

Business law

Lecture-34

INCORPORATION OF COMPANIES; MEMORANDUM OF ASSOCIATION AND ARTICLES OF ASSOCIATION

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OBJECTIVE

After reading this lesson, you should be able to

- (a) Describe the process of formation of a company.
- (b) Explain the different clauses of memorandum of association and the alterations thereof.
- (c) Discuss the contents of articles of association.
- (d) highlight the importance of constructive notice of memorandum and articles of association.

INTRODUCTION

We know that a company is a separate legal entity which is formed and registered under the Companies Act. It may be noted that before a company is actually formed (i.e., formed and registered under the Companies Act), certain persons, who wish to form a company, come together with a view to carry on some business for the purpose of earning profits. Such persons have to decide various questions such as (a) which business they should start, (b) whether they should form a new company or take over the business of some existing company, (c) if new company is to be started, whether they should start a private company or public company, (d) what should be the capital of the company etc. After deciding about the formation of the company, the desirous persons take necessary steps, and the company is actually formed. Thereafter, they start their business. Thus, there are various stages in the formation of a company from thinking of starting a business to the actual starting of the business.

INCORPORATION OF COMPANIES

Company is an artificial person created by following a legal procedure. Before a company is formed, a lot of preliminary work is to be performed. The lengthy process of formation of a company can be divided into four distinct stages : (i) Promotion; (ii) Incorporation or Registration; (iii) Capital subscription; and (iv) Commencement of business. However, a private company can start business as soon as it obtains the certificate of incorporation. It needs to go through first two stages only. The reason is that a private company cannot invite public to subscribe to its share capital. But a public company having a share capital, has to pass through all the four stages mentioned above before it can commence business or exercise any borrowing powers (Section 149). These four stages are discussed as follow :

(2)

Promotion

The term 'promotion' is a term of business and not of law. It is frequently used in business. Haney defines promotion as "the process of organizing and planning the finances of a business enterprise under the corporate form". Gerstenberg has defined promotion as "the discovery of business opportunities and the subsequent organization of funds, property and managerial ability into a business concern for the purpose of making profits therefrom." First of all the idea of carrying on a business is conceived by promoters. Promoters are persons engaged in, one or the other way; in the formation of a company. Next, the promoters make detailed study to assess the feasibility of the business idea and the amount of financial and other resources required. When the promoters are satisfied about practicability of the business idea, they take necessary steps for assembling the business elements and making provision of the funds required to launch the business enterprise. Law does not require any qualification for the promoters. The promoters stand in a fiduciary position towards the company about to be formed. From the fiduciary position of promoters, the following important results follow:

1. A promoter cannot be allowed to make any secret profits. If any secret profit is made in violation of this rule, the company may, on discovering it, compel the promoter to account for and surrender such profit.
2. The promoter is not allowed to derive a profit from the sale of his own property to the company unless all material facts are disclosed. If he contracts to sell his own property to the company without making a full disclosure, the company may either rescind the sale or affirm the contract and recover the profit made out of it by the promoter.

3. The promoter must not make an unfair or unreasonable use of his position and must take care to avoid anything which has the appearance of undue influence or fraud.

Promoter's Remuneration

A promoter has no right to get compensation from the company for his services in promoting it unless the company, after its incorporation, enters into a contract with him for this purpose. If allowed, remuneration may be paid in cash or partly in cash partly in shares and debentures of the company.

Promoter's Liability

If a promoter does not disclose any profit made out of a transaction to which the company is a party, then the company may sue the promoter and recover the undisclosed profit with interest. Otherwise, the company may set aside the transaction i.e., it may restore the property to promoter and recover its money.

Besides, Section 62 (1) holds the promoter liable to pay compensation to every person who subscribes for any share or debentures on the faith of the prospectus for any loss or damage sustained by reason of any untrue statement included in it. Section 62 also provides certain grounds on which a promoter can avoid his liability. Similarly Section 63 provides for criminal liability for misstatement in the prospectus and a promoter may also become liable under this section.

Promoter's Contracts

Preliminary contracts are contracts made on behalf of a company yet to be incorporated. Following are some of the effects of such contracts;

1. The company, when it comes into existence, is not bound by any contract made on its behalf before its incorporation. A company has no status prior to its incorporation.

2. The company cannot ratify a pre-incorporation contract and hold the other party liable. Like the company, the other party to the contract is also not bound by such a contract.
3. The agents of a proposed company may sometimes incur personal liability under a contract made on behalf of the company yet to be formed.

Kelner v Bexter (1886) L.R. 2 C.P.174. A hotel company was about to be formed and promoters signed an agreement for the purchase of stock on behalf of the proposed company. The company came into existence but, before paying the price, went into liquidation. The promoters were held personally liable to the plaintiff.

Further, an agent himself may not be able to enforce the contract against the other party. So far as ratification of a pre-incorporation contract is concerned, a company cannot ratify a contract entered into by the promoters on its behalf before its incorporation. The reason is simple, ratification can be done only if an agent contracts for a principal who is in existence and who is competent to contract at the time of the contract by the agent.

Incorporation

This is the second stage of the company formation. It is the registration that brings a company into existence. A company is legally constituted on being duly registered under the Act and after the issue of Certificate of Incorporation by the Registrar of Companies. For the incorporation of a company the promoters take the following preparatory steps:

- i) To find out from the Registrar of companies whether the name by which the new company is to be started is available or not. To take approval of the name, an application has to be made in the prescribed form along with requisite fee;

- ii) To get a letter of Intent under Industries (Development and Regulation) Act, 1951, if the company's business comes within the purview of the Act.
- iii) To get necessary documents i.e. Memorandum and Articles of Association prepared and printed.
- iv) to prepare preliminary contracts and a prospectus or statement in lieu of a prospectus.

Registration of a company is obtained by filing an application with the Registrar of Companies of the State in which the registered office of the company is to be situated. The application should be accompanied by the following documents:

1. Memorandum of association properly stamped, duly signed by the signatories of the memorandum and witnessed.
2. Articles of Association, if necessary.
3. A copy of the agreement, if any, which the company proposes to enter into with any individual for his appointment as managing or whole-time director or manager.
4. A written consent of the directors to act in that capacity, if necessary.
5. A statutory declaration stating that all the legal requirements of the Act prior to incorporation have been complied with.

The Registrar will scrutinize these documents. If the Registrar finds the document to be satisfactory, he registers them and enters the name of the company in the Register of Companies and issues a certificate called the certificate of incorporation (Section 34).

The certificate of incorporation is the birth certificate of a company. The company comes into existence from the date mentioned in the certificate of incorporation and the date appearing in it is conclusive, even if wrong. Further, the

certificate is 'conclusive evidence that all the requirements of this Act in respect of registration and matters precedent and related thereto have been fulfilled and that the association is a company authorized to be registered and duly registered under this Act.

Once the company is created it cannot be got rid off except by resorting to provisions of the Act which provide for the winding up of company. The certificate of incorporation, even if it contains irregularities, cannot be cancelled.

Capital Subscription

A private company can start business immediately after the grant of certificate of incorporation but public limited company has to further go through 'capital subscription stage' and 'commencement of business stage'. In the capital subscription stage, the company makes necessary arrangements for raising the capital of the company. With a view to ensure protection on investors, Securities and Exchange Board of India (SEBI) has issued 'guidelines for the disclosure and investor protection'. The company making a public issue of share capital must comply with these guidelines before making a public offer for sale of shares and debentures.

