The Motto of Our University
(SEWA)
SKILL ENHANCEMENT
EMPLOYABILITY
WISDOM
ACCESSIBILITY

SELF-INSTRUCTIONAL STUDY MATERIAL FOR JGND PSOU

JAGAT GURU NANAK DEV
PUNJAB STATE OPEN UNIVERSITY, PATIALA

(Established by Act No. 19 of 2019 of the Legislature of State of Punjab)

B.COM (HONS.)

SEMESTER-III

Head Quarter: C/28, The Lower Mall, Patiala-147001
Website: www.psou.ac.in

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B.COM (HONS.)
(Accounting and Taxation)

SEMESTER-III

BCB32301T

COMPANY LAW

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PREFACE

Jagat Guru Nanak Dev Punjab State Open University, Patiala was established in December 2019 by Act 19 of the Legislature of State of Punjab. It is the first and only Open University of the State, entrusted with the responsibility of making higher education accessible to all, especially to those sections of society who do not have the means, time or opportunity to pursue regular education.

In keeping with the nature of an Open University, this University provides a flexible education system to suit every need. The time given to complete a programme is double the duration of a regular mode programme. Well-designed study material has been prepared in consultation with experts in their respective fields.

The University offers programmes which have been designed to provide relevant, skill-based and employability-enhancing education. The study material provided in this booklet is self-instructional, with self-assessment exercises, and recommendations for further readings. The syllabus has been divided in sections, and provided as units for simplification.

The University has a network of 80 Learner Support Centres/Study Centres, to enable students to make use of reading facilities, and for curriculum-based counselling and practicals. We, at the University, welcome you to be a part of this instituition of knowledge.

Prof. (Dr.) G.S. Batra
(Dean Academic Affairs)

B.Com (Hons.)
(Accounting and Taxation)
CORE COURSE
(CC)SEMESTER III
(BCB32301T): COMPANY LAW

MAX. MARKS: 100
EXTERNAL: 70
INTERNAL: 30
PASS: 40%
Credits: 6

Objective

The objective of the course is to impart basic knowledge of the provisions of the Companies Act 2013. Case studies involving issues in company law are required to be discussed.

Course Outcomes:

CO 1:	To understand the regulatory and more general procedural elements pertaining to various company forms, taking into account the Companies Act of 2013 and its regulations.
CO 2:	Prepare the basic legal documents required for formation of a company.
CO 3:	Analyze the managerial composition of companies and examine the process of company meetings.
CO 4:	To evaluate the dividend distribution structure and gain knowledge of the winding up procedure.

SECTION A

Block I: Introduction: Administration of Company Law
Administration of Company Law including National Company Law Tribunal (NCLT), National Company Law Appellate Tribunal (NCLAT), Special Courts
Block II: Formation of a Company
Formation of Company, Characteristics of a company; lifting of corporate veil; types of companies including one-person company, small company and dormant company; association not for profit; illegal association; formation of company, on-line filing of documents, promoters, their legal position, pre-incorporation contract; on-line registration of a company.
Block III: Documents of a Company
Documents – Memorandum of association, Articles of association, Doctrine of constructive notice and indoor management prospectus-shelf and red herring prospectus, Misstatement in prospectus, GDR; Book building; Issue, allotment and forfeiture of share, Transmission of shares, Buyback and provisions regarding buyback; Issue of bonus shares.
Classification of directors, women directors, independent director, small shareholder's director; Disqualifications, director identity number (DIN); Appointment; Legal positions, powers and duties; removal of directors; Key managerial personnel, managing director and manager.

SECTION B

Block IV: Meetings, Committee of board of directors, Meetings of shareholders and board: Types of meeting, convening and conduct of meetings, postal ballot, meeting through video conferencing, e-voting; Committees of Board of Directors - Audit Committee, Nomination and Remuneration Committee, Stakeholders Relationship Committee, Corporate Social Responsibility Committee.
Block V: Dividends and Audit
Dividends, Accounts, Audit– Provisions relating to payment of Dividend, Provisions relating to Books of Account. Audit: Provisions relating to Audit, Auditors' Appointment, Rotation of Auditors, Auditors' Report, Secretarial Audit.

Block VI: Winding Up, Insider-Trading and Insider-Trading
Winding Up - Concept and modes of Winding Up.
Insider-Trading: meaning and legal provisions.
Whistleblowing: Concept and Mechanism.

Suggested Readings:

1. Kuchhal, M.C. (2018), *Modern Indian Company Law*, Shri Mahaveer Book Depot (Publishers), Delhi.
2. Kapoor G.K. and Dhamija,S. (2023), *Company Law*, Bharat Law House, Delhi.
3. Kumar, A. (2022), *Corporate Laws,* Taxmann's Corporate Laws**,** Delhi
4. Chadha, Reena and Chadha, Sumant (2021), *Corporate Laws*, Scholar Tech Press, Delhi.
5. Singh, Avtar (2018*), Introduction to Company Law,* Eastern Book Company

INSTRUCTIONS FOR THE CANDIDATES:
Candidates are required to attempt any two questions each from the sections A and B of the question paper and any ten short questions from Section C. They have to attempt questions only at one place and only once. Second or subsequent attempts, unless the earlier ones have been crossed out, shall not be evaluated.

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B.COM (HONS.)
(Accounting and Taxation)
SEMESTER III
BCB32301T: COMPANY LAW

COURSE EDITOR: DR. ROHIT KUMAR
COURSE COORDINATOR: DR. SULAKSHNA

SECTION A

UNIT NO.	UNIT NAME
UNIT 1	COMPANY: MEANING AND TYPES
UNIT 2	FORMATION OF A COMPANY
UNIT 3	DOCUMENTS OF A COMPANY
UNIT 4	PROSPECTUS
UNIT 5	COMPANY MANAGEMENT
UNIT 6	POWERS AND DUTIES OF DIRECTORS AND KEY MANAGERIAL PERSONNEL

SECTION B

UNIT NO.	UNIT NAME
UNIT 7	MEETINGS
UNIT 8	COMMITTEE OF BOARD OF DIRECTORS-AUDIT COMMITTEE, NOMINATION AND REMUNERATION COMMITTEE, STAKEHOLDER RELATIONSHIP COMMITTEE, CORPORATE SOCIAL RESPONSIBILITY COMMITTEE
UNIT 9	DIVIDEND, ACCOUNTS, AUDIT-PROVISION RELATING TO PAYMENT OF DIVIDEND, PROVISION RELATED TO BOOKS OFACCOUNT
UNIT 10	AUDIT, AUDITORS AND AUDITOR'S REPORT
UNIT 11	WINDING UP: CONCEPT AND MODES OF WINDING UP
UNIT 12	INSIDER TRADING: MEANING AND LEGAL PROVISIONS, WHISTLE BLOWING: CONCEPT AND MECHANISM

B. COM (HONS.)
(Accounting and Taxation)

SEMESTER III
COURSE: COMPANY LAW

UNIT-1 COMPANY: MEANING AND TYPES

STRUCTURE:

1.0 Objectives

1.1 Introduction

1.2 Administration of Company Law

1.2.1 Need for NCLT & NCLAT

1.2.2 Special Courts under Companies Act, 2013

1.3 Meaning and Definition of Company Companies Act, 201

1.4 Nature and Characteristics of company

1.5 Doctrine of Lifting of Corporate Veil

1.5.1 Statutory Recognition of Lifting of Corporate Veil

1.5.2 Lifting of Corporate Veil under Judicial Interpretation

1.5.3 Lifting the Corporate Veil of Small Scale Industry

1.6 Types of Companies

1.7 Summary

1.8 Exercise Questions

1.0 OBJECTIVES

- To define Company as per Companies Act, 2013.
- To explain the features of Company as per Companies Act, 2013.
- To discuss the administration of company law with respect to NCLT, NCLAT and special

courts.

- To elaborate the concept of Lifting of the Corporate Veil.
- To highlight the various types of companies.

1.1 INTRODUCTION:

The Companies Act 2013 introduced new concepts supporting enhanced disclosure, accountability, better board governance, better facilitation of business and so on. It includes associate company, one person company, small company, dormant company, independent director, women director, resident director, special court, secretarial standards, secretarial audit, class action, registered valuers, rotation of auditors, vigil mechanism, corporate social responsibility, E-voting.

A company under law is a corporate body and a legal person having status and personality distinct and separate from the members constituting it. It is called a body corporate because the persons composing it are clothing it with legal personality and made into one body by incorporating it according to the law. The word 'corporation' is derived from the Latin term 'corpus' which means 'body'. Accordingly, 'corporation' is a legal person created by aprocess other than natural birth. As a legal person, a corporate is capable of enjoying many rights and incurring many liabilities of a natural person. In the legal sense, a company is an association of both natural and artificial persons and is incorporated under the existing law ofa country.

1.2 ADMINISTRATION OF COMPANY LAW (INCLUDING NCLT, NCLAT, SPECIAL COURTS)

The National Company Law Tribunal (NCLT) & The National Company Law Appellate Tribunal (NCLAT) are quasi-judicial bodies in India that adjudicate issues relating to Indian Companies established on 1st June, 2016 under the Companies Act, 2013. The constitution of theaforesaid Tribunals is in exercise of the powers conferred by Sections 408 and 410 respectivelyof the new Companies Act, 2013.

Companies (Second Amendment) Act, 2002 provides for the setting up of a National Company Law Tribunal and Appellate Tribunal to replace the existing Company Law Board (CLB) and Board for Industrial and Financial Reconstruction (BIFR).The setting up of NCLT as a specialized institution for corporate justice is based on the recommendations of the Justice Eradi Committee which has been set up to examine the existing law relating to winding up proceedingsof companies in order to re-model it in line with the latest developments and innovations in the corporate law and governance and also to suggest reforms in the procedure at various stages followed in the insolvency proceedings of companies to avoid unnecessary delays in tune withthe international practice in this field.

The Ministry of Company Affairs (MCA) on 1st June, 2016 notified the Constitution of National Company Law Tribunal (NCLT) & The National Company Law Appellate Tribunal (NCLAT) for the efforts to move to a regime of faster resolution of corporate disputes, thus improving the ease of doing business in India.

1.2.1 Need For Nclt & Nclat

The constitution of NCLT & NCLAT was a step towards improving and easing all the judicial matters relating to the Company law under one roof. Some of the most important reasons for NCLT & NCLAT's birth are as follows:

Simple Window: The most important benefit that the tribunals will act as a single window for settlement of all Company law related disputes effectively. It shall avoid unnecessary multiplicity of proceedings before various authorities or courts.

Speedy Process: The NCLT and the NCLAT are under a mandate to dispose of cases before them as expeditiously as possible. In this context, a time limit of three (3) months has been provided to dispose of cases, with an extension of ninety (90) days for sufficient reasons to be recorded by the President or the Chairperson, as the case maybe. The speedy disposal of cases will save time, energy and money of the parties.

Reduction of Work of High Court: The number of pending cases with High Court is too high and now the matters in respect to compromise, arrangement, amalgamations and winding-up transferred to NCLT. Accordingly, NCLT and the NCLAT will reduce the work of overburdened High Courts.

COMPOSITION OF APPELLATE TRIBUNAL

The president and member of the appellate tribunal shall possess following qualifications:

1. The chairperson shall be a person who is or has been;

a) Judge of the Supreme Court; or

b) The Chief Justice of a High Court.

2. A Judicial Member shall be a person who is or has been;

a) Judge of a High Court; or

b) Judicial Member of the Tribunal for five years

3. A Technical Member shall be a person of proven ability, integrity and standing having special knowledge and experience, of not less than twenty-five years, in law, industrial finance, industrial management or administration, industrial reconstruction, investment, accountancy,

labour matters, or such other disciplines related to management, conduct of affairs, revival, rehabilitation and winding up of companies.

1.2.2 Special Courts Under Companies Act, 2013

The main objective for the setting up of Special Courts is to divide the disposal mechanism i.e. the grave offences would be tried by the Special Courts, whereas the minor contraventions and violations would be tried by magistrate courts. The Ministry of Corporate Affairs vide notification dated 18th May, 2016 has notified certain provisions under the Companies Act, 2013 for the setting up of Special Courts to specifically deal with and dispose of criminal offences under the CA, 2013 which are punishable with imprisonment of a period of 2 years or more in anexpeditious manner.

1.3 MEANING AND DEFINITION OF A COMPANY

The word 'company' is derived from the Latin word 'Com=with or together and panis =bread', and it originally referred to an association of persons who took their meals together. Nowadays, the company form of organization has assumed great importance. In the leisurely past, merchants took advantage of festive gatherings, to discuss business matters but now in popular parlance, a company or firm denotes an association of likeminded persons formed for the purpose ofcarrying on some business or undertaking.

Lord Justice Lindley has defined a company as "an association of many persons who contribute money or money's worth to a common stock and employ it in some trade or business and who share the profit and loss arising therefrom. The common stock so contributed is denoted in money and is the capital of the company. The persons who contributed in it or form it, or to whom it belongs, are members. The proportion of capital stock to which each member has contributed entitled is his "share". The shares are always transferable although the right to transfer them may be restricted."

1.4 NATURE AND CHARACTERISTICS OF A COMPANY

Since a corporate body (i.e. a company) is the creation of law, it is not a human being, it is an artificial juridical person (i.e. created by law) and it is clothed with many rights, obligations, powers and duties prescribed by law.

The most striking characteristics of a company are discussed below:

(i) Corporate personality

A company incorporated under the Act is vested with a corporate personality so it bears its own name, acts under name, may has a seal of its own and its assets are separate and distinct from those of its members who compose it. It is also capable of owning property, incurring debts, borrowing money, having a bank account, employing people, entering into contracts and suing or

being sued in the same manner as an individual. Its shareholders are its notional owners as they are not the agents of the company and so they cannot bind it by their acts. They do not own anything in the company except ownership of shares issued and they can be its creditors simultaneously. The company does not hold its property as an agent or trustee for its members and they cannot sue to enforce its rights, nor can they be sued in respect of its liabilities. A shareholder cannot be held liable for the acts of the company even if he holds virtually the entire share capital.

(ii) Company as an artificial person

A Company is an artificial person created by law. It is not a human being but it acts through human beings. It is considered as a legal person who can enter into contracts, possess properties in its own name, sue and can be sued by others etc. It is called an artificial person since it is invisible, intangible, existing only in the contemplation of law. It is capable of enjoying rights and being subject to duties. In common law, a company is a "legal person" or "legal entity" separate from, and capable of surviving beyond the lives of its members. A company is rather a legal device for the attainment of social and economic end. It is, therefore, a combined political, social, economic and legal institution. Thus, the term company has been described in many ways."It is a means of cooperation and organisation in the conduct of an enterprise". It is "an intricate, centralised, economic and administrative structure run by professional managers who hire capitalfrom the investor(s)".

(iii) Company is not a citizen

The company, though a legal person, is not a citizen under the Citizenship Act, 1955 or the Constitution of India. In *State Trading Corporation of India Ltd.* v. *C.T.O.*, A.I.R. 1963 S.C. 1811, the Supreme Court held that the State Trading Corporation though a legal person, was nota citizen and can act only through natural persons. Nevertheless, it is to be noted that certain fundamental rights enshrined in the Constitution for protection of "person", e.g., right to equality(Article 14) etc. are also available to company. Section 2(f) of Citizenship Act, 1955 expressly excludes a company or association or body of individuals from citizenship.

(iv) Company has Nationality and Residence

Though it is established through judicial decisions that a company cannot be a citizen, yet it has nationality, domicile and residence. In *Gasque* v. *Inland Revenue Commissioners*, (1940) 2 K.B. 88, Macnaghten. J. held that a limited company is capable of having a domicile and its domicile is the place of its registration and that domicile clings to it throughout its existence. He observed in this case:

"It was suggested that a body corporate has no domicile. It is quite true that a body corporate cannot have a domicile in the same sense as an individual. But by analogy with a natural person the attributes of residence, domicile and nationality can be given to a body corporate."

(v) Limited Liability

"The privilege of limited liability for business debts is one of the principal advantages of doing business under the corporate form of organisation." The company, being a separate person, is the owner of its assets and bound by its liabilities. The liability of a member as shareholder, extends to the contribution to the capital of the company up to the nominal value of the shares held and not paid by him. Members, even as a whole, are neither the owners of the company's undertakings, nor liable for its debts. This means that the liability of a member is limited. For example, if A holds shares of the total nominal value of 1,000 and has already paid Rs.500/- (or 50% of the value) as part payment at the time of allotment, he cannot be called upon to pay more than Rs. 500/-, the amount remaining unpaid on his shares. If he holds fully-paid shares, he has no further liability to pay even if the company is declared insolvent. In the case of a company limited by guarantee, the liability of members is limited to a specified amount of the guarantee mentioned in the memorandum.

(vi) Perpetual Succession

An incorporated company never dies, except when it is wound up as per law. A company, being a separate legal person is unaffected by death or departure of any member and it remains the same entity, despite total change in the membership as the membership of a company may keep changing from time to time, but that shall not affect its continuity.

The membership of an incorporated company can be changed due to selling/transferring of shares of one shareholder to another or on his death or when a shareholder ceases to be a memberunder some other provisions of the Companies Act. Thus, perpetual succession denotes the ability of a company to maintain its existence by the succession of new individuals who step into the shoes of those who cease to be members of the company. Professor L.C.B. Gower rightly mentions, "Members may come and go, but the company can go on forever.

(vii) Separate Property

A company being a legal person and entirely distinct from its members, is capable of owning, enjoying and disposing of property in its own name. The company is the real person in which all its property is vested, and by which it is controlled, managed and disposed off. Their Lordships of the Madras High Court in *R.F. Perumal* v. *H. John Deavin,* A.I.R. 1960 Mad. 43 held that "no member can claim himself to be the owner of the company's property during its existence or in its winding-up". A member does not even have an insurable interest in the property of the company.

(viii) Transferability of Shares

The capital of a company is divided into parts, called shares. The shares are said to be movable property and, subject to certain conditions, freely transferable, so that no shareholder is

permanently or necessarily wedded to a company. When the joint stock companies were established, the object was that their shares should be capable of being easily transferred. Section 44 of the Companies Act, 2013 enunciates the principle by providing that the shares held by the members are movable property and can be transferred from one person to another in the manner provided by the articles.

A member may sell his shares in the open market and realise the money invested by him. This provides liquidity to a member and ensures stability to the company. The Stock Exchanges provide adequate facilities for the sale and purchase of shares. Further, as of now, in most of the listed companies, the shares are also transferable through Electronic mode i.e. through Depository Participants in dematerialised form instead of physical transfers.

(ix) Capacity to Sue and Be Sued

A company being a body corporate, can sue and be sued in its own name. To sue, means to institute legal proceedings against (a person) or to bring a suit in a court of law. All legal proceedings against the company are to be instituted in its name. Similarly, the company may bring an action against anyone in its own name. A company's right to sue arises when some loss is caused to the company, i.e. to the property or the personality of the company. Hence, the company is entitled to sue for damages in libel or slander as the case may be. A company, as a person distinct from its members, may even sue one of its own members.

A company has a right to seek damages where a defamatory material published about it, affects its business. Where video cassettes were prepared by the workmen of a company showing, their struggle against the company's management, it was held to be not actionable unless shown that the contents of the cassette would be defamatory. The court did not restrain the exhibition of the cassette.

(x) Contractual Rights

A company, being a legal entity different from its members, can enter into contracts for the conduct of the business in its own name. A shareholder cannot enforce a contract made by his company; he is neither a party to the contract, nor be entitled to the benefit derived from of it, asa company is not a trustee for its shareholders. Likewise, a shareholder cannot be sued on contracts made by his company. The distinction between a company and its members is not confined to the rules of privity but permeates the whole law of contract.

Similarly, a member of a company cannot sue in respect of torts committed against the company, nor can he be sued for torts committed by the company. Therefore, the company as a legal person can take action to enforce its legal rights or be sued for breach of its legal duties. Its rightsand duties are distinct from those of its constituent members.

(xi) Limitation of Action

A company cannot go beyond the power stated in its Memorandum of Association. The Memorandum of Association of the company regulates the powers and fixes the objects of the company and provides the edifice upon which the entire structure of the company rests. The actions and objects of the company are limited within the scope of its Memorandum of Association. In order to enable it to carry out its actions without such restrictions and limitations in most cases, sufficient powers are granted in the Memorandum of Association. But once the powers have been laid down, it cannot go beyond such powers unless the Memorandum of Association, itself altered prior to doing so.

(xii) Separate Management

As already noted, the members may derive profits without being burdened with the management of the company. They do not have effective and intimate control over its working and they elect their representatives as Directors on the Board of Directors of the company to conduct corporate functions through managerial personnel employed by them. In other words, the company is administered and managed by its managerial personnel.

(xiii) Voluntary Association for Profit

A company is a voluntary association for profit. It is formed for the accomplishment of some stated goals and whatsoever profit is gained is divided among its shareholders or saved for the future expansion of the company. Only a Section 8 company can be formed with no profit motive.

(xiv) Termination of Existence

A company, being an artificial juridical person, does not die a natural death. It is created by law, carries on its affairs according to law throughout its life and ultimately is effaced by law. Generally, the existence of a company is terminated by means of winding up. However, to avoid winding up, sometimes companies adopt strategies like reorganisation, reconstruction and amalgamation.

To sum up, "a company is a voluntary association for profit with capital divisible into transferable shares with limited liability, having a distinct corporate entity and a common seal with perpetual succession".

1.5 DOCTRINE OF LIFTING OF OR PIERCING THE CORPORATE VEIL

The separate personality of a company is a statutory privilege and it must be used for legitimate business purposes only. Where a fraudulent and dishonest use is made of the legal entity, the individuals concerned will not be allowed to take shelter behind the corporate personality. The Court will break through the corporate shell and apply the principle/doctrine of what is called as "lifting of or piercing the corporate veil". The Court will look behind the corporate entity and

take action as though no entity separate from the members existed and make the members or the controlling persons liable for debts and obligations of the company.

The corporate veil is lifted when in defence proceedings, such as for the evasion of tax, an entity relies on its corporate personality as a shield to cover its wrong doings. *[BSN (UK) Ltd. v. Janardan Mohandas Rajan Pillai [1996] 86 Com Cases 371 (Bom).*]

However, the shareholders cannot ask for the lifting of the veil for their purposes. This was held in *Premlata Bhatia v. Union of India (2004) 58 CL 217 (Delhi)* wherein the premises of a shop were allotted on a licence to the individual licensee. She set up a wholly owned private company and transferred the premises to that company without Government consent. She could notremove the illegality by saying that she and her company were virtually the same person.

1.5.1 Statutory Recognition of Lifting of Corporate Veil

The Companies Act, 2013 itself contains some provisions [Sections 7(7), 251(1) and 339] which lift the corporate veil to reach the real forces of action. Section 7(7) deals with punishment for incorporation of company by furnishing false information; Section 251(1) deals with liability for making fraudulent application for removal of name of company from the register of companies and Section 339 deals with liability for fraudulent conduct of business during the course of winding up.

1.5.2 Lifting of Corporate Veil under Judicial Interpretation

Ever since the decision in *Salomon* v. *Salomon & Co. Ltd.*, (1897) A.C. 22, normally Courts are reluctant or at least very cautious to lift the veil of corporate personality to see the real persons behind it. Nevertheless, Courts have found it necessary to disregard the separate personality of a company in such situations where the corporate veil has been used for commission of fraud or improper conduct. In such a situation, Courts have lifted the veil and looked at the realities of the situation.

1.5.3 Lifting the Corporate Veil of Small Scale Industry

Where small scale industries were given certain exemptions and the company owning an industry was controlled by some group of persons or companies, it was held that it was permissible to lift the veil of the company to see whether it was the subsidiary of another company and, therefore, not entitled to the proposed exemptions. [*Inalsa Ltd. v. Union of India, (1996) 87 Com Cases 599 (Delhi).]*

1.6 <u>TYPES OF COMPANIES:</u>

A. Types of Company on the basis of Incorporation

1. Statutory Companies:

These companies are constituted by a special Act of Parliament or State Legislature and are formed mainly with an intention to provide the public services. Though primarily companies are governed under that Special Act, still the CA, 2013 will be applicable except where the said provisions are inconsistent with the provisions of the Act creating them (as Special Act prevails over General Act). Examples of these types of companies are Reserve Bank of India, Life Insurance Corporation of India, etc.

2. Registered Companies:

Companies registered under the CA, 2013 or under any previous Company Law are called registered companies. Such companies come into existence when they are registered under the Companies Act and a certificate of incorporation is granted to it by the Registrar.

B. Types of Company on the basis of Liability

1. Companies limited by shares:

Companies may be either public or private limited by shares are by far the most common and which has the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them is termed as a company limited by shares. Where the shares are fully paid up, no further liability rests on them. For example, a shareholder who has paid 75 on a share of face value 100 can be called upon to pay the balance of 25 only. Such liability can be enforced during existence of the company as well as during the winding up.

2. Companies limited by guarantee:

In case of such companies the liability of its members is limited to the amount of guarantee undertaken by them and where the members have undertaken, by the memorandum, to contribute to the assets of the company in the event of its being wound-up. The members of such company are also placed in the position of guarantors of the company's debts up to the agreed amount. Clubs, trade associations, research associations and societies for promoting various objects are various examples of guarantee companies.

3. Unlimited Liability Companies:

Companies either a public company or a private company may or may not have share capital. Where the companies not having a limit on the liability of its members is termed as unlimited company. The members are liable for the company's debts in proportion to their respective interests in the company and their liability is unlimited.

C. Types of Company on the basis of number of members

1. Public Company:

A public company u/s 2(71) of the CA, 2013 means a company which is not a private company. Public company may be formed for any lawful purpose by 7 or more persons under Section 3(1) of the CA, 2013. Section 149(1) signifies that every public company shall have minimum 3 director in its Board. It is required under Section 4(1)(a) of the CA, 2013 to add the words "Limited" at the end of its name. Only the shares of a public company are capable of being dealt in on a stock exchange and also unlike private company its shares and debentures canbe transferable freely to the public.

2. Private company: A private company that is a subsidiary of a public company, will be considered a public company defined u/s 2(68) of the CA, 2013 where 2 or more persons hold 1 or more shares in a company jointly they shall be treated as a single member. A private company means a company which by its articles-

a. Restricts the right to transfer its shares;

b. Limits the number of its members to 200 hundred (except in case of OPC)

Private Company under section 3(1) of the CA, 2013 may be formed for any lawful purpose by 2 or more persons and having minimum 2 director in its Board as per section 149(1). Section 4(1)(a) describes that a private company is required to add the words "Private Ltd" at the end of its name. Private Companies prohibit any invitation to the public to subscribe for any securitiesof the company and also enjoy several privileges and exemptions under the Companies Act. Persons who are in the employment of the company; and 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, shall be excluded.

3. One Person Company (OPC):

With the enactment of the Companies Act, 2013 several new concepts was introduced that was not in existence in Companies Act, 1956 which completely revolutionized corporate laws in India. One of such was the introduction of OPC concept. One Person Company u/s 2(62) meansa company which has only one person as a member which may be formed for any lawful purpose by 1 person as per section 3(1) of the CA, 2013. The sole member under section 149(1) can also be director of such OPC. This led to the avenue for starting businesses giving flexibility which a company form of entity can offer, while also offering limited liability that sole proprietorship or partnerships does not offers.

Unlike other private companies OPCs can have only 1 member or shareholder which also enjoy several privileges and exemptions under the Companies Act. The unique feature of OPCs that it separates from other kinds of companies is that the sole member of the company has to mention a nominee while registering the company. Since there is only one member in an OPC, his death will result in the nominee choosing or rejecting to become its sole member.

D. Types of Company on the basis of Domicile

1. Foreign company:

"Foreign company" u/s 2(42) of the CA, 2013 under the provisions of section 379 to section 393 means any company or body corporate incorporated outside India which, has a place of business in India whether by itself or through an agent, physically or through electronic mode; and conducts any business activity in India in any other manner.

2. Indian Company:

A company formed and registered in India is known as an Indian Company.

Other Types of Company:

1. Section 8 Company:

A section 8 company is registered as a limited company under section 8 of the CA, 2013 and holds the licence from Central Government (CG) and

1. has in its objects the promotion of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment or any such other object;

2. intends to apply its profits, if any, or other income in promoting its objects; and

3. intends to prohibit the payment of any dividend to its members.

Section 8 Company is exempted from clause (a) of Section 4(1) which means Section 8 Company is neither required to add the word "Ltd" nor words "Private Ltd" at the end of its name. Section 8 of the CA, 2013 also laid down the provision related to Incorporation, application for licence as section 8 company, grant of licence by CG and revocation of licence byCG.

2. Government Company:

"Government company" means any company in which not less than 51 % of the paid-up share capital is held by the Central Government, or by any State Government or Governments, or partly by the Central Government and partly by one or more State Governments, and includes a company which is a subsidiary company of such a Government company.

3. Small Company:

"Small company" means a company, other than a public company, where:

1. paid-up share capital of which does not exceed 50 lakh rupees or such higher amount as may be prescribed which shall not be more than 10 crore rupees; and

2. turnover of which as per profit and loss account for the immediately preceding financial year does not exceed 2 crore rupees or such higher amount as may be prescribed which shall not be more than 100 crore rupees

Small Company enjoys several privileges and exemptions under the Companies Act and provided that nothing in this clause shall apply to a holding company or a subsidiary company; a company registered under section 8; or a company or body corporate governed by any special Act;

4. Subsidiary Company:

"Subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—

1. controls the composition of the Board of Directors; or

2. exercises or controls more than one-half of the total voting power either at its own or together with one or more of its subsidiary companies:

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

5. Holding Company:

"Holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies or for the purposes of this clause follow the expression "company" includes any body corporate.

6. Associate Company:

"Associate company", in relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.

Explanation: For the purpose of this clause:

1. The expression "significant influence" means control of at least 20% of total voting power, or control of or participation in business decisions under an agreement;

2. The expression "joint venture" means a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement;

7. Producer Company:

A producer company can be defined as a legally recognized body of farmers/ agriculturists with the aim to improve the standard of their living, and ensure a good status of their available support, incomes and profitability.

Some Conditions for Producer Company :

Only persons engaged in an activity connected with, or related to, primary produce can participate in the ownership.

The members have necessarily to be primary producers.

Name of the company shall end with the words "Producer Company Limited".

8. Dormant Company:

A company which has not filed financial statements or annual returns for two financial years consecutively, the Registrar shall issue a notice to that company and enter the name of such company in the register maintained for dormant companies. The company is formed and registered under this Act has no significant accounting transaction for a future project or to hold an asset or intellectual property, and also such a company or an inactive company may make an application to the Registrar for obtaining the status of a dormant company.

"Inactive company" means a company has not made any significant accounting transaction during the last two financial years, or has not filed financial statements and annual returns duringthe last two financial years or which has not been carrying on any business or operation.Thereafter Registrar on consideration of the application shall allow the status of a dormant company to the applicant and issue a certificate. "Inactive company" means a company has not made any significant accounting transaction during the last two financial years, or has not filed financial statements and annual returns during the last two financial years or which has not been carrying on any business or operation.

1.7 SUMMARY:

A Company exists only in the eyes of law as it has no physical existence. It is a voluntary association of persons who come together for carrying some business and sharing profit thereon. It comes into existence only when it is registered under the act and accordingly it becomes a body corporate as it acquires a legal personality of its own, separate and distinct from its members. The company has become the most dominant form of organisation even for a small business the choice of company form has been proved to be beneficial in every manner. Since there is divorce between ownership and management in a company, thus a company is managed by elected representatives called directors who are capable to manage company efficiently.

1.8 <u>EXERCISE QUESTIONS:</u>

I. Define the term company. What are its characteristics?
II. What is Corporate veil? When can be lifted?
III. Describe the various kinds of Companies which can be registered under Companies Act, 2013.
IV. Distinguish between a private and a public company.

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B. COM (HONS.)
(Accounting and Taxation)

SEMESTER III
COURSE: COMPANY LAW

UNIT-2 – Formation of a Company

STRUCTURE:

2.0 Objectives

2.1 Introduction

2.2 Promotion

- **2.2.1 Promoter**
- **2.2.2 Remuneration of a promoter**
- **2.2.3 Functions of a Promoter**
- **2.2.4 Duties of the Promoter**
- **2.2.5 Liabilities of the Promoter**

2.3 Legal position of a promoter

2.4 Pre-incorporation Contracts

2.5 On-line Registration of company

- **2.5.1 Process Registration of Company**

2.6 Certificate of Incorporation

- **2.6.1 Effect of the Certificate of Incorporation**

2.7 Certificate of Commencement of business

2.8 Summary

2.9 Exercise Questions

2.0 OBJECTIVES:

- To explain the various stages of formation and incorporation of company.
- To define promotion and explain the functions and remuneration of promoters.
- To elaborate the legal position and duties and liabilities of a promoter.
- To discuss the concept of pre-incorporation contract.
- To highlight the on-line process of filling documents and registration of company.

2.1 INTRODUCTION

Modern day business requires large amount of money. Also, due to increasing competition and fast changing technological environment, the element of risk is increasing. As a result, the company form of organisation is being preferred by more and more business firms, particularly for setting up medium and large sized organisations. The formation and incorporation of a company are very much similar to the birth of a human as formation of the companies also go through various stages so as to bring a company into existence. The process of an idea converting into a company includes crucial stages of the pre-incorporation and formation stages are discussed in detail as under. This explains the functions, duties and liabilities of a promoter along with providing insights into cases regarding pre-incorporation contract. This chapter also dwells into the integrated process of Company registration.

2.2 PROMOTION

As the name suggests the stage of incorporation deals with the promotions of the yet to be incorporated Company. It is the stage where the Promoter walks in the market of the potential investors to collect the investment towards an idea and also brings together labour, raw materials, managerial ability, machinery etc.

The Promoter induces the poise on the idea, over the investors and tries to build upon the investment so as to be able to incorporate the company. A Promoter is regarded as Parents whereas a company as a child. The Promoter not only passionate towards the company's ideas, but also do the SWOT analysis of the idea with respect to the future prospects and feasibilitywith respect to market expectations.

When promotion begins and ends

There exists fiduciary relationship between promoter and the company from the day the work of floating the company starts and continues up to the time that directors take into their hands what remains to be done in the way of forming the company. When Board of directors are appointed and they start to govern the company then status of promoter generally gets terminated. The first person who control or influence company's affairs, conceive the idea of forming a company, take required steps to incorporate the company are its promoters. They also provide share and loan capital and acquire the business property. They hand over control of the company to its directors after the procedure is complete. A promoter may remain subject to fiduciary and other duties to the company if he becomes a director or agent of it and duties are then owed only in that other capacity.

2.2.1 Promoter:

Section 2(69) of the Companies Act, 2013 defines the term promoter as a person –

i. Who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or
ii. Who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or
iii. In accordance with whose advice, directions or instructions the Board of Directors of the company is accustomed to act.

The aforesaid description of promoter serves a good purpose of fixation of liabilities for wrong doing and not bring out the nature of activities that a promoter is usually associated with. A company may have more than one promoter and a person cannot be held as promoter merely because he is a signatory to the memorandum or that he has provided money for the payment of formation expenses or has worked in professional capacity. For example, in preparation of the documents to be filed for registration of the company or even securing certificate of incorporation of the company. Even if a person has taken a very minor part in the promotion activities, he is treated as a promoter.

2.2.2 Remuneration of a promoter

The promoters are to be paid or agreed to be paid for rendering their services after registration by the company and they can be remunerated in any of the following ways:

- In case of overvaluation and after making full disclosure to an Independent Board of directors or to the intended shareholders the promoter may sell own property to the company for cash or against fully paid shares in the company.
- He may also take commission on shares sold.
- He may be paid a lump sum by a company and such benefit must be disclosed in the prospectus.

2.2.3 Functions of a Promoter

(i) Spotting a Business Demand in the Market

The promoter first identifies idea of a potential business opportunity before promoting a company which may be any new product or a new service or may even be the production or manufacture of an already established product by new means.

(ii) The practicality of the Idea

The promoter evaluates the idea of the new potential company in relation to technical and financial feasibility where he undertakes detailed studies regarding all aspects of the businessidea by using various tools such as the economic analysis of the market, taking opinions of the technical experts of such products, opinions of the chartered accountants, economists etc. The feasibility of the idea can be evaluated using the below mentioned three tests.

- **Technical conceivability:** the ideas of the business may be good but sometimes they may be technically difficult to mature into reality due to some hurdles related to the acquisition of raw material or constraint of manufacturing the product with limited funds.
- **Budgetary feasibility:** Sometimes it is not easy to arrange a large amount of funds and the financial institutions may also be hesitant to give huge loans that are required to start a new venture.
- **Monetary feasibility:** A business idea may be technically and financially feasible but not monetarily appreciable. It may not be gainful and may not give enough returns. In such a case, the promoters refrain from promoting the idea of business.

(iii) Name of the Company

The Promoter after fixing the launch of the idea aims to get a name to the Company. Promoter applies to the registrar of companies of that jurisdiction wherever the promoter intends to make the registered head office of the Company. Application to registrar contains three names "X or Y or Z" in the sequence of priority and Promoter adheres to Section 8 of the Companies (Incorporation) Rules, 2014.

(iv) Finalizing Signatories to MOA

The promoters decide who all will be the members signing the Memorandum of Association of the Company which is to be formed. Generally, the signatories of the MOA are the first Directorsof the Company. The written consent of the signatories of the memorandum is essential to become Directors of the company.

(v) Hiring Professionals

Promoters are required to appoint certain professionals such as mercantile bankers, auditors, lawyers, etc. These professionals aid the promoter in the preparation of necessary documents that are to be filed with the Registrar of Companies during the registration of the Company.

(vi) Preparation of Necessary Documents

The promoters are the ones who are responsible to submit the required documents to the Registrar of the Companies for getting the company registered. These documents are a return of allotment, Memorandum of Association, Articles of Association, consent of Directors and statutory declaration.

2.2.4 Duties of the Promoter

The relation of promoter with the company cannot be described as a principal-agent relation as during pre-incorporation stage, the company has not even come into existence. Various judicial interpretations towards understanding the nature of relation between the promoter and the company has taken place in the common law Courts as well as Indian Courts and it has been decided that the relation between the promoter and the company is fiduciary in nature. Various duties to be performed by the Promoter are:

1. Duty to disclose secret profit

As mentioned earlier the promoters stand in a fiduciary relationship with the company which will be incorporated. The duty of a promoter is to disclose the secret profit made by him if any to the company. The Promoter has a right to claim expenses if any made during the incorporation stage from the company.

2. Duty to keep the company informed about the transactions

A promoter may intend to sell, lease or rent any property of the company. But if such a transaction is made without informing the company, the company may repudiate such contract of sale, lease or rent, the company may even claim the profit made by the promoter from the transaction by allowing such a contract made by the promoter.

3. Fiduciary duty towards the future Shareholders

The promoter is bound by a fiduciary relationship with the company, signatories of memorandum of association and also show the future allottees of share of the company. Relation of trust between promoter and future shareholders goes to show that the promoter shall upholdall the values expected of him by the Company.

4. Duty to disclose profits gained during promotion

The promoter during the promotion of the company may certain times be subjected to certain private arrangements leading to his personal profit, given the promoter stands in fiduciary relationship with the company he must disclose the profits gain during promotion as explained about to the company.

5. Duty to pay the company whatever received as trustee

The promoter stands in a fiduciary relationship with the company, and it is the duty of the promoter to make good to the company whatever he has obtained as the Trustee of the company.

2.2.5 Liabilities of the Promoter

A Promoter is subjected to liabilities under the various provisions of the Companies Act, 2013. The liabilities of the promoter are:

1. Liability to justify the transactions to the company

The promoter stands in a fiduciary relationship with the company, therefore the company has all rights to enquire into the transactions made by the promoter without the consent of the company. The company while dealing with such a transaction may either repudiate such an agreement made by the promoter with the third party or may even sue the promoter to recover the money along with profits so made by him behind the back of the company.

