are cases in which compromise is the best obtainable outcome—usually when disputed resources are limited or scarce. If two managers each need a full-time secretary but budget restrictions make this impossible, they may have to compromise by sharing one secretary.

*Win-Win Orientatio*: A win-win approach differs significantly from the preceding negotiating styles. It is a collaborative approach to negotiation and assumes that solutions can be reached that satisfy the needs of all parties. Most important, it looks beyond the conflicting means of both parties (my way versus your way) and focuses on satisfying the ends each is seeking. . The key is to avoid taking polar positions (arguing over means) and instead to identify the ends or goals of both parties



### **15.9 BASIC RULES OF NEGOTIATION**

1. **Analyze the interest of the parties:** This is important to understand the perceptions, the style of negotiation, and the interests and principles of the counterparts, as well as one's own.
2. **Plan the negotiation, and determine:**
  - What are the expectations from the negotiation?
  - What are the terms of the negotiation?
  - What are the nonnegotiable terms and what can be modified?
  - What is the minimum that an agreement can be reached on?
  - What is the negotiation strategy?
  - What are the most important interests of the other parties?
  - How does one interact with or manage people?
3. **Select the appropriate negotiation technique** from among the following:
  - **Spiraling agreements:** Begin by reaching a minimum agreement even though it is not related to the objectives, and build, bit by bit, on this first agreement.
  - **Changing of position:** Formulate the proposals in a different way, without changing the final result.
  - **Gathering information:** Ask for information from the other party to clarify their position.
  - **Making the cake bigger:** Offer alternatives that may be agreeable to the other party, without changing the terms.
  - **Commitments:** Formalize agreements orally and in writing before ending the negotiation.
4. **Negotiate:** Be sensitive and quick to adapt to changing situations, but do not lose sight of the objective. Avoid confrontational positions and try to understand the interests of the other party. Some aspects that could interfere with the negotiation are:
  - Personal positions and interests
  - Psychological and emotional aspects of the persons (place, placement of chairs, body language, gestures, etc.)
  - Difficulties in communication (differences in languages, different meanings of the same words, etc.)



### 15.10 THE NEGOTIATION PROCESS:

Seven steps can be identified in the process of negotiation from start to the completion of the process. At every level careful planning and execution is required to make negotiations successful. These seven steps of the negotiation are:

**1) Preparing:** A negotiation is an unpredictable path – one will come across unforeseen and unanticipated situations. Hence one needs to be well prepared. Preparations has two broad aims –

- Clarity of objective and the boundaries within which to negotiate for (one's position on the issue and the extent of compromise one would be ready for through a Like-Intend-Must analysis:

#### Identify Own interest

Like	Intend	Must
Interests that one would like to get served. Achieving some of these interests is a <b>happy</b> situation.	Interests that one intends to get served. One is sincerely trying to get these interests served. The results of the negotiations would be considered <b>satisfactory</b> if these interests were served.	Interests that must be served. Achieving these interests is critical otherwise the negotiation could be <b>fruitless</b> .

- Collection and collating data that might come handy later. It is useful to create a checklist for preparation as some items will need to be considered before the negotiation, some during the negotiation, some both before and during negotiation.

**2) Arguing :** This is the first stage of the actual negotiation process, where the two parties are engaged in the process of building a case for their respective stands. The aim of this process is to forcefully inform the other party of the logic & strength of one's stand. Often negotiations tend to fail at this stage because the two parties end up getting hostile when the opponents start at diametrically opposite positions.

One needs to remember that positions taken during this stage seldom result into an exact outcome. The negotiation's aim should be to try & narrow down the difference between the two positions to a common acceptable ground. It is thus imperative for either side to patiently listen to the other side and understand their position entirely.



**3) Signaling:** This phase occurs during the arguing process and usually after some amount of arguing. The two parties are aware of the deadlock and are in a mood to break the deadlock when signaling would occur. The signal refers to verbal or non-verbal clues that opens up the possibility of adjustment in the stance of the person. One should be alert to the following developments:

- Are there any signs of movement in the argument?
- What signals have we made to indicate our own willingness to move?
- If they have been ignored, how can we re-word them?
- What is the cause of opponent's 'stonewalling'? Confidence or lack of it?

**4) Proposing :** This phase is a decisive one. It is the culmination of arguments when based on some signals one proposes for a possible solution. Propositions overcome arguments because arguments cannot be negotiated. Proposals advance negotiations and proposals seize the initiative.

**5) Packaging:** We can think of packaging as considering various proposals that appeared and collating an overall suggested solution for consideration of the other party. We can think of this process comprising of

- Identifying opponent's inhibitions, objectives, priorities, and the signaled possibilities of concessions that they might allow.
- Review opponent's and own objectives by doing a fresh L-I-M (Like-Intend-Must) analysis.
- Is there enough movement indicated to produce a package? This is an important question to be answered as we do not want to package a deal too soon. That way the deal could be half baked or we might reduce the chance of it being acceptable.
- How can you address your package to meet some/all of your opponent's inhibitions?
- What concessions are you looking for? Compare it against the signalled possibilities of concessions that the opponent has shown willingness to concede or to consider.
- What negotiating room do you have in your current position?
- Which concessions are you going to signal in the package?
- What do you want in return?
- How equitable is the concession rate?
- Draw up list of conditions and place them in front of the package.
- Have all the possible variables in the package been considered



**6) Bargaining:** That's what negotiating looks like to a third person as a spectator. But for a negotiator this phase will be successful only if the groundwork has been done.

- Everything must be conditional. Consider this almost a firm rule – without exceptions.
- Decide what we require in exchange for the concessions.
- List and place that at the front of our presentation.
- Signal what is possible if, and only if, the opponent agree to your conditions.
- If the signal is reciprocated present proposals, restating conditions.
- Keep all the unsettled issues linked and trade-off a move on one for a new condition or a move on something else.
- Be ready to bring back into contention any previously 'settled' issues if we need negotiating room under pressure of opposition on a point.

**7) Closing and Agreeing :** This is the final phase where the deal gets finalized and sealed. Closing means ending the bargaining and reaching a stage where we push the opponent to make a decisions on agreeing or otherwise. This is true of overall negotiation process as well as for individual concessions. Agreeing refers to our response to the opponents close. We need to be careful about

- Where we intend to stop trading.
- Is the whole proposal credible – what have we done to check that? Often closing a deal too soon leaves the opponent feeling that he got less than what was available for him.
- Think whether to lead with the summary close and then try the concession close or vice versa. What other close could we use?
- If we are going for a 'final offer' are we serious or is it a bluff? Bluffing 'final offer' can destroy credibility in the current negotiations and in subsequent ones. Do not try to force a 'final offer' under emotional pressure.
- If the close has been successful: what has been agreed? List the agreement in detail. List the points of explanation, clarification, interpretation and understanding.
- If the agreement is oral, send a written note to the opponent of what we believe was agreed as soon as it can be done after the meeting.

### 15.11 INFLUENCING AND PERSUASION SKILLS

Many situations arise where you need to influence the behaviour or attitudes of managers, superiors, colleagues, customers, clients, suppliers and subordinates. Often, you either do not



have or do not wish to use position power. You have to rely on influencing others through assertiveness, negotiation and empowering skills. Influence is an respectable way to change other people's actions("these are the benefits of doing this.") the other ways are-

*Command* ("You have to do this.") or

*Manipulation* ("If you do not do this, I will lose my job.")

**Influence** is much wider in depth and dimension. It is :

- A process not an action
- A set of skills-including body language, listening, building rapport, planning, probing and explaining
- A set of attitudes –including confidence, trust, patience and belief in win-win outcomes
- It is getting people to do things because they want to.
- It requires one to be other focused rather than self focused
- It enables proactive leadership

**Persuasion** is one dimension of influence. It is a direct communication when benefits are stated in a reasoned arguments and competent views dealt with in a respectful manner. The two principles of persuasion are

- **Honour and Respect:** These are communicated in various ways-You can respect people's time by being sensitive about the timing of your communication. Imagine barging in and demanding someone's attention simply because what you have to say is more important to you than to them.
- **Understanding the other person's Frame of Reference:** Each of us have a unique personality but one can get to know a great deal about the other person by approaching things from their point of reference, asking questions and listening.

The first problem one faces while communicating is getting someone's undivided attention. They are probably thinking about something else when you want to communicate with them. So you must grab their attention and get it focused on what you want to communicate. You can use something called the 'hook'. Advertisers do this all the time. Just like a fish being hooked on a line, you need to 'hook' the other person with a real reason for focusing on you. This could be a question or a strong statement – something that takes them away from their current line of thought to focus on your request or idea.

When you have hooked someone, how do you keep them there? This can be achieved through a statement, a group of statements or a question that creates curiosity.

The third technique is by using something called 'emotional word pictures' (EWPs). These can simultaneously communicate with a person's heart and mind, to convey understanding and



emotional feelings. In order to appeal to anyone's motivation to act, we must know these two biggest motivators. The first is: THE DESIRE FOR GAIN.

The other is: FEAR OF LOSS. In any communication you must examine your argument and analyse which desires or fears you are appealing to. This will help you plan the communication suitably .

### **15.12 SELF-EXAMINATION QUESTIONS**

#### **I Multiple Choice Questions**

1. The core of group dynamics is
  - (a) The Levels in the group
  - (b) Group norms
  - (c) Group climate
  - (d) Interaction among members
2. Teams encourage creativity in worker through
  - (a) Team roles
  - (b) Participative management
  - (c) Team agreement
  - (d) Conflict
3. The collaborative approach to negotiation is known as
  - (a) compromise
  - (b) win-lose orientation
  - (c) win-win orientation
  - (d) lose-lose orientation
4. The second stage of the negotiation process is
  - (a) Arguing
  - (b) Preparing
  - (c) Signalling
  - (d) Spiralling

#### **II Essay Type Questions**

1. Describe the various kinds of groups and the characteristics of group personality
2. Explain various team roles.



3. Define Conflict. "Conflict if successfully managed can be constructive." Explain.
4. Describe the negotiation process.

### **III Short Questions**

**Write short notes on**

- (a) Group think
- (b) Quality circles
- (c) Persuasion skills
- (d) Consensus building

### **IV Problems**

1. **Describe the four negotiating styles in relation to each of the following situations:**
  - a. At 4:30 P.M. a boss asks her secretary to work late in order to retype a 25-page report due the next morning. The secretary has an important date that evening.
  - b. A worker finds the smoke from a colleague's cigarettes offensive.
2. **Identify a win-win negotiation in each of these conflicts:**
  - a. A landlord-tenant dispute over who should pay for an obviously necessary painting job.
  - b. A disagreement between two co-workers over who should deliver a proposal to an important client.
3. **Decide which negotiating style is most appropriate in each of the following situations. Explain your choice.**
  - a. Your boss wants you to work during a time you have planned for an out-of-town vacation.
  - b. You are not satisfied with the quality of a recent shipment of metal fasteners, which you use in assembling a product.
  - c. The assistant manager of a bookstore is faced with a customer demanding a refund for a book he claims was a gift. The book has several crumpled pages and a torn cover.
  - d. A supervisor is faced by an irate employee complaining about another worker's "unfair" promotion to a position the employee had sought.

**Answers - I ( MCQs)**

1. (d), 2. (b), 3. (c), 4. (a).



# CHAPTER 16

## COMMUNICATION ETHICS

### Learning Objectives

After reading this chapter, you will be able to understand -

- Significance of ethical communication
- Characteristics of ethical communication
- Factors influencing ethical communication
- Ethical dilemmas in communication
- Guidelines to handle communication dilemma

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*"Because instant information has to be given, it becomes necessary to resort to guesswork, rumours, and suppositions to fill in the voids, and none of them will ever be rectified, they will stay on the readers' memory. How many hasty, immature, superficial, and misleading judgments are expressed every day, confusing readers, without any verification? The press can both stimulate public opinion and miseducate it. Thus, we may see terrorists turned into heroes, or secret matters pertaining to one's nation's defence publicly revealed, or we may witness shameless intrusions on the privacy of well-known people under the slogan: "Everyone is entitled to know everything."*

**Alexander Solzhenitsyn**

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### 16.1 SIGNIFICANCE OF ETHICAL COMMUNICATION

Ethics are those moral principles, which guide the conduct of individuals' and ethical behaviour in the context of an organization implies such decisions which are taken after giving due thought to their impact on the stakeholder and society as a whole:

When an organization communicates internally, it shapes the values of its employees ; when it communicates externally, it influences the perception of the external public. Ethics plays a crucial role in communication. The word ethics encompasses the entire spectrum of human conduct viz.

1. Colleagues,
2. Staff and workers,
3. Shareholders,
4. Customers,



## Business Laws, Ethics and Communication

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5. The community,
6. The government,
7. The environment and even,
8. The nation, and its interest.

Communication has always been of critical importance to the success of companies and corporate reputation is one of a company's most valuable and enduring assets. It plays a central role in the achievement of key business objectives such as creating shareholder value, attracting, retaining and motivating high-quality people, enhancing reputation with all audiences, marshaling stakeholder support on public policy issues, creating consumer preference for products and services, and minimizing the impact a crisis can have on a company's financial position and business prospects. Questions of right and wrong arise whenever people communicate. Ethical communication is fundamental to responsible thinking, decision making, and the development of relationships and communities within and across contexts, cultures, channels, and media. Ethical communication enhances human worth and respect for self and others. In business communication, however, knowing right from wrong doesn't always mean that doing the right thing is either obvious or easy. Ethical communication is fundamental to responsible thinking, decision making, and the development of relationships and communities within and across contexts, cultures, channels, and media. Ethical communication enhances human worth and dignity by fostering truthfulness, fairness, responsibility, personal integrity, and respect for self and others.<sup>1</sup> while unethical communication threatens the quality of all communication and consequently the well-being of individuals and the society in which we live.

An ethical communication:

- includes all relevant information,
- is true in every sense and is not deceptive in any way.
- accurate and sincere. Avoids language that manipulates,, discriminates or exaggerates.
- does not hide negative information behind an optimistic attitude .
- does not state opinions as facts,
- portrays graphic data fairly.

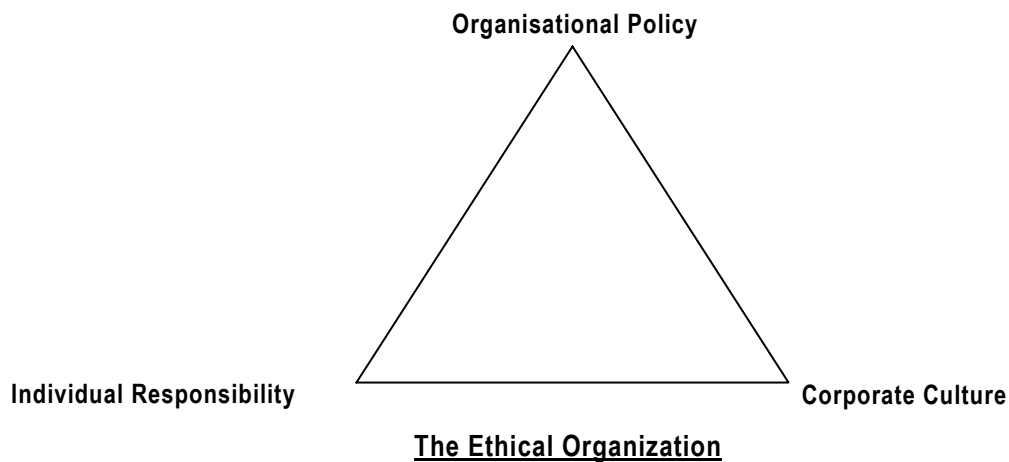
In a nutshell ethical communicators have a "well developed sense of social responsibility. "One is honest with employers, co-workers, and clients, never seeking personal gain by making others look better or worse than they are, don't allow personal preferences to Influence your perception or the perception of others, and act in good faith.

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<sup>1</sup> The National Communication Association



Organizations, like people, should strive for ethical behavior. No one can completely guarantee that a corporation or its employees will behave ethically; yet acknowledgement of occasional failures does not reduce the fundamental ethical responsibility. This philosophical position implies certain actions in three basic areas: cultural, policy, and personal. Ethical organizations are created and sustained by individuals of personal integrity, operating in a culture of principle, and governed by conscientious policies.



## **16.2 FACTORS INFLUENCING ETHICAL COMMUNICATION:**

*1. Every Communication Decision Has Some Ethical Aspect To It, Acknowledged Or Not.*

There are countless complexities involved in the communication process, but communicators initially face three simple choices: to speak, to listen, or to remain silent. Each choice implies an ethical decision.

In a message the sender chooses to disclose information, motives, or feelings to others. That choice inevitably involves an ethical element. Clearly, some messages should not be sent, such as those involving "insider information." To do so gives certain people an unfair advantage in the marketplace. But should one share a rumour about an organizational change with a colleague? Such actions are commonplace and appear to be less objectionable than insider trading.

The timing and mode of communication add another layer of complexity to the ethical dimension. Is it ever wrong to tell the truth? Can one be too blunt? Should certain information be communicated only face-to-face? People inevitably make ethical judgments in choosing the timing, the subject, and mode of their communications.



Few would doubt that ethical concerns are inherent to the act of speech, but what about the act of listening? Simply because someone will speak to us does not oblige us to listen. Even choosing to listen means taking a moral stand.

Remaining silent might seem like the safest way to avoid ethical dilemmas. But even here there is no safe haven. Remaining silent in the face of unlawful behavior or a potentially harmful situation presents a serious ethical decision. Silence signals consent or perhaps tacit agreement,

*2. The Ethical Nature Of Communication Must Be Considered Within The Context Of Who, What, When, And Where.*

Suppose fellow employees discussed a project they were working on. This may seem perfectly ethical on the surface. After all, such discussions actually foster effective interdepartmental relationships; a worthy goal indeed. The problem may be that the discussion took place in a crowded restaurant and a competitor overheard the conversation. When the employees are confronted, they may reply, "What did we say that was wrong? We were not talking to a competitor." But this is, of course, the wrong question. The issue does not concern what was said or even who they were talking to. The ethical issue revolves around where the conversation took place. Herein lies the complexity of ethical issues-evaluations must be made on more than one dimension. Ethical communicators are not concerned with just who or what or where or when, but with all four dimensions simultaneously.

### **16.3 ORGANIZATION VALUES AND COMMUNICATION ETHICS**

A key element in any communication activity is the values of the organization. Values are the principles and ideas that people or organizations strongly believe in and consider important. When people are in doubt about decisions, they frequently rely on deep-seated values to help them make the right choice. In organizations, reliance on shared values makes setting goals easier in the face of the competing ideas, desires, and objectives of individual employees.

One can get a good idea about the values of an organization by examining its vision and mission statement. These statements are short descriptions of the purpose of organizations and the directions they try to take to achieve success. Many organizations post their vision and mission statements in several places so that employees know what the organization values

On the surface, ethical practices appear fairly easy to recognize. But deciding what is ethical, can be quite complex. Under the influence of competition, job pressure, peer pressure, ambition, financial gain (both personal and corporate), business people



sometimes make unethical choices. For example, a recent survey revealed that 20-30% of middle managers had written deceptive internal reports. We are also aware of many companies selling products without disclosure of side effects. An ethical dilemma involves choosing among alternatives that aren't clear-cut (some times conflicting alternatives are both ethical and valid, or perhaps your alternatives lie somewhere in the vast gray area between right and wrong). Suppose you are president of a company that's losing money. You have a duty to your shareholders to try to cut your losses and to your employees to be fair and honest. After looking at various options, you conclude that you'll have to layoff 300 people immediately. You suspect you may have to layoff another 100 people later on, but right now you need those 100 workers to finish a project. "What do you tell them? If you confess that their jobs are shaky, many of them may quit just when you need them most. However, if you tell them that the future is rosy, you'll be stretching the truth.

#### 16.4 ETHICAL DILEMMAS IN COMMUNICATION

**Some of the ethical dilemmas faced while communicating are:**

##### Secrecy

Secrets are kept for both honourable and dishonourable reasons; may be used to guard intimacy or to invade it. Here then lies the challenge for the manager: to determine when secrets are justifiable and when they are not. When the clamp of secrecy tightens too much, the result is lack of innovation.

On the other hand, organizations have a legitimate need to protect certain information. If competitors, for example, gain access to proprietary research and development, they can produce that product for a much lower net cost because they do not have to pay the research and development expenses.

##### Whistle-blowing

Any employee who goes public with information about corporate abuses or negligence is known as a whistle-blower. Corporations and managers legitimately expect employee loyalty. Greed, jealousy, and revenge motivate some whistle-blowers. Some are simply misinformed. Some confuse public interest with private interest. Certainly the community has a right to know about corporate practices that are potentially hazardous, yet courting the whistle-blower too aggressively can be problematic..

##### Leaks

A leak is like anonymous whistle-blowing; one distinction being the propriety of the leak; namely, that the person who leaks information cannot be cross-examined. This often casts



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doubt on the credibility of the claim. The accused does not know who or why a person has chosen to release certain information. Politicians have used leaks for years to, stall a plan, or defame an opponent. Employees may also leak information to the press for honourable or dishonourable reasons. Leaks may cause organizational plans to be altered or forgone altogether. Leaks can be a form of political manoeuvring in the organization or a way to sabotage the career of a colleague competing for a job.

### Rumour and gossip

Rumours and gossip seem to be an inevitable part of everyday corporate life. Even though rumours and gossip often travel through the same networks, there is a distinction between the terms. Rumours tend to focus on events and information, whereas gossip focuses on people. Even though managers usually treat the information as "yet to be confirmed," it may cloud judgments about that employee. The information has a way of creeping into performance evaluations and promotion decisions, even if unintended.

### Lying

A lie is a false statement intended to deceive. Of all the ethical dilemmas discussed thus far, lying would appear to be the least morally perplexing. Most would agree that "one ought not to lie." Yet lies in business are more common than many would care to admit. Lying breaks down the trust between individuals, shaking the foundation of ethical communication.