If the capital has to be raised through a public offer of shares, the directors of the public company will first file a copy of the prospectus with the Registrar of Companies. On the scheduled date the prospectus will be issued to the public. Investors are required to forward their applications for shares along with application money to the company's bankers mentioned in the prospectus. The bankers will then forward all applications to the company and the directors will consider the allotment of shares. If the subscribed capital is at least equal to 90 percent of the capital issue, and other requirements of a valid allotment are fulfilled the directors pass a formal resolution of allotment. However, if the company does not receive applications which can cover the minimum subscription

within 120 days of the issue of prospectus, no allotment can be made and all money received will be refunded.

If a public company having share capital decides to make private placement of shares, then, instead of a 'prospectus' it has to file with the Registrar of Companies a 'statement in lieu of prospectus' at least three days before the directors proceed to pass the first share allotment resolution.

The contents of a prospectus and a statement in lieu of a prospectus are almost alike.

Commencement of Business

A private company can commence business immediately after the grant of certificate of incorporation, but a public limited company will have to undergo some more formalities before it can start business. The certificate for commencement of business is issued by Registrar of Companies, subject to the following conditions.

1. Shares payable in cash must have been allotted upto the amount of minimum subscription
2. Every director of the company had paid the company in cash application and allotment money on his shares in the same proportion as others.
3. No money should have become refundable for failure to obtain permission for shares or debentures to be dealt in any recognized stock exchange.
4. A declaration duly verified by one of directors or the secretary that the above requirements have been complied with which is filed with the Registrar.

The certificate to commence business granted by the Registrar is a conclusive evidence of the fact that the company has complied with all legal formalities and it is legally entitled to commence business. It may also be noted that the court has the

power to wind up a company, if it fails to commence business within a year of its incorporation [Sec. 433 (3)]

MEMORANDUM OF ASSOCIATION

The formation of a public company involves preparation and filing of several essential documents. Two of basic documents are :

1. Memorandum of Association
2. Articles of Association

The preparation of Memorandum of Association is the first step in the formation of a company. It is the main document of the company which defines its objects and lays down the fundamental conditions upon which alone the company is allowed to be formed. It is the charter of the company. It governs the relationship of the company with the outside world and defines the scope of its activities. Its purpose is to enable shareholders, creditors and those who deal with the company to know what exactly is its permitted range of activities. It enables these parties to know the purpose, for which their money is going to be used by the company and the nature and extent of risk they are undertaking in making investment. Memorandum of Association enable the parties dealing with the company to know with certainty as whether the contractual relation to which they intend to enter with the company is within the objects of the company.

Form of Memorandum (Sec. 14)

Companies Act has given four forms of Memorandum of Association in Schedule I. These are as follows :

- | | |
|---------|---|
| Table B | Memorandum of a company limited by shares |
| Table C | Memorandum of a company limited by guarantee and not having a share capital |

Table D Memorandum of company limited by guarantee and having share capital.

Table E Memorandum of an unlimited company

Every company is required to adopt one of these forms or any other form as near there to as circumstances admit.

Printing and signing of Memorandum (Sec. 15).

The memorandum of Association of a company shall be (a) printed, (b) divided into paragraphs numbered consecutively, and (c) signed by prescribed number of subscribers (7 or more in the case of public company, two or more in the case of private company respectively). Each subscriber must sign for his/her name, address, description and occupation in the presence of at least one witness who shall attest the signature and shall likewise add his address, description and occupation, if any.

Contents of Memorandum

1. Name clause

Promoters of the company have to make an application to the registrar of Companies for the availability of name. The company can adopt any name if:

- i) There is no other company registered under the same or under an identical name;
- ii) The name should not be considered undesirable and prohibited by the Central Government (Sec. 20). A name which misrepresents the public is prohibited by the Government under the Emblems & Names (Prevention of Improper use) Act, 1950 for example, Indian National Flag, name pictorial representation of Mahatma Gandhi and the Prime Minister of India, name and emblems of the U.N.O., and W.H.O., the official seal and Emblems of the Central Government and State Governments.

Where the name of the company closely resembles the name of the company already registered, the Court may direct the change of the name of the company.

- iii) Once the name has been approved and the company has been registered, then
 - a) the name of the company with registered office shall be affixed on outside of the business premises;
 - b) if the liability of the members is limited the words “Limited” or “Private Limited” as the case may be, shall be added to the name; [Sec 13(1) (1)]:
Omission of the word ‘Limited’ makes the name incorrect. Where the word ‘Limited’ forms part of a company’s name, omission of this word shall make the name incorrect. If the company makes a contract without the use of the word “Limited”, the officers of the company who make the contract would be deemed to be personally liable [Atkins & Co v Wardle, (1889) 61 LT 23]

The omission to use the word ‘Limited’ as part of the name of a company must have been deliberate and not merely accidental. Note the following case in this regard:

Dermatine Co. Ltd. v Ashworth, (1905) 21 T.L.R. 510. A bill of exchange drawn upon a limited company in its proper name was duly accepted by 2 directors of the company. The rubber stamp by which the word of acceptance were impressed on the bill was longer than the paper of the bill and hence the word ‘Limited’ was missed. Held, the company was liable to pay and the directors were not personally liable.

- (c) the name and address of the registered office shall be mentioned in all letter-heads, business letters, notices and Common Seal of the Company, etc. (Sec. 147).

In *Osborn v The Bank of U. A. E.*, [9 Wheat (22 US), 738]; it was held that the

name of a company is the symbol of its personal existence. The name should be properly and correctly mentioned. The Central Government may allow a company to drop the word "Limited" from its name.

2. Registered Office Clause

Memorandum of Association must state the name of the State in which the registered office of the company is to be situated. It will fix up the domicile of the company. Further, every company must have a registered office either from the day it begins to carry on business or within 30 days of its incorporation, whichever is earlier, to which all communications and notices may be addressed. Registered Office of a company is the place of its residence for the purpose of delivering or addressing any communication, service of any notice or process of court of law and for determining question of jurisdiction of courts in any action against the company. It is also the place for keeping statutory books of the company.

Notice of the situation of the registered office and every change shall be given to the Registrar within 30 days after the date of incorporation of the company or after the date of change. If default is made in complying with these requirements, the company and every officer of the company who is default shall be punishable with fine which may extend to Rs. 50 per during which the default continues.

3. Object Clause

This is the most important clause in the memorandum because it not only shows the object or objects for which the company is formed but also determines the extent of the powers which the company can exercise in order to achieve the object or objects. Stating the objects of the company in the Memorandum of Association is not a mere legal technicality but it is a necessity of great practical importance. It is essential that the public who purchase its shares should know clearly what are the objects for which

they are paying.

In the case of companies which were in existence immediately before the commencement of the Companies (Amendment) Act. 1965, the object clause has simply to state the objects of the company. But in the case of a company to be registered after be amendment, the objects clause must state separately.

- i) **Main Objects** : This sub-clause has to state the main objects to be pursued by the company on its incorporation and objects incidental or ancillary to the attainment of main objects.
- ii) **Other objects**: This sub-clause shall state other objects which are not included in the above clause.

Further, in case of a non-trading company, whose objects are not confined to one state, the objects clause must mention specifically the States to whose territories the objects extend. (Sec. 13)

A company, which has a main object together with a number of subsidiary objects, cannot continue to pursue the subsidiary objects after the main object has come to an end.

Crown Bank. Re (1890) 44 Ch D. 634. A company's objects clause enabled it to act as a bank and further to invest in securities and to underwrite issue of securities. The company abandoned its banking business and confined it self to investment and financial speculation. Held, the company was not entitled to do so.

Incidental acts. The powers specified in the Memorandum must not be construed strictly. The company may do anything which is fairly incidental to these powers. Anything reasonable incidental to the attainment or pursuit of any of the express objects of the company will, unless expressly prohibited, be within the implied powers of the

company.

