

## CHAPTER I

### THE CONCEPT OF PUBLIC INTEREST

#### 1. THE CONCEPT OF PUBLIC INTEREST IN GENERAL

The concept of public interest which has acquired wide recognition in the socio-economic sphere, presents a knotty problem in moulding its acceptable definition. Though the concept can hardly be defined with reasonable prediction, the concept itself is of overwhelming importance, particularly in the Welfare-State.

According to classical economic's view (Plato & Aristotle) public interest is the aggregate of individual utilities. According to them consumer satisfaction, a synonym for private utility was the standard of efficiency of the economic system, such efficiency is the main public interest.

In the Christian order (St. Augustine & Thomas Aquinas) the public interest characterized not merely by the limitation of Government to peace, defence and justice but rather by the participation of Government in the transcendent origin and destination of human life. Peace is the public interest. It is peace in the framework of participation, the participation in transcendent existence and destiny which is the characteristic Christian formula for

the public interest. It might be called est pay participians.

In the era of Lock, Adam Smith & Mill, the public interest leads to range from Laissez Faire to Public Management, Labour and Resources, the entire range coming under the heading of public management of private satisfaction. One type of Socialism. Socialism motivated by private utility and consumer satisfaction of marxist variety.

Karl Marx defines the public interest as that of labour management, termed as ergonomia-from ergon (labour) and nomos (rule-management). By this, Karl Marx aims at the conversion of private utility into the public interest. After this conversion, no private is left, not even consumer satisfaction. The concept of public interest in a socialised order is the same for Marx and Lenin. Lenin adds a concept to define the public interest in the period of transition from the 'false' world of the present to the 'real' world of the future. From Lenin's marxism emerged a peculiar type of a combat party and a combat Government for the duration of the period of transition, the public interest represented by militant communism is conflict management. This was termed as Polemonomia-from Polemos (strife) and nomos (rule, management).

# 1.A ETHICAL FOUNDATION OF THE CONCEPT OF PUBLIC INTEREST

The concept of public interest, has been variously defined. It may be broadly viewed, as synonymous with 'general welfare'. Such a definition holds it capable of permeating all actions both individual and institutional. On the other hand it can be construed narrowly, as an attribute of certain acts confined to the Governmental sector of human activity.

## (I) Positive View :

Positivist thinking has so deeply permeated our social sciences that the word 'public' has frequently come to be applied to purely procedural considerations. Many lawyers and political scientists are prepared to endow any and all acts which conform to 'legitimized' procedure with the attribute or quality of public interest.

## (II) Economists View .

To them 'Free consumer choice' replaces 'legitimacy' as the criterion of public interest and Governmental activity designed to promote such choice is therefore clearly intended to be in public interest. In U.S.A. Anti-Trust legislations and regulations designed to promote honesty in advertising and trading will serve as examples. In India, provisions of M.R.T.P. Act dealing with unfair

practice is also example of such public interest.

(III) Sociologists' view :

The public interest in a given society at a given time is that which conforms to the mores (norms) of the society. Here is the basis of ethical relativism. According to the view point of the particular society, given acts may be deemed in or not in the public interest. The trouble is this point in providing guidelines for individual conduct is that other societies with different mores will come up with different answers. A further difficulty is that within a given society or nation-varied groups will like wise have different mores or will, cloak their particular interests with the sanctity of mores and even as an operational definition the sociologist's criterion is almost as likely to be 'Obscurantist' as useful. The problem is even worse in transitional culture, where the mores do not have even the temporary stability of a settled society. However, the sociologist's approach does at least have the merit of identifying the 'value' element, ethical in nature, in the search of the individual for value guidance-even though the value is relativistic and absolute.

These definitions of public interest are therefore either



purely procedural (legalist) or based on atomistic personal preference (economist) or relativistic and ephemeral (sociologist). In exurably the concept of public interest leads one to search for criterion of general welfare.

#### 1.B MEANING OF PUBLIC INTEREST

According to Concise Oxford dictionary, public interest means an idea of class of objects or a general notion. It is an abstraction from a particular thing, event, etc. forming general notion.

In the words of Hoarse M.Gray 'the concept of public interest like equally vague and undefinable common law rule of reason, has a validity and usefulness as a functional devise for the ordering of human affairs though we never can succeed in defining it with scientific precision.

According to Jerring public interest is a subjective conception, the value of which is psychological and does not extent beyond the significance that each responsible civil servant must find in the phrase for himself. Jerring apparently viewed the concept exclusively from the realm administered by civil servants. Against these restricted definition, C.S.Rao coined it as 'while it is true that the concept may contribute nothing to the formulation of valuable

generalisation and theories about politics and public administration it is word entitled to, if not enjoying top priority in any list of ambiguous words and phrases which never would be missed in the unending dialogue between scholar and man of worldly affairs of any country having any claim to an enlightened social life.<sup>1</sup>

To Friedman - public interest is a constantly shifting composite and balance between the value that direct a particular society at a given time unless we accept a rigid natural law position. It must be distinguished from regulatory, supervisory, enterprising, corrective and other processes. They are not public interest but method of ensuring and protecting them. It must also be distinguished from private interest which is considered as those of special group or individual as opposed to the interest of the community as whole. There a genuine public interest which we might call 'reserve function' of the State, an embodiment of values and interests that bind to gather the many conflicting and contending groups. This reserve function usually becomes conscious and articulate only in times of great emergency such as war, economic or natural disasters. Public interest constantly needs redefining and re-assessment in a never ending re-adjustment proceeding through many channels: such as public discussion in

universities, press and other media of public communication leading in due course to legislative changes.<sup>1</sup>

In the words of Justice Felix Frankfurter of the U.S.A. Supreme Court, quoted in an Indian case, *M.R. Murthy V.I.D. Corporation of Orrisa*<sup>2</sup> "the idea of public interest is vague, impalpable, but all controlling consideration. A thing is said to be in public interest where it is or it can be made to appear to be conducive to the general welfare rather than to the special privileges of a class, group or individual". But the vague concept poses much of its vagueness as a result of political debate, judicial interpretation and transaction into a specific goals of economic performance and achievements. Vagueness disappears when it applies to a specific or particular context or situation.

Justice Mahajan (C.J.) observed, "that the expression public interest is not capable of precise definition as has no rigid meaning and is elastic and takes its colours from the statute in which it occurs, the concept varying with time and state of society and its needs. Thus what is public interest today may not be so considered a decade later".<sup>3</sup>

#### CONCEPT OF PUBLIC INTEREST - DUAL SENSE:

The concept of public interest is usually used in dual sense i.e. (i) Logical sense and (ii) Instrumental sense.

(I) Logical Sense :

Firstly, it is used in logical sense to explicit the measuring of the established basic values of the community. This would be in the public interest to pursue certain goal, because it would be consistent with the measuring of the basic community value.

(II) Instrument Sense :

A policy would be in the public interest if its consequences would implement one or more of the established basic value of the community. Where there is a conflict in the values of the different communities, they are the values of the community, considered to be on the highest rung of the hierarchical ladder that prevail. Implicit in this concept of community is a system of basic values which bind together diverse human forces and relationship into an ordered way of life.

1.C PUBLIC INTEREST, PUBLIC PURPOSE, PUBLIC CONTROL AND PUBLIC POLICY :

While elaborating the concept of public interest, one should keep in mind concepts of public purpose, public control and public policy, as they are closely related to each other.

Public control of business can be justified only on the ground of public interest. On the otherhand, public interest by itself may not mean much if there is no corresponding public control to serve public interest, e.g. under the Companies Act, 1956 Central Government has been entrusted with power to supervise and control the activities of joint stock companies in public interest. For the exercise of anykind of control of business by the Government, it is necessary to show that there is a public purpose behind the exercise of such control.

Public policy comes in as a guide to steer the control on right direction to achieve a particular goal. While an ad-hoc measures may be justified in public interest in some exceptional cases, it is the formulation of certain rules or guidelines which would lend credence to the exercise of public control of business in public interest. Thus a public policy is only a forrunner of public control and both are necessary linked up with the concept of public interest.

PUBLIC POLICY MEANING THEREOF :

Public policy is defined as that principle of law which holds that "no subject can lawfully do that which has a tendency to be injurious to the public good or welfare".<sup>4</sup> In the words of Burrough J. "public policy is very unruly

horse, and when once you get astride it you never know where it will carry you".<sup>5</sup> Lord Davy, in another case<sup>6</sup> observed that 'public policy is always an unsafe and treacherous ground for legal decision...' In one of the Indian case<sup>7</sup> it was described as a vague and unsatisfactory term and also as an elusive concept.

Public policy, it is necessary to emphasise is a term of administration or management. It can connote the formulation of rules or guidelines which precede action. In order to justify any particular measure of control exercised by the Government in pursuance of public policy, even where such a measure of control is in public interest, it has to be shown that there are definite rules or guidelines preceding the exercise of such control. This is not so, where the contemplated action is not in pursuance of any public policy but is otherwise justified in public interest.

It may be submitted that while no one can formulate the abstract principle called 'public interest' and it cannot be considered in vacuo, it can fairly be understood and applied to policy decision. It indicates a standard of goodness for judging private acts and conduct in the social context. It may have to be distinguished from the self interest as such is not necessarily opposed to public

interest. What is required is that it should not be such as to be prejudicial to the public interest, i.e., the common good or general welfare of the community or nation as a whole as also the State of Government which represent it.

It comprises within its ambit the interests of the public health and morals, economic stability of the country, maintenance of purity in public life, prevention of fraud and amelioration of the condition of workmen. The concept of public interest is thus capable of such a comprehensive interpretation as might be required to subserve social goal.

#### 1.D THE CONCEPT OF PUBLIC INTEREST - STATUTORY SUPPORT :

In respect of the concept of public interest a question arise - How far it is supported by statutory provisions?