2. Liability against the misstatement made in the prospectus

Section 26 of the Companies Act, 2013 lists down the matters that are to be stated in the prospectus. The promoter may be held liable for not having complied with the provision. Section 63 of the Companies Act, 1956 also provided criminal liability for misstatement in prospectus and Promoter maybe made liable under this section. Section 63 prescribed imprisonment that may be extended to two years and fine that may be extended to 5000 Rs. for making untrue statements in the prospectus.

Under Section 34 and Section 35 of the Companies Act, 2013 promoter maybe held liable for any untrue statement made in the prospectus because of which a person subscribed for shares and debentures believing the prospectus statements to be true. However, the liability of the promoter is capped towards only the original allottees of the shares and not the subsequent ones.

3. Personal liability towards the contracts

All the contracts entered upon by the promoter during pre-incorporation stage of the Company, the promoter may be held personally liable for the aforementioned contracts till it's discharged according to contract terms or when the company takes up the liability from the promoter after it is incorporated.

4. Liability of the promoter during the winding-up process of the company
In the process of winding up, the official liquidator under Section 340 of the Companies Act, 2013 may by application request the court to make the promoter liable for the misfeasance or breach of trust towards the Company. Also under Section 300 of Companies Act, 2013 promoter may be liable to examination, if it is alleged by the liquidator that there is fraud in the promotion or the formation of the company.

2.3 LEGAL POSITION OF A PROMOTER

The legal position of promoter is quite clear as he occupies an important position and have wide powers relating to the formation of company. He is neither an agent nor a trustee because there is no company and trust yet in existence. Also, a promoter is accountable for the money secretly obtained by him due to the relationship of principle or agent or the trustee and cestui que trust had existed between him and the company when the money was obtained.

2.4 PRE-INCORPORATION CONTRACTS

The pre-incorporation contracts are different to that of an ordinary contract and entered upon by the promoter before the company is incorporated and also these are essential for the successful running of the company in the future. These contracts are Bipartite as promoter enters into a contract with the service providers or the interested persons but its effect is tripartite as the consequential effect of these contracts help the prospective company which is still lingering in its non-incorporated stage. The instruments of Contract are essentially used for the *quid-pro- quo* transactions between two parties, but here it is remarkably used for the benefit of the non- party to contract as legally the company is non-existent.
One cannot make someone liable if they are non-existent and hence not a party to the aforesaid pre-incorporation contract. However, the non-liability of the company with respect to the pre-incorporation contracts was the same as the common law court in India until the passing of the Special Relief Act, 1963 under Section 15(h) and Section 19(e) that makes the pre-incorporation contracts and agreement valid deviating from the trajectory followed under the common law.

- Section 15(h) provides details as to who may obtain specific performance, wherein clause h provides that when a promoter gets into a contract before incorporation on behalf of the company and sends a communication of acceptance to the other party of contract.

- Section 19(e) provides that a party claiming relief under specific performance can be claimed when the promoter of the company before incorporation had entered into contract and if such contract was warranted during incorporation. The company must have accepted the contract and communicated such acceptance to the other party of contract.

The aforementioned provisions of the Specific Relief Act, 1963 changes the course of action in a case between parties where contract was made before incorporation, unlike the regular course of action against the promoter here the company can be made liable if it has accepted the contract and has communicated such acceptance to the other party of the contract.

Finally, it can be concluded regarding the pre-incorporation contracts and Principle of Promoter's liability in pre-incorporation that, common law clearly shows that the promoter shall be held personally liable for the pre incorporation contracts of the company and the same was followed in England and India prior to the legislation of the Specific Relief Act, 1963. It basically goes on to suggest that there is no escape from the liability of the promoter. But there are recognised ways in Indian law to shift the liability of the promoter to the company in case of the pre-incorporation contract wherein the first and foremost way is novation of contract which isalso accepted by the common law courts regarding the shift of liability from Promoter to the company, India but uniquely legislated Specific Relief Act, 1963 providing provisions wherein ifthe contract was entered upon by the promoter during the pre-incorporation stage the party to such contract can make the company liable under Specific relief Act if the company ratify such contract and sends communication to such party of the ratification of the contract. But otherwise the promoter is held liable in case of Pre-incorporation contracts.

2.5 ON-LINE REGISTRATION OF THE COMPANY

The Registration of the Company is legal recognition given to the body corporate under the Company Law and the procedure of registration has been clearly stated in Section 7 of the Companies Act, 2013. This provision clearly lays down the requirements for the incorporation of the company. The details of the documents namely:

- Memorandum of association, which is the constitution of the company wherein in case of a public company to a minimum number of 7 signatories have been fixed and for a private company a minimum number of 2 in the document duly stamped;
- Articles of Association, this is the document filed along with the MOA;
- List of directors, wherein the details regarding their names, occupation and address is mentioned;
- Written consent of the directors, the consent of the directors is to be submitted to the registrar of the companies;
- Verification document, wherein such document is to be digitally signed by any recognised chartered accountant, Company secretary, Advocate.

2.5.1 Process Registration of Company

One can register their company online through the website of the Ministry of Corporate Affairs, whereby integration of various legal steps of the incorporation in the same portal. Further, the process of incorporation or registration requires first to apply for the unique name which shall be

reserved for the proposed company against the payment of Rs. 1000.The next step involves filling up the form online named “simplified proforma for incorporation”. The Performa gives a viable option by filling up the details regarding the information of the promoter of the company that helps to incorporate a company online.

Secondly, the electronic Performa in the form number INC-33 and INC-34 provides the option of filling up the e-MOA (Memorandum of association) and e-AOA (Articles of Association) respectively. The MOA usually describes the object of the company and also describes the directors involved during the incorporation of the company. After the memorandum of association, the e-AOA option is provided so as to ease the process of incorporation even also lays down rules and regulations of company affairs. E-AOA describes the powers, duties and rights of managers, officers and board of directors.

The Article of Association must be signed by all the directors and also attested by two witnesses. And it may be made by the company according to its own requirements, or maybe selected from the various options available in the schedule of Companies Act. It is also known as by-laws of the company or also named as the doctrine of indoor management since it deals with various issues such as:

- amount of share capital and kinds of share,
- rights of each kind of shareholders,
- procedure for making allotment of shares,
- procedure for issuance of share certificate,
- transfer of shares,
- procedure for conducting meetings,
- procedure for appointing or removing directors of the company etc.

All the documents along with the digital signature of all the directors declared to be necessary under Section 7 of the Companies Act are supposed to be attached. The Ministry of Corporate Affairs has simplified the process of getting a DIN number for the directors of the newly incorporated company by including such request form along with the PAN & TAN card of the so proposed entity which is being incorporated. In order to increase the feasibility and scope of the incorporation even further the single-window clearance regarding the incorporation of a company was an action taken by the central government of India.

2.6 CERTIFICATE OF INCORPORATION

The registrar after getting satisfied with the application & documents submitted will consider issuing the certificate of incorporation registration. A certificate of incorporation is the ultimate proof of the existence of a company after filling the memorandum of the association, the article of association and other documents with the registrar.

2.6.1 Effect of the Certificate of Incorporation

1. Certificate of incorporation is the conclusive evidence of the legal existence or presence of the Company as per Section 35 of Companies Act, 1956.
2. Even once the certificate of incorporation is issued it becomes conclusive evidence regarding the legal existence of the company from the date mentioned in the incorporation certificate whether some formal deficiencies in the documents submitted for the incorporation of the company.
3. If the certificate of incorporation was received on 24th but the certificate reflects the date 22nd then the company shall be taken to have come into existence from 22nd as reflected by the certificate of incorporation and this will also authenticate in the eyes of law.

2.7 CERTIFICATE OF COMMENCEMENT OF BUSINESS

- As soon as a private company gets the certification of incorporation it can start its business. Once the certificate of incorporation is received by the company, a public company issues a prospectus for inviting the public to subscribe to its share capital. It fixes the minimum subscription in the prospectus. Then, it is required to sell the minimum number of shares mentioned in the prospectus.
- After completing the sale of the required number of shares, the certificate is sent to the registrar along with the letter from the bank stating that all the money is received.
- The registrar then scrutinizes the documents. If all the legal formalities are done then the registrar issues a certificate known as 'certificate of commencement of business'. This is the conclusive evidence for the commencement of business for the public company.

2.8 SUMMARY

The company's incorporation period can be understood to be the integration of Pre incorporation period and incorporation period. Pre incorporation period may be understood as the idea phase of the company. The promoter who conducts a SWOT analysis of the company to understand the potential of such a company in the marketplace and making it a feasible option to invest upon by the investors and whose name is reflected in the prospectus of the company plays a veryimportant role in collecting the funding for the company. The duties and liabilities of thepromoter has been discussed in detail showing how the relationship between the promoter and the company is fiduciary in nature. The principle of promoter's liability relation to the pre- incorporation contract has been dealt in detail coming to a conclusion that the promoter shall be held personally liable for all the pre-incorporation contracts, unless there is novation of the contract or in case of India when the provisions of Specific Relief Act applies wherein the company ratify the contract and send communication to the other party of contract regarding

their liability. The role of the government in easing the process of incorporation is very crucial as it determines the potential intention of the investors towards companies in the market.
The ease of incorporation has been increased by making it online affair, The Ministry ofCorporate Affairs provides options to incorporate the company with a unique name by providing the online option of submitting the memorandum of association along with the articles ofassociation online with the declaration digitally signed stating that all the procedures of incorporation of a company under law have been followed by the respective company.

2.9 EXERCISE QUESTIONS:

1. Describe various stages of incorporation of public limited company. What documents are required to be filed for incorporation?
2. Write a detail note on Pre-incorporation contracts.
3. Who is Promoter? Discuss about the legal position of promoter and duties and liabilities of Promoter.
4. Discuss the legal formalities required to be compiled with under Indian Companies Act, 2013 and also describe the procedure of on-line registration of company regarding formation of company.

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SEMESTER III

COURSE: COMPANY LAW

UNIT 3: MEMORANDUM OF ASSOCIATION

STRUCTURE

3.0 Objectives of the lesson

3.1 Introduction to Memorandum of Association

3.2 Form and contents

3.3 Name Clause

3.4 Registered Office Clause

3.4.1Verification of Registered Office

3.5 Objects Clause

3.6 Doctrine of Ultra Vires

3.6.1Implied powers

3.6.2 Powers which are not implied

3.6.3 Effects of Ultra Vires Transactions

3.7 Liability Clause

3.8 Association Clause

3.9 Alteration of Memorandum of Association

3.10 Change of Name Clause

3.10.1 Procedure of Change of Name Clause

3.10.2Change of Name Clause on direction from the Central Govt

3.10.3Effect of change of Name

3.11 Change of Registered Office

3.11.1 Change of Registered Office from one town/city/village to another town/city/village in the same state

3.11.2 Change of Registered Office from one state to another state

3.12 Change in Objects Clause

3.12.1 Self -Check Exercise 1

3.13 Change in Liability Clause

3.14 Change in Capital Clause

3.15 Articles of Association

3.16 Relationship between MoA and AoA

3.17 Difference between MoA and AoA

3.18 Contents of AoA

3.19 Regulation required in case of Unlimited Co

3.20 Model form of Articles

3.20.1Signing of Articles

3.21Alteration of Articles

3.21.1Conversion of Private Co into Public Co

3.21.2Conversion of Public Co into Private Co

3.21.3Filing Copy of Special Resolution

3.21.4Filingcopy of Altered Articles

3.22 Limitation on power to alter AoA

3.22.1Effect of Altered Articles

3.23 Binding Effect of MoA

3.23.1 Members bound to the Co

3.23.2Co bound to members

3.23.3 Members bound to members

3.23.4Whether Co or members bound to outsiders

3.23.5 Whether Directors are bound by whatever is contained in the Articles

3.24 Doctrine of Constructive Notice

3.25 Doctrine of Indoor Management

3.25.1 Self-Check Exercise 2

3.26 Exceptions to the Doctrine of Indoor Management

3.27 Summary

3.28 Keywords

3.29 Recommended Readings

3.30 Questions for Exercise

3.0 OBJECTIVES

- To discuss the contents and alteration of Memorandum of Association
- To explain the contents of Articles of Association
- To understand the Doctrine of Constructive Notice
- To explain the Doctrine of Indoor Management

3.1 INTRODUCTION TO MEMORANDUM OF ASSOCIATION

The pre-requisite in the formation of a company is to prepare a document called the memorandum of association. It is the Magna Carta of the Company.The memorandum of association of a company is the foundation upon which alone the company can be incorporated. According to Section 2(56) of the Companies Act, 2013 "Memorandum" means "Memorandum of association of a company as originally framed or alerted from time to time in pursuance of anyprovision of any previous company law or this Act."

It enables shareholders, creditors and all those who deal with the company to know what its powers are and what is the range of its activities. An intending shareholder can find out the purposes for which his money is going to be used by the company and what risk he is taking in making the or money.

3.2 FORM AND CONTENTS

Section 4 (6) requires that the memorandum of a company shall be drawn up in such a form as is given in Tables A,B,C.D & E in Schedule I to the Act as may be applicable in the case of the company.

Section 4 requires the memorandum of a company to contain the following:

(a) The name of the company, with 'limited' or 'private limited' as the last word(s) of the name in the case of public company or a private company, as the case may be. In case of person Company, section 12 requires that the words 'One person Company' must be mentioned in brackets below the name of the company;

(b) The name of the state, in which the registered office of the company is to be situated;

(c) The objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof;

(d) The liability of members of the company, whether limited or unlimited, and also state-

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

(ii) In the case of a company limited by guarantee, the amount up to which each member undertakes to contribute.

(A) To the assets of the company in the event of its being wound-up while he is a member or within one year after he ceases to be member, for payment of the debts and liabilities of the

company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and

(B) To the costs, charges and expenses of winding up and for adjustment

(e) In the case of a company having a share capital-

(i) The amount of share capital with which the company is to be registered and the division into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share; and

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

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

It may be noted that the memorandum of association of a company cannot contain anything contrary to the provisions of the Companies Act. If it does, the same shall be devoid of any legal effect (Section6).

3.3 THE NAME CLAUSE (SEC.4(1)(A)

A company being a distinct legal entity must have a name of its own to establish its separate identity. The promoters are free to choose any suitable name for the company provided.

(A) The last word(s) in the name of the company, if limited by shares or by guarantee is limited or private limited, as the case may be.

(B) The name stated in the memorandum is not-

(a) Identical with or resemble too nearly to the name of an existing company registered under this Act or any previous company law; or

(b) Such that its use by the company-

(i) Will constitute an offence under any law for the time being in force; or

(ii) Is undesirable in the opinion of the Central Government.

Further, a company shall not be registered with a name which contains-

(a) any word or expression which is likely to give the impression that the company is in any way connected with, or having the patronage of, the Central Government, any State Government,or any local authority, corporation or body constituted by the Central Government or any State Government under any law for the time being in force. Thus, words like President, Prime Minister, Central, Municipal. Panchayat may not be allowed.In this context,an important case is being discussed.Facts of the Case **Ewing Vs ButtercupMargarine Dairy Co Ltd.**

In this case, Ewing carried on business under the name of Butter Cup Dairy Co. Another company was registered by the name Buttercup Margarine Co. Ltd. Ewing filed a suit claiming that he had the exclusive right to use the word 'Buttercup'.The Court granted an injunction against the defendant on the ground that the public might think that the two businesses were connected since the word 'Buttercup' was an unnecessary and fancy one.Every Co shall

(a) paint or affix its name, and the address of its registered office, and keep the same painted or affixed, on the outside of every office or place in which its business is carried

on, in a conspicuous position, in legible letters and in the language in general use in thelocality.

(b) Have its name engraved in legible characters on its seal;

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

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

(e) **Company conducting online business**: Every company which has a website for conducting online business or otherwise, shall disclose/ publish its name, address of itsregistered office, the Corporate Identify Number, Telephone number, fax number if any, email and the name ofthe person who may e contacted in case of any queries or grievances on the landing/home page of the said website.

3.4 THE REGISTERED OFFICE CLAUSE [SEC.4(1)(B)]

This clause states the name of the State in which the registered office of the company will be situated. Every company must have a registered office which establishes its domicile and is also the address at which the company's statutory books must normally be kept and to which notices and other correspondence can be done. A company shall, within thirty days of its incorporation and at all times thereafter, have a registered office capable of receiving and acknowledging all communications and notices as may be addressed to it.

3.4.1Verification of the Registered Office

Sub-section (2) of section 12 of the Companies Act, 2013 requires that the company must furnish to the Registrar verification of its registered office within a period of thirty days of its incorporation by filing any of the prescribed documents.

1. The verification of the registered office shall be filed in Form No. INC-22 along with the prescribed fee; and
2. There shall be attached to the Form, any of the following documents, namely-

(a) Registered document of the title of the premises of the registered office in the name of the company; or

(b) Notarized copy of lease/rent agreement in the name of the company along with a copy of rent paid receipt not older than one month;

(c) Authorization from the owner or authorized occupant of the premises along withproof of ownership or occupancy authorization, to use th e premises by the company as itsregistered office; and

(d) Proof of evidence of any utility service like telephone, gas, electricity, etc. depicting the address of the premises in the name of the owner or document, as the case may be, which is not older than 2 months.

Active Company Tagging Identities and Verification (ACTIVE)

As per Rule 25A, added by the Companies Incorporation (Amendment) Rules, 2019, every company incorporated on or before the 31st December, 2017 shall file the particulars of the company and its registered office, in e-Form ACTIVE(Active Company Tagging Identities and Verification) on or before 25.4.2019.

3.5 THE OBJECTS CLAUSE[SECTION 4(1)(C)]

The objects clause defines the objects of the company and indicates the sphere of its activities. As per Section 4(1)(c) , in this clause the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof should be stated.

A company cannot do anything beyond or outside its objects and any act done beyond that will be ultra vires and void and cannot be ratified even by the consent of the whole body ofshareholders. However, a company may do anything which is incidental to and consequential upon the objects specified and such act will not be an ultra vires act.

3.6 DOCTRINE OF ULTRA VIRES

A company which owes its incorporation to statutory authority cannot effectively do anything beyond the powers expressly or impliedly conferred upon it by the statute or memorandum of association. Any purported activity beyond such powers will be ineffective even if agreed to by all the members. This rule is commonly known as 'doctrine of ultra vires'. The word 'ultra menas 'beyond' and the word 'vires' means the 'powers'. 'Ultra vires', therefore, means beyond the powers. So, when used with reference to a company, it means beyond the powers. The powers of a company are essentially derived from the statute constituting it and the memorandum of association. After the advent of Joint Stock Companies, the rule of ultra vires was for the first time laid down by the House of Lords in **Ashbury Rly. Carriage & Iron Company v. Riche.**

The company had been formed with the object of carrying on business as ' Mechanical Engineers and General Contractors'. The contractors entered into an agreement for financing the construction of a railway in Belgium and there was evidence that the agreement had been ratifiedby all the members. The company repudiated the agreement and was sued for breach of contract. The other party brought an action for damages for breach of contract. His contentions were: firstly, that the contract in question came well within the meaning of the words 'general contractors' and, was, therefore, within the powers of the company, and secondly, that the contract was ratified by the majority of the shareholders.The Court held that the term 'general contractors' must be taken to indicate the making generally of such contracts as were connected with the business of mechanical engineers. If, the term ' general contractors' was not so interpreted, it would authorize the making of contracts of any kind and every description and, would virtually allow the carrying on business of any kind whatsoever and would, therefore, be altogether meaningless. Hence the contract was entirely beyond the objects in the Memorandum of Association. In this case, the object of the doctrine was explained by Lord Justice Cairns as follows: to protect investors of the company so that they may know the objects in which

their money is to be employed; and to safeguard the creditors by ensuring that the company funds, to which they must look for payment are not dissipated in unauthorized activities.

3.6.1 Implied Powers

As made out in the doctrine of ultra vires, the powers exercisable by a company are to be confined to the objects specified in the memorandum. However, the powers exercisable inrespect of the objects specified may be express or implied. Every company, in fact, possesses certain powers virtue of its being an incorporated body, such as, for instance, a power to appoint and act through agents, and where it is a trading company, a power to borrow and give security for the purposes of its business, and also a power to sell.

3.6.2 Powers which are not implied

The following powers have been held not to be implied and it is, therefore, prudent in cases where deemed necessary, to include them expressly in the objects-

(i) To acquire any business similar to company's own.

(ii) To enter into an agreement with other persons or companies for carrying on business in partnership or for sharing profits, joint adventure or other arrangements. Very clear powers are necessary to justify such transactions.

(iii) promoting other companies or helping them financially

(iv) Purchasing shares of other companies where such investment authorizes doing indirectly that which will not be intra vires, if done directly.

(v) Buying shares in other companies having similar objects .

(vi) power to sell and dispose of the whole of a company's undertaking;

(vii) power to give gift and make donations or contributions for charities not relating to the objects stated in the memorandum;

(viii) power to use funds for political purposes;

(ix) entering into contracts of suretyship or guarantee.

(x) making of loans by a company not engaged in financing or banking business.

3.6.3 Effects of Ultra Vires Transactions

(i) Void ab inito: The ultra acts are null and void ab initio. The company is not bound by these acts; even the company cannot sue or be sued upon it- Ashbury Railway Carriage and Iron Company v. Riche).

(ii) Injunction : In case a company is about to undertake an ultra vires act, the members (even a single member) can get an order of injunction from the Court retraining the company from going ahead with the ultra vires act.

(iii) Personal Liability of directors: It is one of the duties of directors to ensure that the corporate capital is used only for the legitimate business of the company and hence if such capital is diverted into purposes beyond the company's memorandum, the directors will bepersonally liable to replace it. In case of deliberate mis-application , criminal action can also be taken for fraud.However, a distinction must be drawn between transactions which are ultra

vires the company and the transactions which are ultra vires the directors. Where the directors exceed their authority and do something, the same may be ratified by the general body of the shareholders provided the company has the capacity to do that transaction as per its memorandum of association.

(iv) Acquisition of property that is ultra vires: Where a company's money has been usedultra vires to acquire some property, the company's right over such property is held secured.Besides, the company will be the right party to protect such property against damage by third persons.

(v) Directors personally liable to third parties: In respect of ultra vires transactions, directors and other officers shall be personally accountable to third parties.

3.7 LIABILITY CLAUSE (SEC.4(1)(D)

This clause states the nature of liability of the members. In the case of a company with limited liability, it must state that liability of members is limited, whether it is by shares or by guarantee. This means that in the case of a company limited by shares, a member can be called upon at any time to pay to the company the amount unpaid on the shares. Thus, if his shares are fully paid up, his liability is nil. Where a shareholder holding a 10-rupee share has paid Rs.7 on it, he can be called upon to pay the balance of Rs. 3. But if he has paid the full value of Rs.10 he cannot be required to pay anything more even if the company owes huge debts to its creditors. In the case of companies limited by guarantee, this clause will state the amount which every member undertakes to contribute to the assets of the company in the event of its being wound-up.

In the case of unlimited liability company, whether having share capital or not, this clause shall state that the liability of its members is unlimited.

3.8 THE CAPITAL CLAUSE (SEC.4(1)(E)

This clause must indicate the amount of capital with which the company is registered, and is known as Registered or Authorized or Nominal capital.

As per Sec.4(1)(e), in the case of a company having a share capital, the memorandum must state the amount of share capital with which the company is to be registered and the division thereof into shares of a fixed amount and the number of shares which the subscribers to the memorandum agree to subscribe which shall not be less than one share.

In the case of a public company having a share capital, a share may be either a Preference Share or an Equity share. Thus, a company's capital may be Preference share capital and Equity share capital. This clause shall state the number and value of shares into which the capital of the company is divided.

3.8.1Name of a nominee in case of ' One Person Company'(Sec.4(1)(f)

In the case of One Person Company, the Memorandum must state the name of the person who, in the event of the death of the subscriber, shall become the member of the company.

3.9 THE ASSOCIATION/ SUBSCRIPTION CLAUSE (SEC.4(1)(E)

At the end of the Memorandum of every company, there is an association or subscription clause in which the subscribers to the Memorandum of Association make the following declaration:

1. Signing of the Memorandum and Articles: The memorandum and articles of association of the company shall be signed by each subscriber to the memorandum, who shall add his name, address, description and occupation, if any, in the presence of at least one witness who shall attest the signature and shall likewise sign and add his name, address, description and occupation.

Where the subscriber to the memorandum is a body corporate, the memorandum and articles of association shall be signed by director, officer or employee of the body corporate duly authorized in this behalf by a resolution of the board of directors of the body corporate and where the **subscriber is a Limited Liability Partnership,** it shall be signed by a partner of the Limited Liability Partnership. However, in either case, the person so authorized shall not, at the same time, be a subscriber to the memorandum and articles of Association.

Again, where subscriber to the memorandum is a foreign national residing outside India, the signing will be as per the prescribed procedure.

2. Each subscriber must take at least one share.
3. Each subscriber must write opposite his name the number of shares he takes (section491)(e)

3.10 ALTERATION OF MEMORANDUM

Section 13 provides that the company cannot alter the conditions contained in memorandum except in the cases and in the mode and to the extent express provisions have been made in the Act. These provisions are explained herein below.

3.11 CHANGE OF NAME CLAUSE

3.11.1 Change of name at the instance of the Company: Section 13 provides that the name of a company may e changed at any time by passing a special resolution at a general meeting of the company and with the written approval of the Central Government. However, no approval of the Central Government is necessary if the change of name involves only the addition or deletion of the word "private"(i.e., when public company is converted into a private company or vice versa)

The company shall file with the Registrar of Central Registration Centre-

(a) the special resolution passed by the company; and

(b) the approval of the Central Government.

When any change in the name of a company is made, as aforesaid, the said Registrar shall enter the new name in the Register of Companies in place of the old name and issue a fresh Certificate of Incorporation in Form 2.27 with the new name and the change in the name shall be complete and effective only on the issue of such a Certificate.

In case of a listed company, SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 require that for change of its name the listed company must comply with the following conditions:

(a) a time period of at least one year must have elapsed from the last name change;

(b) at least fifty per cent of the total revenue in the preceding one year period must have been accounted for by the new activity suggested by the new name; or

(c) the amount invested in the new activity/ projects is at least fifty per cent of the assets of the listed entity.

3.11.2 Procedure

(1) On satisfaction of the aforesaid conditions, the company shall file an application for name availability with Registrar of Companies.

(2) On receipt of confirmation regarding name availability from Registrar of Companies, the company, if a listed entity, shall seek approval from Stock Exchange by submitting a certificate from chartered accountant stating compliance with aforesaid conditions.

(3) The company shall file with the Registrar of Central Registration Centre (CRC)

(a) the special resolution passed by the company; and

(b) the approval of the Central Government.

3.11.3 Change of name on a Direction from the Central Government: If through inadvertence or otherwise, a company on its first registration or in its registration by a new name has been registered with a name which, in the opinion of the Central Government, is identical with or too closely resembles the name of an existing company, the company may changes its name within a period of three months from the issue of such direction by passing an ordinary resolution and by obtaining the approval of the Central Government in writing.

Again the company may change its name by following the aforesaid procedure, where an application has been made to the Central Government by a registered proprietor of a trade make within three years of incorporation or registration or change of name of the company and , the opinion of the Central Government, the name is identical with or too nearly resembles a registered trade mark of such proprietor under the Trade Marks Act, 1999. Where such adirection is made by the Central Government , the company shall change its name or new name, as the case may be, within a period of six months form the issue of such direction.

3.11.4 Effect of Change of Name:

(i) The change of name shall not affect any rights/ obligations of the company or render the same defective in legal proceedings by or against it. Moreover, any legal proceedings which might have been continued or commenced by or against the company by its former name may be continued by or against the company by its new name.

Where a company changes its name and the new name has been registered by the Registrar, the commencement of legal proceedings in the former name is not competent.

3.12 CHANGE OF REGISTERED OFFICE FROM ONE PLACE TO ANOTHER PLACE IN THE SAME CITY,TOWN ORVILLAGE (SEC.12)

A company can change its registered office from one place to another within the local limits of the city, town or village where it is situated, by passing a resolution of the Board of directors. However, the company should inform the Registrar the new address within 15 days of the changewho shall record the same.

3.12.1 Self -Check Exercise 1

Discuss the procedure to change the name of a Company.

3.12.2 Change of registered office from one town or city or village to another town or city or village in the same state(SECTION12) - In this case the following procedure is to be followed:

(i) **Special resolution**-A special is required to be passed at a general meeting of the shareholders.

(ii) **Confirmation of Regional Director**- Confirmation of the Regional Director is to be obtained where the change is from jurisdiction of one Registrar of Companies to the jurisdiction of another Registrar of Companies. The application to the Regional Director shall be made in Form INC-23. The Regional Director shall communicate the confirmation within a period of thirty days from the date of receipt of application to the company.

(iii) **Copy of special resolution and confirmation by Reginal Directors to be filed with ROC.A copy of the special resolution,** as aforesaid, is to be filed with the Registrar within 30 days (Section 117). **Copy of the confirmation** by Regional Director shall be filed with the Registrar of Companies **within 60 days** of the date of confirmation. The Registrar is required to register the same and certify the registration within 30 days from the date of filing of such confirmation (Section12).

The certificate issued by the Registrar shall be conclusive evidence that all the requirements of this Act with respect to change of registered office have been complied with and the change shalltake effect from the date of the certificate.

If any default is made in complying with any of the aforesaid requirements, the company and every officer who is in default shall be liable to a penalty of one thousand rupees for every day during which the default continues but not exceeding one lakh rupees.

3.12.3 Change of Registered office from one state to another state- Section 13 contains provisions with respect to the shift of the registered office from one state to another. Shift of registered office from one State to another will involve alteration of memorandum and therefore, requires a more elaborate procedure to be followed viz.

1. Settlement of the list of creditors including debenture holders;

2. Obtaining the consent of the creditors and in case any creditors or creditors object, his debt or claim should be discharged or determined or secured to the satisfaction of the Central Government.

3. Obtaining confirmation from the Central Government.

4. Notice of change of the registered office in the manner prescribed, to be given to ROC within 30 days of the change.

<u>3.13</u> <u>CHANGE IN OBJECTS CLAUSE</u>

Alteration of objects may be discussed under these heads:

1. Alteration of objects by a company which has not issued a prospectus
2. Alteration of objects by a company which has issued a prospectus

1. Alteration of objects by a company which has not issued a prospectus

2. Alteration of objects by a company which has issued a prospectus

Section 13(8) read along with Rule 32 of the Companies (Incorporation) Rules, 2014 provides that a company, which has raised money from public through prospectus and still has any unutilized amount out of the money so raised, shall not change its objects for which it raised the money through prospectus unless a special resolution through postal ballot is passed by the company.

Besides.

1. The notice in respect of the resolution for altering the objects shall contain the following particulars:

(i) total money received.

(ii) total money utilized for the objects stated in the prospectus;

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

(iv) particulars of the proposed alteration / change in the objects.

(v) justification for the alteration/ change in the objects.

(vi) amount proposed to be utilized for the new objects.

(vii) estimated financial impact of the proposed alteration on the earnings and flow of the company;

(viii) other relevant information which is necessary for the members to take an informed decision on the proposed resolution;

(ix) place from where any interested person may obtain a copy of the notice of resolution to be passed.

<u>3.14</u> <u>CHANGE IN LIABILITY CLAUSE</u>

The Companies Act, 2013 or the Rules made thereunder do not contain any provisions with respect to the alteration of liability clause. However, since the relationship between a memberand the company is a contractual relationship, the liability of a member of a company cannot e increased unless the member agrees in writing. The consent of the member may, however, be given either before or after the alteration. Increase in liability may be by way of subscribing for

more shares than the number held by him at the date on which the alteration is made or in any other manner.

In case of unlimited liability company, the liability may be made limited or reduced by re-registration of the company (Section18). The alteration will, however, not affect any debts, liabilities, obligations or contracts entered into by or with the company before the registration of the unlimited company as a limited company (Sec.18(3)

3.15 CHANGE IN CAPITAL CLAUSE

Section 61 provides that, if the articles, authorize, a company limited by share capital may, by an ordinary resolution passed in general meeting, alter the conditions of its memorandum in regard to capital so as-

1. to increase its authorized share capital by such amount as it thinks expedient;
2. to consolidate and divide all or any of its share capital into shares of larger amount than its existing shares e.g. 10 shares of Rs.10 each may be consolidated into one share of Rs.100 each;
3. to convert all or any of its fully paid up shares into stock, and reconvert that stock into fully paid-up shares of any denomination;
4. to sub-divide its shares, or any of them, into shares of smaller amount than fixed by the memorandum, but the proportion of paid and unpaid on each share must remain the same;
5. to cancel shares which, at the date of the passing of the resolution in that behalf, havenot been taken or agreed to be taken by any person and thus diminish the amount of its share capital by the amount of the shares so cancelled.

These five clauses are now explained.

3.16 ARTICLES OF ASSOCIATION

The articles of association of a company are its bye- laws or internal rules and regulations that govern the management of its internal affairs and the conduct of its business.

According to section 2(2) of the Act 'article' means the articles of association of a company as originally framed or as altered from time to time in pursuance of any previous company laws or of the present Act, i.e. the Act of 2013.

The articles regulate the internal management of the company. They define the powers of its officers. They also establish a contract between the company and the members and between the members inter se. This contract governs the ordinary rights and obligations incidental to membership in the company.

Articles are like the partnership deed in a partnership. They set out provisions for the manner in which the company is to be administered. In particular, they provide for matters like the making of calls; forfeiture of shares; directors' qualifications, appointment, powers and duties of auditors; procedure for transfer and transmission of shares and debentures.

3.17 RELATIONSHIP BETWEEN MEMORANDUM AND ARTICLES

The articles regulate the manner in which the company's affairs will be managed. The memorandum defines the company's objects and various powers to achieve them; the articles determine how those objects shall be achieved and those powers exercised. But the Act does not require the articles to provide for certain specified matters in the same way as it requires the memorandum to do. As a result, the contents of the articles of different companies may very substantially, and the utmost flexibility is allowed to the persons who form the company to organize its management as they wish.

The articles of a company are subordinate and controlled by the memorandum of association which is the dominant instrument and contains the general constitution of the company. The memorandum is the foundation and can be altered only under certain circumstances provided by the Act. But the articles are only internal guidelines, over which the members of the company have full control and may alter them according to what they think fit. Due diligence has to be taken to see that regulations provided for in the articles do not exceed the powers of the companyas laid down by its memorandum.

3.18 DISTINCTION BETWEEN MEMORANDUM OF ASSOCIATION AND ARTICLES OF ASSOCIATION

- The main points of distinction between memorandum and articles may be noted as follows:-. The memorandum contains the fundamental conditions upon which alone the company is allowed to incorporated. These conditions are introduced for the benefit of the creditors, and the outside public, as well as the shareholders. The articles of association are the internal regulations of the company; they only regulate the relationship between company and the shareholders / members and amongst the members themselves.
- Memorandum lays down the area beyond which the activities of the company cannot go. Articles provide for regulations inside that area. Thus, memorandum lays down the parameters for the articles.
- Memorandum of association can be altered only under certain circumstances and in the manner provided in the Act. In most of the cases permission of the Central Government / Tribunal is required, beside the approval of the shareholders in a general body meeting either by way of an ordinary resolution or special resolution. Generally, articles can be altered by the members by passing a special resolution only.
- Memorandum of association cannot include clause contrary to the provisions ofthe Companies Act. The articles of association are subsidiary both to the Companies Act and the memorandum of association.
- Acts done by a company beyond the scope of the memorandum are ultra vires and, thus, absolutely void. They cannot be ratified even by unanimous vote by all the shareholders. But the acts beyond the articles can be ratified by the shareholders provided the relevant provisions are not beyond the memorandum.

3.19 CONTENTS OF AOA

- The Articles of Association of a company usually contain rules and regulation respective tables:
- The exclusion, wholly or in part, of the model articles as contained in respective Tables.
- Share capital-shares and their value and their division into equity and preference shares, if any.
- Procedure relating to the allotment of shares, making of calls and forfeiture of shares.
- Rights of each class of shareholders and procedure for variation of their rights.
- Increase, alteration and reduction of share capital.
- Rules relating to transfer or transmission of shares and the procedure to be followed for the same.
- Lien of the company on shares allotted to the members for the amount unpaid in respect of such shares and the procedure in respect thereof.
- Appointment, remuneration, powers, duties etc. of the directors and officers of the company.
- Constitution and composition of Audit Committee, Remuneration Committee, CSR Committee.
- Procedure for conversion of shares into stock and vice versa.
- Notice of the meetings, voting rights of members, proxy, quorum, poll, etc.
- Audit of accounts, transfer of amount to reserves, declaration of dividend, etc.
- Borrowing powers of the company and the mode of exercise of those powers.
- Issue of share certificates including procedure for issue of duplicate shares.
- Winding up of the company.

The Articles of Association must be prepared carefully and it must contain rules in regard to all such matters which are required to be contained therein and which are necessary for the smooth functioning of the company.

3.20 REGULATION REQUIRED IN CASE OF UNLIMITED COMPANY, COMPANY LIMITED BY GUARANTEE AND PRIVATE COMPANY LIMITED BY SHARES

Tables G, H and J appended to Schedule I require the Articles of Association of a guarantee company having share capital and an unlimited liability company having share capital to mention the number of members with which the company proposes to be registered and in case of a guarantee company not having share capital and an unlimited liability company not having share capital, the Articles of Association should also state that the subscribers to the memorandum and such other persons as the Board shall admit to membership shall be members of the company.
A private company having a share capital must provide in the articles, the three restrictions(1) as to the right to transfer shares (2) limit as to number of its member (3) invitation to public to subscribe for any securities of the company. Any other private company (i.e, not having share capital) must provide in its articles, restriction as given under (1) and (2) as mentioned above.

3.21 MODEL FORM OF ARTICLES

As per section 5 of the Companies Act, 2013, the articles of the company shall be in respective forms specified in Tables, F,G, H, I and J in Schedule I as may be applicable to such company. Table F contains model articles for a company limited by guarantee and having a share capital, a company limited by guarantee and not having a share capital, an unlimited company and having a share capital and an unlimited company but not having a share capital respectively.

A company may adopt all or any of the regulation contained in the model articles

A company may adopt all or any of the regulations contained in the model articles applicable to such company.

In case of any company, which is registered under the Companied Act, 2013, in so far as the registered articles of such company do not exclude or modify the regulation contained in the model articles applicable to such company, those regulation shall, so far as applicable, be the regulation of that company in the same manner and to the extent as if they were contained in the duly registered articles of the company.

3.21.1Signing of Articles

As per Rule 13 of the Companies (Incorporation) Rules, 2014, the Memorandum and Articles of Association of the company shall be signed in the following manner:-

Where the subscriber to the memorandum is a body corporate, the memorandum and articles of association shall be signed by director, officer or employee of the body corporate duly authorized in this behalf by a resolution of the board of directors of the body corporate.

Where the subscriber is a Limited Liability Partnership, it shall be signed by a partner of the Limited Liability Partnership, duly authorized by a resolution approved by all the partners of the Limited Liability Partnership.

Where subscriber to the memorandum is a foreign national residing outside India, memorandum and articles of association shall be signed in the manner prescribed in the rules.

3.22 ALTERATION OF ARTICLES

Section 14 provides that subject to the provision of the Act and to the conditions contained in its memorandum; a company may, **by special resolution** alter its articles including alterations having the effect of conversion of-

a) a private company into a public company; or

b) a public company into a private company.

3.22.1Conversion of a Private Company into a Public Company

Where a private company alters its articles in such a manner that they no longer include the restrictions and limitations which are required to be included in the articles of a private company,

that is, the restrictions contained in section2(68),the company shall, as from the date of such alteration, cease to be a private company.
In other words, a private company may convert itself into a self into a public company by omitting the three restrictive clauses of section 2(68)

1.22.2 Conversion of a public company into a Private company
Where alteration of the Articles shall have the effect of conversion of a public company into a private company, the same shall not take effect unless the approval of the Tribunal has been obtained. In other words, if a public company wants to convert itself into a public company by introducing the three restrictive clauses of section2(68), merely passing of special resolution will not be sufficient; it will have to obtain the approval of the Tribunal also.

3.22.3 Filing copy of special resolution
A copy of special resolution altering the articles must be filed with the Registrar within 30 days of the passing of the special resolution as required by section 117. The right to alter articles just by passing special resolution is so important that a company cannot, in any manner, deprive itself of this power.