While drafting the objects clause of a company the following points should be kept in mind.

- i) The objects of the company must not be illegal, e.g. to carry on lottery business.
- ii) The objects of the company must not be against the provisions of the Companies Act such as buying its own shares (Sec. 77), declaring dividend out of capital etc.
- iii) The objects must not be against public, e.g. to carry on trade with an enemy country.
- iv) The objects must be stated clearly and definitely. An ambiguous statement like “Company may take up any work which it deems profitable” is meaningless.
- v) The objects must be quite elaborate also. Note only the main objects but the subsidiary or incidental objects too should be stated.

The narrower the objects expressed in the memorandum, the less is the subscriber’s risk, but the wider such objects the greater is the security of those who transact business with the company.

4. Capital Clause

In case of a company having a share capital unless the company is an unlimited company, Memorandum shall also state the amount of share capital with which the company is to be registered and division there of into shares of a fixed amount [Sec. 13 (4)]. The capital with which the company is registered is called the authorized or nominal share capital. The nominal capital is divided into classes of shares and their values are mentioned in the clause. The amount of nominal or authorized capital of the company would be normally, that which shall be required for the attainment of the main objects

of the company. IN case of companies limited by guarantee, the amount promised by each member to be contributed by them in case of the winding up of the company is to be mentioned. No subscriber to the memorandum shall take less than one share. Each subscriber of the Memorandum shall write against his name the number of shares he takes.

5. Liability Clause

In the case of company limited by shares or by guarantee, Memorandum of Association must have a clause to the effect that the liability of the members is limited. It implies that a shareholder cannot be called upon to pay any time amount more than the unpaid portion on the shares held by him. He will no more be liable if once he has paid the full nominal value of the share.

The Memorandum of Association of a company limited by guarantee must further state that each member undertakes to contribute to the assets of the company if wound up, while he is a member or within one year after he ceased to be so, towards the debts and liabilities of the company as well as the costs and expenses of winding up and for the adjustment of the rights of the contributories among themselves not exceeding a specified amount.

Any alteration in the memorandum of association compelling a member to take up more shares, or which increases his liability, would be null and void. (Sec 38).

If a company carries on business for more than 6 months while the number of members is less than seven in the case of public company, and less than two in case of a private company, each member aware of this fact, is liable for all the debts contracted by the company after the period of 6 months has elapsed. (Sec. 45).

6. Association or Subscription Clause

In this clause, the subscribers declare that they desire to be formed into a

company and agree to take shares stated against their names. No subscriber will take less than one share. The memorandum has to be subscribed to by at least seven persons in the case of a public company and by at least two persons in the case of a private company. The signature of each subscriber must be attested by at least one witness who cannot be any of the subscribers. Each subscriber and his witness shall add his address, description and occupation, if any. This clause generally runs in this form : “we, the several person whose names and addresses are subscribed, are desirous of being formed into a company in pursuance of the number of shares in the capital of the company, set opposite of our respective name”.

After registration, no subscriber to the memorandum can withdraw his subscription on any ground.

Alteration of Memorandum of Association

Alteration of Memorandum of association involves compliance with detailed formalities and prescribed procedure. Alterations to the extent necessary for simple and fair working of the company would be permitted. Alterations should not be prejudicial to the members or creditors of the company and should not have the effect of increasing the liability of the members and the creditors.

Contents of the Memorandum of association can be altered as under :

1. Change of name

A company may change its name by special resolution and with the approval of the Central Government signified in writing . However, no such approval shall be required where the only change in the name of the company is the addition there to or the deletion there from, of the word “Private”, consequent on the conversion of a public company into a private company or of a private company into a public company. (Sec. 21)

By ordinary resolution. If through inadvertence or otherwise, a company is registered by a name which, in the opinion of the Central Government, is identical with or too nearly resembles the name of an existing company, it may change its name by an ordinary resolution and with the previous approval of the Central Government signified in writing. [Sec. 22(1) (a)].

Registration of change of name. Within 30 days passing of the resolution, a copy of the order of the Central Government's approval shall also be filed with the Registrar within 3 months of the order. The Registrar shall enter the new name in the Register of Companies in place of the former name and shall issue a fresh certificate of incorporation with the necessary alterations. The change of name shall be complete and effective only on the issue of such certificate. The Registrar shall also make the necessary alteration in the company's memorandum of association (Sec. 23)

The change of name shall not affect any right or obligations of the company or render defective any legal proceeding by or against it. (Sec. 23).

2. Change of Registered Office

This may involve :

- a) Change of registered office from one place to another place in the same city, town or village. In this case, a notice is to be given within 30 days after the date of change to the Registrar who shall record the same.
- b) Change of registered office from one town to another town in the same State. In this case, a special resolution is required to be passed at a general meeting of the shareholders and a copy of it is to be filed with the Registrar within 30 days. The within 30 days of the removal of the office. A notice has to be given to the Registrar of the new location of the office.
- c) Change of Registered Office from one State to another State to another State.

Section 17 of the Act deals with the change of place of registered office from one State to another State. According to it, a company may alter the provision of its memorandum so as to change the place of its registered office from one State to another State for certain purposes referred to in Sec 17(1) of the Act. In addition the following steps will be taken.

Special Resolution

For effecting this change a special resolution must be passed and a copy thereof must be filed with the Registrar within thirty days. Special resolution must be passed in a duly convened meeting.

Confirmation by Central Government

The alteration shall not take effect unless the resolution is confirmed by the Central Government.

The Central Government before confirming or refusing to confirm the change will consider primarily the interests of the company and its shareholders and also whether the change is bonafide and not against the public interest. The Central Government may then issue the confirmation order on such terms and conditions as it may think fit.

3. Alteration of the Object Clause

The Company may alter its objects on any of the grounds (I) to (vii) mentioned in Section 17 of the Act.

The alteration shall be effective only after it is approved by special resolution of the members in general meeting with the Companies Amendment Act, 1996, for alteration of the objects clause in Memorandum of Associations sanction of Central Government is dispensed with.

Limits of alteration of the Object Clause

The limits imposed upon the power of alteration are substantive and procedural. Substantive limits are provided by Section 17 which provides that a company may change its objects only in so far as the alteration is necessary for any of the following purposes:

- i) to enable the company to carry on its business more economically or more effectively;
- ii) to enable the company to attain its main purpose by new or improved means;
- iii) to enlarge or change the local area of the company's operation;
- iv) to carry on some business which under existing circumstances may conveniently or advantageously be combined with the business of the company;
- v) to restrict or abandon any of the objects specified in the memorandum
- vi) to sell or dispose of the whole, or any part of the undertaking of the company;
- vii) to amalgamate with any other company or body of persons.

Alterations in the objects is to be confined within the above limits for otherwise alteration in excess of the above limitations shall be void.

A company shall file with the registrar a special resolution within one month from the date of such resolution together with a printed copy of the memorandum as altered. Registrar shall register the same and certify the registration. [Sec. 18].

Effect of non Registration with Registrar

Any alteration, if not registered shall have no effect. If the documents required to be filed with the Registrar are not filed within one month, such alteration and the order of the Central Government and all proceedings connected therewith shall at the expiry of such period become void and inoperative. The Central Government may, on sufficient cause show, revive the order on application made within a further period of one month [Sec. 19]

4. Alteration of Capital Clause

The procedure for the alteration of share capital and the power to make such alteration are generally provided in the Articles of Association. If the procedure and power are not given in the Articles of Association, the company must change the articles of association by passing a special resolution. If the alteration is authorized by the Articles, the following changes in share capital may take place :

1. Alteration of share capital [Section 94-95]
2. Reduction of capital [Section 100-105]
3. Reserve share capital or reserve liability [Section 99]
4. Variation of the rights of shareholders [Section 106-107]
5. Reorganization of capital [Section 390-391]

5. Alteration of Liability Clause

Ordinarily the liability clause cannot be altered so as to make the liability of members unlimited. Section 38 states that the liability of the members cannot be increased without their consent. It lays down that a member cannot by changing the memorandum or articles, be made to take more shares or to pay more the shares already taken unless he agrees to do so in writing either before or after the change.