There is a clear evidence in Artha Sastra, that state intervention in business was common feature in the days of Chandragupta Maurya. Punishment had been provided for infraction and there were rules even for the judges to decide the issues raised before them. In recent past the origin of statutory support to the public interest in regulation of conduct of businessmen can be traced to Common Law doctrine, that any agreement in restraint of trade is

void and that any contract which is against public policy is void. This Common Law doctrine was later on incorporated in Statute relating to Contracts e.g. Section 27 of the Indian Contract Act, 1972 provides that "all agreements in restraint of trade is void". The circumstances in which a contract is likely to be struck down as one opposed to public policy are fairly well established in England as well as in India. So a contract of marriage brokerage, the creation of perpetuity and gaming and wagering agreements are all void agreements on the ground of public policy. It is, however, in the second half of nineteenth century that the Courts slowly realised the need for validating laws which interferes with the freedom of private business in public interest. The process was slow but certain. In the United States of America, the Federal Court recognised for the first time separate categories of business affected by public interest in 1877 in the case of *Mann v. Illinois*.<sup>8</sup> In the words of the court, 'property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large when, therefore one devoted his property to a use, in the property public has an interest, he in fact, grants to the public an interest in that use and must submit to the controlled by the public for the common good'. The Court went on expanding the



categories of business and industries, including basic industries, employment agencies, or ice business. The process of expanding the categories of business affected by public interest went on until 1934 when the Supreme Court gave its decision in the case of *NABBI V. NEW YORK*. In this case the Court held that 'there is no closed class or category of business affected with public interest. The phrase 'affected with public interest' can in the nature of things, mean no more than that an industry, for adequate reasons, is subject to control for the public good.

1.E PUBLIC INTEREST AND BUSINESS AND BUSINESS ORGANISATION:  
IS THE BUSINESS CLOTHED WITH PUBLIC INTEREST?

So far as the business and business community is concerned, they were governed by the norms laid down by their association. No sooner the theory of laissez faire was propounded to state that it is the sum total of individual welfare that guarantee economic welfare then it was realised that there is an inherent fallacy in this theory and that given the temptation, the individual businessman may promote his welfare in complete disregard of the welfare of the community. The reason for the behaviour of businessman is the inherent conflict between the self interest and the interest of community, which may be described as conflict of interests. It was realised that the behaviour and attitude of an

individual businessman cannot remain the concern of the businessman or business community alone. The business whether carried on by an individual or by an association of persons is clothed with public interest. How it is clothed with public interest can be judged from two stand points. The positive stand point and negative stand point.

(I) POSITIVE STAND POINT :

Business and businessman cannot function in vacuum. Their activities are dependent on the society and the State, and therefore, business itself is a matter of great public concern. It is business which ensure that the wants of community would be satisfied in the best possible manner. The prosperity of the nation also depends on the business and commerce. In short, we may say that since business contributes to national wealth, business must be deemed to be clothed with public interest. Thus, public interest arises directly from the underlying public interest of all economic activities which are carried on through business, be it production, distribution or supply of goods and services. It is this positive stand point which account for the institutional support which is afforded by the State and other organs of the State.

This institutional support may be in the form of :

- (a) providing infrastructure,

- (b) providing banking facilities,
- (c) providing finance to business through financial institutions.
- (d) providing subsidies, etc.

In order to provide all these facilities, the Government uses public fund.

(II) NEGATIVE STAND POINT :

The extent of public interest in business can also be gauged from negative stand point.

Having provided the facilities and necessary infrastructure to allow business to function with utmost efficiency in congenial atmosphere, the State cannot proceed on the basis that its responsibility is over.

The money employed in business has come from thousands of small investors, it being immaterial whether their saving have been channelised through stock market, bankers, financial institutions, public deposits or otherwise. The State must have some means at its disposal to oversee the direction of investment, whether the investment is put to optimum use, whether the same is frittered away in unproductive activities and also whether the saving of the investors are lost to satisfy the lust of unscrupulous businessman. Any law, regulation or other means at the disposal of

the Government to protect the interest of investors or public have therefore, to be deemed in public interest. The Companies Act, 1956 considered to be the harbinger of public welfare by safeguarding the public interest enshrined in its body either expressly or by implication. This Act is regarded as a progressive piece of legislation having public interest as its sheet-anchor. Looking to the various provisions of the Companies Act 1956 it may be taken as a best example of negative stand point.

The plain meaning of the term public interest refers to the pecuniary stake concerning the people as whole in commercial undertaking. As observed in the case of SOUTH HETTON CO. V. NORTH EASTERN NEWS ASSOCIATION the English Court defined public interest by saying that 'a matter of public interest or of general interest does not mean that which is interesting as gratifying curiosity or a love of information or amusement, but that in which a class of community has a pecuniary interest or some interest by which their legal rights are affected.'

A company or corporation must, therefore, act for the economic betterment and social welfare of the community which created it. Profit can be its goal only to the extent of which it enables it to survive and serve its members and creditors. Society would not like to create an artificial

child or entity who is selfish and acts only in its own interest. In fact company like a natural person must cultivate conscience, and profit must not be its only goal, but it must make an effort to serve not only its shareholders but also its employees, consumers and society at large. Social accountability must be inculcated by all companies and corporations.

Recently, in the case of NATIONAL TEXTILE WORKERS UNION ETC. V. P.R. RAMKRISHNAN & OTHERS, BHAGWATI J.(S.C.) observed that the concept of company has undergone radical transformation in the last few decades. The traditional view that the company is the property of the shareholders is now an exploded myth. Today social scientists and thinkers regard a company as a living, vital and dynamic social organism with firm and deep rooted affiliation with the rest of the community in which it functions. It would be wrong to look upon it as something belonging to the shareholders. It is true that the shareholders bring capital but capital is not enough. It is only one of the factors which contributes to the production and there are employees who provide labour and lastly there are the consumers and rest of the members of the community who are vitally interested in the product manufactured in the concern..."

This shows that the concept of public interest takes the

company outside the conventional sphere of being concerned in which shareholders or members alone are interested. It emphasizes the idea of the company functioning for the public good or general welfare of the community, at any rate but in a manner detrimental to the public interest.

Here it may be submitted that the concept of public interest has to be viewed in its proper perspective depending upon the objective sought to be achieved and context thereof. Business today has to move side by side with the rest of the society. In the words of Professor Kenneth Andrews 'this is the form of a new social contract in which business has to play a leading part'.

## 2. THE CONCEPT OF PUBLIC INTEREST AND COMPANIES ACT, 1956 :

The Indian Companies Act, 1956 is regarded as a progressive piece of legislation having public interest as its sheet-anchor. It is also considered to be the harbinger of public welfare by safeguarding the public interest enshrined in its body either expressly or by implication. In this part of the chapter I have tried to analyse those provisions of the Act which expressly provides for the protection of public interest.

### 2.A EXPRESS PROVISIONS OF COMPANIES ACT. INCORPORATED FOR PROTECTING PUBLIC INTEREST :

(I) Section 81 (4) : Sub-Section 4 of Sec. 81 inserted

by the Companies (Amendment) Act, 1963 empowers the Central Government to order the conversion of debentures issued to or loans obtained from the Government into share capital in public interest.

So far as this provision is concerned, it may be said that the progressive thinking is generally not for outright loans by the Government to private enterprises. It is felt that Government should have a right, where it is necessary and desirable to convert its loans into participating capital and the provision here will enable the Government to do so. However, the loans that are sought to be covered by this provision are loans directly given by Government and it is not to include the loans given by the financial institutions owned by the Government.

(II) TERMINATION OF DISPROPORTIONATELY EXCESSIVE VOTING RIGHTS - POWER OF THE CENTRAL GOVERNMENT TO GIVE EXEMPTION IN PUBLIC INTEREST (Sec. 89 (4) ) :-

This section requires that voting rights shall, in respect of all equity share bear the same proportion as the amount of share capital paid up that is to say voting rights should in all cases be in the same proportion as the amount of share capital paid up. However, Sub-Section 4 empowers the Central Government to give exemption to any company from the requirements of Sub-Sections (1), (2) and (3) of the

Section in public interest. This power of the Central Government is subject to one condition. Every order of exemption made by the Central Government under this Sub-Section requires to be laid before both Houses of Parliament as soon as may be after it is made. It is not made clear, whether this laying down of order is for approval or just for information. If it is for approval and if either House of Parliament does not approve such exemption, legislation is the only remedy.

An order of exemption under Sub-Section (4) if unconditionally made cannot be subsequently revoked by the Central Government.<sup>11</sup> But as pointed out by the Supreme Court,<sup>12</sup> though an order passed in exercise of power under a statute cannot be challenged on the ground of propriety of sufficiently, it is liable to be quashed, if the Court is satisfied that in passing that order the Government did not apply its mind to the relevant facts.

(III) RESTRICTION ON THE TRANSFER OF SHARES IN THE PUBLIC INTEREST (Section 108B) :

One of the characteristics of a company is transferability of shares. The shares of a public company are, subject to certain conditions, freely transferable, so that no shareholder is permanently wedded to a company. When the Joint Stock Companies were established the great object was



that the shares should be capable of being easily transferred. Section 82 of the Companies Act, 1956 enunciates this principle by providing that the shares or other interest of any member shall be movable property transferable in the manner provided for in the the Article of Association of the company. This provides liquidity to the members, as he can freely sell his shares and ensures stability to the company, as the member is not withdrawing his money from the company. However, an important power has been given to the Central Government, through which the Central Government may interfere with the right of the member to transfer his shares. This power to interfere is conferred by Sub-Section (2) of Section 108 B of the Act, which provides that, if the Central Government is satisfied that as a result of a transfer of shares, a change in the composition of the company's Board of Directors is likely to take place, and that such a change would be prejudicial to the interest of the company or to the public interest, it may order that no such transfer shall be made to the proposed transferee or in certain cases it may direct the transfer of shares to itself or to a corporation owned or controlled by it. In order not to affect the liquidity of shares, the period of restriction is limited to sixty days.

(IV) RESTRICTION OF THE TRANSFER OF SHARES OF FOREIGN COMPANY (Section 108 C) :

Sub-Section (1) of Section empowers the Central Government to refuse permission for transfer of shares of foreign company having a place of business in India to any citizen of India or any body corporate incorporated in India under certain circumstances, if it is satisfied that such transfer would be prejudicial to the public interest.

This provision is intended to meet the situation which has come to the notice of the Government of companies which are incorporated outside India but having substantial business in India changing hands, and funds derived from such transfer being misused for obtaining control over other Indian companies.

(V) POWER OF CENTRAL GOVERNMENT TO DIRECT COMPANIES NOT TO GIVE EFFECT TO TRANSFER : (Section 108-D) :

This section empowers the Central Government to direct the companies not to give effect to transfer of shares if as a result of such transfer, a change in the controlling interest of the company concerned, prejudicial to the interest of the company or public interest, is likely to take place. This section freezes the voting rights or other rights in respect of shares or block of shares in relation to which

any direction has been made by the Central Government.