### 16.5 Fraudulent Communication-The Case World Com

*In the late 1990s, a telecommunications firm called WorldCom had the world's largest Internet "backbone" network and was the second largest long-distance provider in the United States. Between 1995 and 2000, WorldCom bought more than sixty other companies, including MCI for \$37 billion. Despite all of this apparent success, in July 2002 WorldCom, facing \$41 billion in debt, filed for bankruptcy, the largest bankruptcy in history.*

*During the investigation that followed, WorldCom was revealed as having a "culture of fraud." For several years profits fell below estimates. If investors knew about the decrease in earnings, the price of the stock would also decrease. Many of the people in positions of authority inside of World Com had huge amounts of money to lose if the stock price were to drop. To appear as though they were meeting earning estimates and to maintain high stock prices, World Com falsified over \$2 billion of revenue and ignored over \$7 billion of expenses in earning reports for 1999 through 2002. This fraudulent communication of profits was finally uncovered in 2002 and the senior executives involved went on to face criminal charges. Although WorldCom has emerged from bankruptcy, this unethical behaviour cost creditors and stockowners billions of dollars.*

#### Euphemisms

By definition, a euphemism is using a less offensive expression instead of one that might cause distress. For example using the expression "passed away" instead "died" is one of the more common examples. This usage is understandable. However, people frequently use these terms to obscure the truth. For example a purchasing agent has a far easier time accepting a "consideration fee" than a "bribe." Petty office theft gets passed off as merely "permanently borrowing" the item instead of "stealing."

#### Ambiguity

Ambiguity, like secrecy, can be used for ethical or unethical purposes .Language itself is made up of various words that carry values. So by using words in certain ways ,one can influence others behaviour and expectations .Because all language contains some degree of vagueness,. Communicators are to some extent held responsible for possible misinterpretations. This means that one must be aware of the probabilistic nature of communication, and need to consider not only their intentions, but also how their messages might be misunderstood.

### 16.6 GUIDELINES TO HANDLE COMMUNICATION ETHICS DILEMMAS

Although some ethical dilemmas are more easily solved than others, all involve making evaluations and judgments about what is morally right and wrong, what is fair and what is not and what will cause harm and what will not Ethical communication requires effective



critical thinking skills, recognizing the importance of diverse perspectives, respect for the well being of self and others, taking responsibility for individual and group actions, and reflecting on the choices group members make.

### **Legal Considerations**

One place to look for guidance is the law. If saying or writing something is clearly illegal, you have no dilemma: You obey the law

### **Moral Considerations**

Although legal considerations will resolve some ethical questions, one has often had to rely on your own judgment and principles. If your intent is honest, the statement is ethical, even though it may be factually incorrect; but if your intent is to mislead or manipulate the audience, the message is unethical, regardless of whether it is true. Looking at the consequences of decisions and opting for a solution that provides the greatest good to the greatest number of people

**Maintain Candour** -Candour refers to truthfulness, honesty, and frankness in your communication with other people. Although revealing everything you know about a situation may not always be appropriate-for instance, providing all your information to adversaries during intense and sensitive negotiations will only compromise your position-

**Keep Messages Accurate** - When you are relaying information from one source to another, communicate the original message as accurately as possible. Ethical communicators do not take liberties with the messages they pass on.

**Avoid Deception** - Ethical communicators are always vigilant in their quest to avoid deception fabrication, intentional distortion, or withholding of information-in their communication.

**Behave Consistently** - One of the most prevalent yet noticeable areas of unethical behaviour is communicating one thing and doing another. You must always monitor your behaviour to ensure that it matches what you say to others.

**Keep Confidences** - When someone tells you something and expects you not to divulge that information to others, a sacred trust has been placed on you.

**Ensure Timeliness of Communication**- The timing of messages can be critical. When you delay sending messages so that others do not fully benefit, they can (rightly) assume that you have acted unethically.

**Confront Unethical Behavior**-To maintain a consistent ethical viewpoint, you must confront unethical behavior when you observe it. Public condemnation of unethical





persons may not be necessary, but it is important that people understand that your own tolerance for unethical behavior is low.

### **16.7 NCA's Credo for Ethical Communication**

The National Communication Association (NCA) states: "ethical communication enhances human worth and dignity by fostering truthfulness, fairness, responsibility, personal integrity, and respect for self and other

- ✓ Truthfulness, accuracy, honesty, and reason are essential to the integrity of communication.
- ✓ Endorse freedom of expression, diversity of perspective, and tolerance of dissent to achieve the informed and responsible decision making fundamental to a civil society.
- ✓ Strive to understand and respect other communicators before evaluating and responding to their messages.
- ✓ Access to communication resources and opportunities are necessary to fulfill human potential and contribute to the well being of families, communities, and society.
- ✓ Promote communication climates of caring and mutual understanding that respect the unique needs and characteristics of individual communicators.
- ✓ Condemn communication that degrades individuals and humanity through distortion, intolerance, intimidation, coercion, hatred, and violence.
- ✓ Commit to the courageous expression of personal convictions in pursuit of fairness and justice.
- ✓ Advocate sharing information, opinions, and feelings when facing significant choices while also respecting privacy and confidentiality.
- ✓ Unethical communication threatens the quality of all communication and consequently the well being of individuals and the society in which we live.
- ✓ Accept responsibility for the short- and long-term consequences for our own communication and expect the same of others.

### **16.8 THE ADVANTAGE OF ETHICAL COMMUNICATION**

Ethical communication promotes long-term business success and profit. However, improving profits isn't reason enough to be ethical; as soon as the cost of being ethical outweighed the benefits, ethical choices would no longer be possible. Surveys report that all employees want to work for organizations with high ethical standards.



Competent people are likely to search for organizations that maintain high ethical standards. When competent people migrate toward ethical firms, everyone benefits because both competence and ethics are perpetuated. Indeed, it is quite easy to make the argument that competence and ethics go hand in hand. They know that ethical practices are the only sure the level of ethical awareness has risen over the last few years. Many companies are reassessing their communication budgets, moving away from traditional, functional approaches to public relations and public affairs and pursuing internal and external corporate communication strategies. The theory and practice arising from corporate communications lies at the heart of effective strategic management, planning and control. New digital media technologies are having greater impact on news management and the monitoring and evaluation of corporate identity, corporate advertising, organizational reputation and overall performance.

### **16.9 SELF-EXAMINATION QUESTIONS**

#### **I Questions (Short/ Essay type Answers)**

1. Explain the significance of ethics in communication. What are the attributes of an ethical communication?
2. Discuss the factors influencing ethical communication
3. Write short notes on
  - (a) Whistle-blowing
  - (b) Organisation values and Communication ethics
  - (c) Timeliness of communication
4. Drawing on your own experience, explain how you think ethical communication strengthens businesses and organizations.

#### **II Activities**

5. Select a major organization that you wish to research. Through an examination of its advertising, pamphlets, shareholder statements, and recent media coverage, or through interviews with executives and other employees, explain what you believe the organization's values are.
6. You have just been promoted to manager and you have developed a good rapport with most of your employees, but Mehta and Sharma are always going to your supervisor with matters that should go through you. Both employees have been at the company for at least 10 years longer than you have, and both know your supervisor very well. Should you speak with them about this? Should you speak with your supervisor?



7. Because of your excellent communication skills, your boss always asks you to write his reports for him. When you overhear the CEO complimenting him on his logical organization and clear writing style, he responds as if he has written all those reports himself. You're angry, but he is your boss. What can you do?

**III Objective / Multiple Choice Questions**

1. What are ethical dilemmas faced while communicating:
  - (a) Secrecy , Whistle-blowing, Leaks, Rumour and Gossip ,
  - (b) Ambiguity , Whistle-blowing, Leaks, Lying, Euphemisms
  - (c) None of the above.
  - (d) Both (a) and (b)
2. Candour refers to:
  - (a) Candour refers to diplomacy in communication with other people.
  - (b) Candour refers to truthfulness, honesty, and frankness in your communication with other people.
  - (c) Candour refers to secrecy in your communication with other people.
  - (d) Candour refers to one of the most prevalent yet noticeable areas of unethical behaviour.
3. What are the advantages of Ethical Communication?
  - (a) Promotes long term business success and profit
  - (b) Sustain organizational image
  - (c) Only (a)
  - (d) Both (a) & (b)
4. What is Whistle-blowing?
  - (a) Going public about corporate abuses
  - (b) Telling others about corporate negligence
  - (c) Only (a)
  - (d) Both (a) & (b)

**Answers:**

1. (d), 2. (b), 3. (d), 4. (d).

# CHAPTER 17

## COMMUNICATING CORPORATE CULTURE, CHANGE AND INNOVATIVE SPIRITS

### Learning Objectives

*After reading this chapter, you will be able to understand*

Corporate culture

Why change is important factor for survival & Growth

Building an innovation friendly organization

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*The real source of wealth and capital in this new era is not material things.. it is the human mind, the human spirit, the human imagination, and our faith in the future.*

**Steve Forbes**

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In the transformation of the caterpillar into the butterfly, the caterpillar constructs a cocoon and then undergoes an astounding transformational process, where the old "caterpillar" molecules actually chemically transform into "butterfly" molecules. They have to stop being caterpillars before they can possibly become butterflies. But then they reassemble and become more than they were. They realize their inherent potential, something that all can do. Thus unrealised organizational and individual potential can be coached and supported by fostering open communication and a culture conducive to change and innovation. Improvement is about understanding and capturing ideas and possibilities, reformulating and restructuring those ideas into a usable form and then transforming them into actions and behaviours. Clearly, innovation is the key driver for wealth creation and economic competitiveness. Those who come up with innovative solutions can expect huge financial rewards and the satisfaction of realizing their vision. In a globalised economy, a city, region, or country wanting to succeed and prosper, must have such innovative and creative individuals to maintain a competitive edge.

### 17.1 WHAT IS CORPORATE CULTURE?

At its most basic, Corporate Culture is described as the personality of an organization, or simply as "how things are done around here." It guides how employees think, act, and feel. Corporate culture is a broad term used to define the unique personality or character



of an organization, and includes such elements as core values and beliefs, corporate ethics, and rules of behaviour norms that are shared by people and groups in an organization and that control the way they interact with each other and with stakeholders outside the organization.

These cultural statements become effective when executives are able to communicate the values of their firm, which provide patterns for how employees should behave. Firms with strong cultures achieve higher results because employees maintain focus both on what to do and how to do it. Organizational values are beliefs and ideas about what kinds of goals members of an organization should pursue and ideas about the appropriate principles of behaviour organizational members should use to achieve these goals. From organizational values develop organizational norms, guidelines or expectations that prescribe appropriate kinds of behaviour by employees in particular towards one another.

Senior management may try to determine a Corporate Culture. They may wish to impose corporate values and standards of behaviour that specifically reflect the objectives of the organization. In addition, there will also be an internal culture within the workforce. Work-groups within the organization have their own behavioural quirks and interactions which, to an extent, affect the whole system.

### **STRONG / WEAK CULTURES**

A strong culture is said to exist where the staff's response to change and innovation is high because of their alignment to organizational values- people do things because they believe it is the right thing to do. Conversely, there is Weak Culture where there is little alignment with organizational values, and control must be exercised through extensive procedures and bureaucracy.

### **17.2 ELEMENTS OF CULTURE**

A number of elements that can be used to describe or influence Organizational Culture:

**The Paradigm:** What the organization is about; what it does; its mission; its values.

**Control Systems:** The processes in place to monitor what is going on.

**Organizational Structures:** Reporting lines, hierarchies, and the way that work flows through the business.

**Power Structures:** Who makes the decisions and how power is distributed across the organization.

**Symbols:** These include the logos and designs, but would extend to symbols of power, such as car parking spaces and executive washrooms!

**Rituals and Routines:** Management meetings, board reports and so on may become more habitual than necessary.



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## Communicating Corporate Culture Change and Innovative Spirits

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**Stories and Myths:** build up about people and events, and convey a message about what is valued within the organization.

Communicating the corporate culture effectively is paramount. For example, at General Electric (GE), corporate values are so important to the company, that Jack Welch, the former legendary CEO of the company, had them inscribed and distributed to all GE employees at every level of the company.

### 17.3 CHANGE

Typically, the concept of organizational change is in regard to organization-wide change, as opposed to smaller changes such as adding a new person, modifying a program, etc. Examples of organization-wide change include a change in mission, restructuring operations, new technologies, mergers, major collaborations, new programs such as Total Quality Management, re-engineering, etc. - a fundamental and radical reorientation in the way the organization operates.

#### WHY IS ORGANIZATION-WIDE CHANGE DIFFICULT TO ACCOMPLISH?

Typically, there are strong resistances to change. People are afraid of the unknown. Many people think things are fine and don't understand the need for change. Many are inherently cynical about change. Many doubt there are effective means to accomplish major organizational change. Often, there are conflicting goals in the organization, e.g., to increase resources to accomplish the change yet concurrently cut costs to remain viable. Organization-wide change often goes against the very values held dear by members in the organization, that is, the change may go against how members believe things should be done.

#### 17.4 RESISTANCE TO CHANGE

No matter whether a change is of major proportions or is objectively rather small, the change manager must anticipate that people in the organization are going to find reasons to resist changes. It is a basic tenet of human behaviour that any belief or value that has been previously successful in meeting needs will resist change.

##### *Reasons Why People Resent or Resist Change*

1. One major reason why people resist change is the potential for loss on a personal level. Objectively, there may be little threat, but people may act as if there is one. Some of the things people feel are at risk during change processes are:

Security

Friends and contacts

Money



Freedom

Pride and satisfaction

Responsibility

Authority

Good working conditions

Status

2. While a feeling of threat is a primary reason why people resist change, there are other factors that can mobilize people into resisting any changes from a status quo. These include:

Change not needed - status quo is working fine

Proposed change does more harm than good

Lack of respect for person responsible for the change

Objectionable way of implementing the change

Negative attitude towards the organization before the change

no opportunity to have input into change

change perceived as implying personal criticism

Change simply adds more work and confusion.

Change requires more effort than to keep status quo

Bad timing of the change

A desire to challenge authority

Hearing about the change secondhand

3. The uncertainty principle

The Uncertainty principle states that when people are faced with ambiguous or uncertain situations, where they feel they do not know what to expect, they will resist moving into those situations. In other words, if people don't know what is to come resistive.

#### **REASONS FOR ACCEPTANCE OF CHANGE**

Resistance to change takes many forms. The more obvious forms consist of active resistance, where people will object, or refuse to cooperate with the change. Other, subtler forms of resistance, however, are more difficult to deal with. For example, at a staff meeting everyone agrees to utilize a new procedure, but several weeks later you discover that the procedure has not been implemented..



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## **Communicating Corporate Culture Change and Innovative Spirits**

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It is helpful to have an understanding of why people resist change, because understanding this allows us to plan communication strategies to reduce resistance from the beginning. While it is likely to encounter people who resist change for the previously stated reasons, one will also encounter people who accept or welcome change. By knowing why people might accept or welcome change one is in a better position to formulate a communication plan to foster acceptance.

### **1. PERSONAL GAIN**

People will be more likely to accept change when they see the possibility that they will gain in some of the following areas:

- Increased Security
- Money
- More Authority
- Status/Prestige
- Better Working Conditions
- Self-Satisfaction
- Better Personal Contacts
- Less Time And Effort

### **2. OTHER FACTORS:**

- Provides A New Challenge
- Likes/Respects The Source
- Likes The Way Change Is Being Communicated
- Reduces Boredom
- Provides Opportunity For Input
- Improves Future
- Perception That The Change Is Necessary

### **17.5 COMMUNICATION AND CHANGE**

Successful change must involve top management, including the board and chief executive. Usually there is a champion who takes the initiative to change by being visionary, persuasive and consistent. A change agent's role is usually responsible to translate the vision to a realistic plan and carry out the plan. Change is usually best





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carried out as a team-wide effort. Communications about the change should be frequent and with all organization members. To sustain change, the structures of the organization itself should be modified, including strategic plans, policies and procedures. The best approaches to address resistances are through increased and sustained communications and education. For example, the leader should meet with all managers and staff to explain reasons for the change, how it generally will be carried out and where one can go for additional information.

A plan should be developed and communicated. Plans do change, so it is necessary to continuously communicate changes and its reasons. Forums should be held for organization members to express their ideas for the plan. They should be able to express their concerns and frustrations as well.

Widely communicate the potential need for change. Communicate continuously the action/s taken and results.

Get as much feedback as practical from employees, including what they think are the problems and what should be done to resolve them. If possible, work with a team of employees to manage the change.

Focus on the coordination of the departments/programs in your organization, not on each part by itself. Have someone in charge of the plan.

Communication is probably the most important skill that people need to have in order to be effective managers. It is probably the most taken for granted, and the area least addressed by developing managers. In situations of instability, or change, or ambiguity, communication becomes even more important.

Poor communication around change issues can:

1. Destroy commitment to an organization
2. Irrevocably damage employee morale
3. Generate huge resistance to change
4. Result in hostility.
5. Lead to performance problems

Communication can be simply described as CREATING UNDERSTANDING. In periods of change (as in "normal" times), the manager must not only pass information to employees, but also ensure that it is understood correctly. After all, the manager stands to lose a great deal if information is not understood, as he or she is accountable for the results. Unfortunately, some managers believe that effective communication consists of sending memo, or telling people orally what is going on, or what will happen. Passing on of



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information is only one part of communication. So, communication must be two-way in manner, where the manager may be communicating to employees, but is also soliciting comments from employees about their level of understanding, and comfort around potential changes.

### **WHO, WHAT, WHEN, HOW?**

There are four decisions that managers must make around communication in change situations:

1. TO WHOM
2. WHAT
3. WHEN
4. HOW

#### ***To whom:***

It is far better for the manager to err on the generous side of communication than on the skimpy. Some managers have a tendency to communicate change on what is termed a "need to know" basis. That is, people who must have the information, get it, but those that are not directly involved, do not (Actually they will eventually through informal channels). While this makes some sense, generally it does not work, resulting in feelings of being left out, not being valued, etc. The basic rule is that communication should take place directly between the manager and employees when employees NEED TO KNOW OR WANT TO KNOW. In other words, except for situations that involve confidential information, even those people who are indirectly affected would like to know what is going on, and how it may affect them. One must also remember that it is rare that any change in an organization will not have an effect, directly or indirectly, upon all members of the organization.

#### ***WHAT:***

In changed situations, it is good to communicate as much information about the change as is available. While this sounds simple, sometimes judgment will have to be exercised regarding confidential information, and information, which is based on speculation or rumour. Clearly, there will be some information, which is not appropriate for release. Speculation and rumour about impending change have the potential for generating a great deal of anxiety. There may be situations where passing on speculative information may not be appropriate. However, if that information has already reached the grapevine, and employees will hear about it anyway, better to have it on the table and in context.

Finally, keep in mind that not only must you communicate facts/information but communicating some of your own feelings and fears about the change will generally make



it "legal" for employees to do likewise. As a manager, it is better to have people's reactions and feelings to be able to help employees deal with resistance. Stating your own feelings honestly is a good starting point for opening up these lines of communication. In summary, communicate as much as you can, and communicate your own feelings and concerns. This will help you be perceived as part of the team.

**WHEN:**

In general, communicate as early as possible about change, but do not assume that once you have done this that the job is over. Communication should occur in anticipation of change, during the implementation, and after to assess its value to employees. Do it early, do it often! One should keep in mind that, depending on the hierarchy or structure of the organization, one may need to think through the order in which things are communicated to people at different levels. Ordinarily, one's boss should be informed prior to major changes, but again that will depend on the climate of the organization.

**HOW:**

Should one use oral or written communication? Below are some guidelines for making this decision.

**Oral face-to-face when:**

1. Receiver is not particularly interested in getting the message. Oral provides more opportunities for getting and keeping interest and attention.
2. It is important to get feedback. It is easier to get feedback by observing facial expressions and asking questions.
3. Emotions are high. Oral provides more opportunity for both sender and receiver to let off steam, cool down, and create a suitable climate for understanding.
4. Receiver is too busy or preoccupied to read, oral provides a better opportunity to get attention.
5. If criticism of receiver is involved, oral provides more opportunity to accomplish this without arousing resentment. Also, oral is less threatening because it has not been formalized in writing. Written communication is not private (at least as receiver sees it) even though it might be marked personal and confidential.
6. Sender wants to persuade or convince. Oral provides more flexibility, opportunity for emphasis, chance to listen and opportunity to remove resistance, and change attitudes.
7. Oral is more natural. For example, in most cases it is more natural to give instructions orally rather than writing them out. Likewise it is more natural to communicate orally with someone who has a desk next to you or who is in an office a few feet away from your own.
8. Discussion is needed. A complicated subject frequently requires discussion to be sure of understanding.



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9. Receiver cannot read language of the sender. Some people can understand a spoken language but cannot read it.

### Use written communication when:

1. Sender wants a record for future references.
2. Receiver will be referring to it later.
3. Message is complex and requires study by receiver.
4. Message includes a step-by-step procedure.
5. A copy of the message should go to another person.

Thus, the main role of the change manager is to work towards reducing the resistance towards change, and increasing the enthusiasm and level of commitment for the change.

## 17.6 SPURRING THE INNOVATIVE SPIRITS

### Innovation – the Key to Success and Survival

Companies that continuously innovate will create and re-invent new markets, products, services, and business models – which lead to more growth. Leaders of successful, high-growth companies understand that innovation is what drives growth, and innovation is achieved by remarkable people with a shared passion for problem solving and for turning ideas into realities through perseverance and a positive attitude. Innovation is dependent on the organisation's ability to recognize market opportunities, internal capabilities to respond innovatively, and knowledge base. The successful business of the future will be one that provides unequalled customer service, delivers an exceptional product or service, and continuously makes innovative improvements. Success in the next decade will depend on managers and leaders capturing the innovative hearts and minds of their workers. This will only happen if businesses breathe, dream and allow innovation at all levels of the business. Preoccupation with gimmicks, short term thinking, bureaucratic rules and procedures will generate more "Going Out of Business" signs than anything else. Innovation comes from a workforce empowered by both their ideas and their ability to contribute to the enterprise. Creating this innovative environment is the greatest business challenge of today's fast paced competitive and borderless business world.