A company, if authorized by its Articles, may alter its memorandum to make the liability of its directors or manager unlimited by passing a special resolution. This rule applies to future appointees only. Such alteration will not effect the existing directors and manager unless they have accorded their consent in writing. [Section 323].

Section 32 provides that a company registered as unlimited may register under this Act as a limited company. The registration of an unlimited company as a limited company under this section shall not affect any debts, liabilities, obligations or contracts incurred or entered into by the company before such registration.

Every company is required to file Articles of Association along with the Memorandum of Association with the Registrar at the time of its registration. Companies Act defines 'Articles as Articles of Association of a company as originally framed or as altered from time to time in pursuance of any previous companies Acts. They also include, so far as they apply to the company, those in the Table A in Schedule I annexed to the Act or corresponding provisions in earlier Acts.

Articles of Association are the rules, regulations and bye-laws for governing the internal affairs of the company. They may be described as the internal regulation of the company governing its management and embodying the powers of the directors and officers of the company as well as the powers of the shareholders. They lay down the mode and the manner in which the business of the company is to be conducted.

In framing Articles of Association care must be taken to see that regulations framed do not go beyond the powers of the company it self as contemplated by the Memorandum of Association nor should they be such as would violate any of the requirements of the companies Act, itself. All clauses in the Articles ultra vires the Memorandum or the Act shall be null and void.

Article of Association are to be printed, divided into paragraphs, serially numbered and signed by each subscriber to Memorandum with the address, description and occupation. Each subscriber shall sign in the presence of at least one witness who shall attest the signatures and also mention his own address and occupation.

Contents of Articles of Association

Articles generally contain provision relating to the following matters; (1) the exclusion, whole or in part of Table A; (ii) share capital different classes of shares of shareholders and variations of these rights (iii) execution or adoption of preliminary agreements, if any; (iv) allotment of shares; (v) lien on shares (vi) calls on shares; (vii)

forfeiture of shares; (viii) issue of share certificates; (ix) issue of share warrants; (x) transfer of shares; (xi) transmission of shares; (xii) alteration of share capital; (xiii) borrowing power of the company; (xiv) rules regarding meetings; (xv) voting rights of members; (xvi) notice to members; (xvii) dividends and reserves; (xviii) accounts and audit; (xix) arbitration provision, if any; (xx) directors, their appointment and remuneration; (xxi) the appointment and reappointment of the managing director, manager and secretary; (xxii) fixing limits of the number of directors (xxiii) payment of interest out of capital; (xxiv) common seal; and (xxv) winding up.

Model form of Articles

Different model forms of memorandum of association and Articles of Association of various types of companies are specified in Schedule I to the Act. The schedule is divided into following tables.

Table A deals with regulations for management of a company limited by shares.

Table B contains a model form of Memorandum of Association of a company limited by shares.

Table C gives model forms of Memorandum and Articles of Association of a company limited by guarantee and not having a share capital.

Table D gives model forms of Memorandum and Articles of Association of a company limited by guarantee and having a share capital. The Articles of such a company contain in addition to the information about the number of members with which the company proposes to be registered, all other provisions of Table A.

Table E contains the model forms of memorandum and Articles of Association of an unlimited company.

A Public Company may have its own Article of Association. If it does not

have its own Articles, it may adopt Table A given in Schedule I to the Act.

Adoption and application of Table A (Section 28). There are 3 alternative forms in which a public company may adopt Articles :

1. It may adopt Table A in full
2. It may wholly exclude Table A, and set out its own Articles in full
3. It may frame its own Articles and adopt part of Table A.

In other words, unless the Articles of a public company expressly exclude any or all provisions of Table A shall automatically apply to it.

Alteration of Articles

Section 31 grant power to every company to alter its articles whenever it desires by passing a special resolution and filing a copy of altered Articles with the Registrar. An alteration is not invalid simply because it changes the company's constitution. Thus in *Andrews v Gas Meter Co.*, A company was allowed by changing articles to issue preference shares when its memorandum was silent on the point.

Alteration of articles is much easier than memorandum as it can be altered by special resolution. However, there are various limitations under the Companies Act to the powers of the shareholders to alter the articles.

In case of conversion of a public company into a private company, alteration in the articles would only be effective after approval of the Central Government [Section 31]. The power are now vested with the Registrar of Companies.

Alteration of the articles shall not violate provisions of the Memorandum. It must be made bonafide the benefit of the company. All clauses in the articles ultra vires the Memorandum shall be null and void, and the articles shall be held inoperative. Alteration must not contain anything illegal and shall not constitute fraud on the minority.

Alteration in the articles increasing the liability of the members can be done only with the consent of the members.

The Court may even restrain an alteration where is likely to cause a damage which cannot be adequately compensated in terms of money. Similarly, a company cannot by altering articles, justify a breach of contract. Any alteration so made shall be valid as if originally contained in the articles.

Where a special resolution has been passed altering the articles or an alteration has been approved by the Central Government where required, a printed copy of the articles so altered shall be filed by the company with the Registrar of Companies within one month of the date of the passing of special resolution.

DISTINCTION BETWEEN ARTICLES OF ASSOCIATION AND MEMORANDUM OF ASSOCIATION

The difference between memorandum of association and articles of association is as under:

Memorandum of Association	Articles of Association
1. It is character of company indicating nature of business & capital. It also defines the company's relationship with outside world	1. They are the regulation for the internal management of the company and are subsidiary to the memorandum.
2. It defines the scope of the activities of the company, or the area beyond which the actions of the company cannot go.	2. They are the rules for carrying out the objects of the company as set out in the Memorandum.
3. It, being the charter of the	3. They are subordinate to

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| <p>company, is the supreme document.</p> <p>4. Any act of the company which is ultra vires the Memorandum is wholly void and cannot be ratified even by the whole body of shareholders.</p> <p>5. Every company must have its own Memorandum</p> <p>6. There are strict restrictions on its alteration. Some of the conditions of incorporation contained in it cannot be altered except with the sanction of the Central Government.</p> | <p>the Memorandum. If there is a conflict between the Articles and the Memorandum, the act of the company</p> <p>4. Any act of the company which is ultra vires the articles can be confirmed by the shareholders if it is intra vires the memorandum.</p> <p>5. A company limited by Shares need not have Articles of its own. In such A case, Table A Applies.</p> <p>6. They can be altered by a special resolution, to any extent, provided they do not conflict with the Memorandum and the Companies Act.</p> |
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CONSTRUCTIVE NOTICE OF MEMORANDUM AND ARTICLES OF ASSOCIATION

The Memorandum and Articles of a company are registered with the Registrar. These are the public documents and open to public inspection,. Every person

contracting with the company must acquaint himself with their contents and must make sure that his contract is in accordance with them, otherwise he cannot sue the company.

On registration the memorandum and articles of association become public documents. These documents are available for public inspection either in the office of the company or in the office of the Registrar of Companies on payment of one rupee for each inspection and can be copied (Sec. 610).

Every person who deals with the company, whether shareholder or an outsider is presumed to have read the memorandum and articles of association of the company and is deemed to know the contents of these document. Therefore, the knowledge of these documents and their contents is known as the constructive notice of memorandum and articles of association.