Rights of affected party :

In case the central government interferes by exercising its power of direction as provided in the section, the grounds on which it proceeds to exercise the power are open to judicial review, where they are not sustainable.

Although section does not specifically provide for a hearing being given to the persons likely to be affected, it does not specifically prohibit such a hearing and the petitioners whose valuable rights were being adversely affected were held to be entitled to a hearing before the final order pursuant to the rule of natural justice.<sup>13</sup>

(VI) DIVIDEND TO BE PAID ONLY OUT OF PROFITS :  
(Section 205) :

One of the main objects of commercial enterprises is to earn profits which are distributed among shareholders by way of dividend.

According to Sec. 205 (1) dividend can only be paid out of (a) the current profits of the company, or (b) past accumulated profits or (c) money provided by the Central Government or State Government, after providing for depreciation in accordance with the provisions of Sub-Section (2).

Accordingly, dividend cannot be paid out of capital. In

one of the case<sup>14</sup> it was held that if a dividend is improperly paid out of capital, it amounts to a breach of trust. It results in an unauthorised reduction of capital and is ultra vires and void. The directors who are knowingly a party to such payment becomes jointly and severally liable to repay the amount so paid with interests. In this respect observation made by Jessel M.R. in Flitcroft's case<sup>15</sup> is worth quoted :

the creditors has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditors, therefore, given credit to that capital, gives credit to the company on the faith of the representation that the capital shall applied only for the purpose of the business and he has therefore a right to say that the corporation shall keep its capital and not return to the share holders.

However, an important exception has been provided to Sub-Section (1) of Section 205 by Sub-Section (1)(c) in the public interest. It provides that the Central Government, may if it thinks necessary to do so in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing for depreciation.

Position in England :

In England there was no general and direct authority on

this point. The Courts have sought to prevent the payment of dividend out of capital by doctrine that 'dividend must not be paid out of capital' or that 'dividend must only be paid out of profits'. These two propositions are generally assumed to be identical.<sup>16</sup> Section 121 of Companies Clauses Act, 1845 relating to statutory companies provides that 'The company shall not make any dividend whereby their capital stock will be in any way reduced... But the section further provides that a part return of capital is permissible with the consent of all secured creditors'. The same is now expressly included under Act. 116 of Table -A.

One of the important rule regarding dividends followed in England is 'dividend cannot be paid if this would result in company's being unable to pay its debts as they fall due'.<sup>17</sup> Secondly losses of fixed assets need not be made good before treating a revenue profit as available for dividend,<sup>18</sup> and it is not legally essential to make any provision for depreciation. Yet in another case<sup>19</sup> it was held that 'if an allowance is made for depreciation and the directors are satisfied that the actual value of the assets in question is in excess of the depreciated value shown in the books, they may write back the appropriate part of the depreciation and thus increase the profits available for dividend.

In England Jenkin Committee recommended that this should be necessary in the case of working assets with limited exception for existing companies, but that there should be no general statutory obligation to make good capital losses before distributing revenue profits.<sup>20</sup> In India, Sachar Committee has recommended far reaching changes in Section 205 of the Act :

So far as Section 205 (1) (c) and its proviso is concerned, it has recommended that since we are not in favour of the company paying dividend without providing for depreciation, we also recommend that the proviso (c) to Sub-Section (1) and the further proviso thereunder should be deleted.

(VII) PROCEEDINGS FOR RECOVERY OF DAMAGES OR PROPERTY.

(Sec. 244) :

This section enumerates the powers of the Central Government, which may be exercised by it, on the basis of Inspector's report. It provides that where from the report of the inspector it appears to the Central Government that a fraud, misfeasance or other misconduct in connection with the promotion or formation or management of the affairs of a company or misappropriation of property has taken place and the company is entitled to bring an action for damages for the misconduct, or for recovery of any property which

has been misapplied or wrongfully retain, the Central Government may itself bring proceeding in the public interest for that purpose in the name of the company or body corporate.

Here it may be mentioned that no provision has been made as to what is to be done with the damages or property recovered as a result of the proceedings taken under Sub-Section (1). In the absence of any express provision to the contrary, presumably they are to be paid or delivered to the company or body corporate on whose behalf, the Central Government has taken action.

In the case of Selanger United Rubber Estate Ltd. V. Cradock (No. 3)<sup>21</sup> the question was about the interpretation of the expression 'or other misconduct'. It was held by the court that the expression 'or other misconduct' should not be interpreted ejusdem generis with fraud and misfeasance but may be taken to include also misconduct not involving moral turpitude. In England also Section (3) of 1967 Act provides that 'if it appears to the Board of Trade that any civil proceeding ought, in the public interest, to be brought by a company they may themselves bring such proceedings in the name and on behalf of the company. This section has replaced section 169 (3) of 1948 Act.

(VIII) IMPOSITION OF RESTRICTIONS UPON SHARES AND  
DEBENTURES AND PROHIBITION OF TRANSFER OF SHARES  
OR DEBENTURES IN CERTAIN CASES : (Sec. 250 (3) & (4) :

This section provides that if as a result of investigation of the ownership of a company under Section 247 or investigation of the interest of members of a company under Section 248 or investigation of associateship with managing agent or otherwise, it appears to the Central Government that there is good reason to find out the relevant facts about any shares in a company, the Central Government may impose restrictions on shares for such period not exceeding three years.

Imposition of restrictions in public interest :

Sub-Sections (3) & (4) of Section 250 provides that as a result of any transfer of shares a change may take place in the composition of the Company's Board of Directors, and such change may be prejudicial to the public interest, the Central Government may restrain such change from taking place and direct that voting rights on those shares shall not be exercisable for any period not exceeding three years. The Central Government may also direct that a change in the composition of Board of Directors before the date of order shall have effect unless confirmed by it.



Power of the Central Government to declare transfer of Shares void :

Where the Central Government has reasonable ground to believe that a transfer of shares in a company is likely to take place whereby a change in the composition of Board of Directors of the company is likely to result and it is of opinion that any such change would be prejudicial to the public interest, it may by order direct that any transfer of shares in the company during the specified period shall be void.

The object of the Section is to make the investigation effective and also to thwart the take over bid by unscrupulous persons, by rendering cornering of shares by unscrupulous persons more difficult.

This Section was amended in 1960 by the Companies (Amendment) Act, 1960. The important inclusion made in the new section is the addition of the word 'otherwise'. By this addition, the scope of section has been widened so as to enable the Central Government to impose restriction in suitable cases although there may not be any investigation under Sections 247, 248 and 249 of the Act.

Position in England :

In England under Section 172-174, the Board of Trade has power to investigate the true ownership or control of companies.

Under Section 172 an inspector may be appointed to investigate and report on the membership of a company for the purpose of determining who are financially interested in it or able to control or influence its policy.

Alternatively, under Section 173, the Board of Trade may take the less drastic step of themselves demanding information on this point. Whether they proceed under Sections 172 & 173 they are, by Section 174 given powerful sanction of ordering that the shares shall be subject to restrictions which prevent rights in respect of them being exercised or enjoyed until the holders have given full information.

In England it was thought that they might be useful in relation to foreign control or the control of newspapers, but in fact in most of the very few cases where Sec. 172 has been invoked, it has been to enable the existing controllers to ascertain the identity of a potential bidder. No use has yet been made of Section 173 & 174.<sup>22</sup>

(IX) APPOINTMENT OR RE-APPOINTMENT OF MANAGING DIRECTOR  
(Sec. 269 (3) & (4) :

Formerly Section 269 required approval of the Central Government for the appointment of Managing Director or Whole time Director for the first time. Now it has been

amended and according to new provision the approval of the Central Government is made obligatory for the first appointment as well as for re-appointment. The Companies (Amendment) Act, 1974 has also provided guidelines for the Central Government, which provides that the Central Government shall not accord its approval unless it is satisfied, that :

- (a) it is in the interest of the company to have Managing Director or Whole Time Director;
- (b) the proposed Managing Director or Whole Time Director is fit and proper person to be appointed as such and that the appointment of such person as Managing Director or Whole Time Director is not against the public interest, and
- (c) the terms and conditions of appointment are fair and reasonable.

The object<sup>of</sup> inclusion of guidelines for the grant or refusal of such approval is to ensure the exercise of power fairly and justly.

#### Sacher Committee's Recommendations :<sup>23</sup>

In the Chapter of management structure and professionalisation of management it has made following recommendation in respect of appointment of Managing or Whole Time Directors:

Consistent with our general approach to insist on governmental approval only in exceptional cases and to allow the companies to function freely within the limits of certain statutory safeguards, we suggest the replacement of the provision of Section 269 by provisions to the following effect :

- (1) A public limited company may appoint a whole time managing director or one or more whole time director or managing director by passing a special resolution, if the following conditions are satisfied :-

- (a) The whole time or managing director proposed to be appointed -

- (i) has completed the age of 30 years and is not above the age of 65 years; and
- (ii) is not a relative of any director, is not a shareholder or a relative of a shareholder of the company holding, in either in cash, more than two percent of the paid up equity capital of the company;

- (b) A return has been filed with the Registrar in the prescribed form containing a certificate as may be prescribed; and

- (c) In the explanatory statement sent to members alongwith the notice for the annual general meeting/general meeting, all material particulars relating to the appointment of the managing or whole time director including information now contained in Form 25 A to 26, as may be relevant to the circumstances of the case, should be incorporated in accordance with the rules to be prescribed in this behalf. However in so far as Form 25A to 26 are concerned, reference to 'proceedings in which the person concerned has been involved' should be changed to 'Prosecution launched against him'.
- (2) Where on an application made to the Central Government by 100 members or by persons holding 10 per cent of the total voting power, or on its own information, it appears that the person, appointed as managing or whole time director has been prosecuted and convicted of an offence specified in the economic offences (non-application of Limitation Act) and of the provisions of the Companies Act and the M.R.T.P. Act and that the Central Government is prima facie of the opinion that he is not fit to be appointed as managing or whole time director of a public company, the Central Government

may refer the same to the Company Law Board with a request that the Board may inquire into the case and record a decision as to whether or not, by reason of the said conviction such a person is not fit and proper to hold the office of managing or whole time director.

Provided that before the Central Government decides to refer and state a case for the decision of the Company Law Board, it shall give the person concerned an opportunity of being heard.