Innovation begins with the leader or business manager. In today's rapidly changing working world, the manager must be more like a coach, or a team leader than a boss, a collaborator instead of a manipulator. The leader must create an environment supporting and nurturing innovation. We are seeing a new world where passion over knowledge, where chaos over structure are the norms. today, citizens and customers hold the government and all organizations to higher expectations.



**17.7 BARRIERS TO INNOVATION**

<b>Stage</b>	<b>Evaluation Criteria</b>	<b>Critical Questions</b>	<b>Organizational Barriers</b>
Idea Generation	Novelty	Is the idea novel?	Highly structured Organisational climate Groupthink Authoritarian communication style Too many rules and regulations Extreme power differences
Feasibility Analysis	Possibility	Is the idea possible?	Lack of corporate resources dedicated to research Lack of commitment to research
Reality Testing	Practicality	Does the idea produce a reasonable return on investment? Does the idea fit with organizational objectives? Does the organisation have the start-up capital for the idea?	Short-term focus Inadequate research on the potential return or marketability of idea Resistance to change
Implementation	Activity	Has the idea been acted on?	Too many priorities Nobody has responsibility for the implementation Over consultation with involved parties Highly unstructured organisational climate



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### 17.8 BUILDING INNOVATION ENABLED ORGANIZATION

There are specific elements that help a company to be more innovative. It is a blend of culture, methodologies, infrastructure, and work practices. A sustainable innovation organization should have:

- Vision and strategy for innovation
- Culture supporting innovation
- Processes, practices and systems supporting innovation
- Top management team leading innovation
- Effective Cross-functional teams
- Empowered employees driving innovation.

#### Finding the Right Balance Between Bureaucracy and Chaos

Successful organizations must balance bureaucratic processes at one extreme with the fluid creative chaos of relationships, interests and transactions, which enable it to be innovative and alive, at the other. There is a risk of another phenomenon, Groupthink. "Groupthink" is defined as a mode of thinking that people engage when they are deeply involved in a cohesive group, where members' strivings for unanimity override their motivation to realistically appraise alternative of action." This is a state where people, even if they have different ideas, do not challenge organizational thinking, and therefore there is a reduced capacity for innovative thoughts.

The key elements in the innovation framework are:

#### **Accessibility**

The major organizational challenge is to make everyone, particularly the workers, active participants in the work process. The innovative enterprise ensures everyone is accessible to each other at all levels within the organization. Accessibility to everyone facilitates a feeling of teamwork, trust and equality. This not only includes the workers, but the customers and suppliers as well. Most organizations are infected by both visible and subtle barriers and limitations based on rank, position and structure. Hierarchical chains of commands, rank and titles affect workers' access to each other. These subtle barriers are like unwritten rules of conduct. They lay out who can talk to whom. Those organizations make it clear, often unconsciously, that top management's role is to think and the lower ranking people at the bottom are to carry out the orders and dictums of those above them. Access by everyone to everyone fosters creativity, helps the flow of innovative ideas, and speeds up the decision making process. A major driver making everyone more accessible to each other is the organizational vision and communication. The vision connects personal goals and dreams of the workers with the goals and



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objectives of the business. Vision statements point to the direction in which the organization is heading. This unifies everyone's efforts toward a common purpose. By contrast, bureaucratic organizations may miss opportunities for innovation, through reliance on established procedures. A policy statement in the employee handbook can be a useful starting point. Here, a commitment to innovation can be made in black and white. The very process of developing this policy statement forces management to articulate goals and commitments. The initial training of employees can also stress the necessity for innovation. Even the corporate philosophy should have a sentence or phrase about the organization's position on innovation.

Innovative organizations need individuals who are prepared to challenge the status quo – be it groupthink or bureaucracy, and also need procedures to implement new ideas effectively

### **Recognize and Reward Innovation**

One of the more radical steps an organization or manager can take is to make innovation a requirement of the job. For example, 3M sets divisional sales targets in terms of new product development. Approximately 30% of an operating unit's sales should come from products developed in the last four years. Bonuses are also tied to this yardstick. It works.

The formal evaluation system also plays an important role. Companies reward activities they value. Employees know this, and react accordingly. Financial rewards have proven successful, but there are other and often more meaningful rewards such as personal recognition. Innovators can be recognized in company newsletters, trade publications, and the local media. Stories about innovators not only provide recognition, but also show others in the organization what the company really values.

Rewarding individual innovators is not the only tactic that can be employed. After all, the objective is to spur on the spirit of innovation throughout the entire organization. Why not recognize an entire unit, department, or division that is particularly innovative? This might encourage the teamwork so necessary for successful innovation.

### **Develop Company Programs That Encourage Innovation**

Some companies, such as IBM, allow their employees to take sabbaticals to work in a new environment or teach in a college. By placing employees in different environments, they can meet new people, come across new ideas, and, hopefully, generate their own novel approaches.

Other major companies have model programs that encourage innovation as well. 3M has a program that allows employees to spend up to 15% of their time working on their own innovative project with little or no direct managerial control. The almost ubiquitous Post-it Notes are a direct result of this rule, and now account for millions of dollars of revenue. And 3M takes it one step further with its Genesis grants. Employees can apply for up to \$85,000 in seed money to carry their projects past the idea state.



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Another program that has been successful involves keeping a written record or log of all suggestions and the actions taken on those ideas. The list is then circulated around the company. Timeliness is also important. Walter Scott of Motorola, Inc., said, "Any employee's recommendation for new methods or change should get a reply in 72 hours or less."

### Foster Informal Communication

The paperwork involved in proposing or even pursuing a project can be a major roadblock to innovation. Employees often feel stifled when asked to fully justify ideas; they may be working on a hunch. In the first place, many of the questions cannot be answered fully until later in the innovation process. Second, many relevant questions cannot even be anticipated. Moreover, the message sent to employees by requiring extensive paperwork is that results must be guaranteed and failure is unacceptable.

Paperwork and administrative regulations are often initiated in organizations to provide some control of organizational events. Informal communication can fill the gap. Managers can keep up-to-date by informally communicating with employees about projects or new ideas. Often, this kind of "checking up" proves more informative than endless reams of paperwork.

Informal communication encourages discussion across departmental boundaries and formal lines of authority. More useful ideas seem to be spawned in such a free-flowing environment. Why? In part, because these discussions expose organizational problems, concerns, and needs, all of which are begging for innovative solutions. Bill Gates, the innovative founder of Microsoft, credits the use of electronic mail as one of the keys in keeping his company on the creative frontier. If someone has a brainstorm, he or she can immediately flash the idea to others for their reactions. He says, "It sparks interest." Adding blackboards, sketchpads, and small conference rooms in the workplace has also proven helpful in encouraging more informal communication. Electronic mail, blackboards, and sketchpads have one common characteristic: mistakes can be quickly and easily corrected. Therefore, speculation, change, and creativity are encouraged. Deletions or additions can be readily made. This is the spirit of informal networks—quick feedback with little fear of change. There are few repercussions when changing an idea in an informal situation. Formal documents are less easily amended. And that is why it so important to set up an informal communication environment.

### Information

The right kind of information is called *innoinformation*. This type of information is critical to the vitality of the enterprise. *Innoinformation* consists of the plans, vision, goals, and all the new ideas affecting the enterprise. The innovative enterprise is looking forward, continuously changing and adapting to the needs of the customer. By providing





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*Innovation* everyone in the enterprise can see new opportunities, not just the people at the top. Idea campaigns, teamwork, benchmarking and other programs keep the organization flexible and vital. One way to ensure people are ready to change is by communicating the ideas and suggestions made by the people within the organization. A constant flow of ideas and suggestions show people that there is a need for change. When people hear new ideas, they are more willing to change. Jack Jackson, a professional speaker from Ft. Worth, Texas said, "If you are going to innovate you must communicate or you won't motivate!"

### **Framework**

The innovative enterprise must constantly adapt, create and innovate. Information and communication are the wind that sails the innovative enterprise toward its destination. Information and communication pose difficult challenges for most businesses. The difficulty lies in balancing the flow of information between providing too much or too little information. Managers complain that they are overloaded while, front-line workers complain, "no one tells them what's going on! In the traditional organization, information represents power. The flow of information is important to keep the enterprise on course. Those businesses faced with a rigid hierarchy have a limited flow of information. They have a major difficulty staying current and flexible. They end up pushing instead of leading their organization to the next juncture. On the other hand, the innovative enterprise effectively uses information and communication to keep everyone informed, working together.

Businesses must concern themselves with providing the right information at the right time, in the most effective manner possible. Successful entrepreneurs have consistent policies and a written business plan that defines short- and long-term requirements for growth and provides a framework for decisions.

The plan needs to be developed with input from all levels of the organization and should be updated at least annually and more frequently if market conditions change. Inhibit or expand the company-wide search for radical ideas through brainstorming and by encouraging actively other idea generation tools.

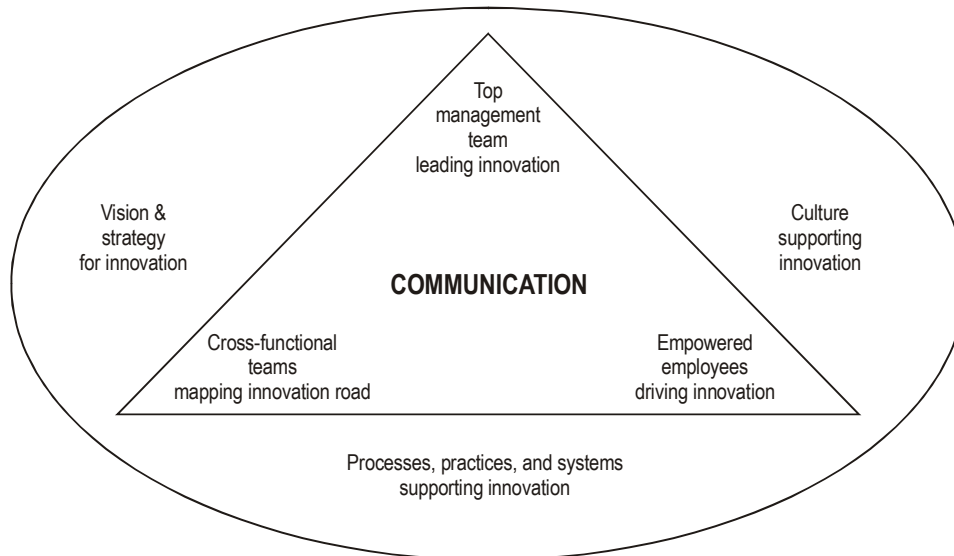
Fostering meaningful dialogue encourages learning and creativity. The rules and culture of the organization encourages the degree of innovation.



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### THE INNOVATIVE ORGANISATION

The best thing to do to guarantee growth is to build a sustainable innovation organization around the following components:

1. Vision and strategy for innovation
2. Culture supporting innovation
3. Processes, practices and systems supporting innovation
4. Top management team leading innovation
5. Cross-functional teams mapping innovation road
6. Empowered employees driving innovation.
7. Finding the Right Balance Between Bureaucracy and Chaos

#### Finding the Right Balance Between Bureaucracy and Chaos

Successful organizations must balance bureaucratic processes at one extreme with the fluid creative chaos of relationships, interests and transactions, which enable it to be innovative and alive, at the other.

Eliminate politics, by giving everybody the same message.

Keep a flat organization in which all issues are discussed openly.

Insist on clear and direct communication.

Prevent competing missions or objectives



Eliminate rivalry between different parts of the organization

Empower teams to do their own things

### **Conclusion**

Stop signs regulate the flow of traffic; they tell people when and where to stop. With too few stop signs, the streets are unsafe. With too many, advancement slows. Either extreme is disastrous. Organizations also have stop and go signs. They may not have red, yellow, and green lights, but they are just as real and have just as much effect on the flow of organizational events. The corporate policies, rules, regulations, procedures, organizational structure, and the day-to-day interactions in meetings, conversations, and memoranda are all varieties of these organizational traffic signals. If there are too many stop signs, then innovative efforts come to a grinding halt. If there are too few, then there is chaos. The objective, then, is to design a system that (a) does not impede the flow of innovative ideas; (b) increases the probability of a safe and speedy passage for useful ideas; and (c) decreases the probability that the poor ideas proceed to the implementation stage. Only through careful and thoughtful planning can each of these goals be achieved.

### **17.9 SELF-EXAMINATION QUESTIONS**

#### **I. Questions (Short /Essay type answers)**

1. What is corporate culture? How can it influence an organisation's ability to achieve its objectives?
2. How are shared values established in an organization? In your opinion, which communication techniques are most effective, and why?
3. Some organizations are flattening their hierarchies by eliminating the jobs of middle managers. How do you think this restructuring has affected communication in those organizations?
4. Why is Organization-Wide Change Difficult to Accomplish?
5. Describe the key elements required by an organisation to develop a sustainable innovative organisation

#### **II. Multiple Choice / Activities**

1. The following are the elements of corporate culture except :
  - (a) Core value of belief
  - (b) Corporate ethics.
  - (c) Religious belief
  - (d) Rules of behaviour



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2. Beliefs and ideas about what kinds of goals, members of an organization should pursue is:
  - (a) Organisational Value
  - (b) Organisational Belief
  - (c) Organisational Culture
  - (d) All of the above.
3. Elements of culture care :
  - (a) Paradigm, control system and power structure
  - (b) Paradigm, control system and symbols
  - (c) Paradigm, control systems, organizational structure, rituals and myths.
  - (d) All of the above.
- 4.. The Paradigm means :
  - (a) What the organization is about and what it does
  - (b) Its mission and values
  - (c) Both (a) and (b)
  - (d) None of the above.
5. Details regarding appointment of managing director of a company and his perquisites would form a part of :
  - (a) Ordinary business in a notice
  - (b) Complex business in a meeting
  - (c) Special business in a notice
  - (d) Specified business in a meeting
6. What are the pillars of transformation?
  - (a) Vision, values & vitality
  - (b) Vision, mission values
  - (c) Vision, neutrality, mission
  - (d) Vision, focus & vitality



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7. Vision provides:
- (a) Decision making power
  - (b) Overarching inspiration
  - (c) Nomenclature
  - (d) Goal
8. Correct statement :
- (a) The PR should have a consistent format
  - (b) The release should have a title and a subtitle on the top.
  - (c) Both (a) and (b)
  - (d) None of the above
9. Press notes are :
- (a) Less formal in character
  - (b) Issued on important matters
  - (c) Heading or subheading is given
  - (d) All of the above
10. Handout is :
- (a) Less formal
  - (b) Bears the name
  - (c) Place and date are indicated on top at right-hand side
  - (d) All of the above

**Answers :**

1. (c), 2. (a), 3. (d), 4. (c), 5. (c), 6. (a), 7. (b), 8. (c), 9. (d), 10. (d).

# CHAPTER 18

## COMMUNICATION IN BUSINESS ENVIRONMENT

### Learning Objectives

*After reading this chapter, you will be able to understand*

Understand how the notice and minutes of a meeting are to be drafted.

Understand the importance and different types of Press Releases.

Understand how the Corporate Announcements by Stock Exchanges are made.

### 18.1. SPECIMEN OF NOTICE

Notice is hereby given that the 10<sup>th</sup> Annual General Meeting of the Members of XYZ Ltd. will be held on Thursday, the 15<sup>th</sup> day of September, 2006, at the Registered Office of the Company at Plot Nos. 16-18, New Electronics Complex, Chambaghat, Distt. Solan (HP), at 10.00 a.m. to transact the following business –

#### **Ordinary Business:**

1. To receive, consider and adopt the Audited Balance Sheet of the company as on 31<sup>st</sup> March, 2006 and the Profit & Loss Account for the year ended on that date and Auditor's and Directors' Reports thereon.
2. To declare dividend for the year ending 31<sup>st</sup> March, 2006.
3. To appoint a director in place of Mr. .... who retires by rotation and being eligible, offers himself for re-appointment.
4. To appoint a Director in place of Mr. .... who retires by rotation and begin eligible, offers himself for re-appointment.
5. To appoint Statutory Auditors of the company; and fix their remuneration.

#### **Special business:**

6. To consider and, if thought fit, to pass with or without modification(s) the following resolution as an ordinary resolution:

“Resolved that pursuant to the provisions of sections 269, 198, 309 and other applicable provisions, if any, of the Companies Act, 1956 the consent of the Company be and is hereby accorded to the re-appointment of and remuneration payable to Mr. P.S. Gill as



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Managing Director for a period of five years w.e.f. 1<sup>st</sup> July, 2006 on the following terms and conditions:

(A) Salary: Rs. 1,50,000 per month

(B) Perquisites:

(i) Medical reimbursement:

Expenses incurred for self and family subject to a ceiling of one month salary in a year or three month's salary over a period of three years.

(ii) Leave travel concession for self and family once in a year in accordance with the Rules of the Company.

(iii) Club fee:

Fees of clubs, subject to a maximum of two clubs provided that no life membership or admission fee will be allowed.

(iv) Personal accident insurance:

Premium not to exceed Rs. 1,0000.

(v) Company's contribution towards pension/superannuation fund as per Rules of the Company for the time being in force but such contribution together with P.F. shall not exceed 25% of the salary or such other increased amount provided that the same is not taxable under the Income-tax Act,1961.

(vi) Company's contribution towards P.F. as per rules of the company for the time being in force but not exceeding 10% of the salary.

(vii) Gratuity not exceeding half month's salary for each completed year subject to a ceiling of Rs. 20 lakhs.

(viii) Free use of the telephone at residence but personal long distance calls shall be billed by the company.

(ix) Free use of company's car with driver for the business of the company.

(x) Earned / Privilege Leave:

One months' leave with full pay and allowances for every 11 months of service subject to the condition that leave accumulated but not availed of will not be allowed to be encashed.



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## Communication in Business Environment

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Regd. Office: For and on behalf of Board of Directors  
16-18, New Electronics Complex  
Chambaghat  
Distt: Solan (HP) Chairman of the Meeting

### Notes:

A member entitled to attend and vote is entitled to appoint a proxy to attend and vote instead of himself and the proxy need not be a member of the company.

Explanatory statement relating to special business is annexed to this Notice as required under section 173 of the Companies Act, 1956.

The Register of members and the Share Transfer Books of the Company will remain closed from 7th day of September, 2006 to 15th day of September, 2006 both days inclusive.

Members are requested to notify immediately change of address, if any, to company's Registered Office. While communicating to the company, please quote the folio number.

Shareholders desirous of obtaining any information concerning the accounts and operations of the company are requested to address their questions to the company's Head office, so as to reach at least 5 days before the date of the meeting so that the information may be made available at the meeting to the best extent possible.

### 18.2 SPECIMEN OF MINUTES OF ANNUAL GENERAL MEETING

Third annual general meeting held at

Place.....

Date.....

Time.....

Present

1. Shri ..... in the chair
2. .... directors.
3. .... Members in person and
4. .... representative of ..... C.A.
5. .... Secretary





1. Notice

The notice convening the meeting was read by the Secretary.

2. Directors' Report and Accounts.

With the consent of the members present, the Director's Report and Accounts having already been circulated to the members were taken as read.

3. Auditors' Report

The Auditors' Report was read

4. Adoption of Directors' Report, etc.

The Chairman then invited queries from the members present on Directors' report, Accounts and Auditors' and auditor's Report, but there was no query. Thereafter, the Chairman proposed the following resolution which was seconded by.....

"Resolved that the Directors' Report, audited Balance Sheet as on 31st March, 2006 and Profit and Loss Account for the year ended 31st March, 2006 and Auditors' Report thereon be and the same are hereby received, considered and adopted."

Carried unanimously.

5. Dividend

Proposed by Shri .....

Seconded by Shri .....

"Resolved that the Dividend as recommended by the Board of Directors for the year ended 31st March, 2006 at the rate of Rs. .... per share on the equity share capital of the company, subject to deduction of tax at source be and is hereby declared for payment to those shareholders whose names appeared on the Register of Members as on ..... 2006."

Carried unanimously

6. Directors

Proposed by .....

Seconded by .....

"Resolved that Shri ..... who retires by rotation and is eligible for re-appointment to and is hereby re-appointed a director of the company."

Carried unanimously.



## Communication in Business Environment

### 7. Auditors

Proposed by .....

Seconded by .....

“Resolved that M/s ..... Chartered Accountants, be and are hereby appointed Auditors of the Company to hold office from the conclusion of this meeting until the conclusion of the next Annual General Meeting at a remuneration of Rs. ....

Carried unanimously.

The meeting closed with a vote of thanks to the Chair.

Dated .....2006.

Chairman

### 18.3 SPECIMEN OF CHAIRMAN'S SPEECH

#### Ladies and Gentlemen,

It gives me great pleasure to welcome you to the 95th Annual General Meeting of your Company. As we gather today, I am sure you share my sense of satisfaction at yet another year of robust performance by your Company. Gross Turnover for the year 2005-06 grew by 21.5% to Rs. 16224 crores, driven by strong top line performance across all businesses. Before exceptional items, pre-tax profit increased by 22.3% to Rs. 3269 crores, and post-tax profit to Rs. 2280 crores, registering a growth of 24.1%. Earnings Per Share (before exceptional items) for the year stands at Rs. 6.08. The financial strength resulting from sustained performance of this nature, and the world-class capability of ITC's human capital constitute the foundations to scale even greater heights in the years to come. As is customary, I append a snapshot of financial performance since 1996.