It is presumed that persons dealing with the company have not only read these documents but they have also understood their proper meaning.

Where a person deals with the company in a manner, which is inconsistent with the provisions of memorandum or articles, or enters into a transaction which is beyond the powers of the company, shall be personally liable to bear the consequences regarding such dealings.

SUMMARY

The whole process of formation of a company can be divided into four distinct stages namely promotion incorporation, capital subscription and commencement of business. However, a private company can start business as soon as it obtains the certificate of information. The memorandum of Association of a company tells us the objects of the company's formation and the utmost possible scope of its

operations beyond which its actions cannot go. The memorandum of association of every clause, objects clause, liability clause, Memorandum of association cannot be altered by the sweet will of the members of the company. It can be altered only by following the procedure prescribed in the Companies Act. Articles of association contain the rules and regulations which are granted for the internal management of the company. The company may alter its articles of association any time by following the procedure as prescribed in the Companies Act. Every person dealing with the company is presumed to have read the memorandum and articles of association and understood them in their time perspective. This is known as doctrine of constructive notice.

KEYWORDS

Promotion: Promotion means the discovery of business opportunities and the subsequent organization of funds, property and managerial ability into a business concern for the purpose of making profits therefrom.

Promoter: A promoter is a person who undertakes to form a company with reference to a given object and brings it into actual existence.

Preliminary Contract: Preliminary contract refers to those agreements or contracts entered into between different parties on behalf and for the benefit of the company prior to its incorporation.

Certificate of Commencement of Business: A public company, having a share capital and issuing a prospectus inviting the public to subscribe for shares, will have to file a few documents with the registrar who shall scrutinize them and if satisfied will issue a certificate to commence business.

Memorandum of Association: It is the document which defines the objects and lays down the fundamental conditions upon which along the company is allowed to be incorporated.

Articles of Association: Articles of association are the rules, regulation and bye-laws for governing the internal affairs of the company.

SELF ASSESSMENT QUESTIONS

1. Explain the process of formation of a company under the Companies Act, 1956.
2. “A certificate of incorporation is conclusive evidence that all the requirements of the Companies Act have been complied with”. Comment.
3. What is a Memorandum of Association ? Discuss its clauses
4. How the alteration in the different clauses of Memorandum of Association can be made?
5. What is Articles of Association ? What are its contents ?
6. Distinguish between Memorandum of Association and Articles of Association.

SUGGESTED READINGS

S.K. Aggarwal, Business Law, Galgotia Publishing Company, New Delhi.

G.K. Varshney, Elements of Business Law, S Chand & Co., New Delhi.

R.H. Pandia, Principles of Mercantile Law, N.M. Tripathi Pvt. Ltd., Mumbai.

S.R. Davar, Mercantile Law, Progressive Corporation Pvt. Ltd., Mumbai.

K.R. Balchandari, Business Law for Management, Himalaya Publication House, New Delhi.

LESSON : 3
PROSPECTUS AND COMMENCEMENT OF BUSINESS

STRUCTURE

Objective
Introduction
Definition of Prospectus
Objects of Prospectus
Requirements regarding issue of Prospectus
Contents of Prospectus
Mis-statement in Prospectus
Statement in lieu of Prospectus
Minimum Subscription
Commencement of Business
Summary
Keywords
Self Assessment Questions
Suggested Readings

OBJECTIVE

After reading this lesson, you should be able to:

- (a) Define a prospectus and explain the requirement regarding issue of prospectus.
- (b) Describe the contents of the prospectus.
- (c) Explain the civil and criminal liabilities for mis-statement in prospectus.
- (d) Discuss the conditions to be fulfilled by a public company to get certificate of commencement of business.

INTRODUCTION

The promoters of a public company will have to take steps to raise the necessary capital for the company, after having obtained the Certificate of Incorporation. A public company may invite the public to subscribe to its shares or debentures. Prospectuses are to be issued for this purpose. To issue a prospectus is very essential for a public company. If the promoters of the company are confident of raising the required capital privately from their friend or relatives, they need not issue a prospectus. In such a case, a statement in lieu of prospectus must be filed with the Registrar. A private company is not allowed to issue a prospectus since it cannot invite the general public to subscribe to its shares and debentures. It is not required to file a statement in lieu of prospectus.

DEFINITION OF PROSPECTUS

Section 2(36) defines a prospectus as “any document described as issued as a prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting orders from the public for the subscription or purchase of any share in, or debentures of, a body corporate”. In simple words, a prospectus may be defined as an invitation to the public to subscribe to a company’s shares or debentures. By virtue of the Amendment Act of 1974, any document inviting deposits from the public shall also come within the definition of prospectus. The word “Prospectus” means a document which invites deposits from the public or invites offers from the public to buy shares or debentures of the company.

A document will be treated as a prospectus only when it invites offers from a public. According to Section 67 the term “public” is defined as, “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”. It further provides that no offer of invitation shall be treated as made to the public if, (i) the same is not calculated to result in the shares or debentures becoming available other than those receiving the offer or invitation; (ii) it appears to be a domestic concern of the person making and receiving the offer or invitation. The ‘public’ is a general word. No particular numbers are prescribed. The point is that the offer makes the shares and debentures available for subscription to any one who brings his money and applies in due form, whether the prospectus was addressed to him on behalf of the company or not. A private communication does not satisfy the above point.

Where directors make an offer to a few of their friends, relatives or customers by sending them a copy of the prospectus marked “not for publication” it is not considered an offer to the public.

The provisions of the Act relating to prospectus are not attracted unless the prospectus is issued to the public. Issued means issued to the public. Whether the prospectus has been issued to the public or not is a matter of fact. The leading case of this point is *Nash v Lynde* (1929) A.C. 158. In this case the managing director of a company prepared a document that was marked “strictly private and confidential” and did not contain the particulars required to be disclosed in a prospectus. A copy of the document along with application forms was

sent to a solicitor who in turn sent it to the plaintiff. The document was held not to be a prospectus and as such the claim of the plaintiff for compensation was dismissed.

In the case *Re South of England Natural Gas and Petroleum Co. Ltd.* (1911) 1 Ch. 573, the distribution of 3,000 copies of a prospectus among the members of certain gas companies was held to be an offer to the public because a person other than those receiving the offer could also accept it. One may note that under Section 67 an offer or invitation to any section of the public, whether selected as members or debenture holders of the company or as clients of the person making the invitation, will be deemed to be an invitation to the public.

The term “subscription or purchase of shares” means taking or agreeing to take shares for cash. Any document to be called a prospectus must have the following ingredients :

- I. There must be an invitation offering to the public;
- II. The invitation must be or on behalf of the company or in relation to an intended company;
- III. The invitation must be to subscribe or purchase.
- IV. The invitation must relate to shares or debentures.

OBJECTS OF PROSPECTUS

The main objects of a prospectus are as follows :

1. To bring to the notice of public that a new company has been formed.

2. To preserve an authentic record of the terms of allotment on which the public have been invited to buy its shares or debentures.
3. To ensure that the directors of the company accept responsibility of the statement in the prospectus.

REQUIREMENTS REGARDING ISSUE OF PROSPECTUS

The relevant requirements regarding issue of prospectus are given below:

1. Issue after Incorporation

Section 55 of the Act permits the issue of prospectus in relation to an intended company. A prospectus may be issued by or on behalf of the company.

- a) by a person interested or engaged in the formation company or
- b) through an offer for sale by a person to whom the company has allotted shares.

2. Dating of Prospectus

A prospectus issued by a company shall be dated and that date shall be taken as the date of publication of the prospectus (Section 55). Date of issue of the prospectus may be different from the date of publication.