- (3) The person against whom the case is referred to the Company Law Board under this section shall be joined as a respondent to the reference and no order shall be passed by the Company Law Board without giving an opportunity to the person concerned of being heard.
- (4) An order by the Company Law Board that by reason of the prosecution and conviction of the person concerned of the offences referred to in clause (2) above, the person appointed as managing or whole time director is not fit and proper to be appointed as managing or whole time director shall be <sup>appealable</sup> ~~appealable~~ to the High Court if it satisfies the provision of Sec. 100 of the Code of Civil Procedure.

- (5) The High Court on hearing an appeal under Sec.100 of Code of Civil Procedure, shall in addition, have the power to order removal from office of any managing or whole time director, and in the event of there being no <sup>p</sup> appeal from the decision of the Company Law Board may order the removal of such person as Managing or whole time director of the company.
- (6) The Company Law Board shall have power on a reference being made to it to pass such an interim order as the nature of the circumstances of the case may require, provided that no such order restraining a person to act as managing or whole-time director shall be passed without giving an opportunity of being heard.

The Committee has also recommended for the deletion of Section 268.

- (7) Where the whole time or managing director proposed to be appointed does not fulfil the conditions laid down in para 5-12, the appointment by special resolution can be made only with the previous approval of the Company Law Board.
- (8) Notwithstanding anything contained in the forgoing provision the Company Law Board may approve the appointment of any whole-time or managing director,

on an application made by the company, on such form and condition as it may deemed fit. If it is shown to the Company Law Board that it would be in the interest of the company to accord such approval.

The Company Law Board may reject the application if it is of the opinion that keeping in mind the interest of the company, it would be proper to reject the application.

So far as this recommendations are concerned, it may be submitted that the committee has altogether deleted the concept of public interest. If these recommendations are implemented, Company Law Board will be the sole judge in respect of the appoint of the whole time or managing director.

(X) POWER OF THE CENTRAL GOVERNMENT TO EXEMPT A COMPANY FROM THE PROVISION OF SUB-SECTION (1) OF SECTION 300 IN PUBLIC INTEREST (SEC. 300 (3) :

Director stands in a fiduciary relation and he is bound by fiduciary duties. One of the fiduciary duties is, that director must not, without the consent of the company place themselves in a position in which there is a conflict between their duties and their personal interest. Good faith must not only be done, but manifestly be seen to be done, and the law will not allow a fiduciary to place him in a situation in which his



judgement is likely to be biased and then to escape liability by denying that in fact it was biased. In order to put the matter beyond doubt, Sub-Section (1) of Section 300 of the Companies Act, 1956 prohibits interested directors from taking part in the proceedings of Board's meeting and it further provides that their presence shall not be considered for the purpose of quorum.

However, an important exception has been created by Sub-Section (3) of Section 300 which empowers the Central Government to exempt a public company or a private company which is subsidiary of a public company from the provision of Sub-Section (1) of Sec. 300, if the Central Government is of the opinion that with regard to the desirability of establishing or promoting any industry, business or trade it would not be in the public interest to apply all or any of the prohibitions contained in this section i.e. Sub-Section (1) of Sec. 300. So far as this sub-Section is concerned it seems that it has been provided to work as a safety valve in case of necessity. Sub-Section (1) puts a blanket ban on the interested directors from taking part in the proceedings of the Board's meeting. Some times, it may become necessary in the public interest to exempt a company from the provisions of Sub-Section (1) of Sec. 300.

SACHER COMMITTEE'S RECOMMENDATION :

This committee has recommended worker participation in the management of the company in Chapter XI of the Report. Consequently it has also recommended changes to be made in Sections 299/300 of the Act. It has recommended that "Worker Director, should not because of Sections 299/300 be barred from participating in the Board's meeting on the item concerning the terms and condition of the employment including question of wages, bonus etc., which would be Common to other employees of the company. Because if that was so, we would be debarring him from participation in the most important aspects with which the workers are concerned. If their representative is not to participate in such matters, the concept of worker's participation will have no meaning.

(XI) POWER OF THE CENTRAL GOVERNMENT TO MAKE REFERENCE TO THE HIGH COURT OF CASES AGAINST THE MANAGERIAL PERSONNEL AND REMOVAL OF MANAGERIAL PERSONNEL IN PUBLIC INTEREST : (Sections 388B to 388C)

Chapter IV of part VI of the Companies Act, 1956, which was amended by the Companies (Amendment) Act, 1963 gives power to the Central Government to remove managerial personnel from office on the recommendation of a High Court.

Under Sub-Section 1(d) of Section 388 B the Central

Government may state a case against the managerial personnel of a company and may refer the same to the High Court with a request that the High Court may inquire into the case and record a finding whether he is a fit or proper person to hold the office of director or any other office connected with the conduct and management of the company. The condition laid down for exercising this power is that the circumstances must suggest that the business of a company is or has been conducted and managed by such person with intent to defraud its creditors, members or any other person or otherwise of a fraudulent or unlawful purpose or in a manner prejudicial to public interest.

Section 388 C empowers the High Court to issue interim order, either on the application of the Central Government or on its own motion, directing the respondent to not to discharge any of the duties of his office untill further order.

The peculiar feature of this section is that interim order may be passed not only in the interest of the members or creditors of the company but also where the public interest requires that such order should be passed, even though the interests of the members or creditors may not require the passing of such orders or may even be prejudicially affected

thereby. No appeal lies against interim orders passed by the High Court as there is no provision for appeal against such orders.

Section 388 E empowers the Central Government to remove the respondent from the office, if the finding of the High Court is against the respondent.

The objects and scope of these sections becomes clear from the explanation given by the Finance Minister while introducing the Bill in the Lok Sabha :

The existing provisions in Sections 397 and 398 of the Companies Act and the others that follow provide for the removal from office in a company of persons found to have been guilty of mis-management in regard to the affairs of that company only. Section 274 disqualifies a person from being appointed as the director of a company if he is convicted by a Court for any offence involving moral turpitude and sentenced to imprisonment for a period of not less than six months. Under this section conviction by Court is a pre-requisite. It is well known how difficult and long drawn out a process is to secure a conviction even when a prima facie case is made out...

The main points in regard to this consideration are that provision is being introduced in Law to deal swiftly and effectively with management of companies where the

behaviour of the officers has been found to be not proper. Such person even if they have committed such anti-social acts in respect of one company only under their management, will be debarred from being employed by other companies. The affected persons will be given an opportunity of a fair hearing before the tribunal. An aggrieved person will also have the right of appeal to High Court and before removing a person from office, the Central Government will give him due notice to explain his position and make a representation.

Observation :

Section 388 B apply to companies both public and private, but do not apply to such bodies corporate or foreign companies which are incorporated outside India, as they are not companies within the definition given in Sec. 3 of the Companies Act, 1956. Further section deals only with a person who is or has been in management and with one whose concern with the management has ceased.

The difference between the provision of Sec. 388 B and Sections 397 and 398 is that under Sec. 388 B only Central Government can apply whereas under Sections 397 and 398 any member etc, can apply for relief.

(XII) PROVISION FOR FACILITATING RECONSTRUCTION AND  
AMALGAMATION OF COMPANIES-POWERS OF THE COURT-  
CONDITIONS REQUIRED TO BE OBSERVED BY THE COURT  
(Sec. 394) :

Section 394 contain provisions for facilitating reconstruction and amalgamation of companies by sale and dissolution or by acquiring undertaking. However, the powers of the Court under this section are subject to the conditions laid down under the two provisos of Sub-Section (1) according to which the Court will not sanction any scheme of compromise or arrangement for the amalgamation of a company which is being wound up, with any other company or companies unless the Court has received a report from the Company Law Board or the Registrar that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or public interest.

Besides, that no order for the dissolution of any transferor company shall be made by the Court unless the Official Liquidator has, on scrutiny of the Books and Papers of the company made report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or public interest.

Further the Court is also required to give notice of application made to it under Sec. 394 to the Central Government and shall take into consideration the representation,

if any, made to it by the Central Government before passing any order.

These two provisos added to Sub-Section (1) by the Amendment Act of 1956 are based on the findings of the Vivian Bose Commission on the Dalmia-Jain Concerns, and are intended as additional safeguards. In the case of R. Summani (P) Ltd.<sup>25</sup> it was held that the obtaining of reports required by the two provisos is a pre-requisite before ordering dissolution of the transferor company.

Prejudicial to the public interest :

If the object and purpose of the amalgamation as found, was to get the benefit of avoidance of capital gain tax, it would be prejudicial to the public interest, even though it did not amount to tax evasion or other illegal act or conduct. The Court in such case would not extend its helping hands to help to do anything which will have the effect of defeating the tax law of the country, though in a legal manner.<sup>26</sup>

But in the case of *In Re A.W. Figgis & Co. (P) Ltd.*<sup>27</sup> it was held that a scheme cannot be considered fraudulent or illegal because it is so arranged as to avoid capital gain tax or any other tax liability as a person is lawfully entitled to do anything or so conduct his affairs as to avoid or reduce liability. So far as the second proviso

of Sub-Sec (1) conceived conflicting views have been expressed by the courts as to the scope of the said proviso. Calcutta High Court has consistently been holding the view that the said proviso applied only in cases where one of the companies of the scheme of amalgamation is wound up or is in the process of being wound up and that it will not apply to cases where there is only a technical winding up. A contrary view has been taken by a Bench of the Karnataka High Court and according to that Court the proviso applies in all cases, and it is necessary that the Court should have the benefit of the report filed by the Official Liquidator before any dissolution order can be made. It may be submitted respectfully that the view expressed by the Karnataka High Court is correct, as the view expressed by the Calcutta High Court obviously ignores the fact that Clause (iv) of Sub-Sec. (1) (b) expressly covers all cases of dissolution without winding up whether winding up proceedings in respect of the company are pending or not. The object of calling for the report of the Official Liquidator is to satisfy the Court that the interest of the shareholders or the public interest are prejudicially affected by the amalgamation.