*(Figures in Rs. Crores)*

ITC: Financial Snapshot 1996 - 2006		
	1996	2006
<b>Gross Income</b>	<b>5188</b>	<b>16511</b>
<b>Profit After Tax</b>	<b>261</b>	<b>2235</b>



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Return on Average Net Assets (%)	30	36
Net Assets Employed	1886	9506
Net Worth	1121	9061
Market Capitalization	5571	73207

As at 31<sup>st</sup> March

During this decade Total Shareholder Returns, measured in terms of increase in market capitalisation and dividends, grew at a compound rate of over 30% per annum, placing your Company among the foremost in the country in terms of efficiency of servicing financial capital. In a testimony to the power of performance, your Company is today counted amongst the top global corporations in the Forbes 2000 List.

You, the shareholders, can draw even greater satisfaction from the fact that these financial results have been achieved even as your Company is creating new benchmarks in Triple Bottom Line performance. **It is a matter of pride that your Company, already a 'water-positive' corporation, became 'carbon-positive' during the year on the back of several energy conservation measures, usage of carbon neutral fuels and carbon sequestration through large-scale agro-forestry programmes.** Your Company is also making rapid strides towards attaining 'zero solid waste' status. Upon this achievement in the near term, your Company would perhaps be the only global enterprise of its size in the world to have achieved these milestones encompassing all three critical facets of environmental sustainability.

Your Company's second Sustainability Report 2005, unveiled in January 2006, details value creation across the three dimensions of the Triple Bottom Line - namely economic, social and environmental. ITC's Sustainability Report, independently assured by Pricewaterhouse Coopers, continues to be the only 'In Accordance Report' by an Indian corporation, as per guidelines of the Global Reporting Initiative. This voluntary disclosure is an attempt to outline a more comprehensive picture of ITC's sustainability performance.

Today's meeting is of special significance, as it marks the completion of a decade since you placed me at the helm of ITC's leadership. It is therefore an opportune time to reflect on the nature and quality of transformation accomplished thus far, and the underlying drivers of such transformation. At the beginning of this period, your Company made the more difficult strategy choice of creating multiple drivers of growth, leveraging opportunities in the emerging Indian economy that best matched proven internal capabilities. The rationalised business portfolio



posed the formidable challenge of enabling the various businesses make the transition from competing in a relatively protected environment to winning in an intensely competitive and rapidly globalising market on the strength of superior value propositions.

Responding to this challenge meant engineering a paradigm shift in the corporate mindset. The entire organisation had to be realigned to a new focus, namely acquiring international competitiveness in cost and quality in each of ITC's businesses. Such realignment was given shape through significant investments in technology, processes, innovation and brands; and crafting a strategy of organisation based on the governance principle of distributed leadership to unleash the entrepreneurial energies of ITC's high quality human resource. **This transformation was powered by the Vision that provides the overarching inspiration; the Values that serve to guide thought and action; and the Vitality that enables excellence in strategy formulation and execution.**

#### **VISION, VALUES AND VITALITY - PILLARS OF TRANSFORMATION**

**The potential of an enterprise for wealth creation is set apart by the distinctive amalgam of its Vision, Values and Vitality. It represents a mix of constancy and change; of a timeless core and constantly evolving strategies and processes built around the core.** The effectiveness of interplay between these complementary elements determines the extent to which latent potential is realised. The enlargement of enterprise potential therefore requires Vision, Values and Vitality to be continuously recharged through practice and insight, revalidated for relevance and tested for appropriateness to the evolving competitive context. It is the role of leadership to nurture a unique combination of the 3Vs towards ensuring that the enterprise sustains superior wealth generating capacity in an environment of escalating competitive pressures. Such leadership, in a multi-business context like that of your Company, needs to extend beyond the corporate level to the strategic business units and their constituents. Distributed leadership then engenders transformation by enhancing adaptive capability and sharpening responsiveness to change. In line with this thought, I will proceed to illustrate the unique blend of Vision, Values and Vitality that has powered the transformation of your Company.

#### **VISION**

A compelling Vision creates and forges corporate identity. It imparts a larger purpose and meaning to individual endeavour. It is aspirational, unifying and motivational. Envisioning a larger societal purpose has always been a hallmark of ITC, described by me in the past as "a commitment beyond the market". We articulated a Vision appropriate to the Indian context, tailored around the deep rural linkages that characterise your Company's value chain relationships. **This compelling Vision of enlarging its contribution to the Indian society has powered your Company over the past decade.** Such a Vision is manifest in multiple



forms, significantly reshaping ITC's profile. The Vision requires each of ITC's businesses to attain leadership on the strength of international competitiveness. Simultaneously, it has driven your Company to also consciously contribute to enhancing the competitiveness of the larger value chains beyond its own operations. This broader commitment has led to the creation of unique business models that synergise long term shareholder value enhancement with fulfillment of the larger societal purpose. It has expanded corporate consciousness in the practice of trusteeship to ensure sustainable wealth creation through contribution to the 'Triple Bottom Line'. Above all, this superordinate purpose of creating growing value for the Indian society has inspired your Company's human resource and aligned their collective endeavour to provide unity of purpose across the organisation.

### VALUES

Values refer to the institutional standards of behaviour that strengthen commitment to the Vision, and guide strategy formulation and purposive action. The core Values of your Company are shaped around the belief that enterprises exist to serve society. In terms of this belief, profit is a means rather than an end in itself, a compensation to owners of capital linked to the effectiveness of contribution to society and the essential ingredient to sustain such enlarged societal contribution. Thus your Company has embraced an extended role of trusteeship that reaches beyond the assets reflected in the balance sheet to encompass societal assets. An unwavering commitment to integrity, ethical conduct, meritocracy, teamwork and abiding concern for stakeholders are at the heart of your Company's value system. **The defining trait of ITC however, is its deeply 'Indian' character that aligns corporate strategy to national priorities. Such a character flows from the Indianness of its soul rather than the origin of its capital.** As a premier 'Indian' enterprise, ITC consciously engages across the value chains towards maximising benefit for the Indian society. **Such a combination of Values determines choice of corporate strategy, orients such strategy in favour of Indian value chains wherever feasible, and engages the organisation willingly in confronting the larger societal challenges of inclusive and sustainable growth. Your Company's abiding commitment to society provides depth of moral content and infuses energy across the enterprise, thus elevating collective corporate effort to the fervour of a mission for the ultimate benefit of all stakeholders, including you, the shareholders.**

### VITALITY

A compelling Vision and strong Values by themselves could not have radically transformed your Company without the Vitality that enables robust strategy formulation and world-class strategy execution. **Vitality in ITC is manifest in many ways including the strengthening competitive capability, the deepening consumer insight, the breakthrough innovations in products and processes, the ability to rapidly absorb knowledge and harness**



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**technology, the widening bandwidth of distributed leadership, a growing nimbleness to proactively manage change and adaptiveness to continuously leverage market opportunities.** ITC's robust strategy of organization, climate of professionalism and time-tested caring culture constitute the framework for effectively channelising corporate Vitality.

The inspiration, courage and commitment derived from the Vision and Values have led to growing Vitality. Such Vitality in turn has led to enhanced market standing and profitability in addition to enlarged contribution across the Triple Bottom Line. A clutch of global honours and recognition for your Company in the last several years testifies to the quality of transformation achieved.

In order to fulfill the Vision of making a substantial and enduring contribution to the Indian society, your Company consciously chose the more challenging strategy of pursuing multiple drivers of growth, against conventional wisdom. Your Company is engaged in managing diversity by creating synergies and special strengths based on cultivating a network of inter-dependencies within the organisation. **ITC's strategy of organisation based on the governance principle of distributed leadership, seeks to derive the benefits of focus for each business while creatively deploying its diverse pool of core competencies to generate distinctive sources of sustainable competitive advantages.** Such effective management of diversity further hones the adaptive capabilities of the organisation towards sustaining long term growth and value creation.

### **BUSINESS PORTFOLIO: STRATEGIC PROGRESS**

The strategic progress in each of the businesses in your Company's portfolio is, I am sure, a source of satisfaction to shareholders. Your Company has made substantial investments in technology, processes and systems, innovation and brand building towards acquiring international competitiveness in terms of quality and cost in each of its businesses. **It is a measure of the continued trust reposed in your Company by consumers that ITC's brands today account for three of the top five FMCG brands in the country.** Shedding undue preoccupation with tactical results, your Company committed to the Hotels business with substantial investment even during a prolonged period of downturn in the industry. The rewards of such commitment are evident today in the rapid strides being made towards attaining leadership position by the ITC Welcomgroup chain. Over the past three years alone, Segment Revenues have nearly quadrupled while Segment Results have grown substantially by over 25 times. Such performance, apart from reflecting world-class hoteliering capability, also reflects the realisation of intended synergies of the amalgamation of ITC Hotels Limited and Ansal Hotels Limited with your Company. **A robust platform has thus been shaped for embarking on the next phase of aggressive expansion that would unveil, at first pass, the finest hotels in Bangalore and Chennai.**



The transformation of the Paperboards business is another demonstration of long term value creation born out of deep commitment. Substantial investment across the value chain, coupled with leveraging special insights as a converter and consumer of high quality packaging, has enabled the turnaround and growth of this business into a position of undisputed leadership in the Indian paperboard market. **The strengthening competitive capability of your Company's Paperboards business has provided the impetus to embark on an ambitious expansion plan to service the growing demand for high quality pulp-based products, including a range of coated and uncoated papers.**

Your Company's Agri-business, engaged in innovatively leveraging digital technology to create value for the Indian farmer, continued to strengthen its position in domestic and global markets as a leading supplier of high quality, identity-preserved agri commodities. This business is rapidly developing into a reliable partner for two-way flow of goods and services in and out of rural markets. Towards achieving this long term goal, the digital infrastructure of the ITC e-choupal is being supplemented with a phased rollout of physical infrastructure called ITC Choupal Saagars to serve as hubs for clusters of villages. While 10 Choupal Saagars are already operational, 9 more are in an advanced stage of completion. The rural retailing initiative will be scaled up by another 40 Choupal Saagars in the next 12 to 18 months. This hub and spoke model is being energised at the village level through sanchalaks and samyojaks drawn from the farming community, who represent the extended enterprise. **The innovative combination of digital, physical and human assets constitutes the basis for your Company's deeper engagement with the rural economy through the progressive development of low cost, broadband fulfillment capability.**

### ***New Growth Drivers***

Your Company is also engaged in blending the multiple competencies residing in its various businesses to create new growth drivers in a bid to secure the future. Competencies are recognised, not by products or physical assets, but by the underlying skills that create value. To illustrate, the Packaged Foods business draws upon the unique sourcing capability of the ITC e-choupal, the cuisine expertise of ITC Welcomgroup, the innovation capacity resident in the ITC R&D Centre and the traditional strengths of branding, trade marketing and distribution to provide distinctive sources of competitive advantage in the marketplace. Conceived on the strength of your Company's deep rural linkages, the Packaged Foods business marks a comprehensive presence across the seed to stomach value chain. Within barely four years of launch, your Company straddles a wide spectrum of value added food products comprising: Staples such as atta, spices and cooking pastes, Snack Foods such as biscuits and pasta, Confectionery and Ready-to-eat foods. The Foods portfolio now comprises 5 brands - Aashirvaad, Sunfeast, Candyman, Mint-O and Kitchens of India - and over 100 distinct products.

**In a testimony to the growing consumer franchise and market standing, Aashirvaad and Sunfeast already feature among the most trusted food brands in a survey by the**



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**Economic Times Brand Equity.** Aashirvaad atta continues to cement its position as the clear leader among national branded players. Kitchens of India has also recently earned the sobriquet of 'Superbrand'. A beginning has also been made towards marketing ITC's world-class packaged food products in overseas markets under the Kitchens of India brand.

Your Company's other growth drivers in the FMCG space have similarly leveraged resident competencies to forge strengthening positions in the marketplace. The Greeting Cards and Stationery business supplements ITC's presence in the tree-to-text book value chain with a slew of value added products. The Lifestyle Retailing business leverages the goodwill of your company's valuable trademarks towards harnessing the significant market opportunity afforded to India post the dismantling of the Multi-Fibre Agreement regime. Wills Lifestyle, another Superbrand in the FMCG stable, is well on the way to becoming the most preferred retail brand. John Players, catering to the mid-market segment, has earned high industry recognition, winning the 'Most Admired Shirt Brand of the Year' award at the Images Fashion Awards 2005. Products of daily relevance to rural markets such as safety matches, incense sticks and iodised salt support the viability of the rural fulfillment channel, while presenting attractive market opportunities.

**While the synergising of in-house skills is contributing to the rapid growth of the new FMCG businesses, such growth in turn has also spurred new opportunities for the other businesses.** The addition of spices in the Foods portfolio and the demand for traceability-led products to meet emerging consumer needs in domestic and overseas markets has led to the development and pilot marketing of organic agri inputs for farmers. Your Company's Agri Business is now engaged in enlarging the scope of organic agri-input options towards offering a total solution package for farmers, addressing crop protection and crop quality requirements.

Each of these FMCG businesses also contributes to enhancing the depth and breadth of your Company's trade marketing and distribution capability. The efficacy of such fulfillment also stands enhanced through the extensive use of Information Technology across the supply chain, drawing upon in-house skills. ITC's IT-backed distribution highway today ensures direct servicing of over 85,000 markets of varying population strata, covering nearly 2 million retail outlets. Further, the Wills Lifestyle and John Players ranges are retailed to customers through nearly 270 Exclusive Brand Outlets and shop-in-shops, and over 1500 multi-brand outlets.

Deep domain knowledge, together with diversity of services, growing global delivery footprint, and world-class infrastructure and processes constitute a robust platform for your Company's Information Technology subsidiary to strengthen its market standing in the IT services and IT enabled services segments.

The substantial progress made in strategy implementation and the resultant financial performance have earned the right for your Company to further aspire to make a larger contribution to the Indian society.





### **CONTRIBUTION ACROSS THE TRIPLE BOTTOM LINE**

Your Company's inspiring Vision enables harmonisation of shareholder value creation with enlarging contribution across the Triple Bottom Line. Indeed, the creative energies of leadership are directed at crafting and honing business models that enmesh these goals in a synergistic manner. Just as your Company's businesses have contributed to strengthening its financial value creating ability, their impact on enhancing economic, social and ecological capital is also growing in magnitude and significance. It is my firm belief that the pursuit of such an approach by the corporate sector can further strengthen the foundation of a fruitful public-private partnership in the achievement of inclusive and sustainable growth, particularly if innovative ways could be found to incentivise wider corporate involvement in addressing social and developmental priorities.

### **INCENTIVISING CSR: MOBILISING CONSUMER SUPPORT**

Detractors of Corporate Social Responsibility seem to lend conceptual credence to the relative inaction of corporates by viewing CSR as a needless drag on the owners of capital. It is often argued that initiatives towards enhancing social and environmental capital are best left to other segments of society. The absence of direct financial reward further disincentivises corporate responses to developmental challenges and thus limits the scope and impact of CSR.

In an emerging economy like India's, with the large challenges of inclusiveness and ecological fragility threatening to undermine the sustainability of economic growth, no single organ of society possesses the resources to address these serious issues. The most crucial resource required to address the various developmental issues is not so much financial as organizational. Although such resources rest in abundance with the corporate sector, in the absence of incentives, the organizational capability of the corporate sector tends to be deployed almost exclusively towards addressing the needs of shareholders through financial performance.

**Powerful incentives will emerge when an enlightened civil society comprising customers, investors, job seekers and policy makers finds the mechanisms to reward enterprises that integrate social and environmental concerns into their business models.** Financial reward arising from the exercise of preference by civil society in favour of responsible corporates can trigger substantial corporate participation in CSR activities. There is already evidence of such a trend emerging in developed markets. As Indian businesses progressively integrate with the global market, the need for responsible business conduct will become an imperative for global competitiveness.

In line with this thought, **your Company is engaged in taking the lead to involve its consumers as partners in progress by bundling CSR as part of its unique value proposition.** By mobilising support of consumers, CSR can serve as an additional



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differentiator for your Company's products and services, thereby simultaneously serving the cause of shareholders as well as society at large. It is hoped that your Company's example will serve to encourage others in the corporate sector to contribute more readily with impactful CSR initiatives. In this context, your Company's support for the setting up of the CII-ITC Centre of Excellence for Sustainable Development is a sterling example of incentivising CSR through recognition of excellence in sustainability practices. The Centre seeks to address the institutional void in developing the requisite capability among Indian industry. The Centre will endeavour to transform Indian businesses by providing thought leadership, promoting awareness and building capacity.

**The compelling Vision of enlarging contribution to society has propelled your Company to engage in its unique endeavours to create benchmark Triple Bottom Line performance.** A growing consumer franchise driven by bundling CSR will provide additional momentum and render long term sustainability to such endeavours by triggering a broader movement.

I know that shareholders of ITC take justifiable pride in its unique contribution across the Triple Bottom Line. I will therefore, as a matter of practice, update you on the progress relating to all three dimensions of value creation.

### **CREATING ECONOMIC MULTIPLIERS**

Your Company's conscious engagement with the entire value chains of which it is a part is resulting in a growing and pervasive economic impact. Over the past decade, the value addition by your Company has grown at a compound annual rate of more than 12% to over Rs. 68,000 crores, representing nearly 1.1% of the value added by the Industry sector of the economy. Nearly 77% of such value added accrued to the Exchequer, providing the much needed resources for deployment in developmental priorities. Foreign exchange earnings of the ITC Group during this period amounted to nearly US\$ 2.5 billion, of which earnings from agri exports constituted nearly 65%. These earnings from linking the Indian farmer with world markets represent well over 2% of the country's agri exports. **Your Company's investments of over Rs.6000 crores towards enhancing the competitiveness of its businesses support direct employment to the tune of 28,000 across the Group and indirect employment across the value chains of nearly 5 million people, whose livelihoods are substantially linked to their association with ITC.** Amongst those associated are a number of enterprises in the small scale and cottage sectors which continue to benefit from adoption of best practices and access to markets. To illustrate, the Incense sticks business of your Company sources products from 8 vendors in the cottage sector, who predominantly employ women. Four of these vendors have earned the ISO 9000 accreditation - a first for this industry. Thus the symbiotic partnership between your Company and such cottage industry vendors leverages complementary strengths for mutual benefit, thereby enabling these enterprises to flourish without the need for public largesse. **Your Company's investment**



plans envisaging Rs.14-15,000 crores over the next few years would further enlarge ITC's economic contribution.

#### **CONTRIBUTION TO SOCIAL AND ECOLOGICAL CAPITAL**

The uniqueness of ITC's contribution to enlarging social and ecological capital lies in being able to enmesh such contribution into the process of generating shareholder value through creative business models. I am referring to the innovative ITC e-choupal business model and the ITC farm and social forestry initiatives. Apart from crafting such business models, your Company is also engaged in implementing various other social development initiatives towards making a meaningful contribution in the economic vicinity of its operating locations.

#### **EMPOWERING THE SMALL FARMER**

The ITC e-choupal initiative is a powerful illustration of linking business purpose with a larger societal purpose. I have been briefing you on the progress of this young initiative from time to time. I will now touch upon its potential to empower the small farmer and thus engender rural transformation.

The ITC e-choupal leverages the power of the Internet to empower the small and marginal farmer with a host of services related to know-how, best practices, timely and relevant weather information, transparent discovery of prices and much more. This digital infrastructure can also be used for channelising services related to credit, insurance, health, education and entertainment. It can also serve as a strong foundation for linking small and marginal farmers to futures markets to facilitate farmer risk management.

The ITC e-choupal is not just a village digital kiosk with a human interface. The access to e-choupals, within walking distance from the farm gate, is supplemented through physical infrastructure - the ITC Choupal Saagar - which functions as a hub for a cluster of villages within tractorable distance. These made-to-design hubs also serve as warehouses, and as rural hypermarkets for a variety of goods. **In effect, the e-Choupal infrastructure is potentially an efficient delivery channel for rural development and an instrument for converting village populations into vibrant economic organizations.**

An environment rife with illiteracy, lack of basic infrastructure and low incomes renders the rollout of this initiative extremely onerous. Despite daunting implementation challenges, the potential benefits of this project have spurred your Company to seek innovative solutions to overcome constraints. **This infrastructure project now comprises about 6000 installations covering nearly 36,000 villages and serving over 3.5 million farmers. Over the next 7-10 years, it is your Company's Vision to create a network of 20,000 e-choupals and over 700 Choupal Saagars entailing investments of nearly Rs.5000 crores, thereby extending coverage to 100,000 villages - representing one sixth of rural India.** This networked rural delivery system can contribute significantly towards addressing the 'knowledge deficit' highlighted so forcefully by the National Commission on Farmers. It can also meaningfully



complement the Bharat Nirman initiative of the government, towards truly securing a 'new deal for rural India'. **The transformational impact of this pioneering initiative continues to earn global and domestic accolades, the most recent of which is the Stockholm Challenge Award 2006.**

#### **AGRO FORESTRY LED RURAL RENAISSANCE**

The labour intensity of agro forestry and the availability of the second highest arable land mass in the world represent two strategic assets that can be leveraged to transform the competitiveness of the tree-to-textbook value chain. Your Company's presence in this value chain provides the basis for a significantly enlarged contribution towards raising living standards in rural hinterlands. I have been briefing you about this special initiative in some detail in my past speeches.

**So far, more than 149 million saplings have been planted in nearly 41,000 hectares under ITC's farm and social forestry programmes, providing over 18 million person days of employment.** The output of the agro forestry programmes accounts for over 91% of the pulp wood requirements of your Company's mill at Bhadrachalam, thus supporting its competitiveness. **The growing competitiveness of your Company's paperboards business provides the impetus for your Company to scale up the afforestation endeavour to cover over 100,000 hectares by planting 600 million saplings over the next few years, creating in the process over 40 million person days of employment among the disadvantaged.**

Apart from contributing to enrichment of social capital, the benefits of your Company's agro forestry initiatives extend to conservation of natural capital as well. Increasing green cover, in situ moisture conservation, groundwater recharge, significant reduction in soil erosion and enrichment of depleted soils are some of the direct environmental benefits.

#### **OTHER SOCIAL INITIATIVES**

Your Company's other social initiatives in the vicinity of its operating locations are centered around three main areas of intervention under 'Mission Sunehra Kal': (a) natural resource management, which includes wasteland, watershed and agriculture development; (b) sustainable livelihoods, comprising genetic improvement in livestock and women's economic empowerment; and (c) community development, with focus on primary education and health and sanitation.

#### **CONTRIBUTING TO NATURAL RESOURCE MANAGEMENT**

The soil and moisture conservation programme is designed to assist farmers in identified moisture-stressed districts. Under your Company's water resource management initiative, over one thousand water harvesting structures provide critical irrigation to nearly 10,300 hectares.



**Over the next 5-7 years, your Company intends to create nearly 6300 water harvesting structures and thereby extend critical irrigation to more than 50,000 hectares of rainfed arable land.**

#### **CREATING SUSTAINABLE RURAL LIVELIHOODS**

The sustainable livelihoods initiative of your Company strives to create alternative employment for surplus labour and decrease pressure on arable land by promoting non-farm incomes. Among many such activities, the programme for genetic improvement of cattle through artificial insemination to produce high-yielding crossbred progenies has been given special emphasis because it reaches out to the most impoverished. **Cattle development centres already cover more than 1,400 villages, providing integrated animal husbandry services to more than 35,000 milch animals.** The initiative for the economic empowerment of women has also registered significant progress. To date, **over 10,600 women have been organised under 630 self-help groups.** More than 4,000 women have been gainfully employed through micro-enterprises or self-employment backed by income generation loans.

#### **CONTRIBUTING TO RURAL COMMUNITY DEVELOPMENT**

Your Company's Community Development Programmes seek to contribute to two of India's most urgent social priorities aligned to the achievement of the Millennium Development Goals - health and primary education. **About 34,000 women-at-risk and children under 5 are being covered every year under the Mother and Child Health programme.** ITC's education support programmes are aimed at overcoming the lack of economic opportunities available to the rural poor. As of now, **ITC's rural education initiative covers over 47,000 children through support to government primary schools and 674 Supplementary Learning Centres.**

#### **CONCLUSION**

Inspired by Vision, driven by Values, powered by Vitality, the journey of the past decade has been most rewarding for your Company's world-class employees and for me, personally. The real transformation lies in their capabilities, their commitment to stay the course of a challenging strategic path, and their willingness to go the distance in their quest for enduring value for the nation and for shareholders. In the unfolding era of new opportunities and new challenges, I seek your support on their behalf, as always.

Thank you for your attention.

#### **18.4 PRESS RELEASES**

The term press release in its narrower sense is used for releases covering news. The press release contains worthwhile material which has some news value. It is not only unnecessary expenditure but also damages the reputation of the concerned publicity / information department if the release is on a very trivial matter.



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The press release should be written in a journalistic style. It should provide facts or information of interest to the readers and should attempt to cover all aspects of a specific subject. There should not be any loose ends. It should be on a subject which is recent or in news. The release should not be generally lengthy. It should be concise and to the point. It has not much place for subsidiary or background material. The release is a piece of clear writing without any ambiguity, without any effort towards colour or ornamentation.

The introduction or lead should be in a summary format as it is a news story. The relative value of the various ingredients of the subjects in the press release is weighted and evaluated and the most pertinent of them are included in the lead.

The releases should have a consistent format. Generally, the name of the organization from where the release emanates is given on the top. The date and place are indicated on the top right side. The release should have a title and a sub-title also, if necessary. It should have a suitable introductory paragraph. In the case of releases from non-official organization, it is desirable also to mention the designation of the person issuing the release and his telephone number.

The press releases covering news in the case of the government are mainly of our types – press communiqués, press notes, handouts, and unofficial stories or unofficial hand-outs.

The press communiqués are issued when some important government decisions or announcements are made such as cabinet appointments, conclusion of the foreign dignitaries' visits, international agreement, etc. The press communiqué is formal in character. It carries the name of the ministry or department and the place the date at the bottom left-hand corner of the release. Generally, the press is expected to reproduce the press communiqué without any substantial change. No heading or subheading is given on press communiqués.

The second category of press releases are press notes. They are less formal in character. They are issued on important matters, e.g., raising or lowering of tariff rates, etc. The press note also carries the name of the ministry/department and the place and date at the bottom left-hand corner. Heading or sub-heading are given in press notes.

The third category are hand-outs. They are issued on a variety of subjects and on day-to-day activities of the ministry/department, VIP speeches, questions and answers in parliament, etc. The hand-out is a less formal type of release and not issued under the government's formal authority. It bears the name of the PIB or other releasing agency on the top without any mention of the ministry/department to which the release pertains. The place and date are indicated on top at right-hand side. One of the most important common categories of hand-outs relate to the speeches of ministers or other high officials. The hand-out is released only when the speech is concerned with governmental activity. No official hand-out is issued if the minister has spoken in his personal capacity as a member of a political organization.



The speech when released to the press in the form of handout is summarized and properly edited. Formal introduce and concluding remarks are omitted and redundant and repetitive material taken out. A proper title and sub-title are given. The important aspects which are to be stressed are included in the beginning paragraph or in the led. The full next of the speech is not released unless the subject is of very great importance.

While covering inaugural and other functions where VIPs make speeches, the press release should stress on the significance of the function and try to spell out in concrete terms the gains to the community rather than reproducing the speech. For instance, the opening of a new branch of a bank or of power house at a particular place should be an opportunity to the communicator to bring out in the press release the specific gains which would accrue to the people of that area rather than only spotlighting on the dignitary and his speech.

The speech of the Prime Minister or of a very important dignitary at formal occasions or at important gatherings is generally released in full to ensure correct reporting. The full text is also helpful to the editors and column writers. It is also utilized for reference purposes in the future.

Unofficial hand-outs are issued on a subject where the government would not like to assume official responsibility in the matter but feels that there may be positive advantages in making information public unofficially. These hand-outs are supplements to oral briefings. They are given across the table to press correspondents and no general release is made. The unofficial hand-out do not have the imprint of the PIB or of other releasing agencies. The date and place are indicated at bottom left-hand corner.

## **MODEL PRESS RELEASES FROM NEWSPAPERS & REGULATORS**

### **1. RETAIL BOOM IN INDIA DRIVES THE THIRD PARTY LOGISTICS MARKET**

Following the sanction of foreign direct investment (FDI), the retail sector in India has been thriving and numerous local and international companies have been thronging to the organized segment. The increasing levels of disposable incomes have catalyzed the growth of the retail sector, creating a need for efficient and cost-effective logistics operations. In such a scenario, third party logistics (3PL) service providers are expected to receive a huge boost from the retail segment. New analysis from Frost & Sullivan([www.transportation.frost.com](http://www.transportation.frost.com)), Strategic Analysis of 3PL Markets in the Indian Retail Sector, reveals that the market earned revenues of US\$49.5 million in 2005 and it is estimated to reach US\$140.0 million in 2012. If you are interested in a virtual brochure, which provides manufacturers, end users, and other industry participants with an overview of the 3PL markets in the Indian retail sector, then send an e-mail to Ravinder Kaur and Surbhi Dedhia, at [ravinder.kaur@frost.com](mailto:ravinder.kaur@frost.com) / [sdedhia@frost.com](mailto:sdedhia@frost.com) with your full name, company name, title, telephone number, fax number, and e-mail address. Upon receipt of the above information, an overview will be sent to you by



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e-mail. Currently, even organized retailers such as those of apparel and lifestyle, consumer durables, food and grocery, footwear and leather, as well as stationery and gifts have not taken well to the concept of 3PL due to their apprehensions of losing control over the supply chain. The transportation is carried out partly by organized service providers and partly by truckers and local transporters.

3PL service providers have to prove their competency by offering cost effective services and building long-term synergetic relationship with the retailers, which will also encourage market entrants to outsource. The service providers will have to prove their expertise since Indian retailers place considerable emphasis on their service providers' trustworthiness, timeliness, and cost effectiveness. "The economical services offered by the unorganized logistics participants discourage retailers from outsourcing to organized service providers," says Frost & Sullivan Research Associate Aarthi Nandakumar. "Hence, there has to be a marked difference in the quality of service offerings, cost, and other value-added services before the retailers begin to work with organized 3PL providers." 3PL service providers need to customize the service offerings and offer them at competitive rates to truly take advantage of the retail boom in India. Market participants will have to strategically position themselves and work closely with the retailers to understand their specific logistics requirements and deliver high-quality service. Retailers' rising need to maintain fewer inventories is yet another factor that will drive the market toward outsourcing. The increasing requirement of forwarding and information management functions will help the retailers to achieve greater productivity and efficiency, encouraging them to outsource to 3PL providers. "Moreover, with the implementation of value-added tax (VAT), 3PL service providers have more opportunity to market their offerings for warehousing services," notes Aarthi Nandakumar. "There will be more scope for alliances and joint ventures with foreign service providers that can establish healthy relationships with retailers in order to strengthen the supply chain process in Indian retailing." The Strategic Analysis of 3PL Markets in the Indian Retail Sector is part of the Asia Pacific Logistics Subscription, which also includes research in the following markets: Strategic Analysis of the ASEAN 3 Third Party Logistics Markets, Strategic Analysis of 3PL Markets in the Indian FMCG Sector, Strategic Analysis of Third Party Logistics Markets in India. All research services included in subscriptions provide detailed market opportunities and industry trends that have been evaluated following extensive interviews with market participants. Interviews are available to the press. Frost & Sullivan, a global growth consulting company, has been partnering with clients to support the development of innovative strategies for more than 40 years. The company's industry expertise integrates growth consulting, growth partnership services, and corporate management training to identify and develop opportunities. Frost & Sullivan serves an extensive clientele that includes Global 1000 companies, emerging companies, and the investment community by providing comprehensive industry coverage that reflects a unique global perspective and combines ongoing analysis of markets, technologies, econometrics, and demographics.





## **2. GUIDELINES ON ANTI MONEY LAUNDERING MEASURES (RELEASED BY SEBI)**

The Prevention of Money Laundering Act, 2002 (PMLA) has been brought into force with effect from 1<sup>st</sup> July 2005. Necessary Notifications / Rules under the said Act have been published in the Gazette of India on 1<sup>st</sup> July 2005 by the Department of Revenue, Ministry of Finance, Government of India.

As per the provisions of the Act, every banking company, financial institution (which includes chit fund company, a co-operative bank, a housing finance institution and a non-banking financial company) and intermediary (which includes a stock-broker, sub-broker, share transfer agent, banker to an issue, trustee to a trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and any other intermediary associated with securities market and registered under section 12 of the Securities and Exchange Board of India Act, 1992) shall have to maintain a record of all the transactions; the nature and value of which has been prescribed in the Rules notified under the PMLA. Such transactions include:

All cash transactions of the value of more than Rs 10 lakhs or its equivalent in foreign currency.

All series of cash transactions integrally connected to each other which have been valued below Rs 10 lakhs or its equivalent in foreign currency where such series of transactions take place within one calendar month.

All suspicious transactions whether or not made in cash.

SEBI has issued a circular reference number ISD/CIR/RR/AML/1/06 dated January 18, 2006 containing the Guidelines laying down the minimum requirements / disclosures to be made in respect of clients. The intermediaries may, according to their requirements specify additional disclosures to be made by clients to address concerns of Money Laundering and suspicious transactions undertaken by clients.

All intermediaries are advised to ensure that a proper policy framework as per the Guidelines on anti-money laundering measures is put into place within one month from the date of the circular. The intermediaries are also advised to designate an officer as 'Principal Officer' who would be responsible for ensuring compliance of the provisions of the PMLA. Names, designation and addresses (including e-mail addresses) of 'Principal Officer' shall also be intimated to the Office of the Director- Financial Intelligence Unit (FIU), 6th Floor, Hotel Samrat, Chanakyapuri, New Delhi -110021, India on an immediate basis.

The detailed procedure incorporating the manner of maintaining information and matters incidental thereto for SEBI registered intermediaries, under the prevention of Money Laundering Act, 2002 and the Rules made thereunder and formats for reporting by the intermediaries are being finalised and would be issued subsequently.



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**3. PRESS NOTE NO 04/2005 RELEASED BY THE MINISTRY OF COMPANY AFFAIRS.**

**F. No. 17/78/2001/CL.V**

**Government of India  
Ministry of Company Affairs  
Press note – 04/2005**

**30<sup>th</sup> July 2005**

Subject: Simplified Exit Scheme, 2005- Extension of scheme by a further period of one month

In order to give an opportunity to defunct companies desirous of getting their names struck off from the Register of Companies under the Companies Act, 1956 through a simplified procedure, the Central Government (M/o Company Affairs) had introduced a scheme namely, "the Simplified Exit Scheme, 2005" (SES, 2005) vide General Circular 2/2005 dated 28.1.2005. The Scheme was effective from 1<sup>st</sup> February, 2005 and was to come to an end on 31<sup>st</sup> July, 2005.

2. On account of difficulties experienced due to adverse weather conditions in different parts of the country, it has been decided to extend the scheme by a further period of one month up to 31.8.2005, to afford further opportunity to defunct companies to avail the benefits of the scheme.
3. Copy of this Press Note has also been placed on the Web page of the Ministry of Company Affairs

**4. DRESS CODE FOR CAS BY AUGUST END 2006 AS APPEARED IN BUSINESS NEWSPAPER.**

A dress code for practicing CAs will be out by August end, with the Institute of Chartered Accountants of India giving finishing touches to the recommendatory proposal to give its professionals a corporate look and don a new brand identity.

ICAI President, TN Manoharan said the proposal would not be mandatory. "It will be more of a recommendation, though we expect it to be followed by professionals," Mr. Manoharan said.

He said the code would not be for day-to-day affairs, but for events like business meetings and other official representations and engagements. Mr. Manoharan clarified the code would be applicable only to professionals working in individual or partnership capacity. "Those who are employed with firms are not bound to follow, as they will be acting as per the requirements and stipulations of the firm they work for," he added. A formal dress code, he said, could be a full-sleeve shirt, tie and shoe.



### **18.5 CORPORATE ANNOUNCEMENTS BY STOCK EXCHANGES**

1. The Sirpur Paper Mills Ltd has informed the Exchange that the production on all machines and normal functioning at the mill at Sirpur Kaghaznagar, has re-started on August 06, 2006. Insurance claim has been lodged with necessary authorities.
2. Rama Newsprint And Papers Ltd has informed the Exchange that ICICI Bank Ltd (ICICI) has withdrawn nomination of Shri Nagesh Pinge as its Nominee Director on the Board of Directors of the Company w.e.f. August 2,2006 and has appointed Ms. Neeta Mukerji as its Nominee Director on the Board of the Company w.e.f. August 2,2006.
3. Satyam Computer Services Ltd has informed the Exchange regarding a press release dated August 07, 2006, titled "Satyam Partners with Planview, Inc.". The details of the press release shall be available on the NSE website (<http://www.nseindia.com>) under: Corporates > Latest Announcements and on the Extranet Server (/Common/Corporate Announcements
4. Wipro Ltd has informed the Exchange that the Board of Directors vide their Circular resolution effective August 04, 2006 resolved to issue and allot 29520 equity shares of Rs.2/- each pursuant to exercise of the stock options by the eligible employees under the Wipro Employee Stock Options Plans i.e., WESOP 1999 and WESOP 2000.

#### **5. Board Meetings Announced**

<b>Company</b>	FLEX INDUSTRIES LTD.
<b>NSE Symbol</b>	FLEX
<b>Board Meeting Date</b>	17-AUG-2006
<b>Purpose</b>	Audited Accounts/ Others
<b>Details</b>	To consider and approve the Audited Annual Accounts for the financial year ended March 31,2006 and to fix the day, date and time of the AGM of the Company.



**18.6 SELF-EXAMINATION QUESTIONS:**

1. Generally, what are the ordinary business and special business that are transacted at Annual General Meeting ?
2. What factors should be kept in mind while writing a Press Release?
3. What are the different types of Press Releases in the case of Government?
4. Draft a corporate announcement by a recognized stock exchange on the matter that the Board of a listed company is considering issue of bonus shares.

**Objective / Multiple Choice Questions**

1. Choose the incorrect statement from amongst the following:
  - (a) The press release should be written in a journalistic style. It should provide facts or information of interest to the readers and should attempt to cover all aspects of a specific subject.
  - (b) There should be loose ends.
  - (c) It should be on a subject in news. The release should not be generally lengthy. It should be concise and to the point.
  - (d) The release is a piece of clear writing without any ambiguity.
2. The press releases covering news in the case of the government are mainly of four types:
  - (a) press communiqués, advertisements, handouts, and unofficial stories or unofficial hand-outs.
  - (b) press communiqués, press notes, handouts, and official stories or unofficial hand-outs.
  - (c) press communiqués, press messages, handouts, and official stories or official hand-outs.
  - (d) press communiqués, press notes, handouts, and unofficial stories or unofficial hand-outs.
3. Which is not a part of Self-Awareness
  - (a) Emotional self-awareness: Reading your own emotions and recognizing their impact; using 'gut sense' to guide decisions
  - (b) Accurate self-assessment: Knowing your strengths and weaknesses
  - (c) Self-confidence: A sound sense of your self-worth and capabilities
  - (d) Organizational Management



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4. Which is not a Quality of a Critical Thinker
  - (a) Closed-minded – is not willing to accept and explore alternative approaches and ideas.
  - (b) Well-informed – Knows the facts and what is happening on all fronts.
  - (c) Experimental – Think through “what if” scenarios to create probable options and then test the theories to determine what will work and what won't.
  - (d) Contextual – Keeps in mind the appropriate context when thinking things through. Apply factors of analysis that are relevant or appropriate.
  
5. Who gave the statement : 'Because of the furious pace of change in business today, difficult to manage relationships sabotage more business than anything else - it is not a question of strategy that gets us into trouble, it is a question of emotions'
  - (a) John Kotter
  - (b) John Nash
  - (c) Daniel Goleman
  - (d) Robbins

**Answers:**

1.(b), 2. (d), 3. (d), 4. (a), 5. (a).

# CHAPTER 19

## BASIC UNDERSTANDING OF LEGAL DEEDS AND DOCUMENTS

### Learning Objectives

*After reading this chapter, you will be able to understand*

- Understand the meaning of deeds and documents
- Know how to draft model deeds and documents
- Know how to prepare the annual report of a company

**Document** : Generally understood, a document is a paper or other material thing giving information, proof or evidence of anything. The Law defines 'document' in a more technical form. For example, Section 3 of the Indian Evidence Act, 1872 states that 'document' means any matter expressed or described upon any substance by means of letters, figures or marks or by more than one of those means, intended to be used, or which may be used, for the purpose of recording that matter. Section 3(18) of the General Clauses Act, 1897 states that the term 'document' shall include any matter written, expressed or described upon any substance by means of letters, figures or marks, or by more by than one of those means which is intended to be used, or which may be used, for the purpose of recording this matter.

**Instrument** : In common parlance, 'instrument' means a formal legal document, which creates or confirms a right or records a fact. It is a formal writing of any kind, such as an agreement deed, charter or record, drawn up and executed in a technical form. It also means a formal legal document having legal effect, either as creating liability or as affording evidence of it. Section 2(14) of the Indian Stamp Act, 1899 states that 'instrument' includes every document by which any right or liability is or purports to be created, transferred, extended, extinguished or recorded.

**Deed** : The Legal Glossary defined 'deed' instrument in writing (or other legible representation or words on parchment or paper) purporting to effect some legal disposition. Simply stated deeds are instruments though all instruments may not be deeds. However, in India no distinction seems to be made between instruments and deeds.

### 19.1 PARTNERSHIP DEED

A partnership firm may be constituted either by oral agreement or a written agreement. A written agreement of partnership or partnership deed is preferred as it minimizes the



challenges of disputes and ambiguities in future. The model form of partnership is given below:

In form, deed can be seen as comprising of the following components:

1. Date
2. Names of Partners
3. Preamble
4. Recitals
5. Attestation
6. Custody
7. Special Rules

The Deed must be executed on a stamp paper of prescribed value. The copy of the deed must be sent to the Registrar of Partnership Firms along with the prescribed form duly completed for issue of ACKNOWLEDGEMENT of firm. All subsequent changes must be notified to the Registrar.

**1. Date:**

“This Deed of partnership Executed on This .....day of ..... between .....”

[NOTES: The date cannot be earlier than the date of stamp paper. An oral Partnership could thereafter be reduced to writing; but the deed must be drawn up within the accounting year; in case where the operation is retrospective it must be indicated in the preamble; under section 40 (b)(v), remuneration to a working partner must be authorized by and be in accordance with the terms of the partnership deed and relate to any period falling after the date of such partnership.]

**2. Names of Partners**

- i. ....son/daughter/wife of  
..... aged ..... years, residing  
at.....  
..... hereinafter called the first party;
- ii. ....son/daughter/wife of  
.....aged..... Years, residing  
at.....  
..... hereinafter called the Second party;
- iii. ....son/daughter/wife of



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..... aged ..... years,  
representing Hindu Undivided family, herein after called the Third Party.

iv. .... representing the  
.....Trust, herein after called the Fourth Party.

v. .... a Company registered under the Companies Act with its  
Registered Office situated at .....  
through it's managing Director.....  
herein after called the fifth Party.

- I. A minor cannot be a partner. He can only be admitted into the benefits of partnership and a clause admitting into the benefits of partnership minors must be part of the terms.
- II. An HUF cannot be a partner as it is not a juridical person but can be represented by its Kartha, a Kartha can be a partner both in his individual capacity as well as in a representative capacity
- III. A Trust cannot be partner as it is not a juridical person
- IV. A Company can be a partner as it is a juridical person
- V. The description of partner 3 and 4 is given to indicate the status- individual or representative of the partner, relevant while declaring their income under the income Tax Act. Even without the description, if the partners can prove that the profits are earned to the detriment of HUF/ Trust funds as the case may be, the profits can be assessed only in the hands of the family/ Trust. The description in the partnership deed is only a 'surplus' information, as a as the partnership is concerned it recognizes only individuals and not the relative family or Trust.
- VI. The number of partners should be limited to 20 members as a partnership can have more than 20 persons. For counting this number minors are to be excluded as minors are not partners.]

### 3. A Preamble:

"If the Deed is Retrospective" "Whereas the aforesaid parties have come together to carry on a business of dealing .....as from.....and the terms and conditions of the partnership as agreed to be hereby set down in writing." If the execution coincides with the date of commencement" "Whereas the aforesaid parties have come together to carry on a business of dealing in ..... in partnership and the terms and conditions of the partnership are hereby mutually agreed to as follows:" When a Proprietary Business is converted: "Whereas the ..... party had been running a business under the name and style of ..... and whereas by mutual consent the said proprietary business is taken over by the parties to work in





partnership the terms and conditions of the partnership as, mutually agreed are hereby set down in writing.”

**1. Date of Commencement:** The date of commencement of the partnership is.....

**2. Business of Partnership:**

The partnership will carry on the business of ..... and such other business or business/ businesses as the parties may from time to time determine.

**3.** The following minors are admitted to the benefits of partnership.

a. Minor ..... by guardian.

b. “..... “etc.

**4. Name:**

The name of partnership firm shall be..... and such other names or names as the parties may from time to time determine.

**5. Place of Business;**

The place of business shall be at ..... and/or such other place/s as the parties may from time to time determine.

**6. Duration;**

The partnership shall be for a period of ..... years and thereafter at WILL

Or

The partnership shall be a partnership at WILL

Or

The partnership shall be for duration of the loan obtained from the financial corporations and after the repayment of the loan at WILL. [Note: If a fixed period is mentioned then after the expiry of the period a fresh deed of partnership, must be executed; hence

it is better to add after the term, “and thereafter at WILL” to do away with the execution of a fresh deed.]

**7. Capital:** The capital contribution by the parties shall be as follows:

a. First party

b. Second party etc.

Where applicable;



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“In the case of the first party whose business/immovable property bearing no ..... has been taken over by this firm he shall be credited with the value of Rs. .... (as per Annexure).” This shall be treated as capital contribution.

**8. Interest on capital:** The fixed capital accounts of partners shall bear no interest/or shall bear interest at 18 % per annum. The current account balances of partners shall bear ..... %” In respect of debit balances if any the partners will be charged interest at 12% p.a. [NOTE: Under Section 40b in the case of any firm assessable as such any payment of interest to any partner which is authorized by and is in accordance with, the terms of the partnership deed and relates to any period falling after the date of such partnership deed insofar as such amount calculated at the rate of eighteen percent simple interest per annum only is admissible.]

**9. Sharing of profits/losses:** In case of profits, it shall be divided as follows:

1. First party ..... %
2. Second
- 3.
- 4.

5. Minor In case of losses:

- 1.
- 2.
- 3.
- 4.

The minors, who are admitted to benefits of partnership shall not be liable for the losses of the firm.

### 10. Accounts

The accounts of the partnership shall be closed once every year, preferably from ..... to .....and a profit and loss account and Balance sheet compiled.

### 11. Borrowing powers:

The partners are free to borrow monies for the purposes of business from banks, financial and lending institutions and from others and for this purpose may designate one or more partners to negotiate and sign on behalf of the firm.

**12.** The partners from amongst themselves may designate one or all of them to act as working Partner/s and pay the following remuneration



On the first 75,000 of the book profit of the firm or in case of loss 90% of such book profits divided equally amongst the working partners

On the next 75,000 of the book profits of the firm 60% of such book profits divided equally amongst the working partners

On the balance of book profits of the firm 40% of such book profits divided equally amongst the working partners

[NOTE: This is the maximum remuneration allowable to partners in the case of a firm carrying on business. In the case of professional firms, maximum allowable remuneration would be:]

On the first Rs. 1,00,000 of the book profit of the firm or in case of loss 90% or Rs.50,000, which ever is more

On the next Rs.1, 00,000 of the book profit 60%

On the balance 40%

The Board has also issued a circular no. 739 dated 25th march 1996 stating that no remuneration will be deductible under section 40(b)(v) of the Income Tax Act unless the partnership deed either specifies the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration.

The Board also said that the following types of clauses, which are vague and indeterminate, are not entitled for deduction for remuneration.

X 1. The partners have agreed that the remuneration to a working partner will be the amount of remuneration allowable under the provisions of section 40(b)(v) of the income Tax Act; or

X 2. The amount of remuneration to working partner will be as may be mutually agreed upon between partners at the end of the year.

[NOTE: The term "Book Profit" means the net profit as shown in the profit and loss account for that year computed in the manner laid down in chapter IV of the Income Tax Act, 1961.]

**13. Bank Accounts;** The partners may open accounts with banks and the banking operations shall be carried on under the signature of One or more partners Or At least two partners Or ..... party. A managing partner, who shall be designated from time to time by the parties

**14.** Death, disability or retirement of any partner or partners will not dissolve the partnership and the remaining partners shall be free to continue the partnership business with or without taking the nominees of such deceased or disabled partner.

[NOTE: If nominee is to be taken follow clause 15.]



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15. In case of death or disability of partner the nominee of such partner shall be taken to the partnership and for the purpose of this clause the nominees of the partners are hereby as follow; FIRST PARTY SECOND PARTY Etc., The partners are free to change the nominees aforesaid mentioned from time to time by notifying the same to the partners.

16. **Variation clause:** Any of the above clauses may be altered or varied or added to by common consent of the parties.

17. **Arbitration;** All disputes arising out of this partnership shall be subject to arbitration. In witness hereof the parties have signed this out of mutual good will and consent. WITNESS

- 1. ....signature of First party
- 2. ....signature of Second party
- 3. .... signature of Third party
- 4. ....signature of Fourth party
- 5. .... Signature of Fifth party

**RECONSTITUTION OF PARTNERSHIP**

Note: This Deed must be on a stamp paper of appropriate value and all legal formalities as is applicable to partnership Deed

This Deed Reconstitution of Partnership executed on this .....day of .....between.....1. ....son / daughter / wife of ..... aged.....years, residing at ..... hereinafter called the first party.

(Repeat for others Parties)

Witnesses as follows

Whereas the parties 1 to 4 were working in partnership along with another Sri....., a business under the name and style of ..... constituted under an instrument of partnership the last of which is dated.....; and Whereas the said Sri..... retired from the old partnership in accordance with a retirement deed dated ..... allowing the other partners to continue the partnership business in the same name with all its assets and liabilities, and Whereas the parties 1 to 4 invited the fifth party to join them in the partnership to carry on the said business for which he has assented, the terms and conditions of the reconstituted partnership are hereby agreed to as follows

- 1. The business under the name and style of ..... carried on by the erstwhile partnership will continue with all its assets and liabilities as the business of this reconstituted partnership.



- The name the partnership business shall continue to be ..... and such other name /s as the parties may from time to time determine. Other clauses as in the partnership deed

**SUB PARTNERSHIP DEED**

[Note: After the enactment of Benami Transactions, (provision) Act 1988, there cannot be a Benami partner in a partnership. ]

A firm cannot be a partner in another firm, even in a representative capacity a partner of a sub partnership cannot be joined in a main partnership as representing the sub partnership. He can join in his individual capacity.

**Deed**

This deed a sub partnership executed on this..... day of ..... 1998 ..... between (mention name and description of parties as in partnership deed) Witnesses as follows:

Whereas the aforesaid parties have come together to work in partnership a business of investing in the business of another partnership, which is carrying on a business in under the name and style of .....And Whereas the partners find it convenient to work in the said other partnership, the terms and conditions of sub partnership are hereby agreed to as follows (Clauses as in other partnership)

The..... Party shall represent the other partnership in the main partnership of .....constituted under an instrument of partnership; he shall account the share of profits / losses from that main partnership to this sub partnership with all other remuneration / compensation that may be paid to him. This will be treated as the profit / loss as the case may be as sub partnership.

**PARTNERSHIP RETIREMENT DEED**

[NOTE: This must be executed on a stamp paper of appropriate value and copy sent to the Registrar of Firms along with the prescribed form duly completed. The execution of a Retirement Deed results in a reconstitution of the firm. A fresh Reconstitution deed must be executed and all formalities applicable to a partnership deed for registration of firm must be complied with under income Tax Act. ]

- This Retirement Deed of Partnership executed on the ..... between: 1. ...., aged about ..... years, s/o ....., residing at ....., hereinafter called the First Party;
- ..... aged about ..... years, s/o ....., residing at ....., hereinafter called the Second Party; and



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3. .... aged about ..... years W/o ....., residing at ....., hereinafter called the Third Party

#### WITNESSES AS FOLLOWS:

WHEREAS the aforesaid parties were carrying on business in partnership under an instrument of partnership the last of which is dated.....? AND WHEREAS the First/Second/Third Party having expressed a desire to retire from the partnership by mutual consent, the terms of retirement are hereby agreed to as follows:

1. ...., will retire from the partnership effective from close of business on .....
2. The firm is free to continue the business with all its assets and liabilities and use the same firm name with the remaining partners.
3. The accounts of the retiring partner is settled in accordance with the books of accounts OR In full and final settlement of his account the ..... party has been given the following assets/  
Rs.....
4. The Retiring partner hereby authorizes the continuing partners to collect all debts of the firm or realize or sell any asset of the firm including any immovable property.
5. In consideration of monies received, the ..... party hereby releases all his rights, title and interest in the balance of assets of the firm including the goodwill.
6. The continuing partners release — party of all debts and obligations including taxes due from the firm as on the date of this deed to third parties.
7. The parties hereby agree to execute such other document/s that may be necessary to give effect to this Partnership Retirement Agreement.

#### WITNESS

1. .... Signature of the First Party
2. .... Signature of the Second Party

#### PARTNERSHIP DISSOLUTION DEED

[NOTE: THIS MUST BE EXECUTED ON A STAMP PAPER OF APPROPRIATE VALUE AND MUST BE FILED WITH THE REGISTRAR OF FIRMS ALONG WITH THE PRESCRIBED FORM DULY COMPLETED.]

If the dissolution involves the transfer of any immovable property to any person other than the original partners then the stamp act prescribes the same duty as conveyance and relevant



state stamp act must be consulted. Section 45(4) of the income tax act which deals with the profits or gains arising from the transfer of a capital asset by way of distribution of capital assets on the dissolution of a firm must be kept in mind.

1. This Deed of Dissolution executed on this day of ..... between: 1.  
.....,s/o....., aged ..... years, residing at  
.....
2. ....,d/o....., aged ..... years, residing at  
.....
3. ....,w/o....., aged ..... years, residing at  
.....
4. ....,s/o....., aged ..... years, residing at  
.....

**WITNESSES AS FOLLOWS:**

WHEREAS the aforesaid parties constituted themselves into a partnership to run a business under the name and style of “..... “ the same having been constituted under an instrument of Partnership, placing the disposal of the partnership their interest in property bearing No .....AND WHEREAS the parties have by mutual consent agreed to dissolve the partnership as from ..... on the terms and conditions of the dissolution agreed to are hereby set down in writing.

or

AND WHEREAS the parties by mutual consent agreed to incorporate the firm by selling all the asset and liabilities of the firm to a new company incorporated under the name and style of — ..... registered as..... with..... The terms and conditions of dissolution are hereby agreed to in writing as follows.

The firm of ..... stands dissolved as from...../ from which date the assets and liabilities of the business of the firm as per Annexure will vest with the newly incorporated Company .....

or

The interest in the property bearing no..... of the several partners shall revert back to the partners in the same manner as before and they are free to hold them as co-owners or in any other mode convenient to them.

or



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The Accounts of the partners have been taken and the accounts are settled in full in accordance with the books of the firm as noted in Annexure 2 to this deed. The partners are agreed on the correctness and finality of the accounts as certified by a Chartered Accountant.

or

The partners have agreed to sell all the liabilities and assets of the firm to the newly incorporated Company.....under a separate agreement signed today in which they will be allotted shares in proportion to their account balances holding not less than 50% of the voting power.

The partner's release each other from all obligation arising from the deed dated ..... save that all statutory liabilities like Income tax shall be proportionately borne by the parties and paid for even after the dissolution and the partners agree to notify the discontinuance of business to the Income tax authorities under section 176 and all other concerned authorities.

### WITNESS

1. .... Signature of the First Party
2. .... Signature of the Second Party
3. .... Signature of the Third Party
4. .... Signature of the Fourth Party

### 19.2 POWER OF ATTORNEY

The law relating to power of attorney falls within the law of agency. A power of attorney is a written instrument empowering a specified person or persons to act for and in the name of person executing it. The instruments of power of attorney are classified into the following two categories:

#### Specific Power of Attorney:

A specific power of attorney is given for a particular specific act for instance for appearance before Tax authorities or before Registrar of Companies for presenting documents for incorporation of a company or before a Sub-Registrar for registration of documents etc.





**General Power of Attorney**

- a) Covering all the acts relating to the execution of the deed. Presenting the same for registration, admitting execution thereof  
etc. can be executed and attested before a Notary Public or a First Class Magistrate.
- b) Such a General Power of Attorney can be registered also.
- c) When an irrevocable power of attorney, having the element of agency coupled with interest covered under section 202 of the Indian Contract Act, 1872, is registered with the registration authorities, the stamp duty payable is as that of a sale/ conveyance.
- d) Such a registered General Power of Attorney as mentioned in (c) above is not entered in Book -I and there is no public notice regarding the same. The same will not be reflected in the encumbrance certificate also.

**Formats**

**To appear before Income-Tax authorities**

I/we, \_\_\_\_\_, residing at \_\_\_\_\_ hereby authorise \_\_\_\_\_, to represent me/my firm/my family in connection with \_\_\_\_\_ for the year —. His statement and explanation will be binding on me/us.

Place:

Date:

I, \_\_\_\_\_ hereby declare that I am duly qualified to represent the above-mentioned person.

Place:

Date:

(Address of Power of attorney holder)

**Before Registrar of Companies**

We the subscribers to the Memorandum and Articles of Association of the proposed Company, hereby authorise to present the Memorandum of Articles of Association and other connected



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documents for the registration of the said company before the registrar of Companies, Karnataka, Bangalore and to make such corrections / alternations / deletions / additions as may be required to be done by the Registrar in the documents and also to receive the certificate of incorporation.

### GENERAL POWER OF ATTORNEY

Know we all men by these presents that I \_\_\_\_\_ do hereby appoint and constitute \_\_\_\_\_ — son/daughter of \_\_\_\_\_ (hereinafter called “Attorney” who has subscribed his/her signature hereunder in token of identification) presently residing at \_\_\_\_\_ to be my lawful attorney in my name and on my behalf to do any one or all of the following acts, deeds and things, namely:

1. To apply for a loan to M/s Can Fin Homes Limited (CFH) for such amount as the Attorney may deem fit and for that purpose to pay the processing fee and sign the loan application in my name and on my behalf and to furnish all the details and information required by CFH and to give any statement, letter, clarification or any other writing required or necessary for availing the said loan from CFH from time to time to follow up the said loan application and do such other things and deeds as may be necessary in relation thereto.
2. To accept the loan offer letter and sign the acceptance thereof in token my acceptance of the terms and conditions therein contained and to pay on my behalf the legal and technical fees and any other charges leviable in respect of the said loan.
3. To receive the disbursement of the said loan and for that purpose give effectual discharge and give all the necessary information and document to assist the Technical and legal Appraisal of the property purchased/to be purchased with the help of the loan.
4. The mortgage my property being \_\_\_\_\_ or any other property he/she may book/buy on my behalf with CFH by deposit of title deeds as security for repayment of the loan granted or to be granted by CFH to me.
5. To deposit on my behalf the documents of title and to state on my behalf to any officer of CFH that the said documents are being deposited for creating a security on the said property by way of deposit of title deeds for repayment of the said loan. The Attorney is fully authorised to make these statements and convey my intentions to create security on my said property or any other property he/she may book/buy on my behalf.
6. He/She is further authorised to make any other statements necessary to create equitable mortgage by deposit of title deeds and also to execute any writings, undertakings, indemnities etc. on my behalf in respect of mortgage of the said property of the repayment of the said loan and any other writings whatsoever required in respect of the said transactions of the loan granted/to be granted to me or creation of the said security.



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7. He/She is also authorised to execute any loan agreement, promissory notes, letter of declaration and indemnity or such other documents as may be required by CFH in respect of the said loan.
8. To acknowledge my liability/debt in respect of the loan.
9. To book a flat/residential unit on my behalf either directly or through the agency of CFH and to execute Agreement for Sale for the same with any builder/seller and make payments to him there for and to present such Agreement for registration before the appropriate Registrar/Sub-Registrar of Assurances or any other authority at any place or places in India as may be necessary. He/She is further authorised to make payments direct to CFH on my behalf for any flat/unit my said Attorney might book through CFH and comply with such conditions/terms CFH may have in this behalf. He/She is authorised to make such payments to CFH as may be demanded to CFH way of service charge etc. He/She is authorised to execute any agreement, letters and documents as may be required by CFH in respect of the above.
10. To admit execution of the Agreement for Sale before the said Registrar/Sub-Registrar of assurances or any other authority or authorities as may be required for the purpose.
11. To obtain possession of the flat/unit as and when the same is ready for occupation.
12. To receive documents on my behalf and execute receipt there for.
13. To sign forms, documents and papers required for the purpose of registration of Co-operative Housing Society or a Limited Company or an Association of Apartment Owners and become member thereof participating in all the meetings and proceedings from time to time, obtain share certificates and/or other documents issued in my name and hold the same as my attorney and obtain possession of the flat.
14. To open and/or operate Bank Account in any bank in India in my name both resident as well as non-resident. The account may be operated in India Currency or foreign Currency to be remitted by me from time to time. He/She is authorised to do all such acts, deeds and things including signing any papers/documents as are necessary and incidental to the above and that

Dated at \_\_\_\_\_ this the \_\_\_\_\_ day of \_\_\_\_\_ 19. (Address)

Specimen signature of Attorney above named

Notary Public.



### **19.3 LEASE DEED**

A lease is defined under Section 105 of the Transfer of Property Act as transfer of enjoyment of immovable property by one person called the lesser to another person called the lessee in consideration of a premium which means a price paid or promised or rent which may be periodical payment of money, share of crops or rendering of services. In order to constitute the valid lease, there must be a transfer of right to enjoyment of immovable property though delivery of possession of the property is not a condition preceded for operation of a lease.

The terms of lease including the period of lease, amount of rent etc. are contained in a leased agreement or deed duly executed and signed by both the lesser and lessee. The model forms of lease deeds are given below:

THIS LEASE is made on this the. day of ... .., between ....., S/o ....., aged about years, residing at ..... (hereinafter called the LESSOR); which expression shall, whenever the context so requires or admits mean and include his/her heirs, executors, Administrators and permitted assignees of the ONE PART;

and ..... son of ..... aged about .. years presently a ..... residing at ....., and Herein after called the LESSEE Whereas, the lessor is the absolute owner of the property ..... (more fully described in the schedule hereunder and hereinafter referred to as 'Schedule Property') and Whereas, the Lessee is desirous of taking on lease the Schedule property for a period of .... from today and, whereas, the Lessor is agreeable for the same.

NOW THEREFORE THIS DEED WITNESSETH that in pursuance of aforesaid agreement and in consideration of the rent hereinafter contained, the Lessor hereby demises by way of lease who Lessee the Schedule Property for a period of .... from today, on the following terms and conditions:

1. That the lessee has undertaken to pay the lessor a monthly rent of Rs.../ (RUPEES ..... ONLY) for the Scheduled Property on or before the .. day of the following calendar month, and .. months rent of Rs.... (RUPEES deposit by the lessee on the date of execution of this lease; the receipt where of the lessor hereby acknowledges and agrees to repay the same without interest at the time of vacating the Scheduled Property, after deducting for damages, if any.
2. The lease shall commence from the ..., day of .. and shall be in force for a period of ....
3. The lessee shall use the Scheduled Property only for residential purpose and shall not assign or sublease or use the Scheduled Premises for any unlawful purposes or alter the Scheduled Property without the consent of the lessor in writing.
4. Whereas the Lessor has installed a telephone bearing No.... at ..... referred to as Scheduled Property. Whereas the Lessee is desirous of using the Telephone facility and



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the Lessor has no objection to the Lessee's usage of the Telephone facility, subject to the conditions that the Lessee shall pay all amounts due to the Department of Telecommunications on the account of the usage of this telephone including call charges (Local, STD, ISD) rental charges, directory charges, service charges etc., from the date of occupation by the lessee. The Lessor shall not be liable for any amounts due for the use of the telephone during the lease period of this agreement.