3. Registration of Prospectus

A copy of every prospectus must be delivered to the Registrar for registration before it is issued to the public. Registration must be made on or before the date of its publication. The copy sent for registration must be signed by every person who is named in the prospectus as a director or proposed director of the

company or by his agent authorized in writing. Where the prospectus is issued in more than one language, a copy of its as issued in each language should be delivered to the registrar. This copy must be accompanied with the following documents:

- a) If the report of an expert is to be published, his written consent to such publication;
- b) a copy of every contract relating to the appointment and remuneration of managerial personnel;
- c) a copy of every material contract unless it is entered in the ordinary course of business or two years before the date of the issue of prospectus;
- d) a written statement relating to adjustments; if any, made by the auditors or accountants in their reports relating to profits and losses, assets and liabilities or the rates of dividends, etc.; and
- e) written consent of auditors, legal advisers, attorney, solicitor, banker or broker of the company to act in that capacity.

A copy of the prospectus along with specific documents must be filed with the Registrar. The prospectus must be issued within ninety days of its registration. A prospectus issued after the said period shall be deemed to be a prospectus, a copy of which has not been delivered to the Registrar for registration. The company and every person who is knowingly a party to the issue of prospectus without registration shall be punishable with fine which may extend to five thousand rupees (Section 60).

4. Expert to be unconnected with the Formation of the Company

A prospectus must not include a statement purporting to be made by an expert such as an engineer, valuer, accountant etc. unless the expert is a person who has never been engaged or interested in the formation or promotion as in the management of the company (Section 57).

A statement of an expert cannot be include in the prospectus without his written consent and this fact should be mentioned in the prospectus. Further, this consent should not be withdrawn before delivery of the prospectus for registration Section (58).

5. Terms of the contract not to be varied

The terms of any contract stated in the prospectus or statement in lieu of prospectus cannot be varied after registration of the prospectus except with the approval of the members in the general meeting (Section 61).

6. Application Forms to be Accompanied with the Copy of Prospectus

Every from of application for subscribing the shares or debentures of a company shall not be issued unless it is accompanied by a copy of prospectus except when it is issued in connection with a bona fide invitation to a person to enter into an underwriting agreement with respect to shares or debentures or in relation to shares or debentures which were not offered to the public [(Section 56(3)].

Section 56(5) provides that the prospectus need not contain all the details required by the Act where the offer is made to exiting members or debenture holders of the company or if such shares or debentures are in all respect uniform with shares or debentures already issued and quoted on a recognize stock ex-

change.

7. Personation for Acquisition etc. of Shares

The provision, consequences of applying for shares in fictitious names to be prominently displayed must be reproduced in every prospectus and every application form issued by the company to any person.

A person who makes in a fictitious name to a company for acquiring shares or subscribing any shares or subscribing any shares shall be liable to imprisonment which may extend to five years similarly, a person who induces a company to allot any shares or to register any transfer of shares in a fictitious name is also liable to the same punishment. [Section 68(a)].

8. Contents as per Schedule II

Every prospectus must disclose the matters as required in Schedule II of the Act. It is to be noted that if any condition binding on the applicant for shares or debentures in a company to waive compliance with any requirements of the Act as to disclosure in the prospectus or purporting to affect him with notice of any contract, document or matter not specifically referred to in the prospectus shall be void [Section 56(2)].

If a prospectus is issued without a copy thereof, the necessary documents or the consent of the experts the company and every person, who is knowingly a part to the issue of the prospectus, shall be punishable with fine which may extend to Rs. 5,000/-.

CONTENTS OF PROSPECTUS

We know that a prospectus is issued to the public to purchase the shares or debentures of the company. Every person wants to invest his money in some sound undertaking. The soundness of a company can be known from the prospectus of a company. Thus, the prospectus must disclose the true nature of company's activities which enable the public to decide whether or not to invest money in the company. In fact, the public invest money in the company on the faith of the representation contained in the prospectus. Therefore, everything should be stated with strict accuracy, and the complete and true position of the company should be disclosed to the public.

Section 56 lays down that every prospectus issued (a) by or on behalf of a company, or (b) by on behalf of any person engaged or interested in the formation of a company, shall :

1. State the matters specified in Part I of Schedule II, and.
2. Set out the reports specified in Part II or Schedule II both Part I and II shall have effect subject to the provisions contained in Part III of that Schedule II.

Part I of Schedule II

1. The main objects of the company with names, descriptions, occupations and addresses of the signatories to the Memorandum of association, and number of shares subscriber by them.
2. The number and classes of shares, and the nature and extent of the interests of the shareholders in the property and profits of the company.
3. The number of redeemable preference shares intended to be issued with

particulars as regards their redemption.

4. The number of shares fixed by the articles of company as the qualification of a director.
5. The names, addresses, description and occupation of directors, managing director or manager or any of those proposed person.
6. Any provisions in the articles or any contract relating to appointment, remuneration and compensation for loss of office of directors, managing director or manager.
7. The amount of minimum subscription.
8. The time of the opening of the subscription list cannot be earlier than the beginning of the fifth day after the publication of prospectus.
9. Amount payable on application and allotment on each share shall be stated. If any allotment was previously made within two preceding years, the details of the shares allotted and the amount; if any, paid thereon.
10. Particulars about any option or preferential right to be given to any person to subscribe for shares or debentures of the company.
11. The number, description and amount of shares and debentures which, within the last two years, have been issued or agreed to be issued as fully or partly paid up than in cash.
12. The amount paid or payable as a premium, if any, on such share issued within two years preceding the date of the prospectus or is to be issued

stating the necessary particulars.

13. The names of the underwriters of shares or debentures, if any, and the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations.
14. The names or addresses description and occupations of the vendors from whom the property has been purchased or is to be purchased, and the amount paid or payable in cash, shares or debentures respectively.
15. The amount of underwriting commission paid within two preceding years or payable to any person for subscribing or procuring subscription for any shares or debentures of the company.
16. Any benefit given to any promoter or officer in preceding two years and the consideration for giving of the benefit.
17. Particulars as to the date, parties and general nature of every contract appointing or fixing the remuneration of managing director or manager, whenever entered into.
18. Particulars of every material contract not entered into in the ordinary course of 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.
19. Names and addresses of the auditors of the company.
20. Full particulars of the nature and extent of interested of the directors or promoter in the promotion of the company or in the property acquired by

the company within two years of the issue of the prospectus.

21. If the share capital of the company is divided into different classes of shares, the rights of voting at meeting of the company and the rights in respect of capital and the dividends attached to several classes of shares respectively.
22. Where the articles of the company impose any restriction upon the members of the company in respect of the rights to attend, speak or vote at meetings of the company or the rights to transfer shares or on the directors of the company in respect of their powers of management, the nature and extent of these restrictions.
23. Where the company carries on business, the length of time during which it has been carried on. 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 had been conducted.
24. If any reserves or profits of the company or any of its subsidiaries have been capitalized, particulars of the capitalization and particulars of the surplus arising from any revaluation on the assets of the company.
25. A reasonable time and place at which copies of all balance sheets and profits and loss accounts, if any, on which the report of the auditors under part II below is based, may be inspected.

Part II of Schedule II

I General Information

1. Names and address of the Company Secretary, Legal Adviser, Lead Man-

agers, Co-managers, Auditors, Bankers to the company. Bankers to the issue and Brokers to the issue.

2. Consent of Directors, Auditors, Solicitors/Advocates, Managers to issue, Registrar of Issue, Bankers to the company, Bankers to the issue and Experts.
3. Expert's opinion obtained, if any.
4. Change, if any, in directors and auditors during the last 3 years, and reasons thereof.
5. Authority for the issue and details of resolution passed for the issue.
6. Procedure and time schedule for allotment and issue of certificates.