3.22.4 Filing copy of Altered Articles
Sub-section(2) of section 14 requires every alteration of the articles and a copy of the order of the Tribunal approving the alteration, where applicable, shall be filed with the Registrar, togetherwith a printed copy of the altered articles, within a period of fifteen days in such manner as may be prescribed and the Registrar shall register the same.
Any alteration of the articles registered under sub- section(2) shall, subject to the provisions of this Act, be valid as if it were originally in the articles.

3.23 LIMITATION ON POWER TO ALTER ARTICLES
1. **Not to be inconsistent with Memorandum**: The alteration must not exceed the powers given by the memorandum or be in conflict with any provisions of the memorandum. In the event of conflict between the memorandum and the articles, it is the memorandum that will prevail.
2. **Not to be inconsistent with Companies Act or any other law**: The alteration mustnot be inconsistent with any provisions of the Companies Act or any other statue- for example, no public company can finance purchase of its own shares (Section67) and if the articles of such a company are altered so as to have such a power than such power will be void.
3. **Not be inconsistent with any alteration made by the Tribunal:**Where under section 242, the Tribunal makes an order with respect to any alteration in the memorandum or articles of a company, then the company shall not have the power to make any alteration which is inconsistent with its orders except with the approval of the Tribunal (Sec.242(5).

4. The altered articles must not include anything which is illegal or opposed to public policy or unlawful.

5. **The alteration must be bona fide for the benefit of the company as a whole:** The alteration will not, however, be bad merely because it inflicts hardship on an individual shareholder.

6. An alteration of articles to effect a conversion of a public company into a private company cannot be made without the approval of the Tribunal (Section14).

7. A company cannot justify breach of contract with third parties or avoid a contractual liability by altering articles.

8. **Retrospective operation of Articles-**The amended regulation in the articles ofassociation cannot operate retrospectively, but only from the date of amendment.

3.24 EFFECT OF ALTERED ARTICLES

Alteration binds members in the same way as original articles. The provision of section 10 providing that the articles shall bind the company and the members to the same extent as if they had been signed by the company and by each member, means the articles as originally framed, or as they may from time to time stand after they have been altered are valid under the provisions of the Act. There is clear power to alter the articles, and as altered, they bind members just in the same way as did the original articles.

3.24.1 Binding Effect of memorandum and articles

Section to provides that the memorandum and articles, when registered, bind the company and its members to the same extent as if they have been signed by the company and by each member and contain covenants on its and his part to observe all the provisions of the memorandum and of the articles. Thus, the company is bound to the members; the members are bound to the company; and the members are bound to the other members by whatever is contained in these documents. But, in relation to articles, neither a company nor its members are bound to outsiders. The discussion on legal effect of the memorandum ad articles may be made under the following heads:-

(a) Members bound to the company;
(b) Company bound to the members;
(c) Members bound to members;
(d) Company and the outsiders.

Members bound to the company

Each member must observe the provisions of the articles and memorandum. For instance, a company has a right of lien on member's shares, or to forfeit the shares on non- payment of calls. Every member is bound by whatever is contained in the memorandum and articles.

Company bound to members

A company is bound to members by whatever is contained in its memorandum and articles of association. The company is bound not only to the "members as a body" but also to theindividual members as to their individual rights. The members can restrain a company from spending money on ultra vires transaction. An individual member can make the company fulfill its obligation to him, such as to send the notice for the meetings, to allow him to cast his vote in the meeting.

Members bound to members

The articles bind the members inter se,i.e. one to another as far as rights and duties arising out of the articles are concerned.

It is well settled that the articles of association will have a contractual force between the association or company on the one hand and its constituent members on the other, but they also constitute a contract between the members inter se.

Whether company or members bound to outsiders

The memorandum or articles do not confer any contractual rights upon outsiders against the company or its members, even though the name of the outsider is mentioned in the articles. An outsider (i.e., a non-member) cannot rely on articles of association for his action against the company.

Whether Directors are bound by whatever is contained in the articles

The directors of a company derive their powers from the articles and are subject to limitation, if any, applied on their powers by the articles. If they contravene any provision of articles, two parties may be affected i.e., the company itself, and the outsiders.

In case of contravention of the provisions of the articles, the directors render themselves liable to an action at the instance of the members. However, members may ratify the act of directors, if they so desire, But, if as a result of breach of duty any loss has resulted to the company, the directors are liable to reimburse the company any loss so suffered.

3.25 DOCTRINE OF CONSTRUCTIVE NOTICE

Section 399 provides that the Memorandum and Articles when registered with Registrar of Companies ' become public documents' and then they can be inspected by any one by electronic means on payment of the prescribed fee.

Failure to supply the copy will make the company as well as every officer in default liable to a fine @Rs.1,000 per day for each day of the default or Rs. 1,00,000, whichever is less.

Therefore, any person who intends to enter into a contract with the company has the means of ascertaining and is thus presumed to know the powers of the company and the extent to which they have been delegated to the directors. In other words, every person, dealing with the company is presumed to have read these documents and understood them in their true perspective. This is known as ‘’doctrine of constructive notice". Even if the party dealing withthe company does not have actual notice of the contents of these documents it is presumed thathe has a tacit notice of them.

3.25.1 Self-Check Exercise 2
Distinguish between Memorandum and Articles of Association.

3.26 DOCTRINE OF INDOOR MANAGEMENT

The rule of constructive notice proved too inconvenient for business transactions, particularly where the directors or other officers of the company were empowered under the articles to exercise certain powers subject only to certain prior approvals or sanctions of the shareholders. Whether those sanctions and approvals had actually been obtained or not could not be ascertained because the investors, vendors, creditors and other outsiders could not dare ask the directors in so many word about those sanctions having been obtained or to produce the relevantresolutions. Since there are no means to ascertain whether necessary sanctions and approvals have been obtained before a certain officer exercises his powers which, as per articles, can only be exercised subject to certain approvals, those dealing what the company can assume that if the directors or other officers are entering into those transactions, they would have obtained the necessary sanctions. So, an outsider is bound to read the documents but he is not bound to do anything more. According to this doctrine, persons dealing with the Company are entitled to presume that internal requirements prescribed in Moa and AoA have been properly complied with. This is known as the doctrine of indoor management' and was first laid down in the case of **Royal British Bank v. Turquand:**
The directors of a company were authorized by the articles to borrow on bonds such sums of money as should from time to time, by a resolution of the company in general meeting, be authorized to be borrowed. The directors gave a bond to T without the authority of any such resolution. The question arose whether the company was liable on the bond. It was held that the company was liable on the bond, as T was entitled to assume that the resolution of the company in general meeting had been passed.

3.26.1 Exceptions to the doctrine of indoor management

The above noted 'doctrine of indoor management ' is, however, subject to certain exceptions. In other words, relief on the ground of indoor management cannot be claimed by an outsider dealing with the company in1 the following circumstances;

- **Where the Outsider had knowledge of Irregularity**- The doctrine does not protect any person who has actual or even an implied notice of the lack of authority of the person acting on behalf of the company. Thus, a person knowing fully well that the directors do not have the authority to make the transaction but still enters into it cannot seek protection under the rule of indoor management as in the Case **Howard Vs Patent Ivory Co Ltd**.

The articles of a company empowered the directors to borrow upto one thousand pounds only. They could, however, exceed the limit of one thousand pounds with the consent of the company in general meeting. Without such consent having been obtained, they borrowed 3,500 pounds from one of the directors who took debentures. The company refused to pay the amount.It was held that the debentures were good to the extent of one thousand pounds only because the director had notice or was deemed to have the notice of the internal irregularity. The director being an insider, the doors of the company are not closed to him.

- **No knowledge of Articles**: The rule cannot be invoked in favour of a person who did not consult the memorandum and articles and thus did not rely on them.
- **Forgery-**The rule of indoor management does not apply to transactions involving forgery or otherwise void or illegal ab initio. In the case of forgery it is not that there is absence of free consent but there is no consent at all. The person whose signatures have been forged is not even aware of the transaction, and the question of his consent being free or otherwise does not arise. Since there is no consent at all there is no transaction. Consequently, it is not that the title of the person is defective but there is no title at all.
- **Negligence**- The doctrine of indoor management in no way, rewards those who behave negligently . Thus, where an officer of a company does something which shall not ordinarily be within his powers, the person dealing with him must make proper enquiries and satisfy himself as to the officer's authority. If he fails to make an enquiry, he is stopped from relying on the doctrine.

3.27 SUMMARY

The memorandum defines the company's objects and various powers to achieve them. The articles regulate the manner in which the company's affairs will be managed. But the Act does not require the articles to provide for certain specified matters in the same way as it requires the memorandum to do. As a result, the contents of the articles of different companies may vary substantially, and the utmost flexibility is allowed to the persons who form the company to organize its management as they wish.

The memorandum is the foundation and can be altered only under certain circumstances provided by the Act .The articles of a company are subordinate and controlled by the memorandum of association which is the dominant instrument and contains the general constitution of the company. Due diligence has to be taken to see that regulations provided for in the articles do not exceed the powers of the company as laid down by its memorandum.

3.28 KEYWORDS

Doctrine of Constructive Notice: According to this doctrine ,any person who intends to enter into a contract with the company has the means of ascertaining and is thus presumed to know thepowers of the company and the extent to which they have been delegated to the directors.

Doctrine of Indoor Management: According to this doctrine,persons dealing with the Company are entitled to presume that internal requirements prescribed in Moa and AoA have been properly complied with.

Doctrine of Ultra Vires:A company which owes its incorporation to statutory authority cannot effectively do anything beyond the powers expressly or impliedly conferred upon it by the statute or memorandum of association. Any purported activity beyond such powers will be ineffective even if agreed to by all the members. This rule is commonly known as 'doctrine of ultra vires'.

3.29 RECOMMENDED READINGS

Company Law by Dr.S.R.Myneni
Company Law by Avtar Singh

Company law by N.D.Kapoor

3.30 Questions for Exercise

1. Discuss the importance and contents of the Memorandum of Association.
2.Explain the procedure of alteration of Memorandum of Association.
3.Discuss the importance of Doctrine of Indoor Management and its exceptions.
4.Compare and contrast the MoA and AoA.

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B. COM (HONS.)
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SEMESTER III

COURSE: COMPANY LAW

UNIT 4: PROSPECTUS

STRUCTURE

4.0 Objectives of the lesson

4.1 Introduction

4.2 What is a public Offer?

4.3 Contents of a Prospectus

4.3.1Penalty for non-compliance

4.3.2Exemptions

4.3.3 Variation in terms of the contract in the prospectus

4.3.4Exit Option

4.3.5Draft prospectus to be made public

4.4 Abridged prospectus

4.5 When prospectus is not required to be issued

4.6 Requirements in relation to a prospectus

4.6.1Dating of a prospectus

4.6.2Registration of a prospectus

4.6.3 When Registrar shall refuse registration

4.6.4 Penalty

4.7 Deemed prospectus

4.8 Shelf prospectus

4.9 Red-herring prospectus and Information Memorandum

4.9.1Self-Check Exercise 1

4.10 Mis-statement in a prospectus

4.10.1 What is an untrue statement?

4.11 Remedies for mis-statements in a prospectus

4.11.1Civil Liability

4.11.2 Defences available to avoid Civil Liability

4.11.3 Criminal Liability

4.11.4 Defences available to avoid Criminal Liability

4.11.5 LiabilityU/S 36

4.11.6 Self-Check Exercise2

4.12 Golden Rule for framing Prospectus

4.13 Allotment of Shares in fictitious names prohibited

4.14 Summary

4.15 Keywords

4.16 Recommended Readings

4.17 Questions for Exercise

4.0 OBJECTIVES OF THE LESSON

- To describe the importance of Prospectus at the time of Issue of shares
- To explain the concept of Misstatements in Prospectus
- To elucidate the liabilities for misstatements in prospectus

4.1 INTRODUCTION

Prospectus is the outline of any plan submitted for public approval of a joint stock company.A prospectus, as per section 2(70) means any document described or issued as a prospectus and includes a red herring prospectus or shelf prospectus or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate.

Thus, a prospectus is not merely an advertisement it may be a circular or even a notice. A document shall be called a prospectus if it satisfies two things:

1. It invites subscription to or purchase of, shares or debentures or any other of a body corporate.
2. The aforesaid invitation is made to the public.

4.2 WHAT CONSTITUTES A PUBLIC OFFER

If any company invites subscription of allots any security to 200 or more persons in a financial year, it will be said to have made a public offer. However, while counting the figure of 200 persons, the following shall not be taken into account:

1. Qualified institutional buyers:
2. Employees, who are offered securities under a scheme of employees stock option as per provisions of section 62(1)(b).

3. Share and debenture issue meant for more than 200 or more would be a public issue.

2. Company offering shares to public should file application on recognised stock exchange- Every company which intends to offer shares or debentures to public for subscription by way of a prospectus is legally obliged to make an application on a recognized stock exchange.

<u>4.3</u> <u>CONTENTS OF A PROSPECTUS</u>

As per the requirement of section 26 of the Companies Act, 2013, contents of a prospectus shall comprise of:

(i) Information to be given in a Prospectus
(ii) Reports to be set out in the Prospectus
(iii) Declaration to be made
(iv) Other matters

Information to be given in a Prospectus

Section 26 of the Companies Act, 2013, as amended by the Companies (Amendment) Act, 2017, requires a prospectus to e dated and signed and state such information and set out such reports on financial information as may be specified by the Securities and Exchange Board in consultation with the Central Government. However, until the Securities and Exchange Board specifies the information and reports on financial information under sub-section(1) of Section 26, the information to be stated, in this regard, shall be as per the regulations made by the Securities and Exchange Board under the Securities and Exchange Board of India Act, 1992.

Declaration

There shall be included a declaration about the compliance of the provisions of this Act and a statement to the effect that nothing in the prospectus is contrary to the provisions of this Act, the Securities Contracts (Regulation)Act, 1956 and the Securities and Exchange Board of India Act, 1992 and the rules and regulations made thereunder.

Other Matters

Prospectus shall also state such other matters and set out such other reports as may be prescribed.

Statement of an Expert included in a Prospectus

A prospectus may contain a statement purporting to be made by an expert. The term 'expert' includes an engineer, a valuer, a chartered accountant, a company secretary, a cost accountant and any other person who has the power to issue a certificate in pursuance of any law. The reports from an expert must not be included in a prospectus unless:

(i) such expert is a person who is not and has not been engaged or interested in the formation or promotion or management of the company.

(ii) he gave his written consent to the issue of the prospectus and had not withdrawn the consent until the prospectus is delivered to the Registrar for registration.

(iii) a statement that he has given and not withdrawn his consent thereto is included in the prospectus.

4.3.1 Penalty for non- compliance

If a prospectus is issued in contravention of the provisions of this section, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees and every person who is knowingly a party to the issue of such prospectus shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees, or with both.

4.3.2 Exemptions

The aforesaid requirements of Section 26, that is, with respect to the contents do not apply to:

(a) **Rights Issue, i.e**. the issue to existing members or debenture holders of a company, of a prospectus or form of application relating to shares in or debentures of the company, whether an applicant has a right to renounce the shares in favour of any other person or not.

(b) **Shares/ Debentures uniform in all respects:** The provisions of Section 26 do not apply to the issue of a prospectus or form of application relating to shares or debentures which are or are to be, in all respects uniform with shares or debentures previously issued and for the time being dealt in or quoted on a recognized stock exchange.

4.3.3 Variation in terms of contract or objects in prospectus (Section27)

If, at any time, the company wants to alter the terms of contract referred to in the prospectus or objects for which the prospectus was issued, it shall not be allowed to do so except by way of special resolution. The notice of the special resolution must clearly indicate the justification for such variation and the same should be published in the newspapers (one in English and one in vernacular language) in the city where the registered office of the company is situated.

Again, it may be noted that a company cannot use any amount raised by it through prospectus for buying, trading or otherwise dealing in equity shares of any other listed company.

4.3.4 Exit Option

The Companies Act, 2013 has for the first time given an exit option to shareholders who do not agree to the proposal to vary the terms of contracts or objects referred to in the prospectus. The exit option shall be given by promoters or controlling shareholders at such exit price and in such manner and conditions as may be specified by the Securities and Exchange Board by making regulations in this behalf.

4.3.5 Draft Prospectus to be made public

As per the existing procedure, 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. In order to introduce enhanced transparency it has been decided that the draft prospectus filed with SEBI would be made a public document. The lead Merchant Bankers shall simultaneously

file copies of the draft document with the stock exchanges where the issue is proposed to be listed. Lead Merchant Bankers shall also make copies available to the public.

4.4 ABRIDGED PROSPECTUS

It is a memorandum containing such prominent aspects of a prospectus as may be prescribed by SEBI ,according to Section 2(1) of the Companies Act 2013. It is shorter than a prospectus and reduces the cost of capital issue. Section 33 of the Companies Act provides that no form of application for the purchase of any of the securities of a company shall be issued unless such form is accompanied by an abridged prospectus.

If a company makes any default in complying with the provisions of this section, it shall be liable to a penalty of fifty thousand rupees for each default (sub-section (3)].

4.5 WHEN PROSPECTUS IS NOT REQUIRED TO BE ISSUED?

Issue of a prospectus by a company is not compulsory in the following cases:

- A private company is not required to issue a prospectus.
- Even a public company need not issue a prospectus if the promoters or directors feel that they can mobilise resources through personal relationships and contacts, and, therefore, the shares or debentures are not offered to the public.
- Where the shares or debentures are offered to existing holders of shares or debentures by way of right (i.e., rights issue) with or without the right of renunciation in favour of other person (Section 26(2)(a)].
- Where the issue relates to shares or debentures which are, or to be, uniform in all respects with shares or debentures previously issued and dealt in and quoted on arecognised stock exchange [Section 26(2)*(b)*].

4.6 REQUIREMENTS IN RELATION TO A PROSPECTUS

4.6.1 Dating of prospectus

Under Section 26, a prospectus issued by or on behalf of a company or in relation to an intended company must be dated. The date on the prospectus shall be deemed to be the date of the publication of the prospectus.

4.6.2 Registration of prospectus

Section 26(1) requires the delivery of a copy of the prospectus to the Registrar on or before the date of its publication. The copy of the prospectus so delivered, should be signed by all the persons named therein as director or proposed director or by his duly authorised attorney.
Every prospectus issued under sub-section (1) shall, on the face of it, -

(a) state that a copy has been delivered for registration to the Registrar and

(b) specify any documents required by this section to be attached to the copy so delivered or refer to statements included in the prospectus which specify these documents.

The Registrar shall not registrar a prospectus unless the requirements of this section with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus.

The aforesaid requirements apply to existing company or any intended company.

No prospectus shall be issued after ninety days from the date on which a copy of it was delivered to the Registrar.

4.6.3 When Registrar shall refuse registration of a prospectus

Section 26(7) provides that the Registrar shall not register a prospectus unless the requirements of Section 26 with respect to its registration are complied with and the prospectus is accompanied by the consent in writing of all the persons named in the prospectus. This, the Registrar will refuse to register a prospectus if-

(a) It is not dated;
(b) It does not contain matters, reports and declaration to be set out in it;
(c) It contains statements or reports of experts engaged or interested in the formation or promotion or management of the company.
(d) It includes a statement purported to be made by an expert without a statement that he has given his written consent to the issue of the prospectus and has not withdrawn such consent before the delivery of a copy of the prospectus to the Registrar for registration;
(e) A copy delivered to the Registrar is not signed by every person who is named therein as a director or proposed director of the company or by his duly authorized attorney;

4.6.4 Penalty

If a prospectus is issued contravention of the aforesaid provisions of Section 26, the company shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees and every person who is knowingly a party to the issue of such prospectus shall be punishable with imprisonment for a term which may extend to three years or with fine which shall not be less than fifty thousand rupees but which may extend to three lakh rupees, or with both [Section 26(9)].

4.7 DEEMED PROSPECTUS [SECTION 25]

Whenever a company allots its shares or securities to an intermediary viz.bank,Issuing House or merchant bank, for the final purpose of offering those shares for sale,a document of Offer for sale is issued by the intermediary/ Issuing House.The shares or debentures will be allotted to these Issue Houses which will in turn invite subscription from the public through their own offer documents. Thus, the company could indirectly raise subscriptions from the members of the public without issuing an offer document or prospectus.

The offer for sale is deemed Prospectus if :

- the offer of the shares or debentures for sale to the public was made within six months after the allotment or agreement to allot; or
- that at the date when the offer was made, the whole consideration to be received by the company in respect of the shares or debentures had not been received by it.

4.8 SHELF PROSPECTUS AND INFORMATION MEMORANDUM [SECTION 31]

"Shelf prospectus" means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus.

Raising finance from the public by means of various securities is a time consuming process. Every time any such issue comes, a fresh prospectus is required to be filed,which involves lot of time,effort and money . Although it is a repetitive matter, the procedural aspects are tedious. In order to reduce the burden on companies, 'shelf prospectus' has been introduced. The validity period of a 'shelf prospectus' cannot exceed one year from the date of opening ofthe first offering of securities under that prospectus. For subsequent offerings, information memorandum updating the information under the various heads will have to be filed and entire set comprising of shelf prospectus and the information memorandum shall constitute the prospectus and have to be circulated to the general public. The shelf prospectus shall havea validity period not exceeding one year which shall commence from the date of opening of the first offer of securities under that prospectus.

(i) A company filing a shelf prospectus shall be required to file an information memorandum with the Registrar before making of any second or subsequent offer of securities under the shelf prospectus.

(ii) The information memorandum shall contain all material facts relating to:
  - New charges created.
  - Changes in financial position as have occurred between the first offer of securities and the succeeding offer of securities.
  - Such other changes as may be prescribed.

(iii) Where an information memorandum is filed every time an offer of securities is made, such memorandum together with the shelf prospectus shall be deemed to be a prospectus.

4.9 RED-HERRING PROSPECTUS [SECTION 32]

"Red herring prospectus" means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

Section 32 of the Companies Act, 2013 contains the following provisions with respect to 'red herring prospectus':

1. A company proposing to make an offer of securities may issue a red herring prospectus prior to the issue of a prospectus.

2. A company proposing to issue a red herring prospectus shall file it with the Registrar at least three days prior to the opening of the subscription list and the offer.

3. The red-herring prospectus shall carry same obligation as are applicable in the case of a prospectus.

4. Any variation between the red herring prospectus and a prospectus shall be highlighted as variations in the prospectus.

5. Upon the closing of the offer of securities, the prospectus stating therein:

a) the total capital raised, whether by way of debt or share capital,

b) the closing price of the securities, and

c) any other details as are not included in the red herring prospectus

shall be filed with the Registrar and the Securities and Exchange Board of India.

4.9.1Self-Check Exercise 1: Distinguish between Shelf Prospectus and Red-Herring Prospectus.

4.10 MIS-STATEMENT IN A PROSPECTUS AND THEIR CONSEQUENCES

The prospective shareholders are entitled to true and faithful disclosures in the prospectus. The persons issuing the prospectus are bound to state everything accurately and not to omit material facts.

4.10.1 What is an untrue statement/mis-statement?

According to section 34(1) of the Act, a statement included in a prospectus shall be deemed to be untrue:

a) if the statement is misleading in the form or context in which it is included; or

b) where any inclusion or omission from a prospectus of any matter is likely to mislead.

Thus, in regard to considering a prospectus as fraudulent, it is not necessary that there should be false representation in it; even if every word included in the prospectus is true, the suppression of material facts may render it fraudulent. To judge its effect, it should be read as a whole. Sometimes half a truth is no better than a downright false statement as highlighted in the case Rex Vs Kylsant.All the statements included in the prospectus issued by the company were literally true. One of the statements disclosed the rates of dividends paid for a number of years from 1911 to 1927.It was not disclosed that the company had suffered lossesfrom 1921 onwards due to the Econonic recession.Dividends had been paid not out of trading profits but out of accumulated capital profits. This material fact was not disclosed.It

was held that the prospectus was false in material particulars and Lord Kylsant, the managing director and chairman, who knew that it was false, was held guilty of fraud.

4.11 REMEDIES FOR MIS-STATEMENT IN A PROSPECTUS

An allottee of shares, who had applied for shares, on the faith of a prospectus 1)containing untrue statement; or 2) including or omitting material fact which have the effect of what is stated as false has remedies against the company, its promoters and director and experts.

It should be noted carefully that the right to claim compensation for any loss or damage is available only to a person who has "subscribed" for shares, debentures or any other security on the faith of the prospectus containing untrue statements. Thus, a subsequent buyer of shares in the open market has no remedy against the company or the directors or promoter. Ifthere is any misrepresentation of a material fact in a prospectus, there may arise 1) civil liability, and 2) criminal liability.

4.11.1 Civil Liability

Section 35(1) provides that where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who-

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

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

3) is a promoter of the company;

4) has authorized the issue of the prospectus; and

5) is an expert referred to in sub-section (5) of section 26, shall, beside punishment under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

4.11.2 Defences available to avoid Civil Liability

No person shall be liable under Section 35(1), if he proves-

1) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, or

2) that it was issued without his authority or consent; or

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

4.11.3 Criminal Liability

According to Section 34, where a prospectus, issued, circulated or distributed includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorizes the issue of such prospectus involving an amount of at least 10 lakh rupees or 1% of the turnoverof the company, whichever is lower, shall be punishable with imprisonment for a term which shall not be less than six months (3years where fraud involves public interest) but which may extend to 10 years and shall also be liable to fine which shall not be less than the amount involved in the fraud. However, where the amount involved in the fraud is less than Rs.10 lakh or 1% of the turnover of the company, whichever is lower and does not involve public interest, any person guilty of such fraud shall be punishable with imprisonment up to 5 years or fine up to Rs. 20 lakh or both.

4.11.4 Defences available to avoid Criminal Liability

The criminal liability will not be attracted if the person proves that:

(i) such statement or omission was immaterial;

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

(iii) the inclusion or omission was necessary.

4.11.5 Liability under Section 36

Section 36 provides that any person who,

(i) either knowingly or recklessly makes any statement, promise or forecast which is false, deceptive or misleading, or

(ii) deliberately conceals any material facts, to induce another person to enter into, or to offer to enter into specified agreements.

shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

Agreements covered under Section 36 include:

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

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

(c) any agreement for, or with a view to obtaining credit facilities from any bank or financial institution.

4.11.6 Self-Check Exercise2: Explain the civil liability for mis-statement in the prospectus.

4.12 GOLDEN RULE FOR FRAMING OF PROSPECTUS

The 'Golden Rule' for framing of prospectus was laid down by Justice Kindersley in New Brunswick & Canada Rly. & Land Co. v. Muggeride as:

Those who issue a prospectus hold out to the public great advantages which will accrue to the persons who will take shares in the proposed undertaking. Public is invited to take shares on the faith of the representations contained in the prospectus. The public is at the mercy of company promoters. Everything must, therefore, be stated with strict and scrupulous accuracy. Nothing should be stated as fact which is not so, and no fact should be omitted the existence of which might in any degree affect the nature or quality of the principles and advantages which the prospectus holds out as inducement to take shares. In a word, the true nature of the company's venture should be disclosed.

In Rex Vs. Kylsant (1932), the prospectus stated that dividends of 5 to 8 per cent had been regularly paid over a long period. The truth was that the company had been incurring substantial losses during the seven years preceding the date of the prospectus and dividends had been paid out of the realized capital profits. Held the prospectus was false andmisleading. The statement though true in itself was rendered false in the context in which it was stated.

Thus,the Golden Rule is that the Prospectus should tell the truth,the whole truth and nothing but the truth.

4.13 ALLOTMENT OF SHARES IN FICTITIOUS NAMES PROHIBITED (SECTION 38)

Any person who

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

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

(c) otherwise induces directly or indirectly a company to allot, or register any transfer of, securities to him. or to any other person in a fictitious name, shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten

years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.

4.14 SUMMARY

Prospectus is the outline of any plan submitted for public approval of a joint stock company. The prospective shareholders are entitled to true and full disclosures in the prospectus. The persons issuing the prospectus are bound to state everything accurately and not to omit material facts. Those who issue a prospectus hold out to the public great advantages which will accrue to the persons who will take shares in the proposed undertaking. Public is invited to take shares on the faith of the representations contained in the prospectus. The public is at the mercy of company promoters. Everything must, therefore, be stated with absolute accuracy. In case there is misstatement, then the persons who authorized the issue of such a prospectus shall be liable to penalty and imprisonment ,depending on the gravity of the offence.

4.15 KEYWORDS

Abridged Prospectus: It is a memorandum containing such prominent aspects of a prospectus as may be prescribed by SEBI, according to Section 2(1) of the Companies Act 2013.

Shelf Prospectus: Shelf prospectus means a prospectus in respect of which the securities or class of securities included therein are issued for subscription in one or more issues over a certain period without the issue of a further prospectus.

Deemed Prospectus: Whenever a company allots its shares or securities to an intermediary viz. bank, Issuing House or merchant bank, for the final purpose of offering those shares for sale, a document of Offer for sale is issued by the intermediary/ Issuing House, which shall be deemed to be a prospectus for all purposes.

Red-Herring Prospectus: "Red herring prospectus" means a prospectus which does not include complete particulars of the quantum or price of the securities included therein.

Untrue statement: A statement is untrue if the statement is misleading in the form or context in which it is included; or where any inclusion or omission from a prospectus of any matter is likely to mislead.

4.17 QUESTIONS FOR EXERCISE

1. Explain the requirements related to the issue of Prospectus**.**

2. Define Red-herring prospectus.

3. Discuss the liabilities for misstatements in a prospectus**.**

4. What is an untrue statement? Who all can be liable for issue of prospectus containing untrue statement?

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B. COM (HONS.)
(Accounting and Taxation)

SEMESTER III

COURSE: COMPANY LAW

UNIT 5: COMPANY MANAGEMENT

STRUCTURE

5.0 Objectives

5. Introduction

5.2 Board of Directors

5.3 Number of Directors in a Company

5.4 Types of Directors

5.5 Women Directors

5.6 Disqualifications for Appointment of Director

5.7 Directors Identity Number

5.7.1 Person Authorized to Obtain Din

5.7.2 Process of Obtaining Din

5.7.3 Forms for Din Application and Modification Thereof

5.7.4 Fees for Din Application

5.7.5 Documents To Be Submitted to Obtain Din

5.7.6 Application for Modification in Particulars of Din

5.7.7 Salient Features of Din

5.7.8 Cancellation/Surrender/Deactivation of Din- Rule 11

5.8 Appointment of Directors

5.9 Legal Positions of Directors

5.10 Let Us Sum Up

5.11 To Check the Progress

5.11.1 Long Answer Questions

5.11.2 Short Answer Questions and Answers

5.0 OBJECTIVES

After going through this unit, you will be able to:

- Understand how company's management is structured
- Classify different types of directors
- Describe the how a person is qualified for director and how a director is disqualified
- Understand how directors are appointed
- What is director identity number

5.1 INTRODUCTION

The advancement in technology and industrialization has resulted in the large scale organizations which involves big investment and high risk. Traditional business organizations like sole trader, partnership firms have certain limitations like limited resources and unlimited liability due to which these organizations are not suitable for undertaking big business. Joint Stock Company is a form of organization which overcomes these inherited limitations of such type of organization. According to Haney, "Joint Stock Company is a voluntary association of individuals for profit, having a capital divided into transferable shares. The ownership of which is the condition of membership".

In such type of big organization like joint stock company, management and ownership vests in different hands. Company is not managed by the owners themselves rather the authority of controlling and managing the affairs of company is transferred to a group of persons which are the directors of the company. This group/team of directors is collectively named as Board of Directors. This Board of Directors is responsible to act in the best interest and to manage the affairs of the company on the behalf of the shareholders and protects the interest of all the stakeholders of the company. These directors are appointed and authorized by the board resolution beyond these they cannot bind company for their actions. Company will be responsible for only those actions of the directors for which they are authorized to.

Section 2(34) of The Companies Act, 2013 describes that "director" means a director appointed to the board of a company. A director is a person who performs all the duties and functions of a director of company under the provisions of the Company Act, 2013.

5.2 BOARD OF DIRECTORS

A joint stock company is an artificial person in the eyes of law having no physical existence. It can enter into a contract. It can sue and can be sued. But it can do so through its representativesor some human agency that are in charge of the management and are authorized to do so. The person who manages the affairs is called director and collectively they are called as Board of Directors or Board.

Section 2(10) of The Companies Act 2013 defines that "Board of Directors" or "Board", in relation to a company, means the collective body of directors of the company.

5.3 NUMBER OF DIRECTORS IN A COMPANY

Section 149(1) of Companies Act, 2013 limits the maximum and minimum number of directors in a company. According to Companies Act, 2013 there should be

- Atleast 3 directors in case of a public company
- Atleast 2 directors in case of a public company
- Atleast 1 directors in case of one person company

A maximum number of 15 directors can be appointed in a company. But a company can appoint more than 15 directors after passing a special resolution in general meeting. Prior approval of central government is not required for appointing more than 15 directors.

	Public Company	**Private Company**	**One Person Company**
Minimum No. of Directors	3	2	1
Maximum No. of Directors	15	15	15
For more than 15 Directors	Pass a Special Resolution	Pass a Special Resolution	Pass a Special Resolution

RESIDENCE OF DIRECTOR IN INDIA [Section 149(3)]

Section 149(3) of Companies Act, 2013 requires that company shall have at least one such director who have stayed in India for a period of not less than 182 days in previous calendar year. At least one director must have residence of India.

5.4 TYPES OF DIRECTORS

Director of the board are generally classified as:

1. **Ordinary Director**
   Ordinary directors are the directors who participate in the Board meetings and in the matters put before the Board. Ordinary directors are not the managing directors of the company.
2. **Managing Director**
   Managing director is a director who is vested and entrusted with substantial powers to manage the affairs of company by the virtue of Article of Association of the company or by passing the special resolution in the general meeting or by the board of directors.
   Managing director is entrusted with the administrative acts of routine nature by the board. Rather to undertake the acts of routine nature like using the common seal of the company on the documents wherever required, to endorse any cheque on the company's account or

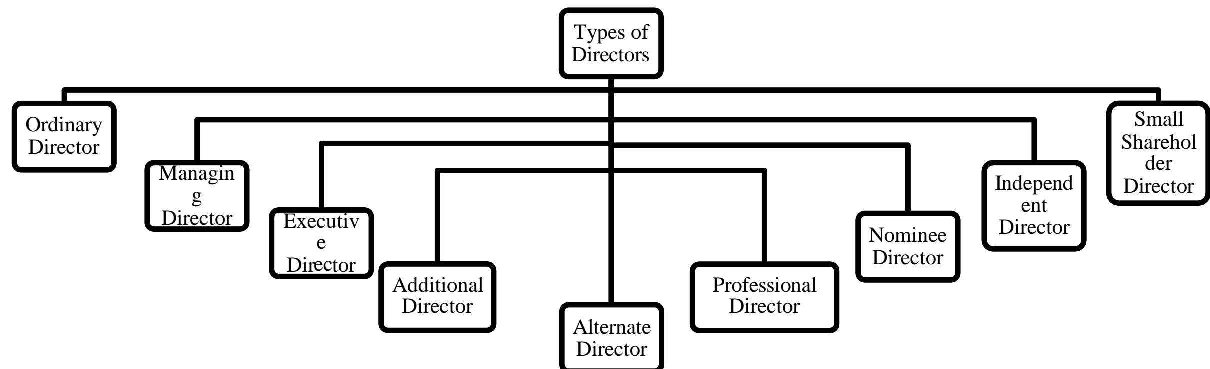
endorsement of any negotiable instrument in the name of company does not included in the administrative acts of routine nature.

3. **Executive Director**

Executive director is also called whole time director. An executive director is a director who is appointed in the whole time employment of the company.

4. **Additional Director**

Additional directors are the directors, according to the section 161 of The Companies Act, 2013, who are appointed by the board between two Annual General Meetings under the provisions of the Articles of Association. This additional director holds the office till the next Annual General Meeting. The total number of directors including additional director shall not exceed the maximum number of director as fixed by the board in Article of Association.



5. **Alternate Director**

According to the section 161 of The Companies Act, 2013, alternate directors are the directors who are appointed by the board to act on the behalf of the "Original Director" who is absent from India for not less than a period of three months. Alternate director can be appointed if so authorized by Article of Association or by passing a resolution in general meeting. Generally, alternative director is appointed for those directors who are Non Resident Indian.

6. **Professional Director**

The professional directors are those who are acquiring professional qualifications of adirector but they do not have interest in the company. These directors are appointed in order to take the advantage of their professional expertise and to utilize that for the board.

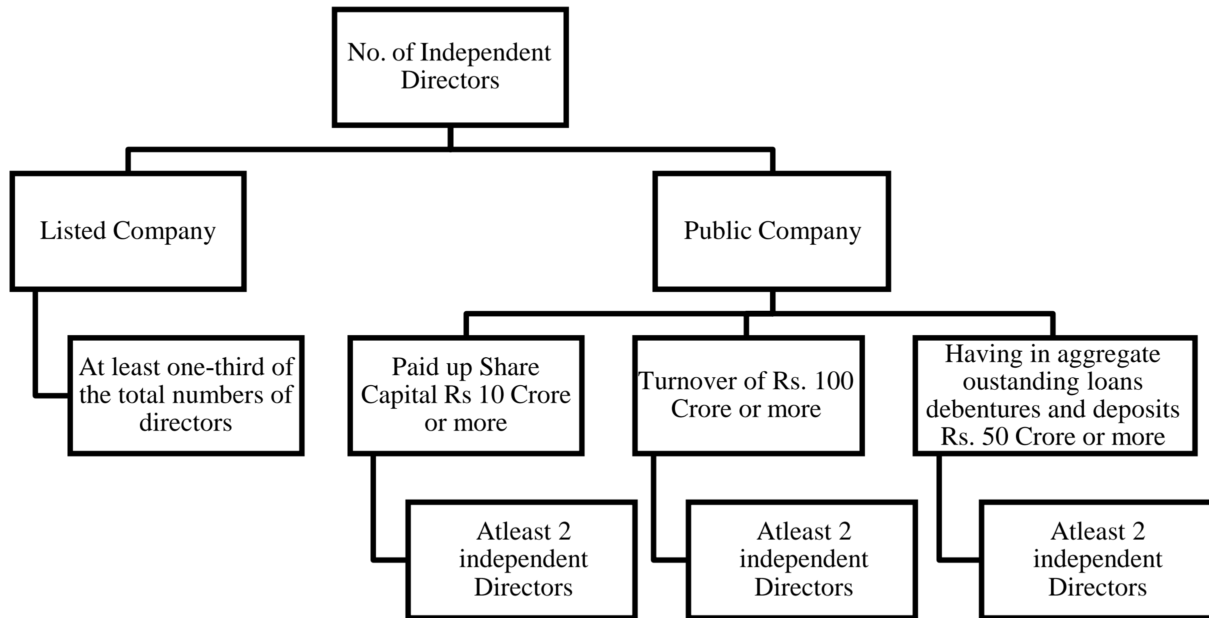
7. **Nominee Director**

Banks and other financial institutions, which provide financial assistance to the company, nominate their representative in the concerned company. These nominated persons are called nominee director

8. Independent Director

Section 2(47) of The Companies Act, 2013 states "independent Director" means an independent director referred to in sub-section (6) of section 149 of Companies Act, 2013. This section includes various provisions and also specifies qualification for an independent director. According to this section, an independent director is a director who is neither a managing director nor a whole time director nor a nominee director and;

a) Who is a person of integrity and have relevant expertise and experience according to the opinion of board;
b) Who is not a promoter of the company or its associate companies like holding or subsidiary;
c) Who is not a relative of a promoter of the company or its associate companies like holding or subsidiary;
d) Who does not have any material relationship with the company or its associate companies like holding or subsidiary during two immediately preceding financial years or during current financial year;
e) Who is not a relative of a person who have any material relationship with the company or its associate companies like holding or subsidiary during two immediately preceding financial years or during current financial year;
f) Who, neither himself or his any relative holds or has held a position of key managerial personnel or has been employee of the company or its associate companies like holding or subsidiary company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;
g) Who, neither himself or his any relative has been an employee or proprietor or a partner in any of the firm of auditors or company secretaries or cost auditors of the company or its associate companies like holding or subsidiary company three financial years immediately preceding the financial year in which he is proposed to be appointed;
h) Who neither himself or his any relative or collectively holds 2 percent or more total voting power of the company;
i) who, neither himself nor any of his relatives is a Chief Executive or director, by whatever name called, of any non-profit organization that receives 25% or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds 2% or more of the total voting power of the company, then also he is not eligible for office of independent director;
j) who possesses such other qualifications as prescribed in Rule 5 as an independent director shall possess.



9. Small Shareholders' Director

According to section 151 of the Companies Act, 2013, every listed company may have one director elected by small shareholders. Companies Act has defined small shareholders as the holders who are holding shares of nominal value of not more than twenty thousand rupees or such amount as may be prescribed.

Terms and Conditions for small shareholders' director

As per the Rule 7 following terms and conditions are to be followed to appoint a small shareholder's director:

i. A listed company may elect a small shareholder's director by acting suo moto upon the notice in writing of not less than 1000 or one tenth of the total number of small shareholders.

ii. The small shareholders intending to propose a person as a candidate for appointing as small shareholder's director shall leave a notice 14 days before the meeting. The notice shall include the details of proposed director. The details include name,address, shares held and folio number etc.

iii. The notice shall be accompanied by a statement signed by the proposed director stating:

   a) his Director Identification Number;
   b) he is not disqualified to become a director under the Act;
   c) his consent to act as the director of the company.

iv. The notice must be signed by 100 small shareholders.

v. In case of listing company, the election of small shareholders director will be through postal ballot.

vi. The tenure of small shareholder's director shall not exceed a period of 3 consecutive years. He shall not retire by rotation. Such director shall not be eligible for the reappointment after the expiry of his term.

vii. Such director cannot hold the office of small shareholder's director in more than two companies at the same time.

5.5 WOMEN DIRECTORS

Rule 3 of the Companies Act, 2013 states that there should be atleast one woman director in

a) Every listed company and;
b) Every public company having a paid up share capital of Rs. 100 crore or more or turnover of 300 crore or more.

Further, if there is any vacancy of a woman director then it shall be filled up by the board of directors within 3 months from the date of such vacancy or not later than immediate next board meeting, whichever is later.

5.6 DISQUALIFICATIONS FOR APPOINTMENT OF DIRECTOR

Section 164 has stated some circumstances in which a person is disqualified for being appointed as director.

1. A person shall not be eligible for appointment as a director of the company if;

a) he is of unsound mind and stands so declared by a competent court;
b) he has been declared as an insolvent;
c) he has applied to be adjudicated as an insolvent and his application is pending;
d) he has been convicted by a court of any offence, whether involving moral turpitude or otherwise, and sentenced in respect thereof to imprisonment for not less than six months and a period of five years has not elapsed from the date of expiry of the sentence. If a person has been convicted of any offence and sentenced in respect thereof to imprisonment for a period of seven years or more, he shall not be eligible to be appointedas a director in any company;
e) an order disqualifying him for appointment as a director has been passed by a court or Tribunal and the order is in force;
f) he has not paid any calls in respect of any shares of the company held by him, whether alone or jointly with others, and six months have elapsed from the last day fixed for the payment of the call;
g) he has been convicted of the offence dealing with related party transactions under section 188 at any time during the last preceding five years; or
h) he has not got the DIN.

2. No person who is or has been a director of a company which-

a) has not filed financial statements or annual returns for any continuous period of three financial years; or
b) has failed to repay the deposits accepted by it or pay interest thereon or to redeem any debentures on the due date or pay interest due thereon or pay any dividend declared and such failure to pay or redeem continues for one year or more, shall be eligible to be re-appointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.

3. A private company may by its articles provide for any disqualifications for appointment as a director in addition to those specified in sub-sections (*1*) and (*2*):

Provided that the disqualifications referred to in clauses (*d*), (*e*) and (*g*) of sub-section (*1*) shall not take effect—

i. for thirty days from the date of conviction or order of disqualification;
ii. where an appeal or petition is preferred within thirty days as aforesaid against the conviction resulting in sentence or order, until expiry of seven days from the date on which such appeal or petition is disposed off; or
iii. where any further appeal or petition is preferred against order or sentence within seven days, until such further appeal or petition is disposed off.

5.7 DIRECTORS IDENTITY NUMBER

Rule 9 of the Companies Rules, 2014 (Appointment and Qualification of Directors) has made it compulsory for every individual who is a director or intends to be the director of a company to have its own Director Identification Number (DIN).

5.7.1 Person Authorized to obtain DIN

An existing director or individual who intends to be director is required to apply for DIN electronically in form DIR-3 to the central government for allotment of a DIN.

5.7.2 Process of Obtaining DIN

a) At the time of Incorporation:

- The Applicant must file the documents with the incorporation application
- Central government will allot the DIN if the documents are proper.

b) At the time of Appointment in the Existing Company:

- Existing company shall pass a resolution in the Board meeting authorizing any existing director to certify DIN application
- Applicant should file the application along with required documents.
- Central government will allot the DIN if the documents are proper.

5.7.3 Forms for DIN application and modification thereof

- **SPICe Form:** Application for allotment of DINs to the proposed first Directors in respect of new companies shall be made in SPICe form only.

- **DIR-3 Form:** Any person intending to become a Director in an existing company shall have to make an application in eForm DIR-3 for allotment of DIN.
- **DIR-6 Form:** Any changes in the particulars of the Directors shall be filed in form DIR-6.

5.7.4 Fees for DIN Application

There is no separate fee for obtaining DIN for the director at the time of incorporation of company. But at the time of appointment in an existence company Rs. 500 shall have to be paid online at the time of uploading DIN application in Form DIR-3.

5.7.5 Documents to be submitted to obtain DIN

- **For Indian National:**
  - Copy of Color Photograph of the Applicant
  - Copy of self-attested PAN as Proof of identity of the applicant (Mandatory)
  - Self-attested copy of any documents as Proof of Address
- **For Foreign National:**
  - Copy of Color Photograph of the Applicant
  - Copy of the Passport duly attested by a Notary and Consulate / Apostille in the country where the applicant is located; as Proof of identity of the applicant (Mandatory)
  - Copy of any one of the below documents duly attested by a Notary and Consulate / Apostille in the country where the applicant is located as Proof of Residence:
    - Bank account statement in country of residence: Not older than 1 year
    - Driving license
    - Electricity bill: Not older than 1 year
    - Telephone bill: Not older than 1 year

5.7.6 Application for Modification in particulars of DIN

If there is any change in the particulars submitted in Form DIR-3/SPICe with respect to Directors, the applicant can submit e-form DIR-6 along with the required attested document.

5.7.7 Salient Features of DIN

- Every individual who is a director or intents to be a director of a company must have to apply for DIN.
- The application for allotment for DIN has to be duly supported with proof of residence and Id proof if the applicant duly attested by him.
- DIN is mandatory for every director for e-filing of forms. It is mandatory for all the directors who holds office in any national, international or multinational company situated in India.
- Validity of DIN is not affected by the resignation from the post of director.

- Even foreign nationals are required to obtain DIN who holds post of director in anyIndian company.
- Only one DIN is required to be appointed as a director of a company. On that DIN an individual can hold infinite directorships in various companies. His DIN will record all the directorship in the database.

5.7.8 Cancellation/Surrender/Deactivation of DIN- Rule 11

Central government or any other competent authority may cancel or deactivate the DIN upon being satisfied in following cases:

a) the DIN is found to be duplicated in respect of the same person provided the data related to both the DIN shall be merged with the validly retained number;
b) the DIN was obtained in a wrongful manner or by fraudulent means;
c) in case of the death of the concerned individual;
d) the concerned individual has been declared as a lunatic or of unsound mind by a competent Court;
e) if the concerned individual has been adjudicated an insolvent
f) on an application made in Form DIR-5 by the DIN holder to surrender his or her DIN along with declaration that he has never been appointed as director in any company and the said DIN has never been used for filing of any document with any authority, the Central Government may deactivate such DIN but after verification of e-records.

5.8 APPOINTMENT OF DIRECTORS

Appointment of directors is must for the success and administration of the company. The appointment of directors is regulated by the Act. An individual who wants to be appointed as a director must have to comply with some provisions which are:

a) Every director must be appointed in the general meeting of the company, except in some cases wherever it is expressly provided by the Act.
b) Every individual who intent to be a director must have a DIN.
c) He must have to provide his DIN and a declaration that he is not being disqualified to become a director.
d) He shall give consent in form DIR-12 to hold the office to the registrar within 30 days of his appointment.
e) Articles of the Company may provide the provisions relating to retirement of the all directors. If there is no provision in the article, then not less than two-thirds of the total number of directors of a public company shall be persons whose period of office is liable to determination by retirement by rotation and eligible to be reappointed at annualgeneral meeting.

A director is appointed in following ways:

1. By the Article as regard first directors (section 152)
2. By the company at General Meeting
3. By the principle of proportional representation
4. By the Board of Directors
5. By third party
6. By the Central Government
7. By the small shareholders
8. By the Tribunal in Sick Industries

1. Appointment of First Director (Section 152)

Generally, the most of the companies name their first director in the Articles o Association. If the name of the first director is not given in the Articles, the members who are the subscribers to the memorandum are deemed to be the first director of the company till the directors are duly appointed.

In case of one person company, an individual member shall be deemed to be the first director of the company until the director is duly appointed by the member (Section 152).

If in any case all the subscribers to the memorandum are bodies corporate, in that case none of the subscribers will be deemed to be the director. In that case the company will have no director until first director is being appointed [Section 152(2)].

2. Appointment of directors at General Meeting

Except first director, all the subsequent directors of the company are appointed in General Meeting. According to Section 152(2), not less than two third of the total numbers of the directors of a public company or a private company which is subsidiary of public company must be appointed by company in general meeting. These directors must be subject to retirement by rotation. Not more than one third of the total number of directors can act as non-retiring directors. The directors of private company must also be appointed by the company in General Meeting.

i. **Retirement by rotation:** According to Section 152(6), two third of the directors are liable to retire by rotation and remaining one third shall retire at Annual General Meeting. According to this Section, all the directors must retire in the course of 3 years in order to prevent mischief of self-perpetuating management. If the number of directors is not in the multiple of three, then it should be round off as one.

   Those directors must retire on the meeting who has been the longest in the office since last appointment. Directors who retire by rotation does not include additional, alternate, debenture holders' or Central government nominee directors. The directors appointed by the financial institutions agreement shall also not liable to retire by rotation.

ii. **Where Annual General Meeting is not held:** The directors would automatically retire from the office on the expiry of their tenure. They cannot prolong their tenure. They ought to have meeting held. It is the duty of the director to call the meeting, they cannot take undue advantage just by omitting to convene meeting.

iii. **Deemed appointment of a retiring director [Section 152(6)(c)]:** The company may reappoint the retiring director or some other person at the Annual General Meeting to fill the vacancy.

iv. **Adjournment of meeting [Section 152(7)(a)]:** If the vacancy of retiring director is not filled and the meeting has not expressly resolved not to fill the vacancy the meeting shall be adjourned.

v. **Automatic Reappointment [Section 152(7)(b)]:** If at the adjourned meeting also the vacancy is not filled and the meeting has not expressly resolved not to fill thevacancy, the retiring director shall be deemed to have been reappointed at the adjourned meeting.

vi. **No automatic reappointment:** At an adjourned meeting, a retiring director shall not be deemed to be automatically reappointed in following cases:

a) Where a resolution for the reappointment of such director was put and lost.\
b) Where the retiring director has, in writing, expressed his willingness to continue;
c) Where he is not qualified or is disqualified for appointment;
d) Where a resolution is necessary for his appointment or reappointment
e) Where it is resolved to fill two or more vacancies by a single resolution.

In case the vacancy is not filled at the annual general meeting and the retiring director is not automatically reappointed, the vacancy may be filled by the Board of Directors.

vii. **Fresh Appointment:** Section 160 provides the procedure of appointment of a person other than retiring director.

viii. **Filing of written consent by directors:** Section 152 requires a new director to file his written consent to act as director within 30 days of his appointment.

3. **Appointment of directors by proportional representation (Section 163)**

Generally directors are appointed by majority votes. Due to which majority shareholders controlling 51% or more votes may elect all their directors and substantial minority I.e. 49% may find no representative on the Board. To protect the interest of the minority shareholders Section 163 has been inserted which has provided opportunities to them to elect their representative on the Board. The Articles may provide that the appointment of not less than two third of the total number of directors of a company shall be according to the principle of proportional representation.

4. **Appointment by the Board of Directors**

Board also has power to appoint

i. Additional Directors
ii. Alternate Directors
iii. Director filling casual vacancy

i. Additional directors: The board may appoint additional director whenever the need arise by passing a special resolution. But the maximum number of directors cannot

exceed its maximum limit mentioned in Articles. This additional director can hold office till next Annual General Meeting and he is not a retiring director. The additional director enjoys the same power as the other directors.

ii. **Alternate Directors:** An alternate director can be appointed on the behalf of the director who is absent from the state where Board meetings are held for more than 3 months. As the alternate director is appointed on the behalf of absent director, that is why the alternate director cannot hold office longer than the period of the absence of the original director from the state irrespective of him attending meetings of the Board. Alternate director can be appointed if it is authorized by its Articles or by passing a special resolution. As alternate director fills the vacancy of the absent director, the duties and liabilities will remain same as of original director.

iii. **Casual Vacancy:** When there is vacancy in the office before expiration of the normal course, like death, insolvency or resignation, that vacancy can be filled by the Board at the meeting. The director appointed in such casual vacancy shall hold the office till tenure of the original director in whose place he is appointed would have hold the office. The director appointed to fill casual vacancy must file his consent with the Registrar within 30 days of his appointment.

5. **Appointment by the third party (Section 152)**

Section 152 permits every public company and private company which is subsidiary of public company to appoint one third of the total number of the directors to be appointed by the third parties other than shareholders on a non-rotational basis. These third parties include debenture holders, financial or banking institutions who have advanced loans to the company. The directors appointed by them are not liable to retire by rotation.

6. **Appointment by Central Government**

Central government has right to appoint directors by passing orders in order to protect the interest of public to prevent mismanagement. Directors appointed by Central Government can hold office for maximum period of three years. This appointment can be done byNational Company Law Tribunal on the recommendation of Central government or on an application of:

i. not less than one hundred members of the company or
ii. of members of the company not holding less than one tenth of the total voting power therein.

7. **Appointment by the Small shareholders**

According to section 151 of the Companies Act, 2013, every listed company may have one director elected by small shareholders. Companies Act has defined small shareholders as the holders who are holding shares of nominal value of not more than twenty thousand rupees or such amount as may be prescribed.

Terms and Conditions for small shareholders' director

As per the Rule 7 following terms and conditions are to be followed to appoint a small shareholder's director:

i. A listed company may elect a small shareholder's director by acting sou moto upon the notice in writing of not less than 1000 or one tenth of the total number of small shareholders.
ii. The small shareholders intending to propose a person as a candidate for appointing as small shareholder's director shall leave a notice 14 days before the meeting. The notice shall include the details of proposed director. The details include name, address, shares held and folio number etc.
iii. The notice shall be accompanied by a statement signed by the proposed director stating:
    d) his Director Identification Number;
    e) he is not disqualified to become a director under the Act;
    f) his consent to act as the director of the company.
iv. The notice must be signed by 100 small shareholders.
v. In case of listing company, the election of small shareholders director will be through postal ballot.
vi. The tenure of small shareholder's director shall not exceed a period of 3 consecutive years. He shall not retire by rotation. Such director shall not be eligible for the reappointment after the expiry of his term.

Such director cannot hold the office of small shareholder's director in more than two companies at the same time.

8. **Appointment by the Tribunal in case of sick industrial companies**

The National Company Law Tribunal can appoint one or more directors who are expert and experienced in management and controlling the affairs of any other company as special director in the Board of the Sick Industrial Company. No provisions related to qualification shares, age, limit, number of directorship, tenure etc shall not apply to the special director appointed by National Company Law Tribunal.

5.9 LEGAL POSITIONS OF DIRECTORS

Directors are appointed to the Board of a company to manage and control the affairs of the company. Their prime task is to protect and the interest of shareholders in good faith. They hold high and responsible positions in the companies like managing director, whole time director or independent director. Despite that it is not easy to explain the legal positions that a director holds in a company. A director acts in different positions in different situations like:

1. **Director as an Agent:** A company is a separate legal entity in the eyes of law and also an artificial person with no physical existence. It cannot act in its own like any human agency. So in order to carry its activities, directors are appointed. These directors act on the behalf of the company in the same way as an agent does for its principle. Director

executes decision making for the benefit of shareholders and enter into contract on behalf of the company. Thus director act as an agent for a company.

2. **Director as Trustees:** Director of a company enjoys various powers in order to exercise its discretion. A director is vested with company's property and their power like a trustee is vested with legal ownership of certain property for the benefit of others. Section 197 of the Companies Act expressly regards director as a trustee in certain circumstances.
3. **Director as Organs of the Company:** Directors are more than just an agent or trustee of a company. Directors are considered as the directing mind or will of the company. The state of mind of the directors is the state of mind of company. The organic theory of corporate treats certain officials as the organs of the company. The Board is considered as primary organ of the company.
4. **Director as an employee:** Director itself does not make any person as an employee. But a company enters into a service contract with the director at the time of his employment. directors who are appointed as employee director or whole time director are considered as an employee.
5. **Directors as Managing Partners:** Some authors treat company as a large partnership and so directors as managing partners as the power to manage the company is in the hands of directors.

5.10 LET US SUM UP

The success of a company depends to a great extent upon the competence and honesty of its directors. Therefore it is desirable that the administration of companies should be in right hands. Hence, it is pertinent to appoint directors according to the provisions of law.

5.11 TO CHECK THE PROGRESS

5.11.1 Long Answer Questions

1. Briefly discuss the provisions of Companies Act regarding appointment of directors of a company.
2. Discuss the various types of Directors.

5.11.2 Short Answer Questions

1. Women directors
2. Legal position of director
3. DIN

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B. COM (HONS.)
(Accounting and Taxation)

SEMESTER III

COURSE: COMPANY LAW

UNIT 6: POWERS AND DUTIES OF DIRECTORS AND KEY MANAGERIAL PERSONNEL

STRUCTURE

6.0 Objectives

6.1 Introduction

6.2 Responsibilities of Directors

6.3 Liabilities of Directors

6.4 Powers of Directors

6.4.1 Power Under Section 179 of Companies Act, 2013

6.4.2 Powers of Board Under Rule 8

6.4.3 Some Other Powers

6.5 Duties of Directors

6.5.1 Fiduciary Duties

6.5.2 Implicit Duties

6.5.3 Statutory Duties

6.6 Removal of Directors

6.6.1 Removal by Board of Directors

6.6.2 Removal by Resignation (Suo Moto)

6.6.3 Removal by the Shareholders

6.6.4 Procedure for Removal of Director

6.6.5 Removal by Tribunal

6.7 Key Managerial Personnel

6.7.1 Managing Director

6.7.1.1 Appointment of Managing Director

6.7.1.2 Powers and Duties of Managing Director

6.7.2 Whole Time Director

6.7.2.1 Difference Between Managing Director and Whole Time Director

6.7.3 Manager

6.7.3.1 Difference Between Manager and Managing Director

6.7.4 Company Secretary

6.7.5 Chief Financial Officer

6.8 Let Us Sum Up

6.9 To Check the Progress

6.9.1 Long Answer Questions

6.9.2 Short Answer Questions and Answers

6.0 OBJECTIVES

After studying this unit, students will be able to:

- Understand the powers of Directors under various statutory provisions
- Understand the fiduciary, implicit and statutory duties of Directors
- Know the procedure of removal of Directors by shareholders
- Know the removal of Directors by Tribunal
- Identify the Key Managerial Personnel
- Distinguish between a Manager, Managing Director and Whole-time Director

6.1 INTRODUCTION

Directors are the persons who provide direction and supervision for the affairs of the company. As per section 2(34) of the Companies Act, 2013 director means a director appointed to the board of a company. Section 149 of the Companies Act, 2013 states that in every board of directors shall have individuals as directors:

- A minimum number of 3 directors in case of public company, 2 directors in case of private companies and 1 director in case of one person Company.
- A maximum of number of 15 directors and this maximum limit can be increased after passing a special resolution.
- At least 1 women director as prescribed for such class of company.
- At least 1 director from every company has stayed in India for a total period not less than 182 days in the previous calendar year.
- At least one third of the total number of director from every listed public company should be on the position of independent directors. The Central Government may also prescribe minimum number of independent directors for any class of public companies.

Directors have a legal position in the company as agents, trustees and as managing partners. Directors must always act in good faith for the company. They have the fiduciary relationship

with the company when they act as agents or officers of the company. They have to follow the articles of association and act through meetings of the Board of Directors. In real sense, the directors are not the agents completely, nor the trustees and managing partners. The role of director in a company describes their position as the combination of all three and more than that also. They are the officers in a concern but without being the legal owner of that concern.

6.2 RESPONSIBILITIES OF DIRECTORS

A Director is responsible for superintendence, control and direction of the affairs of company. The responsibility of company's management and operations lie on the shoulders of directors. They act on behalf of the company and perform their work in best interests of stakeholders, community and protection of environment. He should only act in accordance with the article of association. The director should ensure proper routine working of the company. It is definitely inthe hands of directors that how far they can take a company to the path of growth and innovation.

6.3 LIABILITIES OF DIRECTORS

Directors cannot transfer their responsibilities which are specifically imposed to them and thus they themselves have to face the consequences for their acts in case of any misconduct. Director when use its discretion and judgment for the decisions, then in case of any negligence he shall be personally liable. Thus, under many circumstances the liability of directors arises to the company, co-directors and third parties. It is therefore said that, a person when in power should always act with caution.

6.4 POWERS OF DIRECTORS

The Board of Directors can exercise all such powers and to do all such actions which the Company is authorised to do. The powers of directors are co-extensive with the powers of Company. But there are two limitations on exercising powers by Board –

- Board of Directors cannot do such acts in the general meetings as shareholders can do.
- The power in the hands of directors can be exercised in accordance with the article and memorandum of association.
-

6.4.1 Power under section 179 of Companies Act, 2013

1) Directors have the power to make call on shares in respect of unpaid money.
2) Directors have the power to borrow funds otherwise than on debentures on name of company.
3) Directors can authorize buyback of shares u/s 68.
4) Directors can directly grant loans or can give guarantee in respect of loans.
5) Directors have the power to invest in funds on behalf of company.
6) Directors can issue debentures in or outside India.
7) Directors approve the company's financial statement and board's report.

8) Directors have the power to takeover or acquire a company, or buy substantial stake of another company.
9) Directors can exercise their powers for merger, amalgamation or reconstruction.
10) Directors possess all the powers for company's diversification.

Thus, directors can exercise all the above discussed powers along with any other power relating to the company's matter as prescribed by the company law.

6.4.2 Powers of Board under Rule 8

The following additional powers can be exercised by the Board of Directors only by means of passing resolutions in the Board meeting under Rule 8 of the Companies (Meeting of Board and its Powers) Rules, 2014.

1) Directors have the power to make political contributions.
2) Directors decide appointment and removal of Key Managerial Personnel (KMP).
3) Directors can appoint secretarial and internal auditors.

6.4.3 Some other Powers

There are many other powers in the hands of Board of Directors who are responsible for managing the company and its routine activities. The following points illustrate the matter in which directors can access their powers for taking decisions.

1) Directors have the power to approve interim dividend.
2) Directors recommend the final dividend to be paid to shareholders of the company.
3) Directors appoint whole time secretary for issuance of compliance certificate.
4) Directors have the power to fill the casual vacancy of auditors caused otherwise than by resignation.
5) Directors make decisions for issuing bonus shares and capitalizing the reserves of the company.
6) Directors can appoint buying or selling agents.
7) Directors in the Board have the power to nominate managing director.
8) Directors play a powerful role in issuance and allotment of shares and debentures.

6.5 DUTIES OF DIRECTORS

Directors act on behalf of the Company, and while acting for it, the director needs to take care of his duties. As a responsible person of the Company, the director should always put sincere efforts for protecting the interests of the Company. The duties and responsibilities of Directors stipulated by Companies Act, 2013 can be classified as –

- Fiduciary duties
- Implicit duties
- Statutory duties

6.5.1 Fiduciary Duties u/s 166 of the Companies Act, 2013 ensure that the directors shall keep the interests of company and its stakeholders ahead of their own personal interests.

1) Directors of the company shall act in accordance with the articles of the company as per the provisions of this act.
2) Directors have to act in good faith in order to promote the objects of the company for the benefits of its members as a whole.
3) Directors should work in the best interests of the company, employees, shareholders, community and the environmental protection.
4) Directors shall perform their duties with reasonability, diligence care and skill.
5) Directors shall exercise their independent judgment with appropriateness.
6) Directors shall not involve themselves in any such situation in which their interests act as a conflict with the interests of the company.
7) Directors cannot assign his office to any other person, and if they do so, that assignment will be considered as void,
8) Directors shall not gain any kind of advantage either to him or to the persons related to him.

If any director contravenes any of the above discussed provisions of the section 166 of this act, then he shall be punishable with the fine which shall not be less than one lakh rupees but which may extend to five lakh rupees.

6.5.2 Implicit Duties

1) Directors should ensure value creation in the company with its leadership style. Directors act as a custodian of the governance of company. Thus, they should pass reasonable judgments when it directs, governs and control the company.
2) Directors should identify and evaluate key performance areas and risk areas.
3) Directors should focus on effective strategy formulation and sustainable outcomes.
4) Directors should ensure ethical working environment in the company which is based on four pillars i.e., responsibilities, accountability, fairness, transparency and fairness. They should also see that this ethical culture and standards should be integrated in company's strategies and policies and reflected from it.
5) Directors should ensure that company be a responsible corporate citizen towards the environment and society in which it operates.
6) Directors should also see the working of audit committee and ensure if the committee is working with effectiveness and independence.
7) Directors are responsible for the risk policy and plan.
8) Directors should ensure the alignment of IT in the performance of the company. IT governance is important for a company to survive competition.
9) Directors should ensure compliance of laws, rules, regulations and all relevant standards.
10) Directors should test the company's internal control system timely and draw plans and policies to make it effective.

11) Directors can appoint chief effective officer, which is the most important power that vests with Board. It is the responsibility of directors to appoint a suitable chief executive officer.
12) Directors should ensure that the chairman of the Board works with full independence and ethical tone.
13) Directors should be ready with business rescue plan whenever the company is facing losses.
14) Directors should strive to achieve balance between the company's interests and other stakeholders' interests.
15) Directors should thoroughly study and analyse company's integrated report.

6.5.3 Statutory Duties

1) It is the duty of the directors not to allot any shares until minimum subscription is raised. (sec. 39)
2) It is the duty of directors to sign annual returns and certificates attached with it. (sec. 92)
3) It is the duty of directors to call an annual general time with in proper time after passing a year. (sec. 96)
4) It is the duty of directors to call an extraordinary general meeting on requisition. (sec. 100)
5) It is the duty of directors to state the final statement of company's affairs by preparing profit and loss account and balance sheet and produce before the company along with the director's report. (sec. 128,129 and 134)
6) It is the duty of directors to forward statutory report to every member of the company. (sec. 165)
7) It is the duty of directors to take share qualification.

6.6 REMOVAL OF DIRECTORS

Directors being the representative of the company can anytime be removed from his office on certain parameters. A director being a part of board members owns and manages the company. But, the law specifies if there is breach of any condition or misconduct by the director then he may have to vacate his office. A director can be removed from his office by:

- Board of Directors
- Suo moto u/s 168
- Shareholders u/s 169
- Tribunal u/s 402

6.6.1 Removal by Board of Directors

The board is authorized to remove any director from his office if the director as per section 167 of the Companies Act, 2013 didn't attend all the meetings of the Board for consecutive 12 months without any prior notice or without giving any sick leave. This condition of removal

applies to all the directors except for the director appointed by NCLT or Central Government. The procedure for removal of directors involves –

- Calling of a Board meeting
- Passing of resolution by BOD to call general meeting
- Calling of General meeting of shareholders
- Passing ordinary resolution
- Intimation to ROC by the company3

6.6.2 Removal by resignation (Suo Moto)

The director can Suo Moto resign from his position as per section 168 of the Companies Act, 2013 after giving intimation to ROC and the Company. The director shall give resignation letter by specifying the reason and date of resignation. After giving all the details of resignation to the company, the intimation is then given to ROC by the director and Company both.

6.6.3 Removal by the shareholders (section 169)

1) This section authorizes the company to remove a director by passing an ordinary resolution before the expiry of his office period. The directors can be removed by the shareholders but by giving him reasonable opportunity of being heard under this section except in the following condition:
   - If the director is appointed by the Tribunal under section 242;
   - If the director is a nominee director of a public financial institution, which is by its charter empowered to nominate a person as a director or to remove him notwithstanding any power contained in any other Act;
   - If the director comes within the purview of directors (where not less than two thirds of the total number of directors) appointed according to the principle of proportional representation under section 163 of the Act.
2) Directors can be removed only after meeting the requirement of special notice of any resolution passed to remove a director or to appoint somebody in his place at the meeting in which he is removed.
3) The concerned director should immediately be sent a copy of such notice of resolution to remove a director under this section.
4) The director, whether or not a member of the company, shall be heard while passing the resolution of the company.
5) A vacancy created on removal of director may be filled in the same meeting in which the director is being removed by the appointment of another director, provided that a special notice has already been given relating to that appointment.
6) If the vacancy is not filled in the above discussed way, then it may be filled as a casual vacancy as per the provisions of this Act. But, the vacancy shall be filled on a condition that the director who was removed from his office shall not be re-appointed as a director of the company.

7) A director so removed shall be paid with all the damages and compensation in respects of his removal from his office.
8) The concerned director may also make any representation in writing and requests for its notification to members.

6.6.4 Procedure for removal of director

1) A special notice (section 115) along with the draft resolution is prepared which is to be passed in the Board meeting. The notice for the removal of director is to be furnished atleast 14 days before the meeting.
2) Shareholders those who can send special notice to the Company for removal of directors are the ones holding not less than 1% of the total voting power or holding on which an aggregate sum of not less than ₹5,00,000 has been paid up as on the date of notice.
3) It is to be ensured that the notice for removal of director is for the person otherwise than the director appointed by the Tribunal u/s 242 of the Companies Act, 2013.
4) It is also ensured that the notice for the removal of director is for a director other than appointed with the principle of proportional representation.
5) The concerned director should be given intimation about his removal by sending a copy of the special notice and an opportunity of being heard on the resolution to be passed in the company's meeting.
6) The notice to pass the resolution on removal of director shall be passed to the other members of the company or to be published in an advertisement atleast 7 days before the meeting.
7) The general meeting is held then and an ordinary resolution is passed for the removal of director.
8) Draft minute of the meeting is prepared, duly signed and circulated among the concerned members.
9) File e-form no. DIR-12 with the registrar of companies within 30 days of passing the general meeting resolutions.
10) Necessary entries and records are maintained in the registers of directors, shareholders and key managerial personnel.

6.6.5 Removal by Tribunal

An application is made to the Tribunal u/s 241 for prevention of oppression and mismanagement of company's affairs, the Tribunal when satisfied, order for the removal of any of the directors of the company (Section 242). The Tribunal may also pass the order for the termination or setting aside of an agreement which the company might have made with its directors. After passing the order, the effect will be removal of such director from his office. Such director (including managing director) after the Tribunal's order for termination or setting aside of contract with the company cannot serve as a manager, managing director or director of any company for next 5 years from the order date. Here, the removed director doesn't get any compensation from loss of

his office. National Company Law Tribunal may also modify the agreement of the company with the director or completely terminate it.
This all takes place if the business carried out by the director is against public, government and company policies. When the director seems to be part of any fraud or negligence and working against the business principles, then the NCLT has the power to conduct an inquiry against the director.

6.7 KEY MANAGERIAL PERSONNEL

According to section 2(51) of the Companies Act, 2013, key managerial personnel include:

- Chief Executive Officer or the Managing Director
- Chief Financial Officer
- Manager
- Company Secretary
- Whole Time Director

Key managerial personnel are those who manage the operations of the company. They perform the functions of planning, directing and controlling the activities of the company. They act as a first point of contract between the stakeholders and company. These personnel are responsiblefor important decisions to be taken by the company. Board of Directors appoints key managerial personnel who are expert in their respective field depending upon the scope of the company. These officers may or may not be the director of the company.
As per section 203 of the Companies Act, 2013 read with the Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, the companies which are required toappoint key managerial personnel are:

a) Every listed company and
b) Every other public company having paid-up share capital of 10 crore rupees or more shall have the following whole-time key managerial personnel:
    - Managing Director, or Chief Executive Officer or Manager and in their absence, a whole time director;
    - Company Secretary
    - Chief Financial Officer

6.7.1 Managing Director

According to Section 2 (54) managing director means “a director who, by virtue of articles of a company or an agreement with the company or resolution passed by the company in general meeting or by its board of directors, is entrusted with substantial powers of management of the affairs of a company and includes a director occupying the position of a managing director, by whatever name called.”
A managing director is actually a director who comes at top management officers of the company. He exercises his substantial powers to control the company by acting under thedirections given by the board of directors. The managing director ceases to be so the moment he

ceases to be a director. The managing director who is also called as chief executive officer has authority over all operations in the company. He has the responsibility for the innovation and growth of the company.

6.7.1.1 Appointment of Managing Director

The appointment of a managing director can be made either by:

- an agreement with the company; or
- a resolution passed by the company in the general meeting; or
- a resolution of the Board of Directors; or
- a clause in the articles or association of the company.

With the appointment of managing director, the remuneration and other terms and conditions relating to it are approved by Board of Directors in its meeting. Also, no company can appoint or re-appoint its managing director or whole-time director for a period more than 5 years at a time.

6.7.1.2 Powers and duties of Managing Director

A managing director is the one who manage all the operations of a company. The powers and authorities in the hands of managing director are usually defined by the agreement with which he is appointed by the company and those written in Articles and Memorandum of the company. Those powers and duties are also be exercised which is the outcome of the resolutions of the shareholders or the directors. When there is more than one managing director in the company, the power may relate to particular division. The managing director is given with substantial power to exercise its control over the company. He should ensure proper superintendence and direction while coordinating with other board members. Along with the responsibilities of managing director, he also has the duties and liabilities of an ordinary director.

6.7.2 Whole Time Director

As per sec 2(94), whole time director is the director who is in whole time employment of the company. He is the one devotes almost his whole working time for the work done in company. He doesn't exercise his substantial powers in the management. He is appointed the same way as managing director appointed following the provisions of section 196 of the Act. Whole-time director is more inclined towards performing the important administrative functions.

6.7.2.1 Difference between Managing Director and Whole Time Director

Basis	Managing Director	Whole Time Director
Power	Managing director has substantial powers to take all the important decisions of the company.	Whole-time director's power is stated in his terms of employment, which generally do not have any such discretionary powers to take

		decisions on important matters.
Prohibits	Section 196 prohibits appointing a managingdirector and a manager simultaneously in a company.	A company can appoint a whole-time director and a manager both at same time.
Number of companies	A managing director can hold this same post in more thanone company at a time.	A whole-time director can hold his post in more than one company at same time. He can only work as whole-time employee of one company at a time.
Duration of appointment	No person can be appointed or re-appointed as managing director for more than five years at a time.	There is no such restriction regarding the employment of whole-time directors.

6.7.3 Manager

As per Section 2(53) “manager” means an individual who, subject to the superintendence,control and direction of the Board of Directors, has the management of the whole, or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, whether under a contract of service or not. A manager is a person who work under the control and direction of Board of Directors and entrusted with management of all the company’s affairs.

As per section 196 the Act, the manager is appointed the same way a managing director is appointed. The conditions relating to term of office and number of companies shall be applicable as the same way in case of Managing Director. Thus, a manager can also be appointed or re-appointed for a period of 5 years at a time. And a manager can also hold his position as manager in more than one company at a time which makes it distinctive from a whole-time director.

A manager is appointed by the Board of Directors at a meeting by passing a resolution. This appointment further requires a resolution to be passed at the next general meeting of the company which consists of remuneration to be paid to the manager and terms and conditions for his appointment. The remuneration and terms and conditions are first approved by the board, andthen it is passed for the final decision to be taken at general meeting. Any act done before passing the resolution and getting approval from board of directors shall be void.

6.7.3.1 Difference between Manager and Managing Director

Basis	**Manager**	**Managing Director**
Power	A manager usually has	A managing director exercises

	management rights over whole or substantially whole of the company. He is responsible for overall of management of the company.	substantial powers over the management which would not otherwise be exercisable.
Position of Director	A manager may or may not be on the position of director of a company.	A managing director must be on the position of director.
Number	In a company, there can be only one manager at a time.	A company can have more than one managing director at a time.
Appointment	A manager is appointed under a contract of service or otherwise.	A managing director is appointed by the agreement of the company, or the resolution passed by the shareholders or by the board of directors or by the provisions of article and memorandum of association.
Remuneration	Maximum remuneration payable to a manager is 5% of the net profits	Maximum remuneration payable to the managing directors is 10% of the net profits, in case there is more than one managing director.

6.7.4 Company Secretary

As per section 2(24) of the Act, a company secretary is required to report the Board about the compliance of the provisions and other rules of this Act. A company secretary ensures if the company is following all the required standards and regulations for running the operations and recording it in books of accounts. In some countries, a company secretary is known as the corporate secretary. So, a corporate secretary ensures all about the targets and instructionsimplementation in the company given by the Board. The role of company secretary is described as:

1) To provide assistance to Board of Directors in conducting and managing the company's affairs.
2) To perform duties given to itself by the Board of Directors.
3) To facilitate Board meetings and General meetings and maintain the minutes of the meeting.
4) To represent the company before Tribunals, regulators and other authorities.

6.7.5 Chief Financial Officer

As per section 2(19) of the Companies Act, 2013 Chief financial officer is the one who leads the finance and treasury functions of a business enterprise. He is hired for this position specifically and should not hold any other position like consultant in the company. He works at the senior level executive position and handles the financial position of the Company. CFO manages all thefunds of operations, performs financial planning and is responsible for financial decisions. In case of possibility of financial crisis, CFO should be ready with contingency plans and correctiveaction plans. CFO analyzes company's financial strengths and weaknesses and frame plan of action according to that. The role of CFO is to ensure that company's financial reports are timelyand accurately prepared.

6.8 LET US SUM UP

After studying the concept of Director and their role in the company, we can conclude that Directorship is the most important element on which the future of a business depends. Directors act through a fiduciary relationship with the company and represent the company to everybody inside or outside it. Thus, being a trustee, agent, employee, or officer of the company it is required from them that they must act in good faith only. Directors must have a vision for the company which takes the business to the new level of technology growth and innovation. The statement that 'a company is known from its people' works well in reference to the directors.

6.9 TO CHECK THE PROGRESS

6.9.1 Long Answer Questions

1. What is the procedure of removing a director?
2. Discuss the liabilities of a Director to the Company and outsiders.
3. Explain the powers and duties of Directors.

6.9.2 Short Answer Questions

1. Difference between Manager and Managing Director
2. Difference between Managing Director and Whole Time Director
3. Discuss the procedure of removal of director by Tribunal.

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B. COM (HONS.)
(Accounting and Taxation)

SEMESTER III

COURSE: COMPANY LAW

UNIT 7: MEETINGS

STRUCTURE

7.0 Objectives

7.1 Introduction

7.2 Meaning of Meetings

7.3 Essentials of Meetings

7.4 Types of Meetings

7.4.1 Amendments w.r.t. Meetings via Video Conferencing

7.5 Convenor of Meetings

7.6 Procedure of Meetings

7.6.1 Resolution

7.6.2 Kinds of Resolution

7.6.3 Minutes

7.6.4 Publication of Reports and Proceedings

7.6.5 Service of Documents on Members

7.6.6 Service of Documents on the Company

7.7 Check Your Progress

7.8 Postal Ballet

7.9 Postal Ballet Resolutions

7.10 E-Voting

7.11 Let Us Sum Up

7.12 To Check the Progress

7.12.1 Long Answer Questions

7.12.2 Short Answer Questions and Answers

7.0 OBJECTIVES

After studying the Unit, you would be able to

- Understand the meaning of meetings
- Explore the types of meetings
- Get through the legal aspects of company laws
- Give brief idea about the framework of Indian business laws

7.1 INTRODUCTION

A corporation is a legal entity that consists of a group of people who work together to run a business. A company's management necessitates the efforts of many people who discuss and deliberate matters before making a decision. Decisions are frequently made in meetings, which are a formal interaction between the company's management (usually the directors and in some cases members too).

7.2 MEETING

In common language, the term "meeting" refers to the act of coming face to face, in company, or together. The Oxford Dictionary defines a meeting as "Meeting can be described as a lawful association or gathering of two or more people who have been given prior notice to do business. The meeting must be called and convened legally. Company meetings are these types of gatherings of company members".

7.3 ESSENTIALS OF COMPANY MEETINGS

1. Two or More People: A valid meeting requires the presence of two or more people. The articles of association, on the other hand, may specify that a legal quorum consists of a larger number of people.
2. Lawful Assembly: The meeting must be for the purpose of conducting legal business. In the eyes of the law, an unlawful assembly is not a meeting.
3. Prior Notice: For a meeting to be valid, prior notice is required. In the eyes of the law, a meeting that occurs by chance and is not convened after adequate notice is not a lawful meeting.
4. To Conduct Business: The meeting's purpose is to conduct business. It is not a valid meeting if there is no clear purpose for the meeting or if it is called without one.

7.4 TYPES OF MEETINGS

1. **Annual General Meeting**

   One of a company's most essential meetings is the Annual General Meeting. It normally takes place once a year. AGMs should be held by both private and public limited liability corporations, whether they are limited by shares or by guarantee, and whether or not they have a share capital. The meeting, as the name implies, will be convened once a year to conduct the company's regular business.

According to section 96 of the Companies Act 2013, every public and private company is obligated to hold an annual general meeting, which is monitored by its directors, to evaluate the business's progress and plan future course of action.

• Notification: The meeting must be announced in advance, usually at least 21 days before the appointed date. In some instances, a meeting can be convened at the last minute.

• Meeting time and location: The meeting must take place within normal business hours on a working day and not on a national holiday. In most cases, it must be the company's registered office.

• Meeting due date: Meetings must be convened within nine months of the company's first financial year's end, and within six months of the end of following years' ends. A maximum of 15 months must pass between two sessions. The registrar has the authority to extend the AGM time at his or her discretion, according to the provision (not more than 3months).

• Tribunal calling the meeting: The Act gives the Tribunal (a quasi-judicial body created to arbitrate disputes arising out of company law) the power to convene or make directions for calling the meeting if the meeting is not held within the required period under section 96.

• Penalties for default: Section 99 of the Companies Act 2013 states that anyone who is found to be in default is subject to a fine of up to one lakh rupees, depending on the circumstances.

• Delaying the meeting: There may be times when the company's directors are unable to hold the annual general meeting despite the fact that the deadline has passed. In various instances, as determined by a skilled judge in one of the cases, directors are not liable.

• Delaying the meeting: There may be times when the company's directors are unable to hold the annual general meeting despite the fact that the deadline has passed. In such instances, as determined by a skilled judge in one of the cases, directors are not liable.

• Validity after a delay: While the legal world is divided on whether an AGM convened after defaulting is valid, it is generally considered valid in the eyes of the law once the defaulting members pay a fine.

• First Annual General Meeting: Companies convene their first annual general meeting either immediately or within six months after its incorporation. It's known as the first AGM, or “statutory meeting”. Until 2013, when the company legislation was amended, itwas a mandatory clause. It is now up to the firm to decide whether or not to convene this meeting. Statutory meetings are not required for a private corporation or a public firm with no share capital.

2. **Extra ordinary meetings**

Extraordinary General Meetings are held on a regular basis (EOGM) Ordinary meetings of a firm include Statutory Meetings and Annual General Meetings. Other than these two,all other general gatherings are referred to as Extraordinary General Meetings. As the

name implies, these meetings are called to address any extraordinary issues that arise outside of the regular business of the Annual General Meetings.

EOGMs are typically convened to conduct urgent or extraordinary business that cannot wait until the next Annual General Meeting. Special Business refers to all of the business that is transacted at these meetings.

• Section 100 of the Companies Act establishes the guidelines for the board to summon an extraordinary general meeting to discuss an issue that requires prompt attention.

• Organizing the meeting: The board of directors has the authority to call an extraordinary general meeting (they cannot call AGM). The Act also allows for the meeting to be called upon the request of members who own at least 1/10 of the shares on the voting day or have at least 1/10 of the total voting power. EOGMs can also be called by national company tribunals.

• Time: The meeting is scheduled between two AGMs to tackle a serious issue.

• The nature of the business: Apart from discussing dividends and auditors, the topics discussed in the meeting are unique. Unexpected costs accrued, for example, or a change in the company's affiliation is examples of urgent matters. The issues are those that aren't brought up in statutory or general meetings.

• Requisitioning the meeting: If the board fails to call the meeting within 45 days after sending a requisition notice, the requisitionists can call it within three months (though they have the duty to call it within 21 days). If requisitionists are denied permission to hold EOGM, they are allowed to proceed to tribunals. However, they must first request for permission.

3. Board meetings

Section 173 of the Companies Act 2013 mandates that the board of directors meet in order to perform its rights and functions. This is to ensure that the board of directors effectively oversees the organization.

- First board meeting: The first board meeting should take place within 30 days of the company's incorporation. The board of directors uses their experience and skills to discuss business plans.
- Time and due date: There should be at least four meetings per year, with no more than four months between them. To put it another way, every board meeting must take place within three months in order to complete the needed provision.
- Directors' presence: Directors are not required to be physically present at every meeting; they can be present through video or voice. However, there may be some issues that cannot be handled via video conferencing other audiovisual means, in which case the central government may prohibit their usage. In addition, a director can only be absent if the board of directors gives him or her permission.

- Notice: Every director must be contacted in advance of the meeting at his or her registered address, and notice must be given within seven days. Furthermore, the conclusions of the meetings must be communicated to directors who were unable to attend. If the person in charge of notifying fails to do so, he may face disciplinary action. When directors are alerted, they are ensured to be in compliance with the law.
- Quorum: According to section 174, a certain number of members or directors must be present at the meeting. One-third of the board members, or two directors, will attend the meeting (whatever is feasible).

4. **Other meetings**

In a business, there are a variety of additional types of meetings that take place. There are no clearly defined provisions for such meetings, but they have become part of company law as a result of a number of judicial decisions and interpretations.

• Creditors meetings: Companies can establish arrangements with creditors under section 230 of the Act. Meetings of the directors, board of directors, and creditors are frequently held to consider such arrangements. It's referred to as a creditors' meeting. In some situations, the judiciary may play a significant role in convening creditors' meetings.

• Debenture holders meeting: Companies have the right to issue debentures, and this is referred to as a debenture holders' meeting. The board of directors and debenture holders meet to discuss the rights and duties of debenture holders.

• Audit committee meetings: Companies can have an audit committee made up of directors of companies that are similar to the main company, according to Section 177 of the Companies Act. These auditors have their own meeting to discuss various concerns that come up in audit committee sessions.

5. **Meetings through video conferencing**

Video conferencing or other audio visual means" has been defined as an audio-visual electronic communication facility that allows all participants in a meeting to communicate with each other in real time, without the need for an intermediary, and to participate in the meeting effectively and efficiently. Section 173 sub-section (2) states that directors may attend a Board meeting in person or via video conferencing or other audio visual means, as may be prescribed, that are capable of recording and recognising the directors' attendance as well as recording and storing the proceedings of such meetings, including the date and time.

According to the MCA, Notification G.S.R. No. 409(E). On June 15, 2021, the Companies (Meetings of Board and its Powers) Amendment Rules, 2021, were published, which seek to amend the Companies (Meetings of Board and its Powers) Rules, 2014, by omitting Rule 4, which provided for the restriction on matters not to be

dealt with in a meeting through video conferencing as specified in Rule 4 of the Act. This means that all of the business can now be handled in a video conference board meeting. Certain matters, such as the approval of the annual financial accounts, the Board's report, and the prospectus, were formerly prohibited from being conducted via video conference. Previously, these actions were exclusive to the digital media.

7.4.1 Amendments w.r.t. meetings via video conferencing

Due to the Covid-19 pandemic last year, respite was granted to all enterprises to conduct the aforementioned transactions via e-meetings during the period beginning March 19, 2021, and ending June 30, 2020, originally through the insertion of Rule 4(2) vide. Notification No. G.S.R. 186 [F. No. 1/32/2013-CL-V-Part], dated 19-3-2020, was later extended to 30.09.2020. Now that rule 4 has been permanently eliminated from the Companies (Meetings of Board and its Powers) Amendment Rules, 2021, companies can conduct all business in their board meetings via video conferencing or other audiovisual means.

Rule 3 of the Companies (Meetings of Board and its Powers) Rules, 2014 provides for the requirements and procedures, in addition to the procedures required for Board meetings in person, for convening and conducting Board meetings through video conferencing or other audiovisual means:

(1) Every Company shall make necessary arrangements to avoid failure of video or audiovisual connection.

(2) The Chairperson of the meeting and the company secretary, if any, shall take due and reasonable care:

(a) To safeguard the integrity of the meeting by ensuring sufficient security and identification procedures;

(b) To ensure the availability of proper video conferencing or other audiovisual equipment or facilities for providing transmission of the communications for effective participation of the directors and other authorized participants at the Board meeting;

(c) To record the proceedings and prepare the minutes of the meeting;

(d) To store for safekeeping and marking the tape recording(s) or another electronic recording mechanism as part of the records of the company at least before the time of completion of an audit of that particular year;

(e) To ensure that no person other than the concerned director is attending or have access to the proceedings of the meeting through video conferencing mode or other audiovisual means; and

(f) To ensure that participants attending the meeting through audiovisual means can hear and see the other participants clearly during the meeting, but the differently-abled persons may request the Board to allow a person to accompany him

7.5 PERSONS AUTHORIZED TO CONVENE THE MEETING

The following persons are authorized to convene an extraordinary general meeting.

1. The Board of Directors
2. The Requisitionists

3. The National Company Law Tribunal
4. Any Director or any two Members

7.6 PROCEDURE OF MEETINGS

For efficient operation, all meetings held in businesses must adhere to a set of well-defined norms and procedures. There may be some differences, but the overall procedure remains the same. There are some steps that must be followed:

• Issuance of notice: The board of directors and any other interested parties must be notified in advance of the meeting to ensure their attendance. Depending on the situation, it might be long-term or short-term.

• Notice Contents: The notice must include the following information: the location, date, and time of the meeting, a description of the important topic to be discussed, and a summary of the business. The convener must sign it and include the date of issuance.

• Quorum: The person in charge of informing the meeting must ensure that the meeting has been pre-notified to the necessary quorum, which must be present at the meeting in accordance with the Act. According to Section 174 of the Companies Act, one-third of the total number of members to the meeting constitutes a quorum for the meeting. In a meeting, a minimum of two directors are required to attend the meeting but where the company is owned by a single person then, in that case, the condition does not apply. Throughout the meeting, the quorum must be maintained.

• Chairman: A chairperson is required to preside over every meeting. In most cases, the meeting is chaired by the chairman of the Board of Directors. He is in charge of starting and concluding the motions discussion at the meeting. It is his obligation to guarantee that the meeting runs smoothly. The chairman can also be chosen by a simple majority vote.

• Meeting Resolutions: These are the decisions that are made at each meeting. There are particular procedures and rules that must be followed when they are considered and voted on. These are divided into different sections.

• Voting: There may be issues on which there is no broad agreement, and voting will be required. The chairperson may call the topics (if uncertain) for voting after a thorough debate. In the Companies Act of 2013, there are specific requirements for voting in various meetings. The chairman is in charge of the voting procedure.

• Adjournment and Minutes: After thorough consideration and discussion, the meeting is adjourned and then disbanded, with members dispersing. These discussions must be recorded in an official company document called minutes of meeting, which provides a summary of each meeting. As stated in the meeting, every crucial element must be covered.

7.6.1 Resolution

The meeting is presided over by the chairperson, who is elected by the board. In the event that the chairperson is unavailable, the meeting will be presided over by the Managing Director. When at least one-third of the company's total directors agree to propose a resolution under circulation to be resolved at a meeting, the chairperson is responsible for putting the resolution up for consideration. On the same day, a draft of the proposed resolution should be distributed to all meeting members, along with any other essential documents. The proposed resolution's draft can be passed and circulated among the meeting's participants by handing it over, by speed post, by courier, by email, or by any other recognized electronic means. The proposed resolution should be explained in a letter and delivered to the members of the meeting along with the text of the resolution. When a majority of people vote in favor of a resolution, it becomes law.

7.6.2 Kinds of resolution

A resolution is a legally binding decision made by the directors or shareholders of a limited liability corporation. A resolution can be passed by the members of the meeting if it receives a majority of votes in favor of it. Ordinary resolutions, special resolutions, and written resolutions are the three types of resolutions.

1. **Ordinary resolution**

Ordinary resolutions are those that can be passed with a mere majority vote. Unless there is a need for specific resolution, it can be utilized for anything. Ordinary resolutions are usually lodged with Companies House, a government agency.

2. **Special resolutions**

Special resolutions are those that must be passed by a majority of at least 75 percent of the total votes cast in favor of the resolution at a general meeting. It is typically used when a resolution containing unique or extraordinary concerns cannot be passed by a regular resolution.

3. **Written resolutions**

These are used when the resolution to be passed is an ordinary or basic resolution that does not require a general assembly. It is accomplished by shareholders merely signing and voting on a resolution. If the resolution is an ordinary one, it can be carried with a simple majority, but if it is a special one, 75 percent of votes are required.

7.6.3 Minutes

The minutes of a meeting are an important document that records all of the points, discussions, and decisions made during the meeting. It is an official document that must be consulted before a

new meeting may begin. When the members of the meeting agree the minutes and the chairperson signs them, they are considered final. The minutes are written in a factual manner that summarizes the meeting. It usually contains information about the meeting, such as the date of the meeting, members who attended or did not attend proposed motions and amendments in the meeting, the proposer of the motion and members who approved it, voting procedures, recommendations, and decisions made in relation to the motion, and so on.

7.6.4 Publication of Reports and Proceedings

Every public listed company is required to prepare a report for each annual general meetingunder Section 121 of the Companies Act. In addition, the report must be submitted to the Registrar within 30 days of the annual general meeting.
The registrar must also be informed of the proceedings of meetings and contracts entered into by the other businesses under Section 193(2) of the Companies Act, 2013.

7.6.5 Service of Documents on Members

According to Section 20 of the Companies Act, 2013, a document can be served on company members or executives. The document that has to be served might be sent to the company's registered office and delivered to a member or official. The document must be delivered via registered mail, courier service, hand delivery to the office, or a recognized electronic method. If the member specifies a method of document distribution, the documents should be given to him via that method. The cost of delivery for the prescribed form of delivery is to be paid by the

7.6.6 Service of Documents on the Company

The service of documents on the company is included under Section 20 of the Companies Act, 2013. A document can be served to a company by sending it to the company at the registered office through a registered post, courier service, by dropping it at the registered office or by a recognized electronic means. Transmission of papers by registered email id or other means by which the sender's identity can be verified is an example of electronic means.

7.7 POSTAL BALLOT

"Postal ballot" is defined in section 2(65) of the Companies Act of 2013, as "voting by post by any technological mode." It includes voting by shareholders via postal or electronic means instead of voting in person at a general meeting for the purpose of transacting business. Each item to be passed must be presented in the form of a Resolution and must be supported by an explanation.

Right to Vote

If there is an issue that needs to be decided at the meeting, it is decided by the votes of the members present. Every member who is limited by company shares and has equity share capital has the right to vote on all resolutions that come before the company, according to Section 50(2).

Section 188(1) states that the members who are entitled to vote shall have voting rights on a poll in proportion to the shares held by him to the paid-up equity share capital of the company Members of the firm who are limited by shares and own preference share capital have the right to vote on polls in which the resolution put before the business directly affects the member's preference share rights. Members of the company can also vote on motions such as the company's winding up, repayment, or reduction of the firm's equity or preference share capital. In order to pass a resolution, voting polls are held at a meeting. The chairman initiates the procedure. Voting can be done in a variety of ways, including showing or raising hands, voice votes, raising method (by standing for votes in favor or against a motion), ballot, proxy or postal votes, and so on.

7.8 POSTAL BALLOT RESOLUTIONS

A postal ballot, as defined by Section 110 of the Companies Act, is a mode of voting used when a member who is entitled to vote is unable to vote in person. In this case, the member who is authorized to vote might cast his ballot by posting it. The method of voting via mail is referred to as a postal ballot. Members who would not otherwise be able to vote can now do so via this approach. Except when the poll is for deciding on regular business or when a business in which it is vital to attend and hear directors or auditors in the meeting, the postal ballot can be used for voting in meetings. When it is agreed that the company's resolution will be passed by postal ballot, the firm will send a notice to all members of the meeting, together with a draft resolution explaining the grounds for the poll. They are asked to vote on the motion and turn in their ballots. Voting by mail or through any electronic means is included in the postal ballot method. The vote must be sent within 30 days after the date on which the members were notified of the resolution's passage. Registered mail, courier service, rapid post, or electronic means such as email can all be used to send the vote. A postal ballot cannot be utilized in the event of a one- person corporation or a company with fewer than 200 members.

7.9 E-VOTING

Casting a vote through electronic means, often known as electronic voting, is a method of voting for a resolution. Electronic voting includes punched card voting, optical scan voting, and specialized voting kiosks, as well as telephones, private computer networks, and the internet. The Companies Act, Section 108, offers a mechanism for electronic voting. A corporation with 1000 or more shareholders that is registered under the Companies Act of 2013 should enable electronic voting to its shareholders. Through electronic means, a member can vote even if they are not physically present at a meeting. The electronic voting method can be substituted for the postal ballot. The computerized voting system is more convenient and saves time.

Representation of Government in Meetings of the Companies

If the government is a member of the corporation, a member can be selected by the government to attend meetings. Any person who the government deems fit to attend the meeting can be appointed as a member. The individual designated as the Government's representative must

attend the meeting like any other member and have the same rights and powers as any other member.

7.10 LET US SUM UP

A company is an association of persons registered under the companies Act. All the matters of the company have to be resolved by the members of the company. To decide the crucial matter relating to the company, the discussions which take place are known as meetings of the company. The Companies Act encompasses many provisions in relation to the meetings of the company. The meetings of the company for deciding on ordinary business and special business or extraordinary business takes place by following prescribed procedures and rules. Shareholdersas owners of the company have a right to convene a meeting to pass a resolution. The chairperson of the meeting must convene the meetings. A mandatory quorum is required for the conduct of a meeting.

7.11 TO CHECK THE PROGRESS

7.11.1 Long Answer Questions

1. Explain the term “meeting”? Briefly explain the procedure of conducting meetings
2. Explain the different types of meetings
3. What are the various amendments done by MCA during COVID pandemic on conducting meetings via video conferencing?

7.11.2 Short Answer Questions

1. Write short notes on followings
    a) Postal ballot
    b) Minutes
    c) Quorum
2. What is the least number of board meetings that companies are required to hold in a year?
3. Who are the people who can call for an EGM?

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B. COM (HONS.)
(Accounting and Taxation)

SEMESTER III

COURSE: COMPANY LAW

UNIT 8: COMMITTEE OF BOARD OF DIRECTORS-AUDIT COMMITTEE, NOMINATION AND REMUNERATION COMMITTEE, STAKEHOLDER RELATIONSHIP COMMITTEE, CORPORATE SOCIAL RESPONSIBILITY COMMITTEE

STRUCTURE

8.1 Learning Outcome

8.2 Introduction

8.3 Functions of the Board Committee

8.4 Committee Management

8.5 Committees mandatorily to be constituted under Companies Act, 2013

8.6 Audit Committee

8.7 Nomination and Remuneration Committee

8.8 Stakeholder Relationship Committee

8.9 Corporate Social responsibility Committee

8.10 Convening and conducting Committee meetings

8.11 Summary

8.12 Glossary

8.13 Self-Assessment Questions

8.14 References

8.1 LEARNING OUTCOME

After studying this module you will able to:

- Understand the need for Board Committee
- Know the functions of Board Committee
- Acquaint yourself with the Board Committees mandatorily to be constituted under Companies Act, 2013
- Conceptualize the procedure of convening and conducting Board Committee meeting

8.2 INTRODUCTION

A board committee is a small working group identified by the board, consisting of boardmembers, for the purpose of supporting the board's work. Committees are generally formed to perform some expertise work. Members of the committee are expected to have expertise in the specified field. Committees are usually formed as a means of improving board effectiveness and efficiency, in areas where more focused, specialized and technical discussions are required. These committees prepare the groundwork for decision-making and report at the subsequent board meeting. Committees enable better management of full board's time and allow in-depth scrutiny and focused attention. However, the Board of Directors are ultimately responsible for the acts of the committee. Board is responsible for defining the committee role and structure.

8.3 FUNCTIONS OF THE BOARD COMMITTEE

Committees often serve several different functions:

Governance: In large organizations participation of each and every director is not possible in decisions making of the organization as a whole, a committee is given the power to make decisions, spend money, or take actions. Some or all such powers may be limited or effectively unlimited. Members of the committee take decisions, keeping in view the interest of all stakeholders.

Coordination: Where there is a large board, it is common to have committees with more specialized functions for better coordination - for example, audit committee, finance committee, compensation committee, etc. wherein members meet regularly to discuss developments in their areas, review projects that cut across organizational boundaries, talk about future options, etc

Research and recommendations: Committees are often formed to do research and make recommendations on a potential or planned project or change. For example, an organization considering a major capital investment might create a temporary working committee of several people to review options and make recommendations to the Board of Directors. Such committees are typically dissolved after giving recommendations.

With the increasing business complexities and time commitment of Board members, constituting committees has become inevitable for organization of any significant size. Committees keep the number of participants manageable; in larger groups, either many people do not get to speak or discussion gets quite lengthy.

8.4 COMMITTEE MANAGEMENT

• Committees function in accordance with the terms of reference established by the board.

• Board Committees may be standing committees; or ad hoc committees that cease when the activities are completed. Standing committees should be included in the articles or bylaws.

• Committees recommend policy for approval by the entire board.

• Committees make full use of board members' expertise, time and commitment, and ensure diversity of opinions on the board.

• They do not supplant responsibility of each board member; they operate at the board level and not the staff level.

• Minutes should be recorded for all Committee meetings and final minutes are required to be placed before the Board.

8.5 COMMITTEES MANDATORILY TO BE CONSTITUTED UNDER THE COMPANIES ACT, 2013

In addition to the Audit Committee, the New Act has also mandated the constitution of three additional board committees for all listed companies and such other classes of companies prescribed in the Rules.

• **The Nomination and Remuneration Committee** is expected to ensure among other things that remuneration arrangements support the strategic goals of the business and more importantly to conduct performance evaluation of every director.

• **The Corporate Social Responsibility Committee** would formulate the Corporate Social Responsibility policy of the company, recommend the expenditure that can be incurred for this purpose and monitor such policy of the company from time to time.

• **The Stakeholders Relationship Committee** would help resolve the grievances of the security holders of the company.

A summary of the key provisions related to these Committees is discussed hereunder.

8.6 AUDIT COMMITTEE

Audit Committee is one of the main pillars of the corporate governance mechanism in any company. Charged with the principal oversight of financial reporting and disclosure, the Audit Committee aims to enhance the confidence in the integrity of the company's financial reporting,

the internal control processes and procedures and the risk management systems. Under the Companies Act, 1956, every public company in India having paid-up capital of not less than rupees five crores was required to constitute an Audit Committee under Section 292A The Clause 49 of the Listing Agreement , applicable only to the listed companies, requires all listed companies to duly constitute an Audit Committee with a prescribed set of responsibilities.

Under the Companies Act, 2013(hereinafter called the Act), the Audit Committee's mandate is significantly different from what was laid down under Section 292A of the Companies Act 1956, and its scope and constitution have also been broadened. The Act mandates every listed company and certain other class or classes of companies to constitute an Audit Committee.

Applicability

Section 177 of the Act read with rule 6 of the Companies (Meetings of the Board and is Powers) Rules, 2014 the Board of directors of every listed company and the following classes of companies is required to constitute a Audit Committee of the Board- (i) all public companies with a paid up capital of ten crore rupees or more; (ii) all public companies having turnover of one hundred crore rupees or more; (iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more. The paid up share capital or turnover or outstanding loans or borrowing s or debentures or deposits, as the case may be , as existing on the date of last audited financial statements shall be taken into account for the purposes of this rule.

Composition of the Audit Committee

The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority. The majority of members of Audit Committee including its Chairpersonshall be persons with ability to read and understand, the financial statement. The Revised Clause 49 of the listing agreement effective from 1st October, 2014, provides that audit committee of listed company shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise. Defining the term "financially literate" the clause provides that the abilityto read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows shall be treated as financial literacy. Further it is provided that a member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities. The Chairman of theAudit Committee shall be an independent director. The Chairman of the Audit Committee shall be present at Annual General Meeting to answer shareholder queries. The Company Secretary shall act as the secretary to the committee.

Meetings of the Committee

As per the revised clause 49 the Audit Committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present. Perhaps, the most powerful committee, the Audit Committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee,but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee.

Functions of the Committee

Section 177(4) of the Act provides that every Audit Committee shall act in accordance with the terms of reference specified in writing by the Board. Terms of reference as prescribed by the board shall inter alia, include, –

(a) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;

(b) review and monitor the auditor's independence and performance, and effectiveness of audit process;

(c) examination of the financial statement and the auditors' report thereon;

(d) approval or any subsequent modification of transactions of the company with related parties;

(e) scrutiny of inter-corporate loans and investments;

(f) valuation of undertakings or assets of the company, wherever it is necessary;

(g) evaluation of internal financial controls and risk management systems;

(h) monitoring the end use of funds raised through public offers and related matters.

Role of the Audit committee is also given in the revised clause 49, which includes :

1. oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible;

2. recommendation for appointment, remuneration and terms of appointment of auditors of the company;

3. approval of payment to statutory auditors for any other services rendered by the statutory auditors;

4. reviewing, with the management, the annual financial statements and auditor's report thereon before submission to the board for approval, with particular reference to:

(a) matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (c) of sub-section 3 of section 134 of the Companies Act, 2013

(b) changes, if any, in accounting policies and practices and reasons for the same

(c) major accounting entries involving estimates based on the exercise of judgment by management

(d) significant adjustments made in the financial statements arising out of audit findings

(e) compliance with listing and other legal requirements relating to financial statements

(f) disclosure of any related party transactions

(g) qualifications in the draft audit report

5. reviewing, with the management, the quarterly financial statements before submission to the board for approval;

6. reviewing, with the management, the statement of uses / application of funds raised through an issue (public issue, rights issue, preferential issue, etc.), the statement of funds utilized for purposes other than those stated in the offer document / prospectus / notice and the report submitted by the monitoring agency monitoring the utilisation of proceeds of a public or rights issue, and making appropriate recommendations to the Board to take up steps in this matter;

7. review and monitor the auditor's independence and performance, and effectiveness of audit process;

8. approval or any subsequent modification of transactions of the company with related parties;

9. scrutiny of inter-corporate loans and investments;

10. valuation of undertakings or assets of the company, wherever it is necessary;

11. evaluation of internal financial controls and risk management systems;

12. reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;

13. reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit;

14. discussion with internal auditors of any significant findings and follow up there on;

15. reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a materialnature and reporting the matter to the board;

16. discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern;

17. to look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non-payment of declared dividends) and creditors;

18. to review the functioning of the Whistle Blower mechanism;

19. approval of appointment of CFO (i.e., the whole-time Finance Director or any other person heading the finance function or discharging that function) after assessing the qualifications, experience and background, etc. of the candidate;

20. carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

Powers of the Audit Committee

The Audit committee has the following powers under the section 177:

1. The Audit Committee has the power to call for the comments of the auditors about internal control systems, the scope of audit, including the observations of the auditors and review of financial statement before their submission to the Board and may also discuss any related issues with the internal and statutory auditors and the management of the company.

2. The Audit Committee has authority to investigate into any matter in relation to the items specified in terms of reference or referred to it by the Board and for this purpose the Committee has power to obtain professional advice from external sources. The Committee for this purpose shall have full access to information contained in the records of the company.

3. The auditors of a company and the key managerial personnel have a right to be heard in the meetings of the Audit Committee when it considers the auditor's report but shall not have the right to vote.

As per revised clause 49 the Audit Committee shall have the powers to:

(i) investigate any activity within its terms of reference;

(ii) seek information from any employee;

(iii) obtain outside legal or other professional advice;

(iv) secure attendance of outsiders with relevant expertise, if it considers necessary.

Revised Clause 49 further provides that the Audit Committee shall mandatorily review the following information:

(a) management discussion and analysis of financial condition and results of operations;

(b) statement of significant related party transactions (as defined by the Audit Committee), submitted by management;

(c) management letters / letters of internal control weaknesses issued by the statutory auditors;

(d) internal audit reports relating to internal control weaknesses; and

(e) the appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee.

8.7 NOMINATION AND REMUNERATION COMMITTEE

Applicability

As per section 178 of the Act read with rule 6 of the Companies (Meetings of the Board and its Powers) Rules, 2014, the Board of directors of every listed company and the following classes of companies are required to constitute a Nomination and Remuneration Committee of the Board-
(i) all public companies with a paid up capital of ten crore rupees or more;
(ii) all public companies having turnover of one hundred crore rupees or more;

(iii) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more.

Note: The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the last audited financial statement shall be taken into account for the above purpose.

Composition

The Committee so constituted by the Board shall consist of three or more non-executive directors out of which not less than one-half shall be independent directors. The chairperson of the company (whether executive or non-executive) may be appointed as a member of the Nomination and Remuneration Committee but he shall not chair such Committee. In case of a listed company as per revised clause 49, Chairman of the committee shall be an independent director.
The Chairperson of the Committee or, in his absence, any other member of the committee authorised by him in this behalf is required to attend the general meetings of the company. In contrast to this, the revised clause 49 provides that the Chairman of the Nomination and Remuneration Committee could be present at the Annual General Meeting, to answer the shareholders' queries. However, it would be up to the Chairman to decide who should answer the queries.

Functions:
Sub- sections (2), (3) and (4) of section 178 deal specifically with the functions of the Committee.
The Nomination and Remuneration Committee shall:

1. identify persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, recommend to the Board their appointment and removal. Further it has been attached with a wider responsibility of carrying outevaluation of every director's performance.

2. formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board a policy, relating to the remuneration for the directors, key managerial personnel and other employees. While formulating the policy, the Committee shall consider the following:

(a) the level and composition of remuneration is reasonable and sufficient to attract, retain and motivate directors of the quality required to run the company successfully;

(b) relationship of remuneration to performance is clear and meets appropriate performance benchmarks; and

(c) remuneration to directors, key managerial personnel and senior management involves a balance between fixed and incentive pay reflecting short and long-term performance objectives appropriate to the working of the company and its goals.

Functions of committee as per revised clause 49 of the Listing Agreement

The role of the Committee constituted by a listed company includes:

1. formulation of the criteria for determining qualifications, positive attributes and independence of a director and recommend to the Board a policy, relating to the remuneration of the directors, key managerial personnel and other employees;

2. formulation of criteria for evaluation of Independent Directors and the Board;

3. devising a policy on Board diversity;

4. identifying persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, and recommend to the Board their appointment and removal. The company shall disclose the remuneration policy and the evaluation criteria in its Annual Report.

8.8 STAKEHOLDER RELATIONSHIP COMMITTEE

Applicability
Sub-Section(5) of section 178 provides that the Board of Directors of a company which consists of more than one thousand shareholders, debenture-holders, deposit-holders and any other

security holders at any time during a financial year shall constitute a Stakeholders Relationship Committee.

Composition of Board of Committee

Stakeholders Relationship Committee shall consist of a chairperson who shall be a non- executive director and such other members as may be decided by the Board. The chairperson of the committees or, in his absence, any other member of the committee authorised by him in this behalf is required under the section to attend the general meetings of the company.

Functions

The main function of the committee is to consider and resolve the grievances of security holders of the company. On similar terms revised clause 49 of the listing agreement provides that a committee under the Chairmanship of a non-executive director and such other members as may be decided by the Board of the company shall be formed to specifically look into the redressal of grievances of shareholders, debenture holders and other security holders. The grievances of the security holders of the company may include complaints related to transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends, which shall be handled by this committee.

The current requirement

Under the Listing Agreement clause 49 is for the constitution of a board committee i.e. 'Shareholders/Investors Grievance Committee' under the chairmanship of a non-executive director to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. The main function of this committee is to expedite the process of share transfers.

8.9 CORPORATE SOCIAL RESPONSIBILITY COMMITTEE

Applicability

Sec 135 (1) read with rule 3 of Companies (Corporate Social Responsibility Policy) Rules, 2014, mandates every company (which may include a holding company or a subsidiary company) having:

(a) net worth of rupees five hundred crore or more, or;

(b) turnover of rupees one thousand crore or more or;

(c) a net profit of rupees five crore or more during any financial year to constitute a Corporate Social Responsibility (CSR) Committee of the Board.

Note: Any financial year has been clarified as to imply any of the three preceding financial years.

Composition

Section 135 provides that the CSR committee shall be constituted with three or more directors, out of which at least one director shall be an independent director. Companies (Meetings of Board and Powers) Rules, 2014, however, relax this requirement as below:

1. an unlisted public company or a private company covered under sub-section (1) of section 135 which is not required to appoint an independent director, shall have its CSR Committee without such director.

2. a private company having only two directors on its Board shall constitute its CSR Committee with two such directors:

3. with respect to a foreign company covered under these rules, the CSR Committee shall comprise of at least two persons of which one person shall be as specified under clause (d) of subsection (1) of section 380 of the Act ,i.e. the person resident in India authorized to accept on behalf of the company, service of process and any notices or other documents and another person shall be nominated by the foreign company.

The composition of the Corporate Social Responsibility Committee is required to be disclosed in the Board's report prepared under the Act.

Functions

In accordance with section 135 the functions of the CSR committee include:

(a) formulating and recommending to the Board, a CSR Policy which shall indicate the activities to be undertaken by the company as specified in Schedule VII;

(b) recommending the amount of expenditure to be incurred on the CSR activities.

(c) monitoring the Corporate Social Responsibility Policy of the company from time to time.

(d) Further the rules provide that the CSR Committee shall institute a transparent monitoring mechanism for implementation of the CSR projects or programs or activities undertaken by the company.

8.10 CONVENING AND CONDUCTING COMMITTEE MEETINGS

Annual Calendar

As a good practice a calendar of committee meetings should be maintained so that prior arrangements can be made.

Notice of Committee meetings

Similar to a board meeting the notice of committee meeting be sent to the committee members .

Quorum

Committees shall meet at least as often as stipulated by the Board or as prescribed by any law or authority.

Attendance Register

Attendance register becomes all the more important with the requirement of disclosure of attendance of the members of the board / committee in the Annual Return. Every company should maintain separate registers for the meeting of the Board and that of its committees.

Recording proceedings of Committee Meetings

Section 118 and Rule 25 of the Companies (Management and Administration) Rules, 2014 requires maintenance of minutes for meetings of each of the committees of the Board in adistinct minute book.

8.11 SUMMARY

Board Committees are the pillars of Corporate Governance. As the responsibilities of directors have become more demanding, Boards have increasingly formed committees to deal with some of their more detailed work. As the needs of the Board change, the need for committees may also change. Hence, it is essential that committees and their role be subject to periodic review. Board members should be aware that Board responsibilities remain, when serving on a Board committee, and may be enhanced. To be more effective, Board committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enablethem to discharge their respective duties and responsibilities effectively.

In general, Board committees focus on specific areas allowing the Board to concentrate on broader issues and directions. The work of the committees should be directed by the Board. Board committees should have their own charter setting out their roles and responsibilities, for example, in the area of membership (including succession planning), meeting frequency and coreagenda, committee authority, reporting obligations etc. committees should be appropriately constituted, taking into account any relevant legislation and the objectives of the company. Day by day, the role of independent director is gaining importance in the effect functioning of the Board committees. Board committees with formally established terms of reference, criteria for appointment, life span, role and function constitute an important element of the governance process and should be established with clearly agreed reporting procedures and a written scopeof authority. Board committees should be free to take independent outside professional advice when necessary, at the cost of the company, subject to a proper process being followed.

8.12 GLOSSARY

Audit Committee is one of the main pillars of the corporate governance mechanism in any company. Charged with the principal oversight of financial reporting and disclosure, the Audit

Committee aims to enhance the confidence in the integrity of the company's financial reporting, the internal control processes and procedures and the risk management systems.
Board committee is a small working group identified by the board, consisting of board members, for the purpose of supporting the board's work.

Corporate Social Responsibility Committee would formulate the Corporate Social Responsibility policy of the company, recommend the expenditure that can be incurred for this purpose and monitor such policy of the company from time to time.

Nomination and Remuneration Committee is expected to ensure among other things that remuneration arrangements support the strategic goals of the business and more importantly to conduct performance evaluation of every director.

Stakeholders Relationship Committee would help resolve the grievances of the security holders of the company.

8.13 SELF ASSESMENT QUESTIONS

Q1.What is Board Committee? Discuss the functions of the Board Committee?
Q2. Name different Board committees mandatorily to be constituted under Companies Act, 2013?
Q3.What is Audit Committee? What is its composition? Elaborate the functions and powers of the audit committee?

Q4. Explicate the applicability, composition and functions of the Nomination and Remuneration committee?

Q5. Describe the applicability, composition and function of the stakeholder relationship committee?

Q6. "Corporate social responsibility committee plays a vital role in monitoring C.S.R policy of the company from time to time. "Explain.

Q7. Explain the provisions relating to convening and conducting Board committee meetings?

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SEMESTER III

COURSE: COMPANY LAW

UNIT 9: DIVIDEND, ACCOUNTS, AUDIT-PROVISION RELATING TO PAYMENT OF DIVIDEND, PROVISION RELATING TO BOOKS OF ACCOUNTS

STRUCTURE

PROVISION RELATING TO PAYMENT OF DIVIDEND

9.1 Learning Outcome

9.2 Meaning of Dividend

9.3 Types of Dividend

9.4 Sources of Dividend

9.5 Provisions related to Declaration of Dividend at Annual General Meeting

9.6 Conditions required for declaration of Dividend

9.7 Procedure of Declaration and Payment of Dividend

9.8 Punishment for Failure to Distribute Dividend

9.9 Provision for Declaration of Dividend under the Companies Act, 2013

9.10 Payment of Dividend without Providing for Depreciation

9.11 Declaration of Dividend out of Company's Reserves

9.12 Transfer of Unpaid or Unclaimed Dividend to the Investor Education and Protection Fund

9.13 Interim Dividend

PROVISION RELATING TO BOOKS OF ACCOUNTS

9.14 Leaning Outcomes

9.15 Definition of Books of Accounts

9.16 Requirement of keeping Books of Account

9.17 Place of Keeping Books of Account

9.18 Maintenance of Books of account in electronic form

9.19 Books of Account in Respect of Branch Office

9.20 Accrual basis and Double-entry system of accounting

9.21 Inspection by directors

9.22 Period for which books to be preserved

9.23 Persons responsible to maintain books

9.24 Penalty

9.25 Financial Statement

9.26 Maintenance of Costing and Stock Records

9.27 Summary

9.28 Glossary

9.29 Self-Assessment Questions

9.30 References

PROVISION RELATING TO PAYMENT OF DIVIDEND

9.1 LEARNING OUTCOME

After studying this module the learner will be able to:

(i) Know the meaning, types and sources of dividend

(ii) Understand the conditions required for declaration of dividend

(iii)Acquaint with the procedure of declaration and payment of dividend

(iv)Familiarize with the provisions related to payment of dividend under Companies Act, 2013

(v)Comprehend the provisions related to unpaid/unclaimed dividend and interim dividend

9.2 MEANING OF DIVIDEND

The term 'dividend' has been defined under Section 2(35) of the Companies Act, 2013. The term "Dividend" includes any interim dividend. It is an inclusive and not an exhaustive definition. According to the generally accepted definition, "dividend" means the profit of a company, which is not retained in the business and is distributed among the shareholders in proportion to the amount paid-up on the shares held by them. Dividends are usually payable for a financial year after the final accounts are ready and the amount of distributable profits is available.

Dividend for a financial year of the company (which is called 'final dividend') are payable only if it is declared by the company at its annual general meeting on the recommendation of the Board of directors. Sometimes dividends are also paid by the Board of directors between two annual general meetings without declaring them at an annual general meeting (which is called 'interim dividend'). The companies having license under Section 8 of the Act are prohibited by their constitution from paying any dividend to its members. They apply the profits in promoting the objects of the company.

9.3 TYPES OF DIVIDEND

(a) Interim dividend: The Board of Directors of a company may declare interim Dividend as per Companies Act 2013 during any financial year or at any time during the period from closure of financial year till holding of the annual general meeting out of the surplus in the profit andloss account or out of profits of the financial year for which such interim dividend is sought to be declared or out of profits generated in the financial year till the quarter preceding the date of declaration of the interim dividend.

(b) Final dividends: Dividends paid by the corporation after the financial year has been closed, and the Board of Directors accepted an AGM. The term used except as specified in the Companies Act, 2013 refers only to final dividends.

9.4 SOURCE OF DIVIDEND

No dividend shall be declared or paid by a company for any financial year except—

- Profits of the company for the year for which the dividend is to be paid.
- Undistributed profits of the previous financial year,
- Moneys provided by the Central Government or a State Government for the payment of Dividend as per Companies Act 2013 in pursuance of a guarantee given by the concerned Government.

9.5 PROVISIONS RELATED TO DECLARATION OF DIVIDEND AT ANNUAL GENERAL MEETING

- Dividend is to be declared by the company at its Annual General meeting on such rate as may be recommended by board, and it has no power to declare dividend exceeding the amount recommended by the board.
- On declaration, dividend becomes a debt payable by the company to the registered shareholders, who are entitled to sue the company for the non-payment of the dividend.

- A company cannot pass a resolution for the declaration of dividend, without passing a resolution for the adoption of accounts. Hence, a company shall adopt its books of accounts first and then only, entitled to declare the dividend.

Dividend shall be paid in cash by cheque, warrant or electronically.

9.6 CONDITIONS REQUIRED FOR DECLARATION OF DIVIDEND

1) Depreciation : – In terms of the provision of section 123 of the Act, no company can pay dividend in any year without charging depreciation in the profit and loss account for the current year and that there is no balance of un provided depreciation of any year or years. Depreciation shall be provided in accordance with the provisions of Schedule II to the Companies Act, 2013

2) Transfer to Reserves: - Every company ***may***, before the declaration of any dividend in any financial year***, transfer portion of its net profit to general reserve,*** as it may consider appropriate to the reserves of the company.

3) Set off of previous year losses and depreciation: – A company shall not declare dividend unless carried over previous losses and depreciation not provided in previous year or years, are set off against profit of the company for the current year.

4) Free Reserves: – A company shall not declare or pay dividend out of its reserves, other than free reserves.

9.7 PROCEDURE OF DECLARATION AND PAYMENT OF DIVIDEND

1. Issue at least 7 clear days' notice of the meeting of Board of directors in accordance with the sec- 173 of the companies Act – 2013.
2. Hold Board meeting and pass resolutions for following purposes-

- Approving the annual accounts.

- Recommending the quantum of final dividend to be declared at the next Annual General Meeting.

- Fixing the Day, Date Time and Venue of AGM.

- Approving the Notice AGM,

- Authorizing the Company Secretory/ Director to issue the notice of AGM.

3. The company may transfer to reserve such percentage as it consider appropriate of the current profits.
4. Public Notice of book closure in a newspaper circulating in the district in which the registered office of the company is situated at least 7 days before the date of commencement of book closure.
5. Close the register of members and the share transfer register of the company.
6. Hold the AGM and pass ordinary resolution declaring the payment of dividend to the shareholders of the company as per recommendation of the Board.
7. Open a separate bank account for making dividend payment and credit the same bank account with the total amount of dividend payable within 5 days of declaration ofdividend.
8. Dispatch dividend warrants within 30 days of the declaration dividend. in case of joint shareholders, dispatch the warrant to the first named shareholder.
9. Instructions to all the specified branches of bank that dividend should be paid at par should be sent by the bank.
10. Publish a company notice in a newspaper circulating the district in which the registered office of the company is situated to the effect that dividend warrants have been posted and advising those members of the company who do not receive them within a period of 15 days, to get in touch with the company for appropriate action.
11. Issue bank drafts and/or cheques to those members who inform that they received the dividend warrants after the expiry of their currency period or their dividend warrants were lost in transit after satisfying that the same have not been encashed.
12. Arrange for transfer of unpaid or unclaimed dividend to a special account named Ünpaid dividend account A/c" within 7 days after expiry of the period of 30 days of declaration of final dividend.

9.8 PUNISHMENT FOR FAILURE TO DISTRIBUTE DIVIDEND (SECTION 127)

Punishment For Failure to Distribute Dividend as per Companies Act 2013, Where a dividend has been declared by a company but has not been paid or the warrant in respect thereof has not been posted within thirty days from the date of declaration to any shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with imprisonment which may extend to 2 years and with fine which shall not be less than 1000 rupees for every day during which such default continues and the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues.

Exception (Where No Penalties Applies):

(a) where the dividend could not be paid by reason of the operation of any law;

(b) where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with and the same has been communicated to him;

(c) where there is a dispute regarding the right to receive the dividend;

(d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

(e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period under this section was not due to any default on the part of the company.

9.9 PROVISION FOR DECLARATION OF DIVIDEND UNDER THE COMPANIESACT, 2013

The Companies Act, 2013 lays down certain provisions for declaration of dividend, which are:
(i) Section 51 permits companies to pay dividends proportionately, i.e. in proportion to the amount paid-up on each share when all shares are not uniformly paid up, i.e. pro rata. Pro rata means in proportion or proportionately, according to a certain rate. The Board of Directors of a company may decide to pay dividends on pro rata basis if all the equity shares of the companyare not equally paid up.
However, in the case of preference shares, dividend is always paid at a fixed rate. The permission given by this section is, however, conditional upon the company's articles of association expressly authorizing the company in this regard.

(ii) Final Dividend is generally declared at an annual general meeting [Section 102(2))] at a rate not more than what is recommended by the directors in accordance with the articles of association of a company.

(iii) An interim dividend is declared by the Board of directors at any time before the closure of financial year, whereas a final dividend is declared by the members of a company at its annual general meeting if and only if the same has been recommended by the Board of directors of the Company.

(iv) In accordance with Section 134(3) (k), Board of directors must state in the Directors' Report the amount of dividend, if any, which it recommends to be paid. The dividend recommended by the Board of directors in the Board's Report must be 'declared' at the annual general meeting of the company. This constitutes an item of ordinary business to be transacted at every annual general meeting. This does not apply to interim dividend. (iv) No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with section 123 (2) of the Act or out of

profits of the company for any previous financial year/years arrived at after providing for depreciation in accordance with the provisions of above sub section and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for payment of dividend in pursuance of a guarantee given by the concerned Government [Section 123(1)].

(v) A company may before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

(vi) If owing to inadequacy or absence of profits in any year, a company proposes to declare dividend out of the accumulated profits earned by it in any previous financial years and transferred to reserves, such declaration of dividend shall not be made except in accordance with the Companies (Declaration and Payment of Dividend) Rules, 2014.

(vii) Depreciation, as required under Section 123(1) of the Companies Act has to be provided in accordance with the provisions of Schedule II to the Act.

(viii) A company which fails to comply with Section 73 and 74 of the Companies Act shall not declare any dividend on its equity shares till such default continues.

(ix) The amount of dividend (final as well as interim) shall be deposited in a separate bank account within 5 days from the date of declaration. [Section 123(4)]

(x) Dividend has to be paid within 30 days from the date of declaration.

(xi) In case of listed companies, Section 24 of the Companies Act, 2013 confers on SEBI, the power of administration of the provisions pertaining to non-payment of dividend. In any other case, the powers remain vested in Central Government.

(xii) If dividend has not been paid or claimed within the 30 days from the date of its declaration, the company is required to transfer the total amount of dividend which remains unpaid or unclaimed, to a special account to be opened by the company in a scheduled bank to be called "Unpaid Dividend Account". Such transfer shall be made within 7 days from the date of expiry of the said period of 30 days.

(xiii) In accordance with Section 70, a company cannot buy its own shares if apart from other things provided in the section, it makes default in payment of dividend to any shareholder.

(xiv) Any money transferred to the unpaid dividend account of a company in pursuance of section 124 which remains unpaid or unclaimed for a period of seven years from the date of suchtransfer shall be transferred by the company to the Investor Education and Protection Fund and the company shall file a statement in "Form DIV-5" to the Authority constituted under the Act to

administer the fund and such authority shall issue a receipt to the company as evidence of such transfer. [Section 124(5)]

(xv) Where a dividend has not been paid by the company within 30 days from the date of declaration, every director shall, if he is knowingly a party to the default, be punishable with imprisonment for a term which may extend to 2 years and shall also be liable to a fine of rupees 1000 for every day during which default continues and the company shall be liable to pay simple interest @ 18% per annum during the period for which such default continues. [Section 127]

(xvi) If the company delays the transfer of the unpaid/unclaimed dividend amount to the unpaid dividend account, it shall pay interest @ 12% p.a. till it transfers the same and the interest accruing on such amount shall ensure to the benefit of the members of the company in proportionto the amount remaining unpaid to them. [Section 124(3)]

(xvii) Any dividend payable in cash may be paid by cheque or warrant through post directed to the registered address of the shareholder who is entitled to the payment of the dividend or to his order or in any electronic mode sent to his banker. [Section 123(5)]

9.10 PAYMENT OF DIVIDEND WITHOUT PROVIDING FOR DEPRECIATION

Section 123 (1)(a) of the Companies Act, 2013 provides that no dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year or out of the profits of the company for any previous financial years arrived at after providing for depreciation in accordance with the provisions of Schedule II to the Act and remaining undistributed, or out of both.

Further, rule 3(5) of Companies (Declaration and Payment of Dividend) Rules, 2014 provides that no company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year the loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

9.11 DECLARATION OF DIVIDEND OUT OF COMPANY'S RESERVES

In the event of inadequacy or absence of profits in any year, a company may declare dividend out of surplus reserves subject to the fulfillment of the following conditions, namely:-

a. The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three years immediately preceding that year. However, this condition shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

b. The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the paid-up share capital and free reserves as appearing in the latest audited financial statement.

c. The amount so drawn shall first be utilized to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

d. The balance of reserves after such withdrawal shall not fall below 15% of its paid up share capital as appearing in the latest audited financial statement

9.12 TRANSFER OF UNPAID OR UNCLAIMED DIVIDEND TO THE INVESTOR EDUCATION AND PROTECTION FUND

Section 124(5) of the Act, provides that any money transferred to the unpaid dividend account of a company which remains unpaid or unclaimed for a period of seven years from the date of such transfer is required to be transferred by the company along with interest accrued, if any, thereon to the Investor Education and Protection Fund (IEPF) established under Section 125.

9.13 INTERIM DIVIDEND - SECTION 123(3)

Board of directors of a company may declare interim dividend during any financial year or at any time during the period from closure of financial year till holding of the annual general meeting, out of the profits made by the company during such financial year or out of previous year undistributed profits (subject to Companies (Declaration and Payment of Dividend) Rules, 2014). In case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

PROVISION RELATING TO BOOKS OF ACCOUNTS

9.14 LERNING OUTCOME

After reading this module the learner can:

1. Know the definition of Books of Accounts and its requirements
2. Be acquainted with the provisions relating to place of keeping books of accounts and maintaining it in electronic form
3. Be familiar with the concept of accrual basis and double entry system of accounting
4. Comprehend the rules relating books of accounts of branch office and inspection of books by directors
5. Understand the period for which books are to be maintained, person responsible for maintenance and penal provisions for non-maintenance
6. Conceptualize the provisions related to Financial Statements
7. Grasp the rules relating to maintenance of costing and stock record.

9.15 DEFINITION OF BOOKS OF ACCOUNTS

"Books of account" as defined in Section 2(13) includes records maintained in respect of—

(i) all sums of money received and expended by a company and matters in relation to which the receipts and expenditure take place;
(ii) all sales and purchases of goods and services by the company;

(iii) the assets and liabilities of the company; and

(iv) the items of cost as may be prescribed under section 148 in the case of a company which belongs to any class of companies specified under that section.

9.16 REQUIREMENT OF KEEPING BOOKS OF ACCOUNT (SECTION 128)

Maintenance of books of account would mean records maintained by the company to record the specified financial transaction. It has been specifically provided that every company shall keep proper books of account. This section specifies the main features of proper books of account as under – (i) The company must keep the books of account with respect to items specified in clauses (i) to (iv) of sub-section 2(13) of the Companies Act, 2013 hereinafter referred as Act, which defines "books of account".
(ii) The books of account must show all money received and expended, sales and purchases of goods and the assets and liabilities of the company.

(iii) The books of account must be kept on accrual basis and according to the double entry system of accounting.

(iv) The books of account must give a true and fair view of the state of the affairs of the company or its branches.

9.17 PLACE OF KEEPING BOOKS OF ACCOUNT

Section 128(1) requires every company to prepare and keep the books of account and other relevant books and papers and financial statements at its registered office. However, all or any ofthe books of accounts may be kept at such other place in India as the Board of directors may decide. When the Board so decides the company is required within seven days of such decisionto file with the Registrar a notice in writing giving full address of that other place.

9.18 MAINTENANCE OF BOOKS OF ACCOUNT IN ELECTRONIC FORM

The maintenance of books of account and other books and papers in electronic mode is permitted and is optional. Such books of accounts or other relevant books or papers maintained in electronic mode shall remain accessible in India so as to be usable for subsequent use (the Companies (Accounts) Rules, 2014.

9.19 BOOKS OF ACCOUNT IN RESPECT OF BRANCH OFFICE

The branches of the company, if any, in India or outside India shall also keep the books of account in the same manner as specified in subsection (1), for the transaction effected at the branch office. Further the branch offices are required to send the proper summarized return at

quarterly intervals to the company at its registered office and kept open to directors for inspection.

9.20 ACCRUAL BASIS AND DOUBLE-ENTRY SYSTEM OF ACCOUNTING

According to sub-section (1), books of account are required to be kept on **accrual basis** and in accordance with the **double entry system of accounting**.

Accrual basis of accounting is an accounting assumption or an accounting concept followed in preparation of the financial statements. Accrual concept is one of the four principles or accounting concepts, which involves recording income and expenses as they accrue, as distinct from when they are received or paid. The main feature of the accrual concept is that theaccounting period covers only the revenue and expense transactions of that period and ignoresthe timing of actual cash receipts and payments. In this method, revenues and expenses are identified with specific period of time, such as a month or a year, and are recorded as 'incurred' along with acquired assets, without regard to the date of actual receipt or payment of cash in any form.

Double entry book-keeping is a method of recording any transactions of a business in a set of accounts, in which every transaction has a dual aspect of debit and credit and therefore, needs to be recorded in at least two accounts. For example, when a person (debtor) pays cash to a business for goods he has purchased, the cash held by the business is increased and the amount due from the debtor is decreased by the same amount; similarly, when a purchase is made on credit, the purchase account is debited and the amount owed to creditor is increased by the same amount. This double aspect enables effective control of business because all the books ofaccounts must balance. Thus, double entry book-keeping is a method in which every transaction is recorded in a business in such a manner that it involves one or more debit entries and one or more credit entries. The debit entries / amount must equal the credit entries / amount for each transaction recorded.

9.21 INSPECTION OF BOOKS OF ACCOUNTS BY DIRECTORS

As provided in sub-section (3), any director can inspect the books of accounts and other books and papers of the company during business hours. The expression "Books and Papers" has been defined in section 2(12) which includes accounts, deeds, vouchers, writings and documents. The company is, therefore, required to make available the aforesaid books and papers for inspection by any directors. Such inspection may be done by any type of director- nominee, independent, promoter or whole time.

The proviso to sub-section 3 provides that a director of the Company can inspect the books of accounts of the subsidiary, only on authorization by way of the resolution of Board of Directors. Where any other financial information maintained outside the country is required by a director, the director shall furnish a request to the company setting out the full details of the financial information sought and the period for which such information is sought (Rule 4(2)). The said information shall be provided to director within 15 days of receipt of request (Rule 4(3)). The

director can seek the information only individually and not by or through his attorney holder or agent or representative (Rule 4(4)).

The right to inspect books of accounts and other books and papers under this section has been provided to the directors only.

9.22 PERIOD FOR WHICH BOOKS TO BE PRESERVED

The books of accounts, together with vouchers relevant to any entry in such books, are required to be preserved in good order by the company for a period of not less than eight years immediately preceding the relevant financial year. In case of a company incorporated less than eight years before the financial year, the books of accounts for the entire period preceding the financial year together with the vouchers shall be so preserved. The provisions of Income Tax Act shall also be complied with in this regard.

As per proviso to sub-section 5, where an investigation has been ordered in respect of acompany under Chapter XIV of the Act related to inspection, inquiry or investigation, theCentral Government may direct that the books of account may be kept for such period longerthan 8 years, as it may deem fit and give directions to that effect.

9.23 PERSONS RESPONSIBLE TO MAINTAIN BOOKS

The person responsible to take all reasonable steps to secure compliance by the company with the requirement of maintenance of books of accounts etc. shall be: (sub-section 6) i) Managing Director, ii) Whole-Time Director, in charge of finance iii) Chief Financial Officer iv) Any other person of a company charged by the Board with duty of complying with provisions of section 128.

9.24 PENALTY

In case the aforementioned persons referred to in sub-section (6) (i.e. MD, WTD, CFO etc.) fail to take reasonable steps to secure compliance of this section and thus, contravene such provisions, they shall in respect of each offence, be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees or both.

9.25 FINANCIAL STATEMENT

Definition of Financial Statement

Financial Statement is defined under Section 2 (40), to include –

• Balance Sheet

• Profit and Loss account or Income and Expenditure account

• Cash flow Statement

• Statement of change in equity, if applicable

• any explanatory notes annexed to or forming part of financial statements, giving information required to be given and allowed to be given in the form of notes.

However, the financial statement with respect to one person company, small company and dormant company may not include the cash flow statement. Financial statements should be prepared for financial year and shall be in form as per Schedule III.

Section 129: Financial Statement

This Section seeks to provide that the financial statements shall give a true and fair view of the state of affairs of the companies in the form as provided for different class or classes in Schedule III and shall comply with accounting standards. Insurance companies, banking company, companies engaged in generation / supply of electricity or any other class of companies shall make financial statements in the form as has been specified in or under the Act governing such companies. The financial statement shall be laid in the annual general meeting of that financial year. In case of subsidiary companies, the company shall prepare a consolidated financialstatement of the Company and all subsidiaries and lay before the annual general meeting. The Central Government shall have the power to exempt a class or classes of companies from any of the requirements of this section. The section also provides the penalty where company contravenes the provision of this section.

True and Fair view

As per provisions of sub-sections (1) and (2), every financial statement of the company must give true and fair view of the state of affairs of the company at the end of financial year. True and Fair view in respect of financial statement means-

• financial statements and items contained should comply with accounting standards notified under section 133;

• financial statement shall be in form or forms as provided for different class or classes of companies in Schedule III;

• in case of any insurance or banking company or any company engaged in the generation or supply of electricity or to any other class of company for which a form of financial statement has been specified in or under the Act governing such class of company, not treated to be disclosing a true and fair view of the state of affairs of the company, merely by the reason of the fact that they do not disclose –

— in the case of an insurance company, any matters which are not required to be disclosed by the Insurance Act, 1938, or the Insurance Regulatory and Development Authority Act, 1999;

— in the case of a banking company, any matters which are not required to be disclosed by the Banking Regulation Act, 1949;

— in the case of a company engaged in the generation or supply of electricity, any matters which are not required to be disclosed by the Electricity Act, 2003;

— in the case of a company governed by any other law for the time being in force, any matters which are not required to be disclosed by that law.

Other Requirements for financial statements

(a) Financial statements shall lay before the board of the directors in every annual general meeting of a company.

(b) Where a company has one or more subsidiaries, in additional to financial statement provided in sub-section 2, it shall prepare a consolidated financial statement of the company with salient features of financial statements of subsidiary and subsidiaries in such form as prescribed and the same shall be laid before board in annual general meeting.

(c) Central Government may prescribe for the consolidation of accounts of companies.

(d) Where financial statements of the company do not comply with the applicable accounting standards, the company shall disclose the following: i) the deviation from the accounting standards ii) the reason for such deviation and iii) financial effects arising out of such deviation

(e) Central Government may exempt any class or classes of the companies from complying with any of the requirements of this section or the rules there under, either conditionally or unconditionally as may be specified in the notification.

(f) Central Government may notify the class of companies to mandatorily file their financial statements in Extensible Business Reporting Language (XBRL) format and also the manner of such filing. (Rule 9.3(1))

(g) Financial statement shall include any notes annexed to or forming part of such financial statement, giving information required to be given and allowed to be given in the form of such notes.

Form of Financial Statements (Schedule III)

The financial statements shall be in the form or forms as may be provided for different class or classes of companies. Schedule III contains general instructions for preparation of balance sheet and statement of profit and loss account.

Consolidated financial statements

All companies including unlisted companies and private companies having one or more subsidiary company is required to prepare consolidated financial statements. The clause does not exclude any company from such requirement except that Central Government may exempt any class or classes of companies from complying with any such requirement, conditionally orunconditionally, in public interest. Like financial statements, consolidated financial statements shall also comply with accounting standards.

The consolidated statements is required only if the company has one or more subsidiaries. The word 'subsidiary' includes both, associate company and joint venture. The term 'joint venture' has not been defined. Associate includes a joint venture. If the company has only a joint venture or an associate company but no subsidiary, even then, consolidation of financial statements shall be required.

The statement containing the salient feature of the financial statement of a company's subsidiary or subsidiaries, associate company or companies and joint venture or ventures under the first proviso to sub-section (3) of section 129 shall be in Form AOC-1 (Rule 5).

The Consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III and Accounting Standards, subject however, that if the company is not required to prepare consolidated financial statements under the Accounting Standards, it shall be sufficient if the company complies with provisions on consolidated financial statements provided in Schedule III of the Act (Rule 6)

9.26 MAINTENANCE OF COSTING AND STOCK RECORDS (SECTION 148)

A company engaged in production, processing, manufacturing or mining activity, is also required to maintain particulars relating to utilization of material, labour or other items of cost as the Central Government may prescribe for such class of companies.

9.27 SUMMARY

A dividend is a token reward paid to the shareholders for their investment in a company's equity, and it usually originates from the company's net profits. While the major portion of the profits is kept within the company as retained earnings—which represent the money to be used for the company's ongoing and future business activities—the remainder can be allocated to the shareholders as a dividend. At times, companies may still make dividend payments even when they don't make suitable profits. They may do so to maintain their established track record of making regular dividend payments. Larger, more established companies with more predictable profits are often the best dividend payers. These companies tend to issue regular dividends because they seek to maximize shareholder wealth in ways aside from normal growth. Startups and other high-growth companies, such as those in the technology or biotech sectors, may not offer regular dividends. Because these companies may be in the early stages of development and may incur high costs (as well as losses) attributed to research and development, business expansion, and operational activities, they may not have sufficient funds to issue dividends. Evenprofit-making early- to mid-stage companies avoid making dividend payments if they are aimingfor higher-than-average growth and expansion, and want to invest their profits back into their business rather than paying dividends.

Maintaining of company Book of Accounts is mandatory for all types of companies under the Companies Act, 2013. Private Limited Company, One Person Company and Limited Company

including Small Companies are required to maintain proper book of accounts. Further, the Books of Accounts of a Company is the basis on which financial statements of a Company are prepared for company annual return filing. Therefore, maintenance of proper company account is both mandatory and necessary. A company accounts or company book of accounts is includes the books of account, deeds, vouchers, writings, documents, minutes and registers maintained on paper or in electronic form pertaining to the transactions of the Company. The Company Accounts can be maintained in document format or as an electronic document. With advancements in technology, it is recommended that the accounts be maintained in electronic format through accounting software. The Companies Act, 2013 casts an obligation upon acompany to preserve in good condition the book of accounts together with relevant vouchers to any entry for up to 8 years. The Managing Director, the Whole-Time Director, in charge of finance, Chief Financial Officer or any other person of a company nominated by the Board of Directors is responsible for ensuring that the book of accounts of the company is maintained properly. In case, the Company does not maintain proper Book of Accounts, imprisonment or penalty of up to Rs.5 lakh can be levied under the Act. Therefore, it is vital to maintain the booksof accounts of a company properly with professional help.

9.28 GLOSSARY

Accrual concept is one of the four principles or accounting concepts, which involves recording income and expenses as they accrue, as distinct from when they are received or paid.
Dividend means the profit of a company, which is not retained in the business and is distributed among the shareholders in proportion to the amount paid-up on the shares held by them.
Double entry book-keeping is a method of recording any transactions of a business in a set of accounts, in which every transaction has a dual aspect of debit and credit and therefore, needs to be recorded in at least two accounts.

Final dividends: Dividends paid by the corporation after the financial year has been closed, and the Board of Directors accepted an AGM.

Interim dividend: The Board of Directors of a company may declare interim Dividend as per Companies Act 2013 during any financial year or at any time during the period from closure of financial year till holding of the annual general meeting.

9.29 SELF ASSESMENT QUESTIONS

Q1. What do you mean by dividend? Discuss different types, source and conditions required for declaration of dividend?
Q2. Elaborate the procedure for declaration and payment of dividend? What are the punishments for failure to distribute dividend?
Q3. Explain various provisions for declaration of dividend under Companies Act 2013?

Q4. Explicate the following:

(a) Payment of dividend without providing for depreciation

(b) Declaration of dividend out of company's reserve

Q5.Write short notes on:

(a) Unpaid/Unclaimed dividend

(b) Interim dividend

Q6. Define Books of Account? Discuss the provision related to:

(a) Place of keeping Books of Accounts

(b) Maintenance of Books in electronic form

(c)Books of accounts in respect of branch office

Q7.What is accrual basis and double entry system of accounting in context of books of accounts?

Q8.Who is the persons responsible to maintain books of account of a company? What are the penalties for non-maintenance? For how many period books are to be preserved?

Q9. Define Financial Statement? Explain the legal provisions relating to maintenance of financial statement of a corporate entity?

Q10.Write short note on maintenance of costing and stock records by a company?

9.30 REFERENCES

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SEMESTER III

COURSE: COMPANY LAW

UNIT 10: AUDIT, AUDITORS AND AUDITOR'S REPORT

STRUCTURE

10.0. Objectives

10.1. Introduction

10.2. Provisions Relating to Audit

- **10.2.1. Audit Committee**
- **10.2.2. Qualification of an Auditor**
- **10.2.3. Disqualification of an Auditor**
- **10.2.4. Automatic Vacation of Office**
- **10.2.5. Position of Auditors**

10.3. Appointment of an Auditor

- **10.3.1. Appointment of First Auditors**
- **10.3.2. Appoint of Auditor Against Casual Vacancy**
- **10.3.3. Appoint of Auditor of Government Company**
- **10.3.4. Appointment of Auditor by Special Resolution**
- **10.3.5. Reappointment of Auditor**
- **10.3.6. Removal of Auditor**
- **10.3.7. Remuneration of Auditors**
- **10.3.8. Rights of the Auditor**
- **10.3.9. Duties of the Auditor**

10.4. Rotation of the auditors

- **10.4.1. Compulsory rotation of auditors**
- **10.4.2. Period for rotation**

10.5. Audit Report

- **10.5.1. Meaning and definition**
- **10.5.2. Importance of Audit Report**

10.5.3. Factors to be considered while preparing Audit Report

10.5.4. Types of Audit Report

10.6. Secretarial Audit

10.6.1. Meaning

10.6.2. Need for Secretarial Audit

10.6.3. Benefits of Secretarial Audit

10.6.4. Duties of Secretarial Auditor

10.7. Let Us Sum Up

10.8. Key Words

10.9. Test Your Understanding

10.10. Further Readings

10.0. OBJECTIVES

Going through the chapter, we could:

i. understand the qualification and disqualification as per Companies Act, 2013
ii. know the ways of appointment, reappointment and rotation of an auditor
iii. know the position, roles and responsibilities of an auditor
iv. understand the importance and benefits of auditor's report
v. be acquainted with types of auditor's report
vi. comprehend the meaning, need and benefits of secretarial audit
vii. know the duties of secretarial auditor

10.1. INTRODUCTION

In the present age the importance of auditing has grown to such an extent that even organizations for whom it is not legally mandatory to get their accounts audited, consider it necessary to get their accounts audited. Whatever be the condition of the business organization, the job of the auditor is to examine the books of accounts. Audit is optional in case of a sole proprietorship concern or a partnership firm, but in the case of a company, it is compulsory. However, all formsof business organizations want to get their accounts audited as they wish to ensure that their prepared and maintained accounts are correct and do not contain any fraud or error. Further, an audit report is an appraisal of a business's complete financial status. It is written in a standard format, as mandated by the Generally Accepted Auditing Standards (GAAS). GASS allows certain variations in the report, depending upon the circumstances of the audit work in which the auditor engages. Hence, this chapter is going to dwell into the various provisions relating toaudit, appointment of auditors of different business organizations, preparation of different types of audit reports and needs and benefits of secretarial audit.

10.2. PROVISIONS RELATING TO AUDIT

According to companies Act 2013, every company shall appoint an auditor to audit its books and accounts. After the completion of audit, the auditor has to submit his report to the shareholders of the company. The shareholders do not take part in the day-to-day management of the company. The auditor act as an agent of the shareholders. Therefore, the position of the auditor is very vital.

10.2.1. Audit Committee (Section 242-A Of the Companies Act2000)

Every public company having paid-up capital of not less than ₹5 crores shall constitute a committee of the board as "Audit committee". The committee shall consist of not less than 3 directors as the board may determine of which two-third of the total members shall be directors, other than managing or whole -time directors. Every Audit committee shall act in accordance with terms of reference to be specified in writing by the Board. The members of the Audit committee shall elect a chairman from amongst themselves. The annual report of the company shall disclose the composition of the Audit Committee.

10.2.2. Qualification of an Auditor

Section 141 lays down the qualifications necessary for the appointment of an auditor of a company. According to section 141(1) "A person shall not be qualified for appointment as auditor of company unless he is Chartered Accountant within the meaning of chartered of Chartered Accountants Act,1949". It is further provided that a firm, where of all the partners practicing in India are qualified for appointment as company auditors, may be appointed by its firm name to be auditor a company, in which case any partner so practicing may act in the name of the firm.

10.2.3. Disqualification of an Auditor

The following persons shall not be qualified for appointment as the auditor of a company [Section141(3)]:

(a) A body corporate other than a limited liability partnership Act, 2008.
(b) An officer or employee of the company.
(c) A person who or his relative or partner
  (i) is holding any security of or interest in the company or of its holding or associate company or subsidiary of such holding company.
  (ii) is indebted to the company or its subsidiary or its holding or associate or subsidy of such holding company.
  (iii) has given guarantee or provided any security in connection with the indebtedness of any third person to the company or its subsidiary or its holding or associate company or a subsidiary of such holding company for such amount as may be prescribed.

(d) A person who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed.

(e) A person whose relative is a director or is in the employment of the company as a director or key managerial personnel.

(f) A person who has been convicted by a court of an offense involving fraud and a period of ten years has not passed from the date of such conviction.

(g) Any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

10.2.4. Automatic Vacation of Office

If an auditor after his appointment suffers from any of the disqualification, he shall be deemed to have vacated his office as auditor from the date he has become so disqualified.

10.2.5. Position of Auditors

Position of the auditors of a company may be discussed under the following heads:

a. **As an agent**- The auditor may be regarded as an agent of the shareholders appointed to carry out certain duties as laid down by the act and the articles or agreement for the purpose of the audit. However, constructive notice of facts coming to theknowledge of the auditor cannot be imputed to the shareholders.

b. **As an Officer**- An auditor is an officer of the company for the purpose of sections 299,300,342,336,439 and 463. He is liable for wrongful acts and for defaults just like any director or employee of the company for the purposes of these sections.

c. **As an employee** - The relationship between an auditor and a company is that of a professional man and a client rather than that of a master and a servant.

<u>10.3.</u> <u>Appointment of Auditors</u>

10.3.1. Appointment of First Auditors [sec 139(6)]

The first auditors of a company shall be appointed by the board of directors within one month of the incorporation of the company. The auditors so appointed shall hold office until the conclusion of the first Annual General Meeting of the company.

The company may at the first Annual General Meeting remove the auditors appointed by the board and appoint in their place any other persons as auditors who have beennominated for appointment by any numbers of the company not less than 14 days before the date of meeting.

10.3.2. Appoint of Auditor Against Casual Vacancy [sec 139(8)]

The companies Act has not defined casual vacancy. But, one can say that casual vacancy for an auditor arises due to disqualification, resignation, death, etc. In such case

a. The Board of Directors may appoint an auditor to fill the casual vacancy caused by any reason other than by resignation.
b. Where there is more than one auditor, the remaining auditors may act as the auditor during the vacancy period.
c. Where the casual vacancy is due to resignation, the vacancy can be filled up only at an Annual General Meeting.

Any casual vacancy in the office of an auditor due to:

a. reasons, other than resignation, like death/disqualification u/s141(3) etc. shall be filled by Board of Directors within 30 days.
b. resignation, shall be first filled by Board within 30 days and then approved by shareholder in general meeting within 3months from the Board passing a resolution.
c. Such person shall hold office till the conclusion of the next Annual General Meeting.

10.3.3. Appoint of Auditor of Government Company

The comptroller and Auditor General(CAG) shall appoint an auditor in order to conduct the audit of the company. The CAG shall also give directions and the manner in which such accounts of the government company are necessary to be audited by the auditor.

10.3.4. Appointment of Auditor by Special Resolution [sec 140(4)]

In the case of companies mentioned below, appointment and reappointment of auditors at the Annual General Meeting shall be made only after passing a specialresolution.

i. A company in which not less than 25 % of the subscribed share capital is held as on the date of Annual General Meeting jointly or singly by a nationalized bank or general insurance company.
ii. Any institution, financial or otherwise, established under State Provincial Act in which, not less than 51% of subscribed capital is held by the state government.
iii. A central government or a state government company or public financial institution.

10.3.5. Reappointment of Auditor

Reappointment of a retiring auditor is not automatic. A retiring auditor may be appointed at the Annual General Body Meeting by passing a resolution.

10.3.6. Removal of Auditor [sec 140(1)]

The company can remove an auditor, after giving him reasonable opportunity to be heard, by passing a special resolution.

i. The board shall pass a resolution for the same and within 30 days shall apply to the central government.
ii. The company shall pass a special resolution within 60 days from the date of receipt of approval by central government.
iii. The auditor appointed under section 139 may be removed from his office before the expiry of his term only by a special resolution of the company.

10.3.7. Remuneration of Auditors

According to section 142 of the Companies Act, 2013 the remuneration of the first auditors appointed by the Board of Directors shall be fixed by the company in General Meeting or in such manner as the company in general meeting may determine.

In the case of an auditor appointed under section 139(5) by the Comptroller and Auditor General of India, the remuneration shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

The remuneration under section 142(1) shall, in addition to the fee payable to an auditor, include the expenses incurred by the auditor in connection with the audit of the company and facilities extended to him but does not include any remuneration paid to him at any other service rendered by him at the request of the company.

10.3.8. Rights of the Auditor

The auditor has been granted the following rights by section 143 of the Indian Companies Act, 2013 and the Chartered Accountants Act.

i. Right to Access the books, accounts and vouchers of the company.
ii. Right to receive necessary information and explanation.
iii. Right to Receive the prepared Final Accounts.
iv. Right to visit the branch office.
v. Right to Receive notice and attend the General Meeting.
vi. Right to make statement in the General Meeting.
vii. Right to have technical and legal advice.
viii. Right to sign the audit report and to certify the related documents.
ix. Right to be indemnified.
x. Right to receive remuneration.

10.3.9. Duties of the Auditor

i. To check loans, advances and investment of the company.
ii. To help in investigation.
iii. To issue a Report.

iv. To give a report on the prospectus of the company.
v. To give report on solvency.
vi. To help the Advocate General.

10.4. ROTATION OF THE AUDITORS

According to sub-clause 141(3) a person cannot be auditor of more than twenty companies at a time. For the purpose of counting twenty companies as aforesaid, only public companies and private companies having paid of capital of ₹100 corer or more are to be considered.

10.4.1. Compulsory rotation of auditors

Sec 139(2) of the Act provides for compulsory rotation of the auditors for the listed companies and certain class or classes of companies. The companies that are required to compulsorily rotate their auditors include all unlisted public companies having paid up capital of ₹10 corers or more and all private limited companies with paid up share capital of ₹20 crores or more. Companies having public borrowings from financial institutions, banks or public deposits of ₹50 crores or more are also covered even if their paid up capital be lower than the threshold prescribed [(Rule 5 of the Companies (Audit and Auditors) Rules,2014].

10.4.2. Period for rotation

- Under Section 139 (2) a listed company or class of companies prescribed shall not appoint an individual as auditor for more than 1 term of 5 consecutive years, whereas, an audit firm shall not be appointed for more than 2 terms of 5 consecutive years. After the expiry of the period as afore said, the auditors are required to be rotated.
- As per [Rule 6 (3) (i)], for the purpose of calculating the period of 5 consecutive years or 10 consecutive years as prescribed, the period for which the auditor has held office prior to the commencement of the Act shall also be taken into account.
- The provision to Section 139(2) allows a period of 3 years to the company from the commencement of the Act to comply with the requirements relating to rotation.

10.5. Audit Report

10.5.1. Meaning and definition

Auditor is appointed to verify the accounts of an organisation. After verifying the accounts, the auditor gives the brief description of the work done by him which is signed by him. This description is known as the audit report.

According to Section 143 of the Companies Act, 2013 after the completion of an audit the auditor has to issue a report relating to the accounts, Profit and Loss account and Balance Sheet and relevant documents which are presented by the company in the General Meeting. Therefore, after the completion of the audit the auditor presents a report in which he states his observations as a result of the verifications and his conclusions on the same. This report is known as the *audit report*. In this way the audit report is the end product of each audit. It is the medium through which the auditor expresses his views on the yearly accounts and other details

Joseph Lancaster has defined audit report as, “Report is a statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of the full facts of the subject matter of the Report.

From the above definition the following characteristics of an audit report are observed:

1. Report is a summary of the verification conducted by the auditor.
2. The report also gives details of all the conclusions with the auditor concludes after the verification activities.
3. If required, the auditor also gives his views along with the issues in the report.
4. The report has to be signed by the auditor.
5. Concrete and precise information is received from the report.

10.5.2. Importance of Audit Report

Audit report is important for all those persons and parties which are related to the organisation. The audit report gives time picture of the state of the organisation. The main parties which are benefited from an audit report are as follows:

Investor: It is human nature that while making an investment the investor wants maximum safety and return for his investment. The audit report helps in increasing the confidence of the investor in the organisation and it is on the basis of the audit report only that the investors decide to invest in an organisation.

Shareholders: Shareholders are the actual owners of a company. They are large in number and therefore cannot directly take part in the management of the company. Thus, the company is managed by a group of representatives elected by the holders known as board of directors. In this way there is a separation of ownership and Management in a company. Therefore, the correct information about the work done by directors is available to the shareholders from the audit report only.

Directors: It is not possible for the directors of a company to fore-see all the activities of the company themselves. The main job of the directors is to formulate the policies of the company

on the basis of which work is done by the employees. In such a situation, the directors also want to know the extent to which the employees have done their work according to the policies of the company and their level of honesty and commitment towards their job. Such information can be obtained by them from the audit report

Creditors: The creditors of any organisation are always eager to find out about the financial position of the company. Therefore, the creditors rely on the audit report to find out about the financial situation of the organisations.

Government: Business and government have a direct relationship. The growth of business, industry and finance plays an important role in the growth of the country. Erosion in the capital of the country, embezzlement of capital, discouragement to investments are such issues for which the participation of the government is essential. The government invests its fund in government companies and also gives loans and financial assistance to other businesses and industries. Therefore, the government also wants to know whether its money is safe or not. Such information can be obtained from the audit report.

Taxation Officer: Various officers such as income tax officers, sales tax officers, exciseofficers etc. rely on the audited accounts and take a decision on the basis of the report without doing much verification.

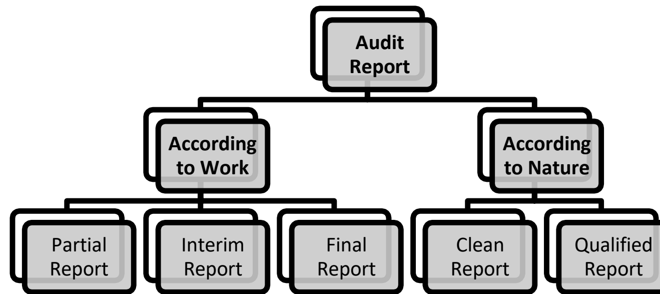
10.5.3. Factors to be considered while preparing Audit Report

A good report should include the following points:

1. The language of the reports should be easy.
2. The report should be divided into paragraphs.
3. The report should be addressed to those people for whom the audit is done, e.g., the report of a company should be addressed to the members.
4. The auditor should refer to all those documents, details and comments that were used by him during the audit.
5. In case of a qualified report, the qualifications should be mentioned very clearly.
6. The reports should be impartial and unbiased and the mistakes in the books of accounts should be stated clearly.
7. The criticism stated in the reports should not be such as to harm any particular person.
8. The report should be as brief as possible without omitting any important fact.
9. It is not desirable to use words having more than one meaning, in the report.
10. At the end of the report the signature of the auditor should be on the left hand side and the word Chartered Accountant should be written below it.
11. On the right hand side, at the end of the report the place and date should be written.

10.5.4. Types of Audit Report

The audit report can be divided in following categories:



(a) Classification according to work: According to work the audit report is divided into three parts:

1. Partial report: If the auditor is not appointed to verify all the accounts but only some books of accounts and the auditor issues a report, then it is known as "partial report". While writing this report the auditor should keep in mind that a person reading the report should not take it as a full report. Therefore, in such kind of a report, theauditor should make it clear that he has been appointed for a partial verification and the report is a partial report.
2. Interim report: When an auditor issues a report in the middle of the year on certain special issues then such a report is known as an "interim report". Normally, such a reportis presented on declaring interim dividend or when the central government issues an order.
3. Final report: When the auditor issues a report after the completion of the audit for the entire business year, then such a report is known as a "final report". Normally an auditor issues such a report only. This report plays an important role in the performance of a company. Therefore, special care should be exercised in framing this report.

(b) Classification according to nature:
According to the nature, the audit report is divided into two parts:

1. **Clean report:** If the auditor after verifying the books of accounts comes to the conclusion that the books of accounts have been appropriately maintained, there is no mistake, inadequacies and frauds, the profit or loss as shown by the Profit and Loss account and the financial position as per the Balance Sheet are correct which means that the auditor has no complaint or suspicion, then in such a situation the report issued by him is called it "clean report". It is also known as an "unqualified report". The goodwill of the organisation increases with such a report.
2. **Qualified report:** If during the audit, the auditor finds any discrepancies, irregularities, frauds other deficiency in the books of accounts, i.e. he is not fully satisfied about the accuracy of the Profit and Loss account and Balance Sheet of

the organisation, then he should write in his report the various points which made the accounts of the organisation inaccurate. The auditor writing this is a qualification in itself. A report which has such qualifications is known as a "Qualified Report".

10.6. Secretarial Audit

10.6.1. Meaning

The term "Secretarial Audit" is a mechanism which is connected with the audit of the non-financial aspects of the company. Every Company, while pursuing its business activities, has to comply with the rules and regulations relating to the Companies Act, Securities laws, FEMA, Industry Specific laws and General laws like Labour laws, Competition law and Environmental and Pollution related laws and should also pursue the good governance practice. Secretarial Audit verifies compliances of such applicable laws, regulations and guidelines. As per Regulation 24A of the SEBI (LODR) Regulations, 2015, every listed entity and its material unlisted subsidiaries incorporated in India is required to undertake secretarial audit and shall annex with its annual report, a secretarial audit report, given by a company secretary in practice, in from no. MR-3 from the year ended 31st March, 2019.
As per section 204(1), only a member of the Institute of Company Secretaries of India holding certificate of practice can conduct Secretarial Audit and furnish the Secretarial Audit Report to the company. He/ she should detect the instances of non-compliances and in result facilitate taking corrective measures. The professional should perform an effective due diligence exercise before the issuance of Secretarial Audit Report.

10.6.2. Need for Secretarial Audit

Secretarial Audit is the process of independent verification, examination of level of compliance of applicable Corporate Laws to a company. An action plan of the corporate secretarial department is to be designed to ensure that all event based and time based compliances are considered and acted upon. Secretarial audit is to be on the principle of "Prevention is better thancure" rather than post mortem exercise and to find faults. Broadly, the need for Secretarial Audit is:

1. Effective mechanism to ensure that the legal and procedural requirements are duly complied with.
2. Provides a level of confidence to the directors & key managerial personnel.
3. Directors can concentrate on important business matters as secretarial audit ensures legal and procedural requirements.
4. Strengthen the image and goodwill of a company in the minds of regulators and stakeholders.
5. Secretarial Audit is an effective governance and compliance risk management tool.
6. It helps the investor in analysing the compliance level of companies, thereby increases the reputation.

10.6.3. Benefits of Secretarial Audit

1. Secretarial Audit can be an effective due diligence exercise for the prospective acquirer of a company or controlling interest or a joint venture partner.
2. It assures the owners and the management that the affairs of the company are being conducted in accordance with requirements of laws and that the owners stake is not being exposed to undue risk.
3. It ensures the management of a company that those who are charged with the duty and responsibility of compliance with the requirements of law are performing their duties competently, effectively and efficiently.
4. It ensures them that they have done everything required under law and that the company had complied with the laws and therefore, they are not likely to be exposed to action by law enforcement agencies for noncompliance by the company.
5. The Secretarial audit can assist bodies like SEBI, Stock Exchange, Financial Institutions, banks etc., measure the levels of compliance and noncompliance by the companies with whom they are concerned.

10.6.4. Duties of Secretarial auditor

As per sec 143(12) (14) of the Act, if Company Secretary in Practice, during conduct ofSecretarial Audit, has sufficient reason to believe that an offence involving fraud is beingcommitted or has been committed against the company by officers or employees of the company,he shall report the same to the Central Government immediately but not later than 60 days of his knowledge with a copy to the Board / Audit Committee seeking their reply within 45 days. The Board / Audit Committee is to reply in writing the steps taken to address the fraud. Then, the Auditor will forward his report and reply of the Board / Audit Committee with his comments to the Central Government within 15 days of reply by Board / Audit Committee. This Report shall be in Form ADT – 4.

10.7. LET US SUM UP

Auditors are appointed in a company to examine the books of account and to report to the shareholders whether a true and fair view of the state of affairs is represented by the financial statements. Though audit of books of accounts is optional for sole proprietorship business and partnership firm, all forms of business organizations want to get their accounts audited as they wish to ensure that their prepared and maintained accounts are correct and do not contain any fraud or error.

Only Chartered Accountants qualify for appointment as a company auditor. Their appointment is normally made at the Annual General Meeting of the company. A retiring auditor may be

reappointed as a company auditor provided he is not disqualified for the appointment or has not shown his unwillingness to continue. In case an auditor is to be removed from office before the expiry of his term, prior approval of the Central Government should be obtained and a special resolution should be passed at the general meeting of the company.
An auditor is an agent of the shareholders of the company but he is neither a financial advisor nor a detective. There are several statutory rights of an auditor like access to books of account, obtain necessary information and explanation, attend general meeting, make necessary correction in financial statements, and visit branches, if required. His duties can be classified as to check loans, advances and investment of the company, to issue a report, to give a report on the prospectus of the company, to help the Advocate General etc. For the whole audit assignment,the auditor must follow the normal procedure of audit, the relevant statutory provisions and the guidelines of International Auditing Standards.
An auditor's report is a valuable aid to the company and its shareholders. The Companies Act requires the auditor to make his report on the accounts examined by him. The auditor is to state whether in his opinion and to the best of his information and according to the explanations given to him, the books of accounts are prepared as per the specified standard. He is also required to state whether proper books of accounts as directed by law have been kept by the company. An auditor will give a clean report when he feels fully satisfied about the accounts and statements being a true representative of the financial position of the company. In case he finds that owingto one reason or the other, the financial statements do not show a true and fair view of the stateof affairs of the company, he may qualify his report.

The term "Secretarial Audit" is a mechanism which is connected with the audit of the non-financial aspects of the company. Every Company, while pursuing its business activities, has to comply with the rules and regulations relating to the Companies Act, Securities laws, FEMA, Industry Specific laws and General laws like Labour laws, Competition law and Environmental and Pollution related laws and should also pursue the good governance practice. Secretarial Auditor verifies compliances of such applicable laws, regulations and guidelines. Secretarial Audit can be an effective due diligence exercise for the prospective acquirer of a company or controlling interest or a joint venture partner. It assures the owners and the management that the affairs of the company are being conducted in accordance with requirements of laws. It is an assisting tool for bodies like SEBI, Stock Exchange, Financial Institutions, banks etc., to measure the levels of compliance and noncompliance by the companies with whom they are concerned.

10.8. KEY WORDS

Auditor: A professional who examines the books of accounts of a company.

Audit Report: An audit report is an appraisal of a business's complete financial status.

Auditing Standard: International guidelines to promote uniformity and consistency in audit

practices.

First Auditor: The auditor appointed by the Board of Directors of the company within one month of incorporation.

Subsequent Auditor: Auditor appointed after the first auditor at the annual general meeting of the company.

Casual Vacancy: Vacancy for an auditor arises due to disqualification, resignation, death, etc.

Financial Statement: Profit and Loss Account, Balance Sheet and other documents forming part of the working results of the company.

Report: Expression of opinion on legally specified matters for circulation among the stakeholders and presentation at annual general meeting.

Partial report: If the auditor is not appointed to verify all the accounts but only some books of accounts and the auditor issues a report, then it is known as partial report.

Clean Report: A report which incorporates the satisfaction of the auditors in respect of Statutory requirements relating to books of account, profit and loss account and balance sheet.

Qualified Report: When auditors express an opinion subject to certain reservations, it is a qualified report.

Secretarial Audit: Secretarial Audit is a mechanism which is connected with the audit of the non-financial aspects of the company.

10.9. TEST YOUR UNDERSTANDING

A) Short answer Questions:

1. Who can be appointed as an auditor?
2. Who can't become an auditor of a company?
3. Who are first auditors and how are they appointed?
4. What are the disqualification of an auditor?
5. Who is empowered to sign auditor's report?
6. Auditors of Government Companies.
7. Resignation by an Auditor.

8. Removal of an auditor.
9. Restriction on number of auditors.
10. Casual vacancy in the office of auditor.
11. Remuneration f auditors.
12. Status of the company auditor.
13. What is auditor's report?
14. Importance of audit report.
15. What is secretarial audit?
16. What are the duties of a secretarial auditor?

B) Essay Type Questions:

1. Explain in detail about the appointment of an auditor in a company?
2. Explain in detail when can an auditor be appointed by special resolution.
3. What are the various provisions in Companies Act regarding "auditor remuneration"?
4. What are the powers and duties of a company auditor?
5. Describe the provisions of the Companies Act, 2013 with regard to qualification and disqualification of the auditor.
6. What is auditor's report? What are its various types? What are its contents?
7. What is audit report? Explain its importance in detail.
8. Explain the features of a qualified report.
9. Discuss about the various aspects that are covered under Companies (Auditor Report) Order, 2016.
10. What do you mean by secretarial audit? What are its needs and importance?

10.10. FURTHER READINGS

The following text books may be used for more in-depth study on the topics dealt with in this unit.

K.C. Garg, Vijay Gupta & Joy Dhingra. *Corporate Laws*, Kalyani Publications, New Delhi.

Ashok Sharma. *Corporate Law*, VK Global Publications, New Delhi.

N.D. Kapoor. *Elements of Mercantile Law*, Sultan Chand and Sons, Delhi

B.M. Jena. *Auditing and Corporate Governance*, Himalaya Publishing House, Mumbai.

Dinkar Pagare. *Principles and Practice of Auditing*, Sultan Chand & Sons, New Delhi.

Kamal Gupta and Ashok Arora. *Fundamental of Auditing*, Tata McGraw-Hill Publishing Co. Ltd., New Delhi.

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SEMESTER III

COURSE: COMPANY LAW

UNIT 11: WINDING UP: CONCEPT AND MODES OF WINDING UP

STRUCTURE

11.0 Objectives

11.1 Introduction

11.1.1 Meaning

11.2 Difference Between Winding Up and Dissolution

11.3 Circumstances of Winding Up

11.4 Who Can Apply for Winding Up

11.5 Functions of Liquidator

11.6 Powers of Liquidator

11.7 Modes of Winding Up

11.7.1 Compulsory Winding Up

11.7.1.1 Grounds for Winding Up By The Tribunal

11.7.2 Voluntary Winding Up

11.7.2.1 Procedure for Voluntary Winding Up

11.7.3 Grounds for Winding Up By The Tribunal

11.7.4 Filing of Winding Up Petition

11.7.5 Difference Between Compulsory And Voluntary Winding Up

11.8 Consequences of Winding Up

11.8.1 Consequences of Winding Up by Tribunal

11.8.2 Consequences of Voluntary Winding Up

11.9 Let Us Sum Up

11.10 To Check the Progress

11.10.1 Long Answer Questions

11.10.2 Short Answer Questions and Answers

11.0 OBJECTIVES

After studying this Unit, you should be able to:

- Explain the meaning of winding up.
- Distinguish between winding up and dissolution
- Circumstances in which company is wound up
- Application of winding up
- Modes of winding up
- Difference between compulsory and voluntary winding up
- Describe the consequences of winding up

11.1 INTRODUCTION

Winding up is a process whereby the existing company's affairs brought to an end. It is a very complex situation where the companies which came into existence in an aspire to grow higher with the passage of each day, in fact each second, 'turn-off' their entire business either voluntarily or by the Tribunal's involvement. The statutory provisions of the winding up and its procedure are dealt under Chapter XX Sections 270 to 378 of the Companies Act, 2013 (substitute of the old Companies Act, 1956). After the completion of winding up process the name of company is struck off from the register of Registrar of Companies.

If incorporation is the process of creating the company, then winding up is the process of bringing an end to the existence of that so called artificial person viz. Company. A company cannot die a natural death. It has a perpetual life span, but if such reasons have appeared which make it necessary to bring an end to its corporate life, then necessary legal mechanisms has to beadopted for winding up. It is a process by which the properties of the company are administered for the benefit of its members and creditors. The person appointed for administering the assets and liabilities is called 'Liquidator'. In case of compulsory winding up, the liquidator is appointed by the Tribunal under section 275 of the Act; or, in case of voluntary winding up, the liquidator is appointed by the company itself under section 310 of the Act. Winding up is also referred as 'Liquidation'. On liquidation, the company's name is deleted from the list of companies by the Registrar of companies and the same is published in the official gazette.

11.1.1 Meaning

Winding up of a company is defined as a process by which the life of a company is brought to an end and its property administered for the benefit of its members and creditors. In words of Professor Gower, "Winding up of a company is the process whereby its life is ended and its Property is administered for the benefit of its members & creditors. An Administrator, called a liquidator is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights."

As per section 2(94A) of the Companies Act, 2013, “winding up” means winding up under this Act or liquidation under the Insolvency and Bankruptcy Code, 2016. Thus, winding up ultimately leads to the dissolution of the company. In between winding up and dissolution the legal entity of the company remains and it can be sued in a Tribunal of law.

11.2 DIFFERENCE BETWEEN WINDING UP AND DISSOLUTION

I) In winding up the assets of the company are sold and the proceeds are utilized in paying off the debts and other liabilities of the company. It is the first stage of terminating the life of a company. While the dissolution is the next stage and after this the company ceases to exist.

II) The winding up proceedings are carried out by a liquidator of the company while in case of dissolution no such proceedings are carried out.

III) Creditors can prove their debts in the winding up but not in the dissolution of the company.

IV) In the cases of winding up it is not always necessary to obtain an order of the court because voluntary winding up may take place, but for dissolution of the company, the order of the court is essential. From the above discussion it should be clear to you that winding up and dissolution of a company is not the same thing.

11.3 CIRCUMSTANCES IN WHICH A COMPANY MAY BE WOUND UP

A company may be wound up by a tribunal where the petition has been filed under the following circumstances:

- A special resolution is passed by the company that the company shall be wound up by the tribunal.
- Failure of the company in reporting a statutory report at the registrar’s office.
- Non-commencement of the company in business within one year of incorporation.
- Number of members has reduced below 7 for a public company or 2 for a private company respectively.
- The debts of the company are unplayable by the company.
- The tribunal is just equitable to wound up the company.
- The company is unable to file its balance sheet or annual return for five financial years consecutively.
- The company has acted against the sovereignty and integrity of the country.

11.4 WHO CAN APPLY FOR WINDING UP

Section 272 provides that a winding up petition is to be filed in the prescribed form no 1, 2 or 3 whichever is applicable and it is to be submitted in 3 sets. An application of winding up may be filed with the petition of winding up by any of the following persons:

- The company
- Any creditor or creditors of the company
- Any of the contributory company
- Any person authorized by the central government

- The state government or the central government

11.5 FUNCTIONS OF OFFICIAL LIQUIDATOR

The Official Liquidator shall be the convener of the meetings of the winding up committee which shall assist and monitor the liquidation proceedings in following areasof liquidation fu nctions, namely:

(i) Taking over assets;
(ii) Examination of the statement of affairs;
(iii) Recovery of property, cash or any other assets of the company including benefits der ived therefrom;
(iv) Review of audit reports and accounts of the company;
(v) Sale of assets;
(vi) Finalisation of list of creditors and contributories;
(vii) Compromise, abandonment and settlement of claims;
(viii) Payment of dividends, if any; and
(ix) Any other function, as the tribunal may direct from time to time.

11.6 POWERS OF LIQUIDATOR

Subject to provisions of Company Law and directions by the Tribunal, the Company Liquidator, shall have the power in the winding up of a company by the Tribunal. These are discussed as follows:

(a) to carry on the business of the company so far as may be necessary for the beneficial wi nding up of the company;
(b) to do all acts and to execute, in the name and on behalf of the company, all deeds, receip ts and other documents, and for that purpose, to use, when necessary, the company's seal;
(c) to sell the immovable and movable property and actionable claims of the company by pu blic auction or private contract, with power to transfer such property to any person or bo dy corporate, or to sell the same in parcels;
(d) to sell the whole of the undertaking of the company as a going concern;
(e) to raise any money required on the security of the assets of the company;
(f) to institute or defend any suit, prosecution or other legal proceeding, civil or cri minal, in the name and on behalf of the company;
(g) to invite and settle claim of creditors, employees or any other claimant and distri bute sale proceeds in accordance with priorities established under this Act;
(h) to inspect the records and returns of the company on the files of the Registrar or any other authority;
(i) to prove rank and claim in the insolvency of any contributory for any balance against his estate, and to receive dividends in the insolvency, in respect of that balance, as a separa te debt due from the insolvent, and rateably with the other separate creditors;

(j) to draw, accept, make and endorse any negotiable instruments including cheque, bill of exchange, hundi or promissory note in the name and on behalf of the company, with the same effect with respect to the liability of the company as if such instruments had been drawn, accepted, made or endorsed by or on behalf of the company in the course of its business;

(k) to take out, in his official name, letters of administration to any deceased contrib utory, and to do in his official name any other act necessary for obtaining payment of any money due from a contributory or his estate which cannot be conveniently done in the name of the company, and in all such cases, the money due shall be deemed to be due to the Company Liquidator himself;

(l) to obtain any professional assistance from any person or appoint any professional, in dis charge of his duties, obligations and responsibilities and for protection of the assets of the company, appoint an agent to do any business which the Company Liquidator is unable to do himself;

(m) to take all such actions, steps, or to sign, execute and verify any paper, deed, document, application, petition, affidavit, bond or instrument as may be necessaryfor:

i) winding up of the company;
ii) for distribution of assets;
iii) discharge of his duties and obligations and functions as Company Liquidator;
iv) to apply to the Tribunal for such orders or directions as may be necessary for the winding up of the company.

11.7 MODES OF WINDING UP

A company may be wound up in any of the following two ways:

11.7.1 Compulsory winding up (Sec. 272)

11.7.2 Voluntary Winding Up

11.7.1 Compulsory Winding Up: As per new Companies Act 2013, a company can be wound up by a tribunal in the below mentioned circumstances:

1. When the company is unable to pay its debts

2. If the company has by special resolution resolved that the company be wound up by the tribunal.

3. If the company has acted against the interest of the integrity or morality of India, security of the state, or has spoiled any kind of friendly relations with foreign or neighboring countries.

4. If the company has not filled its financial statements or annual returns for preceding 5 consecutive financial years.

5. If the tribunal by any means finds that it is just & equitable that the company should be wound up.

6. If the company in any way is indulged in fraudulent activities or any other unlawful business, or any person or management connected with the formation of company is found guilty of fraud, or any kind of misconduct.

11.7.1.1 Grounds For Winding Up By The Tribunal

Section 271 of the Companies Act, 2013 provides various grounds on the basis of which a petition can be filled in the Tribunal for the winding up of the company:

(a) Inability to pay debts: Sub-section (2) of section 271 provides that the inability to pay debts primarily arise under three circumstances:

- Where the company fails to clear the debt of the creditor within three weeks immediately preceding the date of demand for payment being made;

- Where execution or other process issued on a decree or order of any court in favors of the company is returned unsatisfied in whole or part; and
- Where it is proved to the satisfaction of the court that the company is unable to pay its debts. A petition for winding up on the ground of inability to pay debts must contain all the relevant information about the debt. The petition must disclose the assets of the company and whether they are sufficient to meet the liabilities including contingent and prospective liabilities. Further, the petition must also disclose the position of fixed assets as well as valuation of plant and machinery of the company. Where a debt is bona fide disputed by the company and the court is satisfied with the company's defense a winding up order will not be made. In K. Apparao v. Sarkar Chemicals (P) Ltd., the Andhra Pradesh High Court held that where a company has a prima facie sustainable defence or a bona fide dispute of its obligations to discharge the alleged debts or liabilities, the court may not entertain proceedings for the winding up, much less order winding up. Once there is an admission on part of the respondent company of liability of dues payable, then a petition under Section 273 cannot be dismissed on technical grounds. Company courts can exercise their discretionary powers of dismissing the petition even before issuing a show cause notice regarding admission. Despite of repeated demands if a company neglects to pay its debts, it will be considered as an inability of the company to pay its debts and an order of winding up can be passed by the court. By non-payment of the undisputed debt within the period of statutory demand, the company is deemed unable to pay its debts and where the company is unable to pay its debts, winding up ought generally to follow inpublic interest.

(b) Special Resolution: The Company may by special resolution resolve that it be wound up by the Tribunal. The resolution may be passed for any cause whatsoever. However, the Tribunal must see that the winding up is not opposed to public interest or the interest of the company as a whole. Case law: New Kerala Chits & Traders (P.) Ltd. vs. Official Liquidator [1981], it has been observed in this matter that the Tribunal has discretion in the matter and is under no obligation to order winding-up merely because the company has so resolved.

(c) Against National interest: If the company has acted against the interest of sovereignty and integrity of India, the security of the State, friendly relations with foreign States, public order, decency or morality.

(d) Failure of Scheme: If the scheme of revival and rehabilitation is not approved by the creditors, then the company administrator shall submit a report to the Tribunal within 15 days and the Tribunal shall order for the winding up of the sick company. The Tribunal, on passing the order of winding up, shall conduct the proceedings for winding up in accordance with the provisions of Chapter XX [Sec. 271(1) (d)].

(e) Fraudulent and unlawful affairs: If on an application made by the Registrar or any other person authorised by the Central Government by notification under this Act, the Tribunal is of the opinion that the affairs of the company have been conducted in a fraudulent manner or the company was formed for fraudulent and unlawful purposes or the persons concerned in the formation or management of its affairs have been guilty of fraud, misfeasance or misconduct in connection therewith and that it is proper that the company be wound-up; then in such a situation, the Tribunal may, on a petition filed by any authorised person, pass an order for the winding up of the company [Sec. 271(1) (e)].

(f) Default in filling financial statements: If the company has made a default in filling with the Registrar its financial statements or annual return for immediately preceding five consecutive financial years [Sec. 271(1) (f)].

(g) Just and Equitable: When the Tribunal is of the opinion that it is just and equitable that the company should be wound up; then the Tribunal may order the winding up of a company. The circumstances in which the courts have in the past dissolved companies on this ground are as follows:

h) Deadlock: When there is a deadlock in the management of a company, it is just and equitable to order winding up.

i) Loss of Substratum: When the company has failed to materialize the main objects of the company. The important illustration here is the case of German Date Coffee Co, Re [(1882) 20 Ch D 169], where a company was formed for the purpose of manufacturing coffee from dates under a patent which was to be granted by the Government of Germany and also for working other patents of similar kind. The German patent was never granted and the company embarked upon other patents. But, on the petition of a shareholder, it was held that "the substratum of the company had failed, and it was impossible to carry out the objects for which it was formed; and, therefore, it was just and equitable that the company should be wound up.

j) Losses: When a company cannot carry forward its business except bearing the burden of losses, then it is just and equitable for the company to be wound up. The Bombay High Court observed in the case of Shah Steamship Navigation Co, Re [(1901) 10 Bom LR 107] that 'the Court will not be justified in making a winding up order merely on the ground that the company has made losses; and is likely to make further losses.'

k) Oppression of Minority: It is just and equitable to wind up a company where the principle shareholders have adopted an aggressive or oppressive or squeezing policy towards the minority. It has been observed in Tivoli Free, Re, [(1972) VR 445] that 'where more than seventy per cent of a company's funds were being used for objects wholly removed from anything within the memorandum and ninety-three per cent of the shareholders wished to dissociate themselves from the new objects, the company was ordered to be wound up.

l) Fraudulent Purpose: If the company has been conceived and brought forth in fraud or for illegal purposes, then it is just and equitable to wind up the company. In Universal Mutual Aid and Poor Houses Assn vs. A.D. Thoppa Naidu [AIR 1933 Mad 16] the Madras High Court observed, 'where the main object of a company is the conduct of a lottery, the mere fact that

some of its objects were philanthropic will not prevent the company from being ordered to be wound up as being one formed for an illegal purpose.' "Public interest" is also another important ground, on the basis of which the court can order the winding up of the company. On the same ground, an order of winding up passed by the Tribunal can be revoked also.

11.7.2 Voluntary winding up of a company

The company can be wound up voluntarily by the mutual decision of members of the company, if:
i) The company passes a Special Resolution stating about the winding up of the company.
ii) The company in its general meeting passes a resolution for winding up as a result of expiry of the period of its duration as fixed by its Articles of Association or at the occurrence of any such event where the articles provide for dissolution of company.

11.7.2.1 Procedure for Voluntary Winding Up

1. Conduct a board meeting with 2 Directors and thereby pass a resolution with a declaration given by directors that they are of the opinion that company has no debt or it will be able to pay its debt after utilizing all the proceeds from sale of its assets.

2. Issues notices in writing for calling of a General Meeting proposing the resolution along with the explanatory statement.

3. In General Meeting pass the ordinary resolution for the purpose of winding up by ordinary majority or special resolution by 3/4th majority. The winding up shall be started from the date of passing the resolution.

4. Conduct a meeting of creditors after passing the resolution, if majority creditors are of the opinion that winding up of the company is beneficial for all parties then company can be wound up voluntarily.

5. Within 10 days of passing the resolution, file a notice with the registrar for appointment of liquidator.

6. Within 14 days of passing such resolution, give a notice of the resolution in the official gazette and also advertise in a newspaper.

7. Within 30 days of General meeting, file certified copies of ordinary or special resolution passed in general meeting.

8. Wind up the affairs of the company and prepare the liquidators account and get the same audited.

9. Conduct a General Meeting of the company.

10. In that General Meeting pass a special resolution for disposal of books and all necessary documents of the company, when the affairs of the company are totally wound up and it is about to dissolve.

11. Within 15 days of final General Meeting of the company, submit a copy of accounts and file an application to the tribunal for passing an order for dissolution.

12. If the tribunal is of the opinion that the accounts are in order and all the necessary compliances have been fulfilled, the tribunal shall pass an order for dissolving the company within 60 days of receiving such application.

13. The appointed liquidator would then file a copy of order with the registrar.

14. After receiving the order passed by tribunal, the registrar then publish a notice in the official Gazette declaring that the company is dissolved.

11.7.3 Effect of Winding up by tribunal (Sec. 279)

According to this section, the order for winding up of a company shall operate in favors of all the creditors and all contributories of the company as if it had been made out or the joint petition of creditors and contributories.

11.7.4 Effect of voluntary winding up (Sec. 309)

In the case of a voluntary winding up, the company shall from the commencement of the winding up cease to carry on its business except as far as required for the beneficial winding up of its business. The corporate state and corporate powers of the company shall continue until it is dissolved.

11.7.5 Difference Between Compulsory And Voluntary Winding Up

	Compulsory winding Up	**Voluntary winding Up**
1.	Compulsory winding up of a company is brought about by an order of the court.	Voluntary winding up is brought about either by the members or by the creditors of the company without the intervention of the court

2.	In case of Compulsory winding up, the liquidator is appointed by the Court.	In case of Voluntary winding up, the liquidator is appointed either by the members or by the members and creditors, both.

11.8. CONSEQUENCES OF WINDING UP ORDER

11.8.1 Consequences of winding up by Tribunal

(a) The Tribunal must, as soon as the winding up order is made, cause intimation thereof to be sent to the Official Liquidator and the Registrar within a period not exceeding seven days from the date of passing of the order. [Sec. 277]

(b) The petitioner and the company must also file with the Registrar a certified copy of the order. If default is made, then every person responsible for default shall be liable to punishment with fine up to Rs. 1000 for every day.

(c) The order of winding up is deemed to be notice of discharge to the officers employees and workmen of the company except when the business of the company is continued for thebeneficial winding up of the company [Sec. 277(3)].

(d) All actions and suits against the company are stayed, unless the Tribunal gives leave to continue or commence proceedings. Further, any suit or proceeding pending in any other Court shall be transferred to the Tribunal in which the winding up of the company is proceeding [Sec. 279].

(e) The order operates in the interests of all the creditors and all the contributories, no matter who in fact asked for it [Sec. 278].

(f) The Official Liquidator, by virtue of his office, becomes the Liquidator of the company and takes possession and control of the assets of the company [Sec. 275].

(g) All the powers of the Board of directors cease and the same are then exercisable by the Liquidator.

(h) On the commencement of winding up, the limitation remains suspended in favors of the company till one year after the winding up order is made [Sec. 358].

(i) Any disposition of the property of the company, and any transfer of shares in the company or alteration in the status of members made after the commencement of the winding-up shall be void [Sec. 334].

(j) Any attachment, distress or execution put in force, without leave of the Tribunal, against the estate or effects of the company after the commencement of the winding up shall be void [Sec. 335(1) (a)]; but not for the recovery of any tax or impost or any dues payable to Government [Sec. 335(2)].

(k) Any sale held, without leave of the Tribunal, of any of the properties or effects of the company after the commencement of winding up shall be void [sec. 335(1) (b)].

(l) Any floating charge created within 12 months immediately preceding the commencement of winding up is void unless it is proved that the company after the creation of the charge was solvent. [Sec. 332].

11.8.2 Consequences of Voluntary winding up

(a) Effect on status of company [Sec. 309]: The Company shall cease to carry on its business except if it is required to secure a beneficial winding up. In Wills v. Association of Universities of British Common Wealth [1964], it was observed that 'beneficial winding up' is not confined to financial benefit only. It may be for reconstruction and the business may have to be carried onso as to facilitate the smooth taking over.

(b) Board's power to cease [Sec. 313]: On the appointment of the Liquidator, all the powers of the Board of directors cease and went into the hands of the Liquidator.

(c) Avoidance of transfers [Sec. 334]: All transfer of shares and alterations in the status of members, made after the commencement of winding up, are void unless sanctioned by the Liquidator or the transfer is made to the Liquidator.

(d) Discharge of employees [Sec. 334]: A resolution to wind up voluntarily operates as notice of discharge to the employees of the company.

11.9 LETS SUM UP

The Unit has dealt with the process of winding up, modes of winding up and the grounds on which a company can proceed for winding up. The effects and implications of winding up for a company are also summarized. A company being a creation of law can come to an end by the process of law. This process is known as winding up.

11.10 TO CHECK THE PROGRESS

11.10.1 Long Answer Questions

1) List the different modes of winding up a public company.
2) List the four grounds when a company could be wound up on the ground of 'just and equitable'.
3) What are the consequences of winding up?

11.10.2 Short Answer Questions

1) What is meant by dissolution of a company?
2) What do you mean by 'winding up' of a company'?

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SEMESTER III

COURSE: COMPANY LAW

UNIT 12 - INSIDER TRADING: MEANING AND LEGAL PROVISIONS, WHISTLE BLOWING: CONCEPT AND MECHANISM

STRUCTURE

INSIDER TRADING

12.1 Learning Outcome

12.2 Meaning of Insider Trading

12.3 Characteristics of Insider Trading

12.4 Effect of Insider Trading

12.5 Need for regulating Insider Trading

12.6 Regulating Insider Trading in India

12.6.1 Provisions under Companies Act, 2013

12.6.2 SEBI (Prohibition of Insider Trading) Regulation 2015

WHISTLE BLOWING

12.7 Learning Outcome

12.8 Meaning and Characteristics of Whistle-blowing

12.9 Meaning and Characteristics of Whistle-blower

12.10 Purpose of Whistle-blowing

12.11 Types of Whistle-blowing

12.12 Justification of Whistle-blowing

12.13 Effects (Consequences) of Whistle-blowing

12.14 Factors to be considered before Blowing the Whistle

12.15 Whistle-blowing Policy (Creation of Whistle-blowing Culture)

12.16 Whistle-blower Protection

12.17 Famous Whistle-blowers

12.18 Summary

12.19 Glossary

12.20 Self-Assessment Questions

12.21 References

INSIDER TRADING

12.1 LEARNING OUTCOME

After studying this module the learners may:

(i) Know the meaning and Characteristics of Insider Trading

(ii)Understand the effect of Insider Trading

(iii)Comprehend the need for regulating Insider Trading

(iv) Apprehend the provisions of Companies Act, 2013 relating to Insider Trading

(v)Familiar with the SEBI guidelines related to Insider Trading

12.2 MEANING OF INSIDER TRADING

Insider trading is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to non-public information about the company. When insiders, e.g. key employees or executives who have access to the strategic information about thecompany, use the same for trading in the company's stocks or securities, it is called insider trading and is highly discouraged by the Securities and Exchange Board of India to promote fair trading in the market for the benefit of the common investor.

Insider trading can be legal or illegal depending on when the insider makes the trade. Insider trading is legal once the material information has been made public, at which time the insider has no direct advantage over other investors. However, insider trading is an unfair practice and

illegal, wherein the other investors are at a great disadvantage due to lack of important insider non-public information.

The Patel Committee in 1986 in India defined Insider Trading as, "Insider trading generally means trading in the shares of a company by the person who are in the management of the company or are close to them on the basis of undisclosed price sensitive information regarding the working of the company, which they possess but which is not available to others". Thus, in nutshell, insider trading is the buying, selling or dealing in securities of a listed company by a director, member of management, employee of the company, or by any other person such as internal auditor, advisor, consultant, analyst, etc., who has knowledge of material inside information which is not available to general public.

Examples of insider trading:

1. Corporate officers, directors, and employees who traded the corporation's securities after learning of significant, confidential corporate developments.

2. Friends, business associates, family members, and other "tippees" of such officers, directors and employees, who traded the securities after receiving such information.

3. Employees of law, banking, brokerage and printing firms who were given such information to provide services to the corporation whose securities they traded.

4. Other persons who misappropriated, and took advantage of, confidential information from their employers.

12.3 CHARACTERISTICS OF INSIDER TRADING

The fundamental characteristic of insider trading is that market participants have access to different information resulting in information asymmetry. Once the market participants discover that their information asymmetry in the market and that they might not know some information which their counterparty might know, they start factoring this knowledge of the existence of information asymmetry in to the prices they quote, resulting in higher spreads. Gradually,market participants, who don't have access inside information, leave the markets after suffering losses. All his results in the markets either becoming inefficient or in some limited casescompletely collapsing.

Thus, the chief characteristics of insider trading are: (1) Insider possess the inside information which is not available to the general public; (2) Insider uses confidential information for his own benefit either by making gain or avoiding loss; (3) Information is used to the detriment of persons who do not have that information; (4) Information is material

12.4 EFFECT OF INSIDER TRADING

The practice of insider trading is frowned at for the effect it casts which can be elucidated in the following terms:

1. Insider trading is not based on a level playing field and proves injurious to the interests of the shareholders of the company as their interest at large is completely neglected in light of the insider's self-interest.

2. It discourages the general public from participating/investing in the capital market as it deteriorates their confidence in the integrity of the system.

3. It symbolizes misappropriation of corporate valuable information that is essentially the sole property of the issuer company and thus hurts their exclusive proprietary right to it.

4. It gives rise to potential conflicts of interests in which the company's best interest may wrongfully take second place to the insider's self-interest.

5. It corrodes the trust of the investors in the market, the primary victim of insider trading. When investors are driven from the market, the market becomes less liquid, and thus less able to fuel the expanding capital demands of free enterprise.

6. In today's international capital market, if insider trading in a particular state's markets occurs frequently, that market will be less attractive for foreign investors ultimately leading to disinvestment in it because of which the reputation of the market suffers internationally.

7. All this could harm the economy as a whole.

12.5 NEED FOR REGULATION OF INSIDER TRADING

The existence of a fair, vibrant and efficient Securities Market is one of the essential ingredients for economic growth of a country. To instil confidence, trust and integrity in the securities market, the market regulator needs to ensure fair market conduct. Fair market conduct can be ensured by prohibiting, preventing, detecting and punishing such market conduct which leads to 'market abuse'. Market abuse is generally understood to include market manipulation and insidertrading, as such an activity which erodes investor confidence and impairs economic growth.

Causes of Prohibiting Insider Trading

Prohibition of insider trading is needed due to the following reason:

1. Insider trading violates the fiduciary duties that corporate employees, as agents, owe to their principals, the shareholders.

2. Because managers control the production of, disclosure of, and access to inside information, they can transfer wealth from outsiders to themselves in an arbitrary and hidden way.

3. Insider trading can adversely affect securities markets.

12.6 REGULATING INSIDER TRADING IN INDIA

In order to prevent this outcome and to protect the interests of market participants who do not have access to inside information, the prohibitions against insider trading are in place. The prohibition against insider trading helps in ensuring fairness, achieving information symmetry and ultimately market efficiency. The regulation of insider trading in India can be studied under the following two heading:

(a) Provisions under Companies Act, 2013

(b) SEBI (Prohibition of Insider Trading) Regulations, 2015

12.6.1 Provisions Under the Companies Act, 2013

It is important to know Section 195 of the Companies Act,2013 which reads as under :
(1) No person including any director or key managerial personnel of a company shall enter into insider trading.
Provided that nothing contained in this sub-section shall apply to any communication required in the ordinary course of business or profession or any other law.

Explanation – For the purpose of this section –

(a) " insider trading" means –

(i) An act of subscribing, buying, selling, dealing or agreeing to subscribe, buy, sell or deal in any securities, by any director or key managerial personnel or any other officer of a company either as principal or agent if such director or key managerial personnel or any other officer ofthe company is reasonably expected to have access to any non-public price sensitive information in respect of securities of company; or

(ii) an act of counseling about procuring or communicating directly or indirectly any non-public price-sensitive information to any person;

(b) "price-sensitive information" means any information which relates, directly or indirectly, to a company and which if published is likely to materially affect the price of securities of the company.

(2) If any person contravenes the provisions of this section, he shall be punishable with imprisonment for a term which may extend to five years or with fine which shall not be less than five lakh rupees but which may extend to twenty-five crore rupees or three times the amount of profits made out of insider trading, whichever is higher, or with both."

With the new Insider Trading Regulations coming into force one is compelled to refer the provisions included in the Companies Act, 2013 mentioned above.

12.6.2 Sebi (Prohibition of Insider Trading) Regulations, 2015

(A) Communication or procurement of unpublished price sensitive information:

(1) No insider shall communicate, provide, or allow access to any unpublished price sensitive information, relating to a company or securities listed or proposed to be listed, to any person including other insiders except where such communication is in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.

(2) No person shall procure from or cause the communication by any insider of unpublished price sensitive information, relating to a company or securities listed or proposed to be listed, except in furtherance of legitimate purposes, performance of duties or discharge of legal obligations.

(3) Notwithstanding anything contained in this regulation, an unpublished price sensitive information may be communicated, provided, allowed access to or procured, in connection with a transaction that would:–

(i) entail an obligation to make an open offer under the takeover regulations where the board of directors of the company is of informed opinion that the proposed transaction is in the best

(ii) not attract the obligation to make an open offer under the takeover regulations but where the board of directors of the company is of informed opinion that the proposed transaction is in the best interests of the company and the information that constitute unpublished price sensitive information is disseminated to be made generally available at least two trading days prior to the proposed transaction being effected in such form as the board of directors may determineinterests of the company;

(4) For purposes of sub-regulation (3), the board of directors shall require the parties to execute agreements to contract confidentiality and non-disclosure obligations on the part of such parties and such parties shall keep information so received confidential, except for the purpose of sub-regulation (3), and shall not otherwise trade in securities of the company when in possession of unpublished price sensitive information.

(B) Trading when in possession of unpublished price sensitive information:

No insider shall trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price sensitive information:

Provided that the insider may prove his innocence by demonstrating the circumstances including the following: –

(i) the transaction is an off-market *inter-se* transfer between promoters who were in possession of the same unpublished price sensitive information without being in breach of regulation 3 and both parties had made a conscious and informed trade decision;

(ii) in the case of non-individual insiders: –

(a) the individuals who were in possession of such unpublished price sensitive information were different from the individuals taking trading decisions and such decision-making individuals were not in possession of such unpublished price sensitive information when they took the decision to trade; and

(b) appropriate and adequate arrangements were in place to ensure that these regulations are not violated and no unpublished price sensitive information was communicated by the individuals possessing the information to the individuals taking trading decisions and there is no evidence of such arrangements having been breached;

(iii) the trades were pursuant to a trading plan set up in accordance with regulation 5.

(2) In the case of connected persons the onus of establishing, that they were not in possession of unpublished price sensitive information, shall be on such connected persons and in other cases, the onus would be on the Board.

(3) The Board may specify such standards and requirements, from time to time, as it may deem necessary for the purpose of these regulations.

(C) Trading Plans:

(1) An insider shall be entitled to formulate a trading plan and present it to the compliance officer for approval and public disclosure pursuant to which trades may be carried out on his behalf in accordance with such plan.

(2) Such trading plan shall:–

(i) not entail commencement of trading on behalf of the insider earlier than six months from the public disclosure of the plan;

(ii) not entail trading for the period between the twentieth trading day prior to the last day of any financial period for which results are required to be announced by the issuer of the securities and the second trading day after the disclosure of such financial results;

(iii) entail trading for a period of not less than twelve months;

(iv) not entail overlap of any period for which another trading plan is already in existence;

(v) set out either the value of trades to be effected or the number of securities to be traded along with the nature of the trade and the intervals at, or dates on which such trades shall be effected; and

(vi) not entail trading in securities for market abuse.

(3) The compliance officer shall review the trading plan to assess whether the plan would have any potential for violation of these regulations and shall be entitled to seek such express undertakings as may be necessary to enable such assessment and to approve and monitor the implementation of the plan.

(4) The trading plan once approved shall be irrevocable and the insider shall mandatorily have to implement the plan, without being entitled to either deviate from it or to execute any trade in the securities outside the scope of the trading plan.

Provided that the implementation of the trading plan shall not be commenced if any unpublished price sensitive information in possession of the insider at the time of formulation of the plan has not become generally available at the time of the commencement of implementation and in such event the compliance officer shall confirm that the commencement ought to be deferred until such unpublished price sensitive information becomes generally available information so as to avoid a violation of sub-regulation (1) of regulation 4.

(5) Upon approval of the trading plan, the compliance officer shall notify the plan to the stock exchanges on which the securities are listed.

(D) Disclosures of Trading by Insiders

General provisions:

(1) Every public disclosure under this Chapter shall be made in such form as may be specified.

(2) The disclosures to be made by any person under this Chapter shall include those relating to trading by such person's immediate relatives, and by any other person for whom such person takes trading decisions.

(3) The disclosures of trading in securities shall also include trading in derivatives of securities and the traded value of the derivatives shall be taken into account for purposes of this Chapter: Provided that trading in derivatives of securities is permitted by any law for the time being in force.

(4) The disclosures made under this Chapter shall be maintained by the company, for a minimum period of five years, in such form as may be specified.

Disclosures by certain persons:

(1) Initial Disclosures:

(a). Every promoter, key managerial personnel and director of every company whose securities are listed on any recognised stock exchange shall disclose his holding of securities of the

company as on the date of these regulations taking effect, to the company within thirty days of these regulations taking effect;

(b) Every person on appointment as a key managerial personnel or a director of the company or upon becoming a promoter shall disclose his holding of securities of the company as on the date of appointment or becoming a promoter, to the company within seven days of such appointment or becoming a promoter.

(2) Continual Disclosures:

(a) Every promoter, employee and director of every company shall disclose to the company the number of such securities acquired or disposed of within two trading days of such transaction if the value of the securities traded, whether in one transaction or a series of transactions over any calendar quarter, aggregates to a traded value in excess of ten lakh rupees or such other value as may be specified;

(b)Every company shall notify the particulars of such trading to the stock exchange on which the securities are listed within two trading days of receipt of the disclosure or from becoming aware of such information.

(3) Disclosures by other connected persons:

Any company whose securities are listed on a stock exchange may, at its discretion require any other connected person or class of connected persons to make disclosures of holdings and trading in securities of the company in such form and at such frequency as may be determined by the company in order to monitor compliance with these regulations.

(E) Codes of Fair Disclosure and Conduct

Code of Fair Disclosure:

(1) The board of directors of every company, whose securities are listed on a stock exchange, shall formulate and publish on its official website, a code of practices and procedures for fair disclosure of unpublished price sensitive information that it would follow in order to adhere to each of the principles set out in Schedule A to these regulations, without diluting the provisions of these regulations in any manner.

(2) Every such code of practices and procedures for fair disclosure of unpublished price sensitive information and every amendment thereto shall be promptly intimated to the stock exchanges where the securities are listed.

Code of Conduct:

(1) The board of directors of every listed company and market intermediary shall formulate a code of conduct to regulate, monitor and report trading by its employees and other connected

persons towards achieving compliance with these regulations, adopting the minimum standards set out in Schedule B to these regulations, without diluting the provisions of these regulations in any manner.

(2) Every other person who is required to handle unpublished price sensitive information in the course of business operations shall formulate a code of conduct to regulate, monitor and report trading by employees and other connected persons towards achieving compliance with these regulations, adopting the minimum standards set out in Schedule B to these regulations, without diluting the provisions of these regulations in any manner.

(3) Every listed company, market intermediary and other persons formulating a code of conduct shall identify and designate a compliance officer to administer the code of conduct and other requirements under these regulations.

(F) Principles of Fair Disclosure for purposes of Code of Practices and Procedures for Fair Disclosure of Unpublished Price Sensitive Information

1. Prompt public disclosure of unpublished price sensitive information that would impact price discovery no sooner than credible and concrete information comes into being in order to make such information generally available.

2. Uniform and universal dissemination of unpublished price sensitive unpublished price sensitive information to avoid selective disclosure.

3. Designation of a senior officer as a chief investor relations officer to deal with dissemination of information and disclosure of unpublished price sensitive information.

4. Prompt dissemination of unpublished price sensitive information that gets disclosed selectively, inadvertently or otherwise to make such information generally available.

5. Appropriate and fair response to queries on news reports and requests for verification of market rumors by regulatory authorities.

6. Ensuring that information shared with analysts and research personnel is not unpublished price sensitive information.

7. Developing best practices to make transcripts or records of proceedings of meetings with analysts and other investor relations conferences on the official website to ensure official confirmation and documentation of disclosures made.

8. Handling of all unpublished price sensitive information on a need-to-know basis.

(G) Minimum Standards for Code of Conduct to Regulate, Monitor and Report Trading by Insiders

1. The compliance officer shall report to the board of directors and in particular, shall provide reports to the Chairman of the Audit Committee, if any, or to the Chairman of the board of directors at such frequency as may be stipulated by the board of directors.

2. All information shall be handled within the organisation on a need-to-know basis and no unpublished price sensitive information shall be communicated to any person except in furtherance of the insider's legitimate purposes, performance of duties or discharge of his legal obligations. The code of conduct shall contain norms for appropriate Chinese Walls procedures, and processes for permitting any designated person to "cross the wall".

3. Employees and connected persons designated on the basis of their functional role ("**designated persons**") in the organisation shall be governed by an internal code of conduct governing dealing in securities. The board of directors shall in consultation with the compliance officer specify the designated persons to be covered by such code on the basis of their role and function in the organisation. Due regard shall be had to the access that such role and function would provide to unpublished price sensitive information in addition to seniority and professional designation.

4. Designated persons may execute trades subject to compliance with these regulations. Towards this end, a notional trading window shall be used as an instrument of monitoring trading by the designated persons. The trading window shall be closed when the compliance officer determines that a designated person or class of designated persons can reasonably be expected to have possession of unpublished price sensitive information. Such closure shall be imposed in relation to such securities to which such unpublished price sensitive information relates. Designated persons and their immediate relatives shall not trade in securities when the trading window is closed.

5. The timing for re-opening of the trading window shall be determined by the compliance officer taking into account various factors including the unpublished price sensitive information in question becoming generally available and being capable of assimilation by the market, which in any event shall not be earlier than forty-eight hours after the information becomes generally available. The trading window shall also be applicable to any person having contractual or fiduciary relation with the company, such as auditors, accountancy firms, law firms, analysts, consultants etc., assisting or advising the company.

6. When the trading window is open, trading by designated persons shall be subject to preclearance by the compliance officer, if the value of the proposed trades is above suchthresholds as the board of directors may stipulate. No designated person shall apply for pre- clearance of any proposed trade if such designated person is in possession of unpublished price sensitive information even if the trading window is not closed.

7. The compliance officer shall confidentially maintain a list of such securities as a “restricted list” which shall be used as the basis for approving or rejecting applications for preclearance of trades.

8. Prior to approving any trades, the compliance officer shall be entitled to seek declarations to the effect that the applicant for pre-clearance is not in possession of any unpublished price sensitive information. He shall also have regard to whether any such declaration is reasonably capable of being rendered inaccurate.

9. The code of conduct shall specify any reasonable timeframe, which in any event shall not be more than seven trading days, within which trades that have been pre-cleared have to be executed by the designated person, failing which fresh pre-clearance would be needed for the trades to be executed.

10. The code of conduct shall specify the period, which in any event shall not be less than six months, within which a designated person who is permitted to trade shall not execute a contra trade. The compliance officer may be empowered to grant relaxation from strict application of such restriction for reasons to be recorded in writing provided that such relaxation does not violate these regulations. Should a contra trade be executed, inadvertently or otherwise, inviolation of such a restriction, the profits from such trade shall be liable to be disgorged for remittance to the Board for credit to the Investor Protection and Education Fund administered by the Board under the Act.

11. The code of conduct shall stipulate such formats as the board of directors deems necessary for making applications for pre-clearance, reporting of trades executed, reporting of decisions notto trade after securing pre-clearance, recording of reasons for such decisions and for reporting level of holdings in securities at such intervals as may be determined as being necessary to monitor compliance with these regulations.

12. Without prejudice to the power of the Board under the Act, the code of conduct shall stipulate the sanctions and disciplinary actions, including wage freeze, suspension etc., that may be imposed, by the persons required to formulate a code of conduct under sub-regulation (1) and sub-regulation (2) of regulation 9, for the contravention of the code of conduct.

13. The code of conduct shall specify that in case it is observed by the persons required to formulate a code of conduct under sub-regulation (1) and sub-regulation (2) of regulation 9, that there has been a violation of these regulations, they shall inform the Board promptly.

WHISTLE BLOWING

12.7 LEARNING OUTCOME

After studying this module the learners may:-

(i)Know the meaning and characteristics of Whistle- Blower and Whistle-Blowing

(ii)Understand the purpose and types of Whistle-Blowing

(iii)Comprehend the justification and effects of Whistle-Blowing

(iv)Apprehend the factors to be considered before blowing the whistle

(v)Acquaint with the Whistle-Blowing policy

(vi) Familiarize with the policies of protection of Whistle-Blower

(vii)Know some famous Whistle –Blowers of the world

12.8 MEANING AND CHARACTERISTICS OF WHISTLE-BLOWING

The term whistle-blower was first discussed by Dogget, J., in the case of Winters V. Houston Chronicle Pub. Co., The word is derived from the practice of English bobbies, who would blow their whistles when they noticed the commission of a crime. The whistle would alert both law enforcement officers and the general public of danger.

Whistle-blowing is when a worker reports suspected wrongdoing at work. Officially this is called 'making a disclosure in the public interest'. Whistle-blowing means exposing an employer's wrongdoing to outsiders such as the media or government regulatory agencies. The term whistle-blowing is also used for internal reporting of misconduct to management, especially through anonymous reporting mechanisms often called hot lines. The blowing of the whistle would alert both law enforcement officers and the general public of danger.

According to Near and Miceli, "whistle blowing is the disclosure by a current or former organisation member of illegal, i efficient or unethical practices in an organisation to persons or parties who have the power or resources to take action."

James defined Whistle-blowing as "an attempt by an employee or former employee of an organisation to disclose what he or she believes to be wrongdoings in or by the organisation."

In the words of Zarinah Anwar, "whistle blowing is a term used to describe the disclosure of information that one reasonably believes to be evidence of contravention of any laws or regulation or information that involves mismanagement corruption or abuse of authority.

Characteristics of Whistle-Blowing:

1. The matters which are of substantial importance to the public interest only fall under the purview of whistle-blowing. Information about wrong doing disclosed in personal interest is not considered as whistle-blowing.

2. Whistle-blowing can be done by a member or former member of an organisation. Information about wrongdoing disclosed by outsiders, Such as, media, social activists, etc., is not considered as whistle-blowing.

3. Whistle-blowing is done based on an appropriate moral motive.

4. The act of whistle-blowing is done voluntarily. Disclosure of information done due to legal requirement is not termed as whistle-blowing. However, the distinction between voluntary disclosure and disclosure by legal requirement is not always clear.

12.9 MEANING AND CHARACTERISTICS OF WHISTLE-BLOWER

A whistle-blower is a person who exposes misconduct, alleged dishonest or illegal activity occurring in an organisation. The alleged misconduct may be classified in many ways; for example, a violation of a law, rule, regulation and/or a direct threat to public interest, such as fraud, health and safety violations, and corruption. Thus, the Whistle-blower is a concerned citizen, who is totally inspired by public interest, and open to disclosing a significant wrongdoingto a person capable of investigating and facilitating correction of such wrong doing. A workercan report things that are not right are illegal or if anyone at work is neglecting their duties, including:

- someone's health and safety is in danger
- damage to the environment
- a criminal offence
- the company isn't obeying the law (like not having the right insurance)
- covering up wrongdoing

Characteristics of Whistle-Blower

1. Whistle-blowers are employees or ex-employees who expose or publicize wrong doing within their places of employment or industries, often causing legal repercussions against their employers.

2. Whistle-blower is prepared to take full responsibility for their actions.

3. Whistle-blowers disclose information about misconduct in their workplace that they feel violates the law or endangers the welfare of others.

4. Whistle-blowers are generally well educated and hold professional positions.

5. Implies a concern for the preservation of ethical values which overrides a concern for self-preservation.

6. Whistle-blowers open themselves to the risk of losing personal and financial security, counter-accusation and alienation and yet they feel compelled to make the disclosure and to stand by it.

12.10 PURPOSE OF WHISTLE-BLOWING

1. To draw attention to unethical, inappropriate or incompetent conduct which has or may have detrimental effects either for the institution or for those affected by its functions.
2. It extends to situations where an individual believes that an activity is harmful while others involved are not aware of it or reject the perception that is involved.

12.11 TYPES OF WHISTLE-BLOWING

Internal Whistle-blowing: This is a type of whistle-blowing whereby a wrongful or illegal act is reported inside the organisation. A whistle-blower is termed as internal when an employee airs his complaint internally. The issue of internal-whistle blowing helps organisations rectifieswrong doings before it goes public and causing damages to such company's reputation as well as its shareholders.

External Whistle-blowing: This is a type of whistle blowing whereby a wrongful or illegal act is reported to sources outside the organisation. A whistle-blower is termed as external when an employee blows the whistle outside the organisation, e.g., to media or a regulatory body.

Personal Whistle-blowing: It refers to blowing the whistle on the offender. Here the charge is not against the organisation or system but against one individual.

Anonymous Whistle-blowing: When the identity of the whistle-blower is not revealed, it is called 'anonymous whistle-blowing.' Anonymity is often required where the stakes are high;those cases where the perpetrators will spare no effort or expense in identifying and "dealing with" any whistle-blower.

Government Whistle-blowing: It refers to the disclosure made about wrongdoing practiced by government officials.

Corporate Whistle-blowing: It refers to the disclosure made about wrongdoing practiced in a business.

12.12 JUSTIFICATION OF WHISTLE-BLOWING

Employees who blow the whistle on their company for perceived wrongdoing face risks that range from termination to less desirable assignments or exclusion from social invitations. It is sometimes argued that internal whistle blowing is always wrong on the ground that employees have a contractual duty to be loyal to their employer and to keep all aspects of the business confidential. However, ethicists Norman Bowie and Sisela Bok believe that an employee's loyalty to his employer is not absolute and that the ethical duty to blow the whistle overrides the employee's obligation of loyalty if certain conditions are met.

An employee should ask himself/herself how much harm has been done or might be done to victims as a result of the unethical behaviour. If one person will be harmed, it is very unlikely to

be a situation that warrants whistle-blowing, unless the magnitude of the unethical action is enormous in character. Employees should further take cognizance of the fact will the victims really be the "beneficiaries" as a result of whistle-blowing. If a third party is going to be benefited at the cost of whistle-blowing without any credible gain to the company, employees, customers or the society at large, it is very unlikely that the efforts of whistle-blowing have a meaningful effect.

Whistle-blower should bear in mind that his or her action to blow the whistle will have direct consequences on the Company and its officers and therefore, a strong moral justification must exist for blowing the whistle. The employees should blow the whistle only on the fulfillment of the following conditions:

1. The Whistle-blower is thoroughly convinced of the genuineness of the facts contained in the whistle-blowing after investigation. In other words, the whistle-blower must make sure that his or her claim is legitimate.

2. The purpose behind blowing whistle should be right. The whistle-blower must have valid reasons to believe that revealing the wrongdoing to the public will result in the necessary changes to remedy the situation.

3. The whistle-blowing must take place after official channels and internal remedies have been attempted. In other words, all efforts to prevent a wrong have been failed.

4. The whistle-blower must have absolute proof that there will be dire consequences on the company, its employees and customers, environment, etc., as a result of the occurrence of the unethical transaction/dealing. The greater the misdeed, the more likely that it is morally right to blow the whistle.

5. The employee must have valid reasons to believe that revealing the wrongdoing to the public will result in the necessary changes to remedy the situation.

6. There must be some chance that the act of whistle-blowing will be a success.

12.13 EFFECTS (CONSEQUENCES) OF WHISTLE-BLOWING

Consequences of whistle-blowing can be of two types’ Negative consequences and positive consequences. A brief description is given below:

Negative Consequences

1. **Termination:** Although it is illegal to fire someone for whistle-blowing, some whistle-blowers have been terminated. However, if you are terminated for whistle-blowing, it is within your right to file a lawsuit against the employer. If laws do not exist in that location to specifically protect whistle-blowers, an employee may not have strong legal recourse against the termination.

2. Stress: Additionally, an employee retained after event may experience difficulty in future promotions or could face demotion. Whistle-blowers often suffer from anxiety, insomnia and headaches due to this. In this type of situations, there are sometimes retaliatory acts against the whistle-blowers causing them heightened stress and discomfort in their job. Stress can also be caused by being closely supervised or alienated by fellow employees.

3. Mistrust: Whistle-blowing can lead to a breakdown of trust. If trust breaks down between managers and employees, tension and effective working relationships among employees become challenging.

4. Unproductive Environment: The work environment and the overall atmosphere will render the workplace unfriendly or unwelcoming. Whistle-blower may get the cold shoulder or be treated like a rat or snitch. This may create a hostile workplace for the whistle-blower and distract employees from their tasks.

5. Ostracism: A whistle-blower's chances of employment elsewhere can suffer as a result of his/her involvement in the reporting of the company's wrongdoing. Other companies are likely to shun such an individual because no organisation wants another's drama.

6. Damage to Employer: Whistle-blowing often causes financial turmoil and public relations problems for the employer.

Positive Consequences:

There are also positive effects that can result from whistle-blowing. These are as follows:

1. Whistle-blowing can help the organisation by informing the wrongdoing to the top management at early stage, so that management can take appropriate corrective action at once. This can help to avoid the wrongdoing become more serious and uncontrollable in future that may affect the public interest which may incur lawsuit to organisation. Therefore, whistleblowing can benefit the organisation by lowering the cost of doing business through reducing unnecessary lawsuit that may face by organisation because of wrongdoing or fraudulent.

2.Whistle-blowing is the result of a company making decisions for whatever reason that are either illegal or unethical and that differ directly from the ethical standards set by the company The decision affects the employee enough to motivate him to make complaints internally or externally.

3. Whistle-blowing can change policies that benefit employees as well as other individuals. For example, in 1996 Jeffrey Wigand, a tobacco researcher, blew the whistle on the Brown & Williamson Tobacco Corporation, claiming the company knew tobacco was addictive. The result was a change in public policy, as well as a change in public perceptions of the tobacco industry. This had a far-reaching positive effect on society as a whole.

4. Whistle-blowing also helps to promote about code of ethics to society. Whistle blower may serve as role model or hero of the society that encourage ethical behavior adapted by everyone in society.

12.14 FACTORS TO BE CONSIDERED BEFORE BLOWING THE WHISTLE

The following factors must be considered before blowing the whistle:

1. A whistle-blower must check whether it is really a genuine case or not. He/she should make sure the situation warrants whistle-blowing. He/she also determine the type of wrongdoing and to whom it should be reported. This will assist in gathering the right evidence.

2. Whistle-blower must believe that blowing the whistle will serve some good purpose and that appropriate action will be taken on their whistle-blowing.

3. Before blowing whistle, whistle-blower should gather all of the facts related to the situation. The information must be specific and credible. Whistle-blowers should verity and document their information. They should also photocopy all relevant documents before blowing the whistleit may be difficult to gain access afterwards.

4. Whistle-blower must keep a list of names and contact information. He should also identity party involved with the activity. Further he should consider each person who received a copy of the email, memo or letter and include everyone who attended a meeting where this activity was discussed.

5. Whistle-blower must stay with the facts.

6. Whistle-blower must decide whether to be open or anonymous.

7. Whistle-blower must decide whether current or alumni whistle-blowing is the best alternative.

8. Whistle-blower must follow proper guidelines in reporting the wrongdoing. Check forms, meeting deadlines, and other technicalities.

12.15 WHISTLE-BLOWING POLICY (CREATION OF WHISTLE-BLOWING CULTURE)

A whistle-blowing policy elaborates the procedure by which an employee lodges a complaint about an unethical or unlawful behavior by a colleague or supervisor. The general standard is that the behavior should be reported if the employee believes it is in violation of a clear mandate or public policy regarding health, safety, welfare or environmental protection.

Objectives of Internal Whistle-blowing Policy

The objectives of an internal whistle-blowing policy are as follows:

1. To build and strengthen a culture of transparency and trust in the organisation.

2. To encourage employees to bring ethical and legal violations they are aware of to an internal authority so that action can be taken immediately to resolve the problem.

3. To protect the company from such actions that may lead to incorrect financial reporting and are not in line with applicable company policy.

4. To minimize the organization's exposure to the damage that can occur when employees circumvent internal mechanisms.

5. To let employees know the organisation is serious about adherence to codes of conduct.

Components of Whistle-blower Policy

1. Purpose: Whistle-blower policy must incorporate clear purpose with statement of intent to protect the whistle-blower to the fullest extent possible. The purpose could include some of the types of concerns people should be encouraged to bring forward**.**

2. Establishment of Review System: The whistle-blower policy cannot just be to report the problem to the supervisor. There needs to be an independent review system, perhaps something along the lines of an ombudsman who reports directly to the board of directors of the organisation.

3. Provision for Action: An explanation of what actions the organisation will take as a result of the whistle-blowing activity shall be provided.

4. Confidentiality: Most whistle-blower policies have an added clause about maintaining the confidentiality or anonymity of the whistle-blower.

5. Policy against Retaliation: Another key component of a good whistle-blower policy is a strong no-retaliation component that has penalties for retaliation--penalties that are enforced. Without an enforceable no-retaliation policy, rank and file employees will not buy into thesystem as they feel vulnerable for speaking out.

6. Communication and Training: The introduction or modification of a whistle-blower policy must be communicated at a workplace so employees on all levels are aware of it. It should be communicated by email or printed copy to every employee and posted in all public places as well as published in the employee handbook and new employee orientation materials. Training should emphasize the need for transparency and the prohibition of retaliation.

7. Whistle-blowers as Allies: A good whistle-blower policy should be conceived of and designed around the idea of whistle-blowers as allies, not adversaries. Looking at whistle-blowers as allies and making a relatively small investment in procedures to protect them enables organisations to improve transparency, empower employees, discover unethical or illegal practices as early as possible and enhance legal compliance.

Barriers to Internal Whistle-blowing Policy

The barriers to an internal whistle-blowing policy are:

1. A lack of trust in the internal system

2. Unwillingness of employees to be "snitches"

3. Misguided union solidarity

4. Belief that management is not held to the same standard

5. Fear of retaliation

6. Fear of alienation from peers

Importance of Internal Whistle-blowing Policies

There are a number of reasons why implementing a whistle-blowing policy is beneficial:

1. Provide protection to the people in your own organisation who have the courage to speak up about matters that concern them.

2. Avoid unwanted publicity in the event that some of your staff are engaged in unscrupulous behaviour.

3. Generate positive publicity from a social responsibility perspective.

4. Reinforce a culture of values-based leadership and senior management accountability.

5. Increase confidence in the quality of leadership being demonstrated across all locations in the company. (Especially in companies that operate across a geographically diverse area)

6. Having such a policy should enable an organisation to deal with a concern internally and in an appropriate manner, rather than publicly. Publicity about a malpractice can severely harm an organization's reputation and funding potential and have a similar impact on other organisations in the same sector.

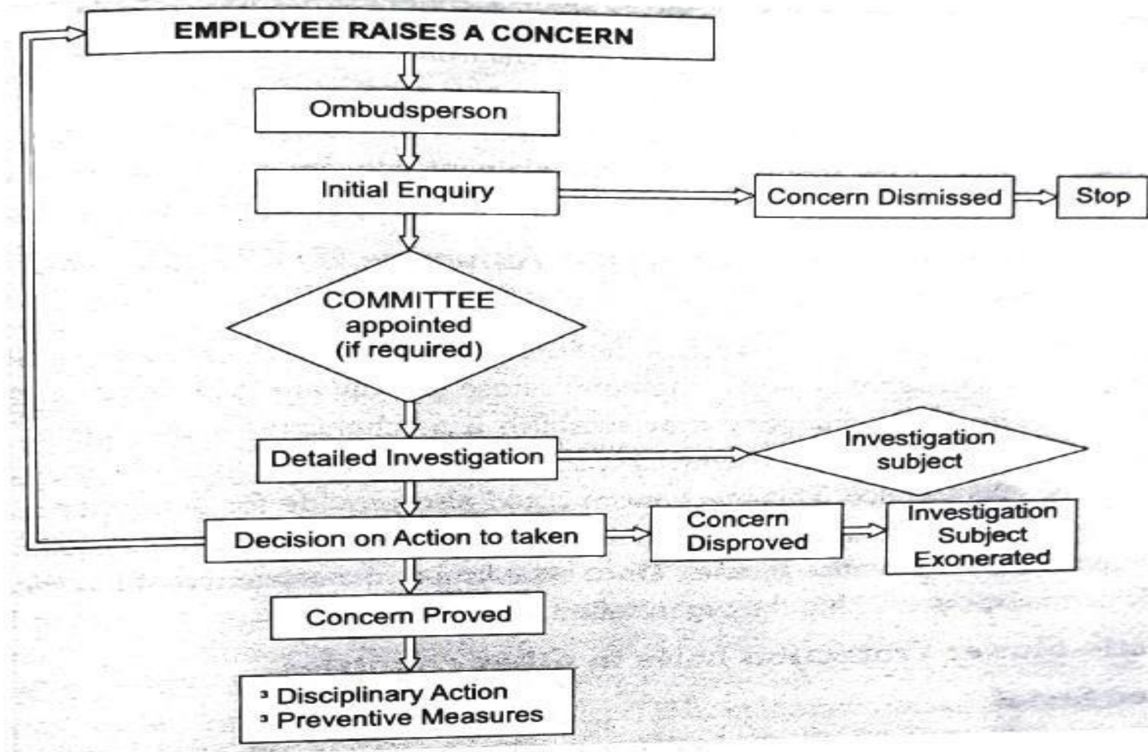
7. A whistle-blowing policy should encourage a climate of open communication which enables staff to voice concerns at the earliest opportunity and thus averts a larger issue in future. Also, if the employee's concerns are misplaced, then this misunderstanding can be addressed sooner rather than later.

8. Knowing that an organisation has a clear policy on whistle-blowing and is serious about dealing with malpractice should act as a deterrent to those who may be considering an illegal, improper or unethical practice.

Process of Internal Whistle-blowing:

The process of Whistle-blowing can be understood by the diagrarn given below. It basically involves five steps. At first when a concern is raised by an ernployee, it is communicated to the

Ombudsperson, who could be any person a legal adviser, audit committee or a compliance officer. This would result in initial enquiry, which could be dismissed when it is found that the complaint is frivolous or insignificant and the proceedings can be stopped. On the other hand if the complaint turns out to be a genuine one an enquiry committee can be appointed and which may take up further investigations and based on the results of the investigation appropriate actionmay be taken against the wrongdoer as the case may be.



12.16 WHISTLE-BLOWER PROTECTION

The question of whistle-blowers being protected under law is academic. In a democracy all its citizens have constitutional freedoms. No person, even a whistle-blower can be denied such freedoms- he has the right to a fair trial. But in reality, whistle-blowers in India have it bad. RTI activists have been murdered for exposing scams across the country.

Whistle-blowers normally face a lot of problems in their careers. By exposing corruption among their superiors, they face the possibility of direct or indirect punishment. This could be in the form of lack of advancement and promotions ultimately leading to their careers failing.

While countries such as the USA and the UK had enacted laws to ensure whistle-blowerprotection n the late 1980s and late 1990s (respectively). The early 2000s saw a surge in such legislation around the world, such as in South Africa (2000) and Japan (2004). At the same time. Right to Information and anti-corruption movements gathered speed around the world. The United Nations Convention against Corruption (UNCAC) was also set up in 2005 and part of the

Group of 20 (G20 s Anti-Corruption Action Plan drafted in Seoul in 2010 specifically focused on whistle-blower protection.

Legal s

The Whistle-blowers' Protection Bill,2011, which was passed February, 2014 by the Rajya Sabha after being passed by the Lok Sabha in 2011, is the first law of the country, dealing specifically with whistle-blowers and their protection, if a disclosure against a public servant or a pubic authority is made.

The Act aims to protect honest officials or persons from harassment but does not provide for any penalty for harassing a public servant/any other person making a disclosure. Also, the Bill does not provide for admission of anonymous complaints by the competent authority. The CVC and the head of the organisation have to protect the identity of the complainant. However, the Vigilance Commission can reveal the identity of the complainant to the head, if it is of the opinion that it is necessary to do so.

Non-mandatory requirements as per Annexure ID of Clause 49 of the Listing Agreement

Security Exchange Board of India (SEBI) has prescribed the listing agreement that is required to be executed between a stock exchange and a company whose security are to be listed on that exchange. As per this listing agreement, the company may establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. This mechanism could also provide for adequate safeguards against victimization of employees who avail of the mechanism and also provide for direct access to the Chairman of the Audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organisation.

Whistle-blower Protection Laws in other countries:

United States

Whistle-blower Protection Act, 1989, protects the federal government employees who provide evidence for any transgressions.

The Sarbanes-Oxley Act of 2002 deals with corporate governance and provides significant corporate whistle-blowing protection. This act contains diverse civil, criminal and administrative provisions which contribute towards making this statute an extremely important whistle-blower protection law.

United Kingdom

The Public Interest Disclosure Act 1998 came into force on 2 July, 1999. The Act protects workers that disclose information about malpractice at their workplace, or former workplace,

provided certain conditions are met. The conditions concern the nature of the informationdisclosed and the person to whom it is disclosed. If these conditions are met, the Act protects the worker from suffering detriment as a result of having made the disclosure. If the conditions are not met a disclosure may constitute a breach of the worker's duty of confidence to his employer.

Japan

The Whistle-blower Representatives on Protection Act (Law No. 122 of 2004) was passed by the House of Representatives on 25th May, 2004 and, less than one month later, by the House of Councilors on l4 June. was promulgated on 18 June. The new Act protects those who expose corporate or government misconduct from unfair treatment, such as dismissal, demotion or salary cuts.

Canada

The Public Servants Disclosure Protection Act (PSDPA) came into force in Canada on April l5, 2007. The Act creates two distinct processes: a disclosure process; and a reprisal complaints process. It also creates two new bodies: the Office of the Public Sector Integrity Commissioner (PSIC) and the Public Servants Disclosure Protection Tribunal. The goal of this law is to enhance the ability of federal government organisations to identify wrongdoings, to resolve the situations and to protect employees from reprisals when allegations of wrongdoing are made in good faith and pertain to serious matters as defined by the Act.

12.17 FAMOUS WHISTLE-BLOWERS

1. Cynthia Cooper

Cynthia Cooper is an internal auditor and consultant who is best known for being the whistle-blower who exposed massive accounting fraud at WorldCom in 2002. A native of Clinton, Mississippi, Cooper worked as the Vice President of Internal Audit at WorldCom. After conducting a thorough investigation in secret, she informed the audit committee of WorldCom's board that the company had covered up $3.8 billion in losses through phony bookkeeping. At the time, this was the largest incident of accounting fraud in U.S. history.

2. Sherron Watkins

Sherron Watkins is the former Vice President of Enron Corporation who alerted then CEO Ken Lay in August 2001 to accounting irregularities within the company, warning him that Enron might implode in a wave of accounting scandals. She helped to uncover the Enron scandal in 2001. She has testified before Congressional Committees from the House and Senate investigating Enron's demise. Ms. Watkins has been lauded in the press for her courageous actions. TIME magazine named Sherron, along with two others, Coleen Rowley of the FBl and Cynthia Cooper of WorldCom, as their 2002 Persons of the Year, for being "people who didright just by doing their jobs rightly".

3. Satyendra Kumar Dubey

Satyendra Kumar Dubey was project director at the National Highways Authority of India (NHAI).In letter to the then Prime Minister Atal Behari Vajpayee, he accused his employerNHAI that there is corruption in the building of the stretch of highway where he was working.He was assassinated in Gaya, Bihar for fighting corruption in the Golden Quadrilateral highway construction project. Satyendra Kumar Dubey has been posthumously honoured with the Whistle-blower of the Year 2004 Award by one of the world's leading freedom-of-expression groups, the UK-based Index on Corruption.

4. Manjunath

Manjunath Shanmugam, an IIM graduate gave his life to the country while trying to expose the corruption in petroleum marketing. For a month or so, his heroic efforts to expose corruption caught the attention of the nation. Fighting corruption in petroleum sector was put on the national agenda only for few days. It was ironical that within few days of the murder of Manjunath, the corruption charges against Satish Sharma the new avatar of petroleum corruption were dropped.

12.18 SUMMARY

Insider trading in normal parlance is known as trading in the securities of a company by persons who are in the management of the company or have close proximity to them on the basis of knowledge of an Unpublished or Undisclosed Price Sensitive Information (UPSI) which is not available in the public domain. Insider trading, based on UPSI, is illegal and unethical as it is unfair to the other investors who do not have access to such information. The rules governing insider trading are complex and vary significantly from country to country. The extent ofenforcement also varies from one country to another.

A whistle-blowing mechanism not only helps in detection of fraud, but is also used as a corporate governance tool leading to prevention and deterrence. The term "whistle-blower" was first applied to government employees who "go public" with complaints of corruption or mismanagement in the public or government organisations. It is now used in connection with similar activities in the private business sector as well. Business history is replete with the cases of corruption and mismanagement and, in turn, cases of whistle-blowing. In this chapter, an attempt has been made to discuss nature and scope of whistle-blowing. Besides, we have also discussed the legal mechanism of whistle-blowing in India.

12.19 GLOSSARY

Anonymous Whistle-blowing: When the identity of the whistle-blower is not revealed, it is called 'anonymous whistle-blowing'.

Corporate Whistle-blowing: It refers to the disclosure made about wrongdoing practiced in a business.

External Whistle-blowing: This is a type of whistle blowing whereby a wrongful or illegal act is reported to sources outside the organisation.

Government Whistle-blowing: It refers to the disclosure made about wrongdoing practiced by government officials.

Insider trading: is the trading of a public company's stock or other securities (such as bonds or stock options) by individuals with access to non-public information about the company.

Internal Whistle-blowing: This is a type of whistle-blowing whereby a wrongful or illegal act is reported inside the organisation.

Personal Whistle-blowing: It refers to blowing the whistle on the offender. Here the charge is not against the organisation or system but against one individual.

Whistle-blowing: means exposing an employer's wrongdoing to outsiders such as the media or government regulatory agencies. The term whistle-blowing is also used for internal reporting of misconduct to management, especially through anonymous reporting mechanisms often called hot lines.

12.20 SELF-ASSESSMENT QUESTIONS

Q1.What is Insider-trading? Discuss its characteristics in detail?
Q2. Elaborate the effect of Insider-Trading? What are the needs for regulating Insider-Trading?
Q3. Explicate the provisions of Indian Companies Act, 2013 on Insider trading?
Q4. Explain briefly the SEBI guidelines on Insider Trading?

Q5. Do you think whistle-blowing is morally correct? What are the moral grounds on the basis of which a whistle-blowing can be justified?

Q6. Write meaning characteristics of whistle-blowing and whistle-blower. What are the consequences of whistle-blowing? Explain.

Q7. What is whistle-blowing? What protection do whistle-blowers have in India?

Q8. Discuss objectives, components, process and importance of internal whistle-blowing policy? What are the barriers to internal whistle-blowing policy?

Q9. Write short notes on the following:

(i) Whistle-blower protection in India

(ii) The Importance of Internal Whistle-blowing Policies

(iii) Factors to be considered before Blowing the Whistle

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