5. During the lease period, the lessee shall pay the electricity and water charges to the respective departments promptly and obviate disconnection at any time.
6. The lessee shall permit the lessor or his agents, to enter the Scheduled Property at all reasonable times for the purpose of periodical inspection.
7. The lessor shall pay the building tax whenever the same shall fall due.
8. The Lessor hereby covenants with the Lessee that the Lessee paying the rent hereby stipulated and performing the conditions and covenants herein, shall quietly and peacefully hold, possess and enjoy the Scheduled Property during the said term of lease, without any interruption and disturbance either from the Lessor or anybody claiming under her.
9. Termination of the Lease - The Lessor has right to terminate the lease and re-enter into another lease
  - i. by serving .. days notice prior to the termination of the lease.
  - ii. By Afflux to time
  - iii. In the event of non-payment of rent by the lease for a period of two consecutive months.
  - iv. In the event of Breach of by either party of the terms and conditions and covenants hereof.
10. Handing over the premises to the Lessor - The lessee shall deliver back in good condition as it was on the day of the occupation, the possession of the Scheduled Premises to the Lessor immediately upon the expiry of the said terms and conditions or on earlier termination.
11. The lessee shall enjoy the schedule property during the said term of lease on as is where is condition of the property. and the lessor will not be bound to make any additions or alterations of any kind to the said property. However any Major repairs not attributable to lessee, shall be undertaken by lessor



**Basic Understanding of Legal Deeds and Documents**

**SCHEDULE**

..... Squares of house bearing No., at..... measuring East to West ..... M. North to South .....

M and bounded on :

East by : ....

West by :...

North by :...

South by :...

Fixtures provided by the Lessor -

Fans - . Nos.

Geysers - . Nos.

Exhaust Fan - . No.

In Witness whereof the parties hereto have their respective hands and seals to this Agreement on the day, month, year first written above.

**Witness**

1. LESSOR

2. LESSEE

**19.4 AFFIDAVIT**

An affidavit is a written statement used mainly to support certain applications and in some circumstances as evidence in court proceedings. A person who makes the affidavit is called the Deponent and must swear or affirm that the contents are true before a person who has the authority to administer oaths in respects of the particular kind of affidavit. The model form of affidavit is given below:

I ..... son of ..... aged ..... years, residing at ....., hereby declare on oath as follows:  
“ .....  
.....  
.....  
.....  
.....”  
.....”Sworn on this .....th day of .....

Date:

Signature:

Place:



### **19.5 INDEMNITY BOND**

A contract of indemnity as defined under Section 124 of the Indian Contract Act, 1872 is a contract by which one party promises to save the other from laws cost to him by the contract of the promissory himself or by the contract of any other person. A person who gives the indemnity is called indemnifier and a person for whom protection is given is called the indemnity holder. The model form of indemnity bond is given below:

Name of the Assessee:

P.A.N. No.Assessment Year:

I. .... son/ wife/ daughter of ..... Resident of ..... do hereby agree to indemnify the Government of India for any loss that may occur on giving credit for the Certified Photostat copies of the TDS Certificates/ ...../...../ ..... for a sum of Rs..... being ... % of my share in the total TDS of Rs. .... of ..... I further declare that the credit for consolidated TDS Certificate was not claimed in the hands of the Association of

Persons,..... .

Date:

Signature:

Place:

### **19.6 GIFT DEED**

The law relating to gifts is provided for in the Transfer OF Property Act, 1882 and Indian Succession Act, 1925. Gift is defined as the transfer of certain movable or immovable property made voluntarily and without consideration by one person called the donor to another called the donee and accepted by or on behalf of the donee. A gift to be valid must be accepted by the donee during the life time of the donor. Registration of a gift often immovable property is must and that of movable property is optional. The model form of deed of gift is given below:

A Gift Deed requires compulsory attestation by witness. S123 spells out the requirement. Transfer how effected:

For the purpose of making a gift of immovable property, the transfer must be effected by a registered instrument signed by or on behalf of the donor, and attested by at least two witnesses.

For the purpose of making a gift of movable property, the transfer may be effected either by a registered instrument signed as aforesaid or by delivery. Such delivery may be made in the same way as goods sold may be delivered.



**Basic Understanding of Legal Deeds and Documents**

THIS DEED OF GIFT is made at (city) on this \_\_\_ day of \_\_\_, 19\_\_ BETWEEN:  
\_\_\_\_\_, an Indian Inhabitant residing at Flat No.\_\_\_\_, \_\_\_ Floor,  
\_\_\_\_\_ Co-operative Housing Society Ltd. \_\_\_\_\_, (city),  
hereinafter called "THE DONOR" of the ONE PART and \_\_\_\_\_, also an  
Indian Inhabitant of (city), residing at Flat No.\_\_\_\_, \_\_\_ Floor, \_\_\_\_\_ Co-  
operative Housing Society Ltd. \_\_\_\_\_, (city), hereinafter called "THE  
DONEE" of the OTHER PART.

WHEREAS the Donee \_\_\_\_\_ is the \_\_\_\_\_ of Donor \_\_\_\_\_.

AND WHEREAS the Donor is the member of \_\_\_\_\_ society which is duly registered  
under the Maharashtra Co-operative Societies Act 1960, (hereinafter referred to as the and is  
the as the said society. The donor has 5 fully paid up shares of the said society. The donor  
has acquired a flat No. \_\_\_ on the \_\_\_ floor admeasuring \_\_\_ sq. mtrs. in the building  
known as " \_\_\_\_\_" (hereinafter referred to as the "said building") situate at  
\_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, (city), (hereinafter referred to as  
"the said flat") more particularly described in the Schedule hereunder written "said society").

WHEREAS the Donor has full right title and interest in the said shares/flat more particularly  
described in the Schedule hereunder written.

AND WHEREAS the Donor desires to gift his right, title and interest in the said share/flat in the  
said building of the said society more particularly described in the Schedule hereunder written  
to the Donee hereto.

**NOW THIS DEED OF GIFT WITNESSETH AS FOLLOWS: -**

The Donor out of natural love and affection for the Donee, hereby transfers by way of gift his  
right, title and interest in the said shares and the said flat more particularly described in the  
Schedule hereunder written to the Donee absolutely for ever.

The Donee accepts the gift and agrees to hold the right title and interest of the Donor in the  
said shares/the said flat in the said building of the said society more particularly described in  
the Schedule hereunder written of the said flat from the Donor.

**SCHEDULE OF PROPERTY ABOVE REFERRED TO**

IN WITNESS WHEREOF the parties hereto have hereunder set and subscribed their  
respective hands on the day and the year first hereinabove written.

SIGNED AND DELIVERED)

by the within named "DONOR" )

\_\_\_\_\_ ) \_\_\_\_\_

in presence of ..... )





1) \_\_\_\_\_)

2) \_\_\_\_\_)

SIGNED AND DELIVERED)

by the within named "DONEE" )

\_\_\_\_\_ ) \_\_\_\_\_

in presence of ..... )

1) \_\_\_\_\_)

2) \_\_\_\_\_)

**GIFT DEED**

THIS DEED OF GIFT is made at (city) on this \_\_\_\_ day of \_\_\_\_\_, 19\_\_ BETWEEN:  
\_\_\_\_\_, an Indian Inhabitant residing at Flat No.\_\_\_\_, \_\_\_ Floor,  
\_\_\_\_\_ Co-operative Housing Society Ltd. \_\_\_\_\_, (city),  
hereinafter called "THE DONOR" of the ONE PART and \_\_\_\_\_, also an  
Indian Inhabitant of (city), residing at Flat No.\_\_\_\_, \_\_\_ Floor, \_\_\_\_\_ Co-  
operative Housing Society Ltd. \_\_\_\_\_, (city), hereinafter called "THE  
DONEE" of the OTHER PART.

WHEREAS the Donee \_\_\_\_\_ is the \_\_\_\_\_ of Donor \_\_\_\_\_.

AND WHEREAS the Donor is the member of \_\_\_\_\_society which is duly registered  
under the Maharashtra Co-operative Societies Act 1960, (hereinafter referred to as the and is  
the as the said society. The donor has 5 fully paid up shares of the said society. The donor  
has acquired a flat No. \_\_\_\_on the \_\_\_ floor admeasuring \_\_\_\_\_ sq. mtrs. in the building  
known as " \_\_\_\_\_" (hereinafter referred to as the "said building") situate at  
\_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, (city), (hereinafter referred to as  
"the said flat") more particularly described in the Schedule hereunder written "said society").

WHEREAS the Donor has full right title and interest in the said shares/flat more particularly  
described in the Schedule hereunder written.

AND WHEREAS the Donor desires to gift his right, title and interest in the said share/flat in the  
said building of the said society more particularly described in the Schedule hereunder written  
to the Donee hereto.

**NOW THIS DEED OF GIFT WITNESSETH AS FOLLOWS: -**

The Donor out of natural love and affection for the Donee, hereby transfers by way of gift his  
right, title and interest in the said shares and the said flat more particularly described in the  
Schedule hereunder written to the Donee absolutely for ever.



**Basic Understanding of Legal Deeds and Documents**

The Donee accepts the gift and agrees to hold the right title and interest of the Donor in the said shares/the said flat in the said building of the said society more particularly described in the Schedule hereunder written of the said flat from the Donor.

**SCHEDULE OF PROPERTY ABOVE REFERRED TO**

IN WITNESS WHEREOF the parties hereto have hereunder set and subscribed their respective hands on the day and the year first hereinabove written.

**SIGNED AND DELIVERED)**

by the within named "DONOR" )  
\_\_\_\_\_ ) \_\_\_\_\_

in presence of ..... )  
1) \_\_\_\_\_ )  
)  
2) \_\_\_\_\_ )

**SIGNED AND DELIVERED)**

by the within named "DONEE")  
\_\_\_\_\_ ) \_\_\_\_\_

in presence of ..... )  
1) \_\_\_\_\_ )  
)  
2) \_\_\_\_\_ )

**19.7 COMPANY – Memorandum and Articles of Association**

A company is incorporated by means of a Memorandum of Association and Articles of Association registered with the Registrar of Companies who will issue on registration a certificate of incorporation (Specimen form is given below)

The Companies act, 1956

Memorandum of Association

1. Section 14

Memorandum of Association of a Company shall be in such one of the forms in Tables B, C, D and E in Schedule - 1 as may be applicable to the case of the company or in a form as near there to as circumstances admit.



2. Section 15 printing and signature
3. Section 26 Articles of Association There may in the case of Public Company limited by shares, and there shall in the case of an unlimited Company or a company limited by guarantee or a private company limited by shares, be registered with the

Memorandum, Articles of Association signed by the subscribers of the memorandum prescribing the regulations, relations for the company. Specimen forms are given below

**REGISTRATION - LETTER TO REGISTRAR OF COMPANIES**

Letter to Registrar at time of Incorporation The Registrar of Companies Dear Sir, Sub : Incorporation of ..... We enclose the following documents for the incorporation of

.....

1. Memorandum and Articles of the Company duly stamped and signed by the subscribers.
2. Declaration of Compliance in Form No. 1
3. Notice of the situation of the Registered Office of Company in form No. 18.
4. Particulars of Directors in Form No. 32 in duplicate
5. Registrar's letter confirming availability of name.
6. Power of Attorney in favour of Mr. \_\_\_\_\_ We request that the Certificate of Incorporation be issued. Yours faithfully,

**MEMORANDUM OF ASSOCIATION MEMORANDUM OF ASSOCIATION OF.....PRIVATE LIMITED**

(Company Limited by Shares) (Incorporated under the Companies Act, 1956)

I. The Name of Company is ..... PRIVATE LIMITED.

II. The Registered office of the Company will be situated in the State of.....

III. The objects for which the Company is established are : A) MAIN OBJECTS TO BE PURSUED BY THE COMPANY ON ITS INCORPORATION ARE :

1. To carry on the business as .....
- .....
- .....
2. To carry on all or any of the business on matters relating to research, development and application



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## Basic Understanding of Legal Deeds and Documents

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of.....  
.....  
.....  
.....

### **B) OBJECTS INCIDENTAL OR ANCILLARY TO THE ATTAINMENT OF THE MAIN OBJECTS :**

1. To buy, sell, export and deal in all works, plant, machinery and materials commonly dealt in by persons engaged in the above lines of business and also manufacture, experiment with and render marketable all products residual and by products obtained incidental to any of the business carried on by the Company.
2. To enter into agreements and contracts with Indian or Foreign individuals, firms, companies or other organizations for technical, financial or other assistance or collaboration for carrying out all or any of the objects of the Company.
3. To establish and maintain any agencies in India or any part of the world for the business of the Company or for the sale of any materials or things for the time being at the disposal of the company for sale.
4. To advertise and adopt means of making known the business activities of the Company or any articles or goods traded or dealt in by the company in any way as may be expedient including posting of bills in relation thereto and the issue of circulars, books and pamphlets and price list and conducting of competitions, exhibitions, demonstrations and giving of prizes and rewards.
5. To buy, sell, prepare, treat, repair, alter, manipulate, exchange, hire, let on hire, import, export, dispose of any deal in all kinds of articles or raw materials which may be required for any of the business which the company is authorized by its memorandum to carry on or which may seem capable of .
13. To promote and form and to be interested in and to take, apply for, acquire, hold and dispose of shares in any other company having objects similar altogether or in part to those of this company or carrying on any business capable of being conducted so as directly or indirectly to benefit the company and to subsidize or assist such company financially or otherwise by subscribing for, or guaranteeing the subscription and issue of shares, stocks, debentures or other securities of such company.
14. To pay for any properties, rights or privileges acquired by the company in shares or debentures of this company or partly in shares or debentures and partly in cash or otherwise and to give shares or stock or debentures of this company in exchange for shares or stock or debentures of any other company.



15. To procure the incorporation or the recognition of the company in any state or place in India or abroad and to establish and regulate agencies for the purposes of the Company's business.
16. To draw, accept, make, endorse, discount and negotiate promissory notes, checks, hundies, bills of exchange, commercial or mercantile instruments connected with the business of the company subject to the provisions of Banking Regulation Act, 1949.
17. To borrow or raise money with or without security or to receive money on deposit at interest or otherwise in such manner as the company may think fit and in particular by the issue of debentures convertible into shares of this company and in security of any such money so borrowed, raised or received, to mortgage, pledge or charge the whole or any part of the property, assets or revenue of the Company, present or future including its uncalled capital by special assignment or otherwise or to and to purchase, redeem or pay off any such securities. The Company shall not carry on the business of banking as defined under the Banking Regulations Act, 1949. The acceptance of deposits shall be subject to the provisions of Section 58A of the Company's Act, 1956 and the rules framed there under.
18. To sell or in any other manner deal with or dispose of the undertaking or property of the company or any part thereof for such consideration as the company may think fit and in particular for shares, debentures and other securities of any other Company having objects altogether or in part other company having objects altogether or in part similar to those of the company and to promote any other company or companies for the purpose of its or their acquiring all or any of the property, rights or liabilities of this Company.
19. To improve, manage, work, develop, exchange, lease, mortgage, turn to account, abandon or otherwise deal with all or any part of the property, rights and concession of the company.
20. To engage workers, laborers, staff, clerks, accountants, Technicians, Engineers, Architects, Consultants and such other categories of employees needed for the carrying out of the objects of the company upon such terms and conditions as to remuneration, benefits, sharing of profits, payment of bonus, etc., as may be found expedient and appropriate and change, alter, delete such terms as to remuneration etc., as and when warranted and to dismiss, discharge, suspend, terminate, retire or otherwise determine their employment as circumstances warrant from time to time.
21. To provide for the welfare of the Directors, Managing Director and employee's of the Company and wives, widows and families or the dependants of such persons by building or contributing to the building of houses, dwellings or by grants of money, pension, allowances, bonus or other payments or by creating and from time to time subscribing or contributing to provident or other charitable associations, institutions, funds or trusts and



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- to subscribe or contribute or otherwise assist or to guarantee money to charitable, benevolent, religious, scientific, national or other claim to support or aid by the company either by reason of locality of operation or public and general utility or otherwise.
22. To distribute any of the property of the company among the members in specie or kind in accordance with law.
  23. To establish, provide, maintain and conduct, subscribe to or otherwise subsidize or aid research laboratories and experimental work shops for scientific and technical research and experiments, and for tests and investigations of all kinds, and to undertake and prosecute scientific and technical researches, experiments, tests and experiments of all kinds and to undertake and prosecute scientific and technical studies and scientific and technical research investigation and invention by providing, maintaining, investigation and invention by providing, maintaining, endowing, subsidizing or assisting laboratories, workshops, libraries, lecturers, classes, demonstrations, meetings and conferences and by providing or supplementing the remuneration of scientific or technical professors or teachers and by providing and awarding exhibition, scholarships, prizes, and grants in aid to students or intending students or otherwise, and generally to assist, promote, encourage and reward studies, experiments, researches, investigations, enquiries and inventions of any kind whatever that may be considered likely to assist any of the business which the company is authorized to carry on.
  24. To open account or accounts with any individual, firm or company or with any bank or banks and to pay into and withdraw money from such account or accounts.
  25. To remunerate any person, firm or company for services rendered or to be rendered for the formation or promotion of the company or acquisition of property by the company or the conduct of its business whether by cash or by allotment to them of shares or securities of the company or the conduct of its business whether by cash or by allotment to them of shares or securities of the company credited as paid up in full or part or otherwise and to pay commission to brokers and others for selling or guaranteeing the subscription of any shares or securities of the company.
  26. To pay all costs, charges and expenses, incurred in connection with incorporation of the company including costs, charges and expenses for negotiations, contracts and arrangements made prior to and in anticipation of formation and incorporation of the company and for issue of capital and charges in connection therewith.
  27. To lend or deposit monies belongings to or entrusted to or at the disposal of the company to such person, firm or company and in particular to customers and others having dealings with the company with or without security upon such terms as may be thought proper and to guarantee the performance of contract by such person, firm or company but not to do the business of banking as defined in the Banking Regulations Act, 1949.



28. To let on lease or otherwise deal with the whole or any part of the property of the company.
29. To purchase or by any other means acquire and protect, prolong and renew, whether in India or elsewhere any patents rights, 'BREVETS D' INVENTION, licenses, protections and concessions which may appear likely to be advantageous or useful to the company and to use and turn to account and to manufacture under or grant licenses or privileges in respect of the same and to spend money in experimenting upon and testing and in improving or seeking to improve any patents, inventions or grant licenses to use or to vend the same.
30. To invest and deal with the moneys of the Company in any securities, shares, investments, properties movable or immovable and in such manner as may from time to time be determined and to sell, transfer or deal with the same.
31. To create any depreciation fund, reserve fund, sinking fund, insurance fund or any special or other funds whether for depreciation or for repairing, improving, extending or maintaining any of the property of the company or for redemption of redeemable preference shares or for any purposes, whatsoever to the interest of the company.
32. To appoint sole or regional selling agents or distributors for the products of the company and also buying agents for the raw materials or other products required for the company subject to the provisions of section 294 of the Companies Act, 1956 and also to open depots for effecting such sales or purchases.
33. To do all or any of the above things and all such other things as are incidental or as may be thought conducive to the attainment of the above objects or any of them in India or in any other part of the World and as principals, agents, contractors, trustees, agents or otherwise and by or through sub-contractors, trustees, agents or otherwise and either alone or in conjunction with others.

**C) OTHER OBJECTS NOT INCLUDED IN (A) AND (B) ABOVE:**

1. To carry on the business of importers, exporters and dealers of all kinds of merchandise, raw-materials, manufactured goods, materials, produce and provision of every description and to carry on business as commission agents, forwarding agents and general merchants.
2. To transact and carry on all kinds of agency business connected or beneficial to the business of the company.
3. To start or acquire existing workshop dealing in engineering goods and services.
4. To purchase or otherwise acquire and deal in real and personal property of all kinds and in particular lands, buildings and any claims, interests and rights in the undertaking acquired.



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5. To buy, sell, manufacture, refine, manipulate, import, export and deal Wholesale and Retail in commodities, substances, apparatus, articles and things of all kinds capable of being used or which can conveniently be dealt in by the company in connection with any of its objects.
- IV. The liability of the members is limited.
- V. The authorized share capital of the company is Rs.....  
divided into ..... equity shares of  
Rs..... each to be issued and held on such terms and  
conditions as the Board of Directors may decide with powers to consolidate, sub-divide,  
reduce, increase or change the conditions of issue or type of share from time to time.  
We, the several persons whose names, addresses and descriptions are subscribed  
hereunder are desirous 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 to our respective names.

Sl.No. Names, Address and Occupations of the subscribers      No. of shares

Taken by each Subscriber Signature of the Subscriber Names, Address Description and  
Occupations of witness

Dated .....This Day of .....at.....

### CHECKLIST - ARTICLES OF ASSOCIATION

(Checklist in the office of Registrar of Companies)

1. In the Case of a private company, see whether the definition of a private company is reproduced.
2. Increase of share capital: An ordinary resolution would be sufficient and a special resolution is not required in case there is no article regarding capital.
3. Reduction of capital : Surrender of shares amounts to reduction of capital provisions of section 100-105 to be complied with.
4. Disproportionate calls cannot be allowed on same class of shares - Section 91
5. Voting rights : Voting rights cannot be vested with debenture holders (vide Section 117) .  
Is this complied with Section 87 also to be consulted.
6. Discount on issue of share or debentures. Is the Commission or discount payable on issue of shares or debentures in conformity with section 76 and 79
7. Holding of annual general meeting: Is the regulation relating to the holding of the annual general meeting in accordance with the Section 210 of the Act.