II. Financial Information

1. Report by the Auditors

A report by the auditors of the company as regards (a) its profits and losses and assets and liabilities of the company and (b) the rates of dividend, if paid by the company during the preceding 5 financial years.

If no accounts have been made up in respect of any part of the period of 5 years ending on a date 3 months before the issue of the prospectus, the report shall, in addition, deal with either the combined profits and losses and assets and liabilities of its subsidiaries or each of the subsidiary, so far as they concern the members of the company.

2. Reports by the Accountants

- (a) A report by the accountants on the profits or losses of the business for the preceding 5 financial years, and on the assets and liabilities of the business on a date which shall not be more than 120 days before the date of the issue of the prospectus. This report is required to be given, if the proceeds of the issue of the shares or debentures are to be applied directly on the purchase of any business.
- (b) A similar report on the account of a body corporate by an accountant if the proceeds of the issue are to be applied in the purchase of shares of a body corporate so that body corporate becomes a subsidiary of the acquiring company.
- (c) Principal terms of loans and assets charged as security.

3. Statutory and other Information

Statutory and other information minimum subscription, underwriting commission and brokerage; date of allotment, closing date, date of refund, option to subscribe, material contracts and inspection of documents, etc. are required to set out in the prospectus.

Part III of Schedule II

Part III of the schedule consists of provisions applying to Part I and II of the said schedule.

- A. 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 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.

- B. In the case of a company which has been carrying on business for less than 5 financial years, reference to 5 financial years means reference to that number of financial years for which business has been carried on.
- C. Reasonable time and place at which copies of all balance sheets and profit and loss accounts on which the report of the auditors is based, and material contracts and other documents may be respected.

“Term year” wherever used herein earlier means financial year.

Declaration

That all the relevant provision of the Companies Act, 1956 and the guide lines issued by the Government have been complied with and no statement made in the prospectus is contrary to the provisions of the Companies Act, 1956 and rules thereunder. The prospectus shall be dated and signed by the directors.

Statement by Experts

1. Experts to be unconnected with formation or management of company (Section 57). Where a prospectus includes a statement made by an expert, he shall not be engaged or interested in the formation, promotion or management of the company. The expression ‘expert’ includes an engineer, accountant, a valuer and, any other person whose profession gives authority

to a statement made by him.

2. Expert's consent to issue of prospectus containing statement by him (Section 58). A prospectus including a statement made by an expert shall not be issued, unless (a) he has given his written consent to be issued of the prospectus with the statement included in the form and context in which it is included and; (b) statement that he has given and has not withdrawn his consent as aforesaid appears in a prospectus.

A wholesome rule intended to protect intending investors by making the expert a party to the issue of the prospectus and making him liable for untrue statements (Section 58). Penalty [Section 59 (1)], if any, prospectus is issued in contravention of Section 57 or 58, the company, and every person who is knowingly a party to the issue thereof, shall be punishable with fine which may extent to Rs. 5,000/-

MIS-STATEMENT IN THE PROSPECTUS

A prospectus is an invitation to the public to subscribe to the shares or debentures of a company. Every person authorizing the issue of prospectus has a primary responsibility to see that the prospectus contains the true state of affairs of the company and does not give any fraudulent picture to the public. People invest in the company on the basis of the information published in the prospectus. They have to be safeguarded against all wrongs or false statements in prospectus. Prospectus must give a full, accurate and a fair picture of material facts without concealing or omitting any relevant fact. This is known as the 'Golden Rule' for framing prospectus as laid down in *New Brunswick etc. Co. V.*

Muggeridge [(1860) 3 LT 651]. The true nature of company's venture should be disclosed. The statements which do not qualify to the particulars mentioned in the prospectus or any information is intentionally and willfully concealed by the directors of the company, would be considered as mis-statement.

Thus, the term 'venture statement' as 'mis-statement' is used in a broader sense. It includes not only false statements which produce a impression of actual facts. Concealment of a material fact also comes within the category of mis-statement.

A statement included in a prospectus shall be deemed to be untrue, if

- The statement is misleading in the form and context in which it is included; and
- the omission from a prospectus of any matter is calculated to mislead (Section 65).

If there is any misstatement of a material fact in a prospectus as if the prospectus is wanting in any material fact, this may arise-

1. Civil Liability
2. Criminal Liability
- 1. Civil Liability**

A person who has induced to subscribe for shares (or debentures) on the faith of a misleading prospects has remedies against the company, directors,

promoters, and experts. Every person who is a director and promoter of the company, and who has authorized the issue of the prospectus [Section (2)].

a) Compensation

The above persons shall be liable to pay compensation to every person who subscribes for any shares or debentures for any loss or damage sustained by him by reason of any untrue statement included therein [Section 62(1)].

In *McConnel V. Wright* (1903 1 Ch 5460) it has been held that the measure of the damages is the loss suffered by reason of the untrue statement, omissions, etc. the difference between the value which the shares would have had and the true value of the shares at the time of the allotment.

b) Rescission of the Contract for Misrepresentation

Avoiding the contract is rescission. Any person can apply to the court for rescission of the contract if the statements on which he has taken the shares are false or caused by misrepresentation whether innocent or fraudulent.

The contract can be rescinded if the following conditions are satisfied:

- 1) The statement must be a material misrepresentation of fact
- 2) It must have induced the shareholder to take the shares.
- 3) The deceived shareholder is an allottee and he must have relied on the statement in the prospectus.
- 4) The omission of material fact must be misleading before rescission is granted.

5) The proceedings for recession must be started as soon as the allottee comes to know of a misleading statement.

c) Damages for Deceit as Fraud

Any person induced to invest in the company by fraudulent statement in a prospectus can sue the company and person responsible for damages. The share should be first surrendered to company before the company is used for damages.

Fraud occurs when any statement is made without belief in the truth or carelessly. A statement made with knowledge that it is false, will constitute fraud or deceit. In the leading case on the point - Derry V. Peek (1889 14 AG 337). It has been held that if the person making the statement honestly believes it to be true, he is not guilty of fraud even if the statement is not true. The facts of this case were:

The Tramway company had power by special Act to make tramways and to use steam power with the consent of the Board of Trade. The plans of the company are approved honestly. The directors of the company believed that since the plans were approved, permission to use steam power from Board of Trade was only a formality and would be granted. Prospectus was issued wherein the directors stated that the consent to use steam power was obtained by the company. Subsequently, the consent was refused and company had to be wound up. On the action by plaintiffs for deceit it was held that the directors were not liable for fraud as they honestly believed that the consent would be obtained, though the statement was untrue.

d) Liability for non-compliance

A director or other person responsible shall be liable for damage for non-compliance with or contravention of any of the matters to be stated and reports to be set out in the prospectus as provided [by Section 56(41)].

e) Damages for Fraud under General Law

Any person responsible for the issue of prospectus may be held liable under the general law or under the Act for misstatements or fraud.

f) Penalty for Contravening Section 57 & 58

If any prospectus is issued in contravention of Section 57, (experts to be unconnected with formation or management of company), or Section 58 (expert's consent to issue of prospectus containing statement by him) the company and every person who is knowingly party to the issue thereof, shall be punishable with fine which may extend to Rs. 5,000/-.

g) Penalty for issuing the Prospectus without Registration

If a prospectus is issued without a copy of thereof being delivered to the Registrar, the company and every person who is knowingly a party to the issue of the prospectus shall be punishable with fine which may extend to Rs 5,000 [Section 60(5)].

Defence against Civil Liability

Every person made liable to pay compensation for any loss or damages may escape such liability by proving that :

- I. Having consented to become a director of the company, he withdrew his consent before the issue of the prospectus and that it was issued without

his authority or consent.