Sacher Committee's recommendations.<sup>28</sup>

... Whatever may be the legal position, we feel that it may not be necessary for the Official Liquidator to make scrutiny of the books and papers of the company and report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the public interest or to the interest of its members, before the company can be dissolved. In the winding up chapter we have already recommended that in the case of voluntary winding up it is not necessary that before the company is dissolved, the Official Liquidator should file a report pursuant to Sections 497 (6) or 509 (6) of the Act. In the case of amalgamation too the matter is already before the Court, the Court is expected to protect the interest of everybody concerned, it is not appreciated why a further report by the Official Liquidator pursuant to second proviso to Sec. 394 (1) should be necessary. We accordingly recommend that this requirement should be dispensed with. Instead it should be provided in the Section that at the expiry of six months after certified copy of the order of the Court approving the scheme of amalgamation is filed with Registrar, transferor company should be deemed to have been dissolved. Even otherwise, Sec. 559 already provides for declaration by the Court of any dissolution being void whether in pursuance of Part VII or under Section 394 or otherwise, and for

passing such order as i may think fit. We think that this would offered sufficient protection to any person to re-open the matter within a period of five years of the date of dissolution, as recommended by us in Chapter XII".

By this recommendation the Sacher committee has recommended the deletion of the second proviso of Section 394 (1).

So far as this recommendation of the Sacher Committee is concerned it may be submitted that the Committee has not taken into consideration the views expressed by the Vivian Bose Commission on the Dalmia-Jain concerns that "this two provisos are interced as additional safeguards", that is to say, in addition to the existing provisions of the Companies Act, 1956.

(XIII) POWER OF THE CENTRAL GOVERNMENT TO PROVIDE FOR AMALGAMATION OF COMPANIES IN NATIONAL INTEREST i.e. PUBLIC INTEREST ( Sec. 396 (1)):

This Sub-Section is intended to provide, at the instance of the Central Government for the amalgamation of two or more companies in the public interest. The words Public Interest were substituted for the words National Interest by the Companies (Amendment) Act, 1960. Thus, where the Central Government is satisfied that it is

necessary in the public interest that two or more companies should amalgamate, the Central Government may by order notified in the Official Gazette provide for amalgamation of these companies into single company.

The power to order compulsory amalgamation is evidently an ancilliary power intended to be used in cases of unsatisfactory situations in the private sector. Under such power, the Central Government, instead of nationalising the whole of a particular industry, may, in the national or public interest, choose to improve operative efficiency and ensure better management by a process of amalgamation of small and inefficient units into large companies with sounder capital structures and better system of management.

This power of the Central Government is made accountable, to the Parliament and therefore Sub-Sec. (5) provided that Copies of every order made under this section shall, be laid before both Houses of Parliament. So far as this section is concerned, the observation made by the Sacher Committee is worth considering.<sup>29</sup>

Under the existing scheme of the Act, amalgamation of companies could be ordered by the Court or by the Central Government (Sections 391 to 394 and 396 of the Act). While in the case of approval by the High Court, some

procedural requirements (Sections 391 to 393) have to be gone through before the scheme becomes final. In the case of approval by the Central Government a case of public interest has to be shown to exist before the Central Government can exercise its power under Sec. 396 of the Act. Even in the case of an order by the Central Government there are some procedural requirements, but then there are not as elaborate as the procedure under the Companies (Court) Rules, 1956. The Central Government has so far been exercising its powers under Sec. 396 only in the case of wholly owned public sector companies. The provisions of this section not so far been applied to private sector companies though we do not see any bar against its application even in respect of private sector companies. Recently, under a notification issued by the Department of Companies Affairs pursuant to Sec. 620 of the Act, the word 'Court' occurring in Sec. 394 has been substituted by the words 'Central Government' thereby giving jurisdiction to the Central Government to approve scheme of amalgamation of Government Companies. Thus, the Central Government is already in a position to exercise power both under Section 391 to 394 and 396 of the Act in so far as Government Companies are concerned. This dual option for Government companies, in our view can be reduced to a single option under

Section 396 on /.

In case of procedural matter, the Committee has observed and recommended<sup>30</sup> that "we have earlier referred to the two alternative modes by which amalgamation of Government Companies can be brought about by the Central Government. Government Companies, by their very nature, are meant to subserve public interest or public policy in some manner. The ownership of such companies also vests in the public at large. In view of this ownership pattern, the interest of shareholders, which is one of the important interest to be taken care of in any scheme of amalgamation is not likely to be adversely affected in case of amalgamation of Government companies. The interest of creditors are to be protected in any case irrespective of the authority passing the order of amalgamation. It can, therefore, be safely assumed that a scheme of amalgamation or merger of Government Companies, which has been already carefully considered by the concerned Governmental authorities will be in public interest as gauged at the relevant time. We therefore, see no difficulty in the Central Government exercising its power under Section 396 in all cases of amalgamation between Government Companies. There need be no occasion for

exercising of power of the Central Government in respect of government companies under Sections 391 to 394.

SICK INDUSTRIAL UNITS AND SACHER COMMITTEE'S  
RECOMMENDATIONS : <sup>31</sup>

There is another category of cases of amalgamation scheme. We feel, the provisions of Section 396 of Act can be readily evoked by the Central Government in sanctioning scheme of amalgamation in the public interest. These cases pertain to amalgamation of sick industrial units, with healthy units. In order to facilitate such amalgamation, Finance Act. No. 2 of 1977 had inserted a new Sec. 72A in the Income Tax Act relaxing provisions contained in the Act relating to set-off of accumulated business loss and unabsorbed depreciation allowance. The cases covered are of amalgamation of companies owning and industrial undertaking. The pre-requisite for availing of the tax benefit is that the Central Government or the recommendation of the specified authority is satisfied that certain conditions specified in this behalf are fulfilled and thereupon the Central Government makes a declaration to that effect. The declaration referred to above will be made by the Central Government if three conditions specified in this behalf are fulfilled. Among them there



is one condition that the 'amalgamation is in public interest'. The Central Government has evolved certain guidelines for the purpose of determining whether scheme of amalgamation can be considered to be in the public interest or not. There is also a provision in the procedure laid down for this purpose, that if the specified authority is satisfied that the scheme of amalgamation is in the public interest and that other conditions mentioned in Sec. 12 (1) of the Income Tax Act are also fulfilled it may indicate the amalgamated and amalgamating companies that, in the event of amalgamation being finally affected on the lines of the scheme presented and approved by the specified authority, it would make recommendation to the Central Government for making a declaration under Sec. 72(1) of the Income Tax Act. The point of departure from the existing arrangements which are emphasising is that in such case of amalgamation where the existence of public interest has been clearly acknowledged by the specified authority, the scheme of amalgamation should be approved by the Central Government itself in exercise of its powers under Sec. 396 of the Act rather than by forcing the companies to approach the Court for this purpose under the provisions of Sections 391 to 394 of the Act. This would in fact facilitate speedy amalgamation of sick units

with the healthy ones and would thus advance the very purpose for which the benefit under Sec. 72 A of the Income Tax Act has been extended. We would, however, suggest that the exercise of these powers under Section 396 by the Central Government may be confined to companies which do not come within the ambit of the M.R.T.P. Act. Wherever the amalgamating company is covered by the M.R.T.P. Act the scheme of amalgamation would still be on the existing lines under the Act. We would further suggest that necessary rules may be framed by the Central Government for facilitating the passing of an order under Sec. 396 on application being made by the companies and for these purposes Sec. 396 may be modified to confer powers on the Central Government to frame the necessary rules.

So far as this recommendation is concerned, it may be submitted that it will not be wise to implement it. The reason for this suggestion is that in order to take advantage of the liberal policy of the Government some unscrupulous industrialists may convert their healthy units into sick units., and the procedure under Sec. 396 as compared to Sections 391 to 394 is liberal, it will not be possible for the Court or the Central Government to discover the unhealthy practices adopted by these unscrupulous industrialists to convert their healthy units into sick units.



(XIV) PREVENTION OF OPPRESSION AND MISMANAGEMENT  
POWER OF COURT ( Sections 397 and 398) :

Company form of business organisation is essentially democratic in form. Practically every questions relating to the management of the affairs of business is required to be decided upon either by a simple majority or by a special majority of the votes of the shareholders or it may be said that supremacy of majority is the fundamental rule of company law. Sometimes majority shareholders are tempted to utilise this rule to serve their own personal ends and to ignore minority interest. It may be pointed out here that under the 1913 Act, there were no effective and adequate remedies to protect minority interests.

However, the Companies <sup>(Amendment)</sup> Act, 1959 introduced two sections 153C and 153 D in order to provide an alternative remedy to winding up in case of mismanagement of companies and oppression of the minority by the majority. These two sections were based on Section 210 of the English Companies Act, 1948. Now this section has also been replaced by section 75 of the English Companies Act, 1980. In the new section, the word 'Oppression' has been replaced by 'Unfairly prejudicial'. In India present Act provides the provisions under section 397 and 398 to protect the minority members particularly against oppression by the majority and mismanagement of the affairs of the company.

Section 397 lays down that when the affairs of the company are being conducted in a manner prejudicial to public interest or in a manner oppressive to any member or members, an application may be made to the court by the requisite number of members for appropriate relief. Oppression, complained of must be of such nature as would justify the making of winding up order on the ground that it is just and equitable that the company should be wound up but that to winding up would unfairly prejudice such oppressed member or members. If this is proved, the Court may with a view to bring to an end the matters complained of, make such an order as it think fit.

Looking to the wordings of Section 397 shareholders rights or interest may be protected by exercising qualified rights in two cases :

Firstly that the affairs of the company are being conducted in a manner prejudicial to the public interest, or secondly that the affairs of the company are being conducted in a manner oppressive to any number of members of the company.

So far as the first case is concerned, the wordings 'are being conducted in a manner prejudicial to the public interest or' have been inserted in Sections 397 and 398 by the Companies (Amendment) Act, 1963 in order that the Court

and the Central Government may have power to interfere in cases where eventhough, there may be no prejudice to any shareholder, the oppression or mis-management complained of is prejudicial to the public interest. While introducing the Amendment Bill, the Finance Minister Explained the object of insertion of the concept of public interest as under :<sup>32</sup>

The Bill also seek to introduce the concept of public interest, under those provisions of the Companies Act where minority shareholders or the Central Government have been given powers to apply to the Court for prevention of oppression or mismanagement, by the provisions of the amending bill. It will now be possible for the Central Government to move to the Court under Section 397 and 398 of the Act or take action for appointing directors under Sec. 408, suo motu on the ground of public interest, and not merely where a company's affairs are being conducted in a manner prejudicial to the interest of shareholders.

#### Scope of Section :

Clause (b) of Sub-Section (2) of Section 397 indicates that the Court will entertain an application under this section only when oppression is of such a nature as will

make it just and equitable for the Court to wind up the company, but the order winding up would unfairly prejudice the interest of the oppressed member or members and the remedy of winding up to eliminate oppression may be worse than the disease itself. Here it may be submitted that section 397 provides for an alternate remedy to oppressed member or members of the company.

Procedural defects :

Though by this amendment, right to apply has been given, where the affairs of a company are conducted in a manner prejudicial to the public interest but question arises whether an application under this section is possible, because of the condition laid down in clause (b) of Sub-Section (2). The conditions laid down under this clause cannot be satisfied in such case as conducting the affairs of a company in <sup>a</sup> manner prejudicial to the public interest cannot be just and equitable for ordering the winding up of the company.

But in the case of Balchandra Dharmajee Makaji V. Alokock Ashdown & Co. Ltd.<sup>33</sup> it was observed that having regard to the provisions of Sections 397, 398 and 408 as amended by the Companies (Amendment) Act, 1963 where the concept of 'public interest' is introduced, it would appear that the Court winding up a company will have to take into

consideration not only the interest of shareholders and creditors but also public interest in the shape of needs of the community and interest of the employees etc.

What is Oppression ?

Oppression as per Lord Simonds is any act exercised in a manner burdensome, harsh and wrongful. In the case of *Elder V. Elder & Waston Ltd*<sup>34</sup> it was observed by Lord Cooper 'that the essence of the matter seems to be that the conduct complained of should at the outset involve departure from the standard of fair dealing and a violation of the conditions of fair play on which every shareholders who has entrusted his money to the company is entitled to rely.'

Here succinctly it has been stated that the complaining shareholders must be under a burden which is unjust, harsh or tyrannical. A persistent course of unjust conduct must be shown where allegation of these nature are made in a petition and substantiated, the company can even be ordered to purchase the minority shares at a fair value.<sup>35</sup>

But in the case of *Mehta Bros. V. Calcutta Landing and Shipping Co. Ltd*,<sup>36</sup> it was held that negligence and inefficiency do not amount to oppression or mismanagement as contemplated by the Act. In another case<sup>37</sup> it was held that act of omission may amount to oppressive conduct if

it is designed to achieve an unfair advantage. In an Indian case<sup>38</sup> it was held that inefficient management will not amount to oppression, though it may amount to mismanagement so as to come under Section 398. Nor will oppression not relating to the company's affairs but directed towards a third person come under this section.

Recently the Supreme Court, after reviewing the leading authorities, observed<sup>39</sup> "it is not enough to show that there is just and equitable cause for winding up of the company, though that must be shown as preliminary to the application under section 397. It must further be shown that the conduct of the majority shareholders was oppressive to the majority as members and this requires that events have to be considered not in isolation but as a part of consecutive story. There must be continuous act on the part of the majority shareholders, continuing upto the date of petition, showing that the affairs of the company were being conducted in a manner oppressive to some part of the members. The conduct must be burdensome, harsh and wrongful and mere lack of confidence between the majority and minority shareholders would not be enough unless the lack of confidence springs from oppression of minority by a majority in the management of the company's affairs, and such oppression must involve at least an element of lack of

probity or fair dealing to members in the matter of his proprietary rights as a shareholders."

SOME OF THE GROUNDS WHICH HAVE BEEN ACCEPTED BY THE  
COURTS AS PROPER REASONS FOR ACCEPTING PETITION AGAINST  
OPPRESSION : !

- (a) When an attempt is made by the majority to force new and risky subjects on unwilling minority.<sup>40</sup>
- (b) When an attempt is made to deprive a member of his ordinary membership rights.<sup>41</sup>
- (c) When the conditions of fair play are violated.  
Refusal to register transfer of shares bequeathed to member owing to private dispute.<sup>42</sup>
- (d) Where a majority shareholders persistently flouted the decision of the Board of Directors and made it impossible for the company to function.<sup>43</sup>
- (e) Where the affairs of the company are being conducted by the directors doing nothing to defend its interest when they ought to do something.<sup>44</sup> It was observed "The affairs of a company can be conducted oppressively by the directors doing nothing to defend its interest which they ought to do something just as they can conduct its affairs oppressively by doing something injurious to its interest when they ought not to do it".

In England Cohen Committee Report itself instances two situation evinced<sup>as</sup> for the employment of the Section 210 (now Sec. 75, of 1980 Act) of the English Companies Act, 1948 corresponding to Sec. 397 of the Indian Companies Act, 1956. They are :

- (1) Where controlling directors unreasonably refuse to register transfer of the minority's holding as to force a sale to themselves at a low price, and
- (2) Where they take excessive remuneration so as to leave nothing for distribution by way of dividend.

The Jenkin Committee added two further illustrations :-

- (i) the issue of shares to Directors and others on advantageous terms, and
- (ii) passing of non-cumulative preference dividends shares held by the majority.

So far as former is concerned, it seems very doubtful whether this would in fact be caught by the section as at present worded unless it was done habitually.

CONDITIONS FOR AN APPLICATION UNDER SECTION 397 OF THE COMPANIES ACT, 1956 :

- The conditions laid down in clauses (a) and (b) of s/s (2) must exist before the Court can entertain an application.
- (a) There should be oppression : The members permitted



to apply to the Court under Sec. 397, must show that the affairs of the company are being conducted in a manner oppressive to some part of members in their capacity as members or members of the company as such.

- (b) The fact must justify winding-up: It is to be noted that Sec. 397 does not purport to apply to every case in which the facts would justified the making of winding-up order to those cases of that character which have in them the requisite element of oppression. For this purpose the term just and equitable be interpreted in liberal way.

Gower,<sup>45</sup> while criticizing the decision given in the case of *Re. Bellard Silk Ltd.*<sup>46</sup> observed that the interpretation placed on the requirements that it must be just and equitable to wind up the company is particularly unfortunate, it seems clear that this was intended to relate merely as a proof of grounds and not to require the petitioner to show that he was entitled to a winding up order.

- (c) Oppression must be of a continuing nature : The phrase of the affairs of the company are being conducted suggest prima facie a continuing process and is wide enough to cover oppression by anybody who is taking part

in the conduct of the affairs of the company whether defacto or de jure.

- (d) Victim of the oppressive act must be a member : The section gives no guidance as to the meaning of the term oppressive although it does indicate that the victim or victims of the oppressive conduct must be a member or members of the company as such.

PREVENTION OF MISMANAGEMENT - SECTION 398

Section 398 of the Companies Act, confers very important right on the members of the company. It lays down that the requisite number of members as laid down by section 399 of the Act, may apply to the Court for relief on the ground of mismanagement of the affairs of the company. As per the provisions of the Section, the petitioners must be established that :-

- (1) the affairs of the company are being conducted in a manner prejudicial to the public interest or the interests of the company or
- (2) a material change has taken place in the management or control of the company, whether an alternation in the board of directors or in the ownership of the Company's shares or if it has no share capital in its membership in any manner whatsoever and that by reasons of such a change, it is likely that the affairs of the

company will be conducted in a manner prejudicial to the public interest or the interests of the company.

So far as this section is concerned, it may be submitted that unlike section 397, this section has no counterpart in the English Companies Act. It was recommended by the Company Law Committee to provide relief against mismanagement of the affairs of the company, which cannot otherwise be suitably dealt with under any other provisions of the Act. In order to grant relief under this section, it is not necessary for the Court that there are facts to justify the making of winding up order. It is enough if the affairs of the company are conducted in a manner prejudicial to the interest of the company or public interest.

In an Indian case,<sup>47</sup> a petition was filed against the company by certain shareholders on the ground of mismanagement by directors. The Court made a thorough enquiry and found that considerable amount had been drawn by the Vice-Chairman for his personal use, large sums were owing to the Government, machinery was lying in a state of disrepair and, moreover, that shareholders outside the Vice-Chairman's group were not powerful enough to set things right. All these facts clearly stated a position of mismanagement and the court appointed two administrators for a period of six months to

manage the affairs of the company and vested in them all the powers of the board of directors.

Who may apply to the Court for relief (Section 399):

As per the provisions of the Section, an application can be made (a) by requisite number of members as specified in Sub-Section (1) and it is immaterial whether the members are Equity shareholders or Preference shareholders. The section does not limit the right to members holding equity shares only or (b) by the Central Government under Sub-Sec. (4) and (5) of the Section.

Can Majority Shareholders apply for Relief?

The answer is yes. In the case of *In Re. Sindri Iron Foundry (P) Ltd.*<sup>48</sup> it was held that it is not only the oppressed minority which can apply to the Court for relief, rather an oppressed majority may also apply, if it is rendered completely ineffective by the wrongful acts of the minority group.

Powers of the Court : The power of the Court under Sections 397 and 398 are very wide. Therefore, the petition should state in clear terms the nature of relief sought. The order of the Court may provide for :

- (a) the regulation of the conduct of the company's affairs in future,

- (b) the purchase of the shares or interests of any member of the company by other members or by the company,
- (c) in the case of a purchase of its shares by the company, the consequential reduction of its share capital,
- (d) the termination, setting aside or modification of any agreement between the company and the managing director, any other director and the manager upon such terms and conditions as may, in the opinion of the Court be just and equitable in all the circumstances of the case,
- (e) the termination, setting aside or modification of any agreement with any person provided due notice has been given to the party concerned and his consent obtained,
- (f) the setting aside of any transfer made by the company within three months before the date of application under Sections 397 and 398 which would, if made by an individual be deemed in his insolvency to be fraudulent preference,
- (g) any other matter for which in the opinion of the Court, it is just and equitable that provision be made.

Curtailment of the Power of the Company to alter,  
Memorandum and Article of Association :

The Act empowers the company to alter or add to its memorandum and Articles of Association by special resolution. But where a Court order makes any alternation in the Memorandum or Articles of Association of a company, the company shall not have the power to make any alteration in the Memorandum or Articles of Association that is inconsistent with the Court order except by the leave of the Court. If any such alternation is made, it shall be communicated to the Registrar within thirty days of the Court's order.

(XV) POWERS OF CENTRAL GOVERNMENT TO PREVENT OPPRESSION  
OR MISMANAGEMENT ( Section 408) :

This section was inserted by the Joint Committee, as in their opinion's the Central Government should be vested with powers to prevent mismanagement or oppression, by nominating one or two members of the company to hold office as director (Now such number) for a period not exceeding three years. (Report para 146 sub-para 4).

According to the provisions of the section, where there is oppression or mismanagement within the scope of sections 397 and 398, at least one hundred members of the

company or members holding not less than one-fourth of the total voting power therein may apply to the Central Government for relief against oppression or mismanagement. The section also empowers the Central Government to move in the matter of its own motion.

After due enquiry, if the Central Government, is convinced that the affairs of the company are being conducted, (a) in a manner which is oppressive to any member of the company, or (b) in a manner which is prejudicial to the interests of the company or to Public interest, it may appoint such number of persons as it may, by order in writing, specify as being necessary to effectively safeguard the interest of the company or its shareholders or the public interest.

So far as this section is concerned, an important amendment was made by the Companies (Amendment) Act, 1960 whereby the words 'being members of the company' were omitted. The object of this amendment is to facilitate the choice of independent persons as nominees of the Government. By another amendment the number of members required to join in the application to the Government was reduced to 100 members instead of 200 in order not to make it too difficult to present such applications. Further to prevent changes in the Board of Directors that may stultify the nomination

of directors by the government, it has been provided that no change in the Board of Directors of a company on which Government has appointed directors in the exercise of the powers conferred by this section shall have effect unless approved by the Government.

Limitations on the Powers of the Government :

Before resorting to this section, it is a condition precedent that the Central Government should be satisfied that the affairs of the company are being conducted

- (1) either in a manner oppressive to any members or
- (2) in a manner prejudicial to the interest of the company or public interest.

This suggests that the powers of the Central Government is not an absolute power, but it is subject to the limitations laid down in the section itself. The Central Government does not have absolute discretion to appoint directors only on its subjective satisfaction. The satisfaction of the Government cannot be arbitrary or whimsical. Since the exercise of the powers under this section has grave consequences and must have serious consequences on the reputation and credibility of the management of the company, it must be exercised sparingly and only when the requisite conditions of the section are fully complied with. It has been held that the



Government cannot be the final arbiter of the conditions under which the power can be exercised.<sup>49</sup>

Government Policy under this Section :

The power under this section can be invoked only in those genuine cases where minority shareholders case show prima facie with documentary and other evidence that there has been mismanagement or oppression, and that for the proper management of the company, it is essential that the Central Government should appoint one or two directors on the Board of the company in the interest of the company as a whole.

The powers under this section are extraordinary and are exercised only where government is satisfied that the affairs of a company are unduly oppressed, and where it is felt that quick action is needed such as cannot be had under the necessarily protected proceedings of a Court <sup>of</sup> Law. Government will take great care to see that the section is not only invoked lightly by disgruntled shareholders to satisfy their own private ends.<sup>50</sup>

Amendment made by the Companies (Amendment) Act, 1974.

During the working of this section it has been found in few cases, that the Government nominated directors have not been able to function effectively, being in hopeless

minority. Having regard to the composition of the Board of Directors. The only proper course open to Government in such cases was to resort to such time consuming proceedings as application under Sections 397 or 398<sup>or 388B</sup> as the nature of the case required or to order an investigation or special audit. In order, therefore, to make such appointment more purposeful and effective, it is considered necessary to empower the Central Government to appoint such number of directors in the circumstances of each case as may be required to enable them effectively to discharge their responsibilities in the light of objectives for which their appointment were made. It is also proposed to empower the Central Government to issue directions to companies where an appointment of directors<sup>is</sup> made under Section 408. The directors appointed under this section are also required to keep the Government informed about the affairs of the company from time to time.

This new provision was added by the Companies (Amendment) Act, 1974. The merit of this new provision is that it gives a power of direct action to interfere and control the management of the companies by controlling the Board of directors itself, by appointing such number of directors as may be required for the purpose. Now, it is hoped, that the power to call for report (Sub-Section (6) ) and power to issue directions (Sub-Section (5) ) will play a vital

role in disciplining the company's management.

Experience of the working of this section has shown that the nominee directors, majority of whom are government servants play very little role in achieving the goal as laid down in the section. The reasons for this may be stated to be (a) lack of time (b) lack of knowledge, (c) lack of liking for management, and (d) lack of interest in the company, having nothing at stake in the company managed by them. In order to remove this defect, it is necessary that while making appointment under Section 408 the Central Government should take into consideration, the back ground of the persons, his knowledge, experience and liking for the management. The appointment of government servants or other officers of the government as a directors under Section 408 must be avoided.

Is this Section (Sec. 408) Violates Article 14 of the Constitution of India ?

The answer is in negative. Since the powers vested in the Central Government by this section are of urgent emergent nature, the government is not required to give notice individually to each shareholder and conduct a time consuming enquiry before taking action under this section. Such a course of action would frustrate the object of the section which is to step into the company's administration

in certain circumstances, so as to prevent oppression of the shareholders, the company and the public. The powers exercised by the Central Government under this section are not intended to interfere with the existing management or to replace it, but only to maintain a control over it. By their very nature the powers under this section are restricted only to the number of directors to be appointed and the ~~direction~~ of the order.<sup>51</sup>

Sub-Section (5) and its effect :

This sub-section provides that after the Central Government has appointed directors under the section and so long as they remain in office, no change in the Board of Directors shall have effect unless confirmed by the Central Government. In effect this means that at annual general meeting, unless the same directors as retire by rotation happen to be re-appointed, no new candidates will have chance of being appointed without confirmation by the Central Government. Nor can additional directors to be opted by the Board, nor new persons be appointed to fill casual vacancies, unless the Central Government is inclined to confirm them. One curious result flowing from this is that the existing directors in the Board whose conduct was the cause of complaint, are themselves enabled to continue through being reappointed at the annual general meeting.

It has been held by the Court<sup>52</sup> "that the directors appointed under Section 408 (1) are required to hold office as directors for the period mentioned in the order. If the operation of order is stayed by the Court, its validity does not come to an end at the end of the prescribed period and therefore selection of ordinary Directors after the date on which the order would have expired is still subject to confirmation by the Central Government under Sub-Section (5)." This judgement is doubtful and points requires to be reconsidered.<sup>53</sup>

In the recent case<sup>54</sup> while dismissing the petition challenging the order of the Company Law Board and the Central Government made under Section 408 it was held that if the majority shareholders act in a manner which is oppressive to the minority that it is one of the circumstances which can be taken into consideration while exercising such power. When the affairs of the company are conducted in a manner prejudicial to interest of the company or public interest or in a manner oppressive to any member of the company, the Central Government has power to take action under Sec.408. The proviso to Section 408 (1) does not in any way limit or control the power of the Central Government to act when affairs of the company are being conducted against the interests of the company or public interest. The proviso

to Section 408 (1) gives the Central Government the power to pass an order directing the company to amend its articles, so as to provide for appointment of directors by proportional representation instead of the Central Government itself passing order appointing directors. The condition for acting under the proviso remains the same, namely that the affairs of the company are being conducted in a manner oppressive to any member of the company or public interest. The bare reading of proviso shows that the Central Government may under certain circumstances come to the conclusion, where the conditions set out in Sub-Section (1) exist, that it is not necessary to appoint governmental directors and it would be sufficient to direct the company to amend its articles in a manner indicated in Section 265 and to make appointments in pursuance to the said amended Articles. There is no conflict between the substantive provisions of Section 408(1) and proviso to warrant the conclusion that the powers under Section 408 (1) can be exercised only in the case of oppression on the minority shareholders by the majority. Nor is there any ambiguity in the language employed in Section 408 (1) which necessitates taking the help of proviso in order to interpret the said provision.

The powers of the Central Government under Sections 408 and 409 are preventive in nature. The powers are exercised in order to see that in future the affairs of

the Company are conducted in a manner which is not prejudicial to the interest of the company, its members or to the public interest. An order under Section 408 may not be able to cure the illegal or prejudicial acts which may have already been performed by the company and its directors, but it can try and prevent repetition of such acts in future by appointing the directors of the Company. It is said 'prevention is better than cure'.

It was further held that when an order under section 408 has to be passed by the Central Government, the principle of natural justice have to be complied with. It is immaterial whether such an order is being passed for the first time or an order is proposed to be passed for the continuance of the directors already appointed. It was held that it is for the Central Government to decide as to how many directors are to be appointed and who should be appointed. The only opportunity which has to be granted to a party is to show cause whether any director should be appointed or not. The section does not postulate hearing a party as to whether it object to any particular person being appointed as director or not. It is for the government to consider who is best person to be so appointed. This is a matter of discretion which has to be exercised by the Government and there can be no question of applying the principle of natural justice

at this stage, when once a party has been heard on the question as to whether government director should or should not appointed. If a person appointed as a director whose interest is in conflict with that of the company and whose appointment is not in the interest of the company or in public interest than, possibly such appointment can be challenged as being ultra vires of Section 408 of the Act.

Sacher Committee's Recommendations for Better and Quicker remedies for Oppression and Mismanagement

The committee has proposed that whilst the order of the Central Government may be appealed against on certain grounds to the High Court, the order itself ought not to be disturbed until adjudication of the appeal by the High Court. In view of the seriousness of the consequences of an order passed under section 408 and in view of the various provisions of the Companies Act relating to the holding of annual general meeting, appointment of directors at such meeting etc. it would be necessary to further provide that such appeals to the High Court should be disposed of as expeditiously as possible and it is for this reason that we are providing for a period of six months for the disposal of the appeal.

With regard to Section 409 which empowers the Central



Government to prevent change in the Board of Directors likely to affect the company prejudicially we are of the opinion that this power should be retained but hereafter be exercised by the Company Law Board. So far as this recommendation is concerned, it may be stated that it is a proper recommendation, as the proceeding<sup>e</sup> under Section 409 commence on a complaint, and necessary<sup>L, il</sup> involves a right of parties. It would, therefore be appropriate that the powers under this section are exercised by a quasi-judicial body. It has further recommended that the complaint specified in Section 409 (1) should not be restricted to those in management but that the provisions of Section 409 (1) may also be available to the shareholders of the company provided they fulfil the qualifications of members having the right to apply under Section 397.<sup>56</sup>

The Committee has also recommended for the deletion of Clause (2) (b) of Section 397. It has<sup>recommended</sup> far reaching changes in Sections 397, 398, 408 and 409 of the Act and also for their redrafting as per its recommendations.<sup>57</sup> So far as Section 397 is concerned, it may be submitted that in order to mitigate the rigour of the section, it requires to be modified. Under the existing provisions of law, in order to justify intervention of the Court, it is necessary

that there must exist at the date of the petition a course of oppressive conduct, there must be continuous acts on the part of the majority shareholders continuing upto the date of the petition showing that the affairs of the company are being conducted in a manner burdensome, harsh and wrong-ful. These conditions are too onerous. In order to mitigate the rigour of these conditions, the section ought to be available even where the complaint concerns a single act of oppression, not necessarily a continuing one. This would enable effective action to be taken through the medium of Section 397 petition - which the rule in Foss V. Harbottle<sup>58</sup> would prevent in a suit at the instance of a shareholder. The basic principle underlying the rule in Foss V. Harbottle is the right of the majority shareholders to conduct the affairs of the company. In this case it was laid down that in order to redress a wrong done to a company or a property of a company, to enforce the right of the company the proper plaintiff is the company itself and the Court will not ordinarily entertain an action brought on behalf of the company by a shareholder. If each individual member was allowed to sue in respect of wrong done to the company there would be no end to fruitless and vexatious litigation--besides if the thing complained of was one which in substance the majority of the company were entitled to do,

there would be no use in having a litigation about it when the ultimate end would only be that a meeting be called, where the will of the majority would prevail. The rule in Foss V. Harbottle thus prevents an action by a member particularly minority where what is complained of is :

- (a) a breach of fiduciary duty by promoters or directors,
- (b) negligent mismanagement of the company's affairs,
- (c) procedural irregularities which an ordinary resolution could put right.

Even though the will of majority prevails, there are number of occasions when the principle of majority rule has been misused. The whip of majority has often produced sullen effects, prejudicial to the best interest of the company. On these occasions an individual member or the minority shareholders may bring an action. These are the exceptions to the rule in Foss V. Harbottle. In these cases the will of supermajority of the majority cannot prevail. These exceptions are based on the principle of natural justice and fair play. These are briefly as follows :

- (a) Where the act done is illegal or ultra vires the company.<sup>59</sup>
- (b) Where the majority are committing a fraud on the minority and are in control of the company.<sup>60</sup>

- (c) Where the act can only be done by a special resolution, but in fact has been done by a simple majority.<sup>61</sup>
- (d) Where the personal rights of an individual member have been infringed.<sup>62</sup>
- (e) Where there is oppression of minority or mismanagement of the affairs of the company<sup>63</sup>

In spite of these exceptions, the rule in *Foss V. Harbottle* has often proved an obstacle in the way of minority. Now time has come, when, without affecting rights of action by suit by individual member, an additional avenue of relief is afforded to minority shareholders entitled to apply under Sections 397 and 398. The Sacher Committee has rightly recommended "that the persons having a right to apply to the Court under Section 397 may also complain of acts of mismanagement on the part of those in conduct of the affairs of the company and the Court may in its discretion having regard to the nature of the acts complained of, grant such relief as it may think fit."<sup>64</sup>

(XVI) FINAL MEETING AND DISSOLUTION (Sections 497 Sub-Section 6, 6A and 6 B and Section 509):

Sub-Section 6 of Section 497 and Section 509 reads as "The official liquidator on receiving the account and

either the return mentioned in Sub-Section (3) or the return mentioned in Sub-Section (4) shall as soon as may be, made and the liquidator and all officers, past or present, of the company, shall give the official liquidator all reasonable facilities to make a scrutiny of the books and papers of the company and if on such scrutiny the official liquidator makes a report to the Court that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members or to public interest, then from the date of the submission of the report to the Court the company shall be deemed to be dissolved. Sub-Section 6A provides that if on such scrutiny the official liquidator makes a report to the court that the affairs of the company have been conducted in a manner prejudicial as aforesaid, the Court shall by order direct the Official Liquidator to make a further investigation of the affairs of the company and for that purpose shall invest him with all such powers as the Court may deem fit. Sub-Section 6 B provides that on the receipt of the Official Liquidator's report on such further investigation the Court may either make an order that the company shall stand dissolved with effect from the date to be specified by the Court therein or make such other order as the circumstances of the case brought out in the report permits. These Sub-Sections were

substituted in the place of original Sub-Sections by the Companies (Amendment) Act, 1965 for the following reasons:

"On the basis of the findings of the Vivian Bose Commission and the recommendations made by the Daphtary-Sastri Committee, it is proposed to amend Section 497 and 509 to provide that a company which has been brought under voluntary liquidation should not be dissolved until the Official Liquidator has scrutinised the books and papers of the company and made a report to the Court that its affairs have not been conducted in a manner prejudicial to the interest of its members or the public interest."<sup>5</sup> (Clauses 55 and 56, Notes on Clauses).

Sacher Committee's Observation and Recommendations in respect of Sections 497 and 509 :

In voluntary winding up, the entire proceedings are carried out in accordance with the direction of the members or creditors as the case may be. Unless some aggrieved person applies to the Court for making suitable order, the entire process is not subject to scrutiny of either the Court or any other outside agency. Sometimes, it is likely that directors with improper and for dishonest motives put the company into voluntary liquidation, so that their mismanagement and/or misapplication of company's funds would be covered up, and the whole affair is quietly forgotten. The observation of Enquiry on the administration of Dalmia-Jain (Paras 423 and 810 Part 5) companies

regarding the manner in which some companies in the group had been wound up voluntarily, and the methods that were adopted by the management led to constituting Daphtary-Sastri Committee which recommended that Sections 497 and 509 be amended to provide for scrutiny by Official Liquidator, and until that is done, company shall not be dissolved. Accordingly, Sections 497 and 509 were amended in 1965 by substituting Sub-Sections (3) (4) and (5). As a result of this amendment, the voluntary liquidation now, after the final meeting is required to file an account showing how the winding up has been conducted and the manner in which the property of the company has been disposed of with the Registrar and the Official Liquidator within one week after the final meeting.

The Official Liquidators under Sub-Section (6) of Sections 497 and 509 on receiving the account has to scrutinise the books and papers of the company. After such scrutiny if the Official Liquidator is of the opinion that the affairs of the company have not been conducted in a manner prejudicial to the interest of its members, or to the public interest, he has to file a report in the Court to that effect. The company shall be deemed to be dissolved only thereafter. Prior to the amendment, three months after lying of the accounts at the final meeting and

filling copies of the same with the Registrar, the company was deemed to have been dissolved. This position exists even now most of the other countries of the world.<sup>67</sup>

The amendments introduced in 1965 have imposed a heavy and onerous burden on the Official Liquidator. After the affairs of the company are finally concluded, the Official Liquidator has to scrutinise the books, and other records of the company from the date of winding up, and also, carry out further investigation as may be directed by the Court, and then file his report. This duty on the Official Liquidator demanded professional skill which in the very nature of things can only be rendered by professionals like accountants and lawyers. In fact, it would be a virtual investigation into the affairs of the company since the incorporation of the company. Such an important task cannot be treated lightly, and cannot be discharged affectively unless the person entrusted with this work has the necessary expertise. The other point taken into consideration by the Committee is backlog of a number of cases in which final report have not been filed by the Official Liquidators. As per the Report the number of report pending were 794 on 31-3-75, 778 on 31-3-76 and 758 on 31-3-77, the number of reports scrutinised were 45 on 31-3-75, 65 on 31-3-76 and 14 on 31-3-77, and the number of reports in which adverse



comments made were only one on 31-3-76 and three on 31-3-77. The reason for this was the heavy work schedule with the Official Liquidators. It will be seen from the above, that the number of cases in which adverse reports have been filed is not even one percent. This is because of the existing law, which contains a number of regulatory provisions which has improved the working of the corporate sector. In the words of the Committee's the corporate sector is also subject to discipline now. Here it will not be out of place to quote from the report of the Working Group set up under the Administrative Reform Commission on Company Law in 1967.

the complaint by Official Liquidators of the heavy burden cast on them as a result of amendments were justified and were also supported by several witnesses from the profession who gave evidence before the Group."

The Working Group recommended in para 13-9 that the legal provision may suitably be amended to relieve the Liquidators of their additional burden of work, which they can hardly carry out. In their view, this important work of investigational nature should be undertaken by the Department through different regional and State Organisations only in the case of public companies.

In view of the Sachar Committee there is no need for the scrutiny by the Official Liquidators as provided in Sub-Section (6) of Section 497 and 509 of the Act, as the scrutiny by the Official Liquidators has not indicated any serious defaults. The Committee has therefore, recommended that Sub-Sections (6 A) and (6 B) of Section 497 and 509 should be deleted and to make consequential changes in Sub-Section (3) of Sections 497 and 509.<sup>68</sup>

It has further recommended that the procedure provided in the section 497 and 509 prior to the Amendment Act, of 1965 will have to be restored with the modification that the period of 3 months mentioned in the Old Sub-Section (5) should be raised to 6 months. This Sub-Section should also enable the liquidator to move the Court for deferring the date of dissolution.

Obversion in respect of the recommendations of Sachar's Committee :

The sections 497 and 509 were amended in 1965 by the Companies (Amendment) Act, 1965 on the recommendations of Daphtary-Sastri Committee which was constituted, on the basis of the findings of Vivian Bose Commission, which had inquired into the affairs of the Dalmia-Jain Companies. The Commission came across number of irregularities and also the manner in which some companies in the group had

been wound up voluntarily. The existing provisions in respect of voluntary winding up were found to <sup>be</sup> defective. <sub>L</sub> The defect which was found by them was want of scrutiny of accounts and other records of the company, which gave unscrupulous management an opportunity to conceal their mismanagement or misapplication of company's fund. Daphtary-Sastri Committee therefore, recommended that Sections 497 and 509 be amended to provide for scrutiny by the Official Liquidators, and until that is done, company shall not be dissolved. The object of this amendment is to bring out that the affairs of the company had not been conducted in a manner prejudicial to the interest of its members and the public interest. In other words, the object of the new provisions is to protect the interests of the members of the company and also the public interest. It will be not a wise step to delete these provisions for the sake of administrative convenience. If the present set up is overburden, then some other alternative may be found and provided, but not at the cost of the interests of the members of the company or public interest.

2.B THE PROVISIONS OF THE INDIAN COMPANIES ACT, 1956  
UNDER THE SHADOW OF PUBLIC INTEREST OR PUBLIC INTEREST  
BY IMPLICATION :

In this part of the chapter, my endeavour will