## **Business Laws, Ethics and Communication**

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8. Delegation of powers of the Board: All the powers of the Board cannot be delegated to others. Refer to Section 292 of the Act and see whether the regulation is in agreement with the Act.
9. Delegation of powers to call on shares the uncalled capital can be mortgaged but the power to call on shares cannot be delegated to the mortgages (Sec 292 verify whether this is contravened)
10. Quorum of Board: Is the quorum of Board of Directors, in conformity with section 287 of the Act? (1/3rd or 2 which is higher)
11. Resolution by circulation among the Board of Directors: Is this in accordance with Section 289 of the Act.
12. Appointment of alternate directors: This power can be exercised only by the Board and not by an individual director under the circumstances indicated in section 313 of the Act.
13. Calling of extra-ordinary general meeting by requisition: Does this regulation confirm to the requirements of section 169 of the Act.
14. Notice of meeting: Verify whether the provisions of section 172 are complied with the case of a public company? A shorter notice can be provided in the case of a private company and sec.170 (1) (ii) is to be kept in mind.
15. Quorum for the general meeting: Minimum two or five members present in person in case of a private company and public company respectively should be provided.
16. In case of a public company, if directors are named in the Articles all the first directors should retire at the first annual general meeting; if there is no provision for their appointment at an earlier general meeting. See whether this requirement is satisfied by the concerned regulation. All the directors can retire every year. Sec.255
17. Verify whether there are any regulations (in the case of a private company) which are not applicable to them and if any, point out to the party.
18. Subscription clauses: Is it on the lines of memorandum?

### **ARTICLES OF ASSOCIATION**

Articles OF ASSOCIATION OF.....PRIVATE LIMITED (Company Limited by Shares ) (Incorporated under the Companies Act, 1956)

1. The Regulation contained in the table 'A' in the First Schedule to the Companies Act, 1956 shall apply to this company so far only as they are not inconsistent with any of the provisions contained in these regulations are made in these regulations.



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2. In these Regulations :

The “Act” means the Companies Act, 1956, or any statutory modification or Re-enactment thereof for the time being in force. “The Company” means “\_\_\_\_\_ - PRIVATE LIMITED”

“Directors” means the Directors for the time being of the company or as the case may be, the Directors assembled at a Board.

“The Seal” means the Common Seal of the Company. Unless the context otherwise requires, words or expressions contained in these Regulations shall bear the same meaning as in the Act or any statutory modification thereof in force at the date at which these Regulations become binding on the company.

### PRIVATE COMPANY

3. The Company is a Private Company within the meaning of section 2(35) and 3(1) (iii) of the Act and accordingly:

- a) The right to transfer the shares of this company shall be restricted in the manner and to the extent hereinafter appearing in these Regulations.
- b) The number of members of the Company shall be limited to 50 (fifty) not including:
  - i. Persons who are in the employment of the Company: and
  - ii. Persons who having been formerly in the employment of the Company, were members of the Company while in that employment and have continued to be members after the employment ceased. Provided that where two or more persons hold one or more shares in the company jointly, they shall for this purpose be treated as a single member.
- c) No invitation shall be issued to the public to subscribe for any shares in or debentures of this company.

### COMMENCEMENT OF BUSINESS

4. The Business of the Company may be commenced as soon as the Directors think fit, notwithstanding that the whole of the Capital may not have been subscribed or only part of the shares may have been issued or allotted and only part of the capital has been paid up.

### CAPITAL

5. (a) The Authorized Share Capital of the Company is Rs.....divided into..... Equity Shares of Rs ... each with power to increase, sub-divide, consolidate or reduce the Capital subject to the provisions of the Companies Act, 1956.



- (b) The Company shall have power to issue preference share including redeemable preference shares in accordance with the provisions of Sections 80 and 85 of the Act or any statutory modification thereof.
- (c) The Company shall have powers to issue shares at a discount but in doing so it shall comply with the provisions of Section 79 of the Act or any statutory modification thereof.
- (d) Subject to the provisions of these Articles, the shares shall be under the control of the Board, who may allot or otherwise dispose of the same to such persons on such terms and conditions and at such time as the Board thinks fit subject to Article 3 thereof.

**FORM OF TRANSFER**

- 6. Subject to the restrictions hereinafter provided, shares in the Company shall be transferable by written instrument in the prescribed form signed by both the transferor and the transferee.

**TRANSFER OR TO CONTINUE TO BE MEMBER UNTIL TRANSFER REGISTERED**

- 7. The transferor shall be deemed to remain the holder of shares until the name of the transferee is entered on the register of members in respect thereof.

**POWER OF BOARD TO DECLINE TRANSFER**

- 8. a) The Board may refuse to register any transfer of shares
  - i. Where the share is not fully paid up:
  - ii. When the Company has a lien on the said share or shares:
  - iii. Without stating any reason there for where it is not proved to their satisfaction that the proposed transferee is a responsible person:
  - iv. Where the Board is of opinion that the proposed transferee is not a desirable person to admit to membership. But Clauses (iii) and (iv) of this article shall not apply where the proposed transferee is already a member.
- b) If the Board of Directors refuse to register the transfer of shares the Board shall within 2 months of the date on which the application of transfer was lodged with the Company, give notice of refusal to the transferor and transferee.

**POWER TO DECLINE REGISRTRATION UNTIL CONDITIONS FULFILLED**

- 9. The Board of Directors may decline to register any transfer of shares until the instrument of transfer is accompanied by the share certificate to which it relates and such other



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evidence as the Directors may require to prove the title of the Transferor to make the transfer.

### **PRE-EMPTION OF SHARES**

10. No shares of the company shall except as hereinafter provided by transferred unless and until the rights of pre-emption hereinafter conferred shall have been exercised.

### **DIRECTORS TO HAVE ABSOLUTE DISCRETION IN RECOGNISING TRANSFERS.**

11. The Board of Directors may in its absolute discretion and without assigning any reason decline to register any proposed transfer of shares notwithstanding anything apparently to the contrary in these articles. Notice of refusal to transfer shall be given to the transferor and the transferee within two months from the date on which the notice of transfer was lodged with the company.
12. Every member who intends to transfer shares (hereinafter called the "VENDOR") shall give notice in writing to the Company of his/her intention to transfer and that notice shall constitute the Company his/her agent for the sale of the said shares in one or more lots at its discretion to members of the Company at a price to be agreed upon by the Vendor and the Company or in default of agreement at a price which the Board of Directors for the time being shall certify by writing under its hand in consultation with the Auditors of the Company to be in its opinion the fair selling value thereof as between a willing vendor and a willing purchaser. In so certifying the Auditors or the Board of Directors shall be considered as experts and not as arbitrators and accordingly the Indian Arbitration Act will not apply.
13. Upon the price being fixed as aforesaid the Company shall forthwith give notice to all the members of the Company of the number and price of the shares to be sold and invite each of them to state in writing within 21 days from the date of the said notice whether he is willing to purchase any, and if so, what maximum number of the said shares.

### **BOARD TO ALLOCATE THE SHARES TO MEMBERS WILLING TO BUY**

14. At the expiration of the said twenty one days subject to the provisions of Section 108 of the Companies Act, 1956 the Company shall allocate the said shares amongst the member or members who shall have expressed his/her or their willingness to purchase as aforesaid, and if more than one, so far as may be, pro rata according to the number of shares already held by him/her or them respectively, or by casting lots among the willing members when only one share is available for sale, provided no member shall be obliged to take more than the said maximum number of shares so notified by him/her/them as aforesaid. Upon such allocation being made the Vendor shall be bound on payment of the said price to transfer the shares to the



purchaser or the said price to transfer the shares to the purchaser or purchasers and if he/she/they make/s default in so doing the company may receive and give a good discharge for the purchase money on behalf of Vendor and enter the names of the purchaser in the Register of members as holder by transfer of the said shares purchased by him/her/them.

#### **TRANSFER OF SHARES NOT THUS TAKEN TO BE DISPOSED OF OTHERWISE**

15. In the event of the whole or part of the shares not being sold under Articles 14 hereof, vendor may at any time within six calendar months after the expiry of the said twenty one days transfer the shares not so sold to any person at any price.

#### **EXCEPTION**

16. Articles 10, 11, 12, 13, 14 and 15 above shall not apply to transfer of the shares to a person who is already a member of company nor to a transfer by a share holder by way of gift or with or without any pecuniary consideration to the spouse of such member or to parents, son, daughter, sister and brother of such member not to a transfer merely for the purpose of effectuating the appointment of New Trustees nor to a transfer by a trustee to a beneficiary provided that it is proved to the satisfaction of the Board of Directors that the transfer bonafide falls within any one of the exceptions herein.

#### **TRANSMISSION OF SHARES**

17. a) On the death of a member in the case of joint holding the survivor or survivors shall be the only persons recognized by the Company as having any title to his/her interest in the shares without prejudice to the liability of the estate of the deceased joint holder in respect of any shares which had been jointly held by him/her with other person.
- b) The executor or Administrators or holders of a Succession Certificate or the legal representative of a deceased member (not being one or more joint holders) shall be the only persons recognized by the Company as having any title to the shares registered in the name of such members and the Company shall not be bound to recognize such Executors or Administrators or holders of a Succession Certificate or the legal representatives unless such executors or Administrators or legal representatives shall have first obtained probate or letter or administration or Succession Certificate as the case may be from a duly constituted court in the Union of India, provided that in any case where the Board in its absolute discretion think fit, the Board may dispense with production of probate or letters of administration or Succession Certificate upon such terms as to indemnity or otherwise as the Board in their absolute discretion may think necessary and register the name of any person who claims to be absolutely entitled to the shares standing in the name or a deceased member, as a member.



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## Basic Understanding of Legal Deeds and Documents

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### GENERAL MEETING

18. The quorum for a General Meeting of the Company shall be two members present in person.
19. An Annual General Meeting of the Company may be convened by giving not less than 21 days notice in writing. All other General Meeting may be convened by giving not less than 7 days notice in writing. It shall also not be necessary for the Board to annex explanatory statement to the notice calling general meeting.
20. The provision of Section 171 to 186 of the Companies Act, 1956, shall not apply to this Company. The proxy shall be a member of this Company.
21. The accidental omission to give any such notice to or the non receipt of any such notice by any of the members to whom it should have been given shall not invalidate any resolution passed or proceedings held at any such meeting.

### BOARD OF DIRECTORS

22. a) Until and otherwise determined at a general meeting the number of Directors shall be not less than two and not more than twelve including all kinds of Directors.  
b) The following shall be the first Directors of the Company:
  1. \_\_\_\_\_
  2. \_\_\_\_\_
23. A Director of the Company shall not be required to hold any qualification share.
24. The Chairman for each meeting shall be appointed amongst the Directors to conduct the proceedings of the meeting.
25. Subject to the provision of the act, the Board of Directors may from time to time appoint one or more of their body to the office of Managing Director, Technical Director, Executive Director, Commercial Director or Whole time Director, for such terms and at such remuneration, whether by way of salary or commission or participation in profits or partly by way of one and partly in another, as they may think fit. The Board may define, limit and restrict their powers and fix their remuneration. A Director so appointed shall not while holding that office is subject to retirement by rotation.
26. The Board shall have power to co-opt one or more persons to be directors so that the total number shall not exceed twelve and such persons shall hold office unto the date of next annual general meeting of the company, but shall be eligible for reappointment by the company as a Director at the meeting. The Company at that meeting may fix the terms of office and other terms and conditions in respect of such directors reappointed.



## **Business Laws, Ethics and Communication**

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27. Until and otherwise determined in the General Meeting every Directors shall be entitled to a sitting fees for each meeting of the Board of Directors attended by him/her. The amount of sitting fees shall be fixed by Board of directors subject to provisions of the companies act. The Directors shall also be entitled to be repaid all traveling and hotel expenses properly incurred by him/her:-
- a) In attending and returning from the meeting of the Board of Directors or any Committee thereof:
- or
- b) In connection with the business of the company.
28. A Director, during any absence of not less than three months from India, may with the approval of the Board of Directors appoint any person to be an alternate Director during such absence and such appointment shall have effect and such appointee while he holds the office as an alternate director shall be while he holds the office as an alternate director shall be entitled to the notices of the meetings of Directors and to attend and vote thereat as a Director and shall ipso facto vacate the office, if and when the appointer returns to India or vacates the office as a Director removes the appointee director from office by a notice in writing under his hand. If the term of office of the original, Director is determined before he returns to India, any provision for the reappointment of retiring director in default of another appointment shall apply to the original director and not to the alternate director.
29. The Board of Directors shall have power to appoint additional Directors, but in doing so the provisions of Section 260 of the Act or any statutory modifications thereof, shall be complied with.
30. Subject to the provisions of the Section 262 of the Act or any statutory modifications thereof, the Board of Directors shall have power to fill up casual vacancies.
31. If any Director, being willing, shall be called upon to perform extra service or to make any special exertions in going or residing away from his usual place of residence for the purpose of the Company or in giving special attention to the business of the Company or as a member of a Committee of the Board, then the Board may subject to the provision of Section 314 of the Act, remunerate the Director so doing, either by a fixed sum or by a percentage of profits or otherwise and such remuneration may be in addition to or in substitution to any other remuneration to which he may be entitled.
32. In case the Union Government or any State Government or any Industrial Finance Corporation or Company sponsored or Financed by any of the aforesaid Governments or the State Financial Corporation or the State Industrial Investment and Development Corporation Limited or any other financial institution or Bank grants loan or accepts



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## Basic Understanding of Legal Deeds and Documents

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participation in the Capital and Direction of the company, such government, corporation, financial institutions or Bank may during such period as they hold shares in the company or the loans granted by them remain unpaid, be entitled to nominate one or more directors to protect the interest of such Government, Corporation, Financial institution or Bank on the Board of Directors of the Company. Such directors shall not be liable to retire by rotation.

33. No Director shall be disqualified from his office by contracting with the Company nor shall such contract entered into by or on behalf of the company in which any Director is in any way interested, be avoided nor shall any Director so contracting or being so interested be liable to account to the company any profit realized by any such contract by reason only of such Directors holding such office or of that fiduciary relationship thereby established ; but the nature of his interest must be disclosed at the meeting of Directors at which the contract is first taken into consideration if his interest is then existing or in any other case at the first meeting of the Directors held after the acquisition of the interest.
34. All acts done by the Directors or by a Committee of Directors or by any person acting as Director shall notwithstanding that if be afterwards discovered that there was some defect in the appointment of any such Director or person acting as aforesaid or that they or any of them were disqualified be as valid as if every such person had been duly appointed.

### **POWER AND DUTIES OF DIRECTORS**

35. The power and responsibilities of the Board of Directors of the Company shall be as laid down in the Companies Act, 1956 and in Table 'A' thereof except in so far as they stand modified by the provision of these articles.

### **BOARD MEETING**

36. Subject to the provisions contained in Section 287 of the Act, the quorum for a meeting shall be one third of its total strength (any fraction contained in that one third being rounded off as one) or two directors whichever is higher.

### **BORROWING POWERS**

37. Subject to the provisions of the Act, the Board of Directors may from time to time raise or borrow any sums of money for and on behalf of the company from the members of other persons, companies, Banks or Financial institutions or they may themselves advance money to the company on such terms and conditions as may be approved by the Directors.
38. The Board of Directors may, from time to time secure the payment of such money in such manner and upon such terms and conditions in all respects as they think fit and in





particular by the issue of Debentures or Bonds of the company, or by Mortgage or charge of all or any part of the property and of its uncalled capital for the time being.

**DIVIDENDS AND RESERVES**

39. The Company in general meeting may declare Dividends but no Dividends shall exceed the amount recommended by the Board.
40. The Board from time to time pays to members such interim dividends as appeared to it be justified by the profits of the Company.
41. The Board, may, before recommending any dividend, set aside out of the profits of the company such sums as it thinks proper as a reserve or reserves which shall, at the discretion of the Board, be applicable for any purpose to which the profits of the company may be properly applied, including provision for meeting contingencies or for equalizing dividends; and pending such application, may, at the like discretion, either be employed in the business of the company or be invested in such investments as the Board may, from time to time, think fit.
42. No dividend shall bear interest against the Company.
43. The Company in general meeting may, upon the recommendations of the Board, resolve to capitalize any part of the amount for the time being standing to the credit of any of the company's reserve accounts or to the credit of the profit and loss account or otherwise available for distribution and to apply the same for paying up any amounts for the time being ; unpaid on any shares held by such members and or paying up in full on issued shares of the company to be allotted and distributed, credited as fully paid up amongst members as bonus shares.
44. The Board may deduct from any dividend payable to any member of all sums of money, if any, payable by him to the company on account of calls or otherwise in relation to shares of the company.

**SEAL**

45. The Board shall provide for safe custody of the Seal.
46. The Seal of the Company shall not be affixed to any instrument except by the authority of a resolution of the Board or a Committee of the Board authorized in that behalf except in the presence of any one Director who shall sign every instrument to which the seal of the Company is so affixed in his presence.

**SECRECY**

47. Every Director, Secretary, Trustee for the company, member of a committee, Officer, servant Agent, Accountant or other person employed in or about the business of the



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company shall if so required by the Board before entering upon his duties sign a declaration pledging himself to observe a strict secrecy respecting all transactions of the company with its customers and the state of accounts with individuals and in matters relating thereto and shall obey such declaration pledge himself not to reveal any of the matters which may come to his knowledge in the discharge of his duties except when required so to do

### INDEMNITY

48. Every Director, Manager and other officers and Auditors of the company or their respective heirs, administrators or Executors shall be indemnified and secured harmless by the company against all actions, costs, losses, expenses which they or any of them or any of their heirs, Administrators or executors may incur or become liable to by reason of any contract entered into or at or thing done by him as such officer or Auditor or in any way in the discharge of his duties including travelling expenses and the amount for which such indemnity is provided shall immediately attach as lien on the property of the Company and have priority as between the matters over all other claims. We, the several persons whose names, addresses and descriptions are subscribed hereunder are desirous of being formed into a company, in pursuance of this Articles of Association.

Sl.No.	Names, Address and Occupations of	No. of shares Taken by each Subscriber	Signature of the Subscriber	Names, Address Description and Occupations of Winnessibers

Dated .....This Day of .....at.....

### 19.8 ANNUAL REPORT OF A COMPANY

Section 219(1) of the Companies Act, 1956 requires that a copy of every balance sheet (including the profit and loss account, auditor's report, directors' report, directors' report and every other document required to be annexed or attached thereto) which is to be laid before the annual general of the company shall be sent, not less than 21 days before the meeting, to every member of the company". Besides, a copy each must be sent to every trustee for the debentures holders of the company and to all other persons so entitled.

### CONTENT OF ANNUAL REPORT

- Company information
- Organization structure
- Leadership team



People  
Technology  
International operations  
Corporate social responsibility  
Directors' report  
Independent financials – 10 year highlights  
Consolidated financials – 5 years highlights  
Graphs – Independent financials  
Managements discussion and analysis  
Auditors Reports  
Balance Sheet  
Profit and Loss Account  
Cash Flow Statements  
Schedules forming part of accounts  
Notes forming part of accounts  
Statement pursuant to Section 212 of the Companies Act, 1956  
Information on Subsidiary Companies  
Auditors reports on Consolidated Financial Statement  
Consolidated Balance Sheet  
Consolidated Profit And Loss Account  
Consolidated Cash Flow Statement  
Schedules forming part of Consolidated Accounts  
Notes forming part of Consolidated Accounts.

### **19.9 SELF-EXAMINATION QUESTIONS**

#### **I Questions (Short/ Essay type Answers)**

1. What is deed?
2. Explain partnership deed.
3. Elaborate partnership deed format.



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## Basic Understanding of Legal Deeds and Documents

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4. What are the guidelines to draft partnership dissolution deed?
5. Define Power of Attorney.
6. Prepare a draft of Power of Attorney to be submitted before Income Tax Authorities.
7. Specify General Power of Attorney.
8. Discuss Lease Deed.
9. What is Affidavit?
10. Explain Indemnity Bond.
11. Discuss Gift Deed.
12. Explain Articles of Association.
13. Draft a report of Board of Directors to the members.
14. What is Annual Report of a company and briefly discuss the content of Annual Report.

### II Objective / Multiple Choice Questions

1. What is a 'Document?'
  - (a) A paper or other material giving information, proof or evidence of anything.
  - (b) A special type of paper or other material giving information, proof or evidence of anything.
  - (c) both a and b
  - (d) None of the above.
2. 'Deed' is:
  - (a) Instrument in writing (or other legible representation or words on parchment or paper) purporting to effect some legal disposition.
  - (b) Instrument in writing (or other legible representation or words on parchment or paper) purporting to effect no legal disposition.
  - (c) Instrument in writing (or other legible representation or words on parchment or paper) purporting to effect some illegal disposition.
  - (d) Instrument in writing (or other legible representation or words on parchment or paper)not purporting to effect some legal disposition.
3. Deed comprises of the following components except:
  - (a) Date



- (b) Preamble
  - (c) Recitals
  - (d) Special Rules
4. Choose the false statement:
- (a) A firm cannot be a partner in another firm, even in a representative capacity a partner of a sub partnership cannot be joined in a main partnership as representing the sub partnership. He can join in his individual capacity.
  - (b) Partnership retirement Deed must be executed on a stamp paper of appropriate value and copy sent to the Registrar of Firms along with the prescribed form duly completed. The execution of a Retirement Deed does not result in a reconstitution of the firm. A fresh Reconstitution deed must be executed and all formalities applicable to a partnership deed for registration of firm must be complied with under income Tax Act.
  - (c) If the partnership dissolution involves the transfer of any immovable property to any person other than the original partners then the stamp act prescribes the same duty as conveyance and relevant state stamp act must be consulted.
  - (d) A specific power of attorney is given for a particular specific act for instance for appearance before Tax authorities or before Registrar of Companies for presenting documents for incorporation of a company or before a Sub-Registrar for registration of documents etc.
5. A lease is defined as transfer of enjoyment of immovable property by one person called the lesser to another person called the lessee in consideration of a premium, which means a price paid or promised or rent which may be periodical payment of money, share of crops or rendering of services. In order to constitute the valid lease, there must be a transfer of right to enjoyment of immovable property though delivery of possession of the property is not a condition preceded for operation of a lease as per;
- (a) Section 105 of the Transfer of Property Act
  - (b) Section 106 of the Transfer of Property Act
  - (c) Section 106(a) of the Transfer of Property Act
  - (d) Section 107 of the Transfer of Property Act

**Answers :**

1. (a), 2. (a), 3. (d), 4. (b), 5. (a).