- II. The prospectus was issued without his knowledge or consent and that on becoming aware of its issue he forth with gave reasonable public notice that it was issued without his knowledge or consent.
- III. After the issue of prospectus, and before allotment thereunder he, on becoming aware of any untrue statement therein withdrew his consent to the prospectus and gave reasonable public notice of the withdrawal.
- IV. If a director, etc., has reasonable ground to believe that the statement was true and he, in fact, believed it to be true up to the time of allotment, he is not liable. But it is not enough for a director to say that he was honest, he has to show that his honest belief was based on reasonable grounds.
- V. If statement is a correct and fair representation or extract or copy of the statement made by an expert who is competent to make it and had given his consent and had not withdrawn it, the director, etc., is not liable. Likewise, if the statement is a correct and fair representation or extract or copy of an official document or is based on the authority of an official person, no liability attaches to the director etc.

2. Criminal Liability

Every person who authorized the issue of prospectus shall be punishable for untrue statement with imprisonment for a term which may extend to 2 years or with fine which may extend to Rs. 5,000/- or with both [Section 63(1)].

Penalty for Fraudulently inducing Persons to Invest Money [Section 68]

Any person who either knowingly or recklessly makes any statement, prom-

ises or forecast which is false, deceptive or misleading or by any dishonest concealment of material facts, induces or attempts to induce another person to enter into;

- Any agreement with a view to acquiring, disposing of, subscribing for, or underwriting shares or debentures;
- An agreement to secure to any of the parties from the yield of shares or debentures; or by reference to fluctuation in the value of shares or debentures; shall be punishable for a term which may extend to 5 years or with fine which may extend to Rs. 10,000/- or with both.

Defence against Criminal Liability

Any person made criminally liable can escape the same as proving that

- the statement was true [Section 63(i)]. statement was immaterial; or
- he had a reasonable ground to believe and did upto the time of the issue of prospectus that the statement was true [Section 63(i)].

STATEMENT IN LIEU OF PROSPECTUS (SECTION 70)

A company having a share capital which does not issue a prospectus or which has issued a prospectus but has not proceeded to allot any of the shares offered to the public for subscription, shall not allot any of its shares or debentures, unless at least three days before the allotment of shares or debentures, this has been delivered to the Registrar for registration a 'statement in lieu of prospectus' signed by every person who is named therein as a director or a proposed director of the company or by his agent authorized in writing, in the form and

containing the particulars set out in Part I of Schedule III and setting out the reports specified in Part II of Schedule III subject to the provisions contained in Part III of that Schedule (Section 70).

A private company on becoming a public company shall deliver to the Registrar a statement in lieu of prospectus in the form containing the particulars specified in Part I of Schedule IV with report set out in Part II of Schedule IV subject to the provisions contained in Part III of that Schedule [Section 44(2)(b)].

If the company acts in contravention of the provisions, the company and every director who is at fault shall be punishable with fine which may extend to Rs. 1,000/-.

If the 'statement in lieu of prospectus' include any untrue statement, any person who authorized the delivery of the statement in lieu of prospectus shall be, punishable with imprisonment up to two years or with fine which may extend to Rs. 5,000/- or with both. He can avoid liability if he proves either that the statement was immaterial or that he had reasonable ground to believe that the statement was immaterial or that he had reasonable ground to believe that the statement was true. The civil and criminal liability for mis-statements or misrepresentations is the same as in the case of a prospectus [Section 70(5)].

MINIMUM SUBSCRIPTION (SECTION 69)

When shares are offered to the public the amount of minimum subscription has to be mentioned in the prospectus. It means the amount which, in the opinion of the directors, is enough to meet the purchase price of any property,

preliminary expenses and working capital. No allotment shall be made until at least so much amount has been subscribed for. If the minimum subscription has not been received within 120 days, of the issue of the prospectus, the money received from the applicants must be repaid without interest. If the money is not paid back within 130 days, the directors become personally liable to pay it with interest, unless they can show that default was not due to any negligence or misconduct or their part.

COMMENCEMENT OF BUSINESS

A private company can commence business immediately on its incorporation. A public company has to, however, comply with certain additional formalities before it can commence its business. This can be grouped under the following three heads.

1. Public Company Issuing a Prospectus

No public company having a share capital and issuing a prospectus inviting the public to subscribe for its shares, shall commence business or borrow unless it has obtained 'certificate of commencement of business' from the Registrar of Companies. The certificate of commencement of business will be issued after the following formalities are complied with -

- a) At least minimum subscription has been raised;
- b) every director of the company has paid to the company, on each of the shares taken by him or agree to be taken by him the amount payable by him on application and allotment of the shares;

- c) Obtain or apply for permission for dealing of the shares or debentures on the recognized stock exchange so that no money is repayable to application for an shares of debentures offered for public subscription by reason of any failure to apply for, or to obtain stock exchange permission;
- d) A duly verified declaration has been filed with the Registrar by one of the director or the secretary or of the secretary in whole time practice that the above provisions have been complied with [Section 149(1)].

2. Public Company Not Issuing a Prospectus

Where a company having a share capital has not issued a prospectus inviting the public subscribe for its shares, it can commence business or exercise any borrowing powers if the following conditions are fulfilled:

- A statement in lieu of prospectus has been filled in the Registrar.
- Every director of the company has paid to the company, on each of the shares taken or contracted to be taken by him for cash, the application and allotment money.
- There has been filed with the Registrar a duly verified declaration by one of the directors or the secretary, a secretary in whole time practice, in the prescribed form, that the above provisions have been complied with.

When the company fulfils the above conditions, the Registrar shall certify that it is entitled to commerce business and that the certificate shall be conclusive evidence that the company is so entitled [Section 149(3)].

Any contract made by a public company after incorporation but before the

date on which it is entitled to commence business shall be provisional only and shall not be binding on the company until the certificates is obtained [Section 149(4)].

Thus where goods are supplied to the company which never become entitled to commence business not one can sue the company for the price of goods supplied to it.

3. Failure to Commence business

It may also be noted that the court has the power to wind up a company, if it does not commence its business within a year of its incorporation [Section 433(3)].

SUMMARY

A prospectus means any invitation issued to the public inviting it to deposit money with the company or to take share or debentures of the company such invitation may be in the form of a document or a notice, circular, advertisement etc. Section 55 states that every prospectus must be dated, and that date is deemed to be the date of publications of the prospectus, prospectus should neither contain any mis-statement i.e. untrue or misleading nor omit to disclose any material fact. If there is any mis-statement or omission of material facts, then the directors, promoters, the persons responsible for the issue of prospectus, and the company incur a liability for the same. The company can also allot shares or

debentures without issuing the prospectus. However, in such a case, a statement known as 'Statement in lieu of Prospectus' is required to be prepared and filed with the Registrar of Companies.

KEYWORDS

Prospectus: A document inviting offers from the public for the subscription of shares in or debentures of a company is known as a prospectus.

Minimum Subscription: Minimum subscription is the amount which, in the opinion of the board of directors, must be raised by the issue of share capital.

Statement in lieu of Prospectus: If a public company makes a private arrangement for raising capital then it must file a statement in lieu of prospectus with the Registrar three days before any allotment of shares or debentures can be made.

Civil Liability: It means the liability to pay damages or compensation.

Criminal Liability: Criminal liability means the liability which involves punishment of imprisonment or fine or both.

SELF ASSESSMENT QUESTIONS

1. What is a prospectus? Explain the requirements regarding issue of prospectus.
2. Is it compulsory for a company to issue prospectus?
3. Explain the civil and criminal liabilities for misstatement in the prospectus of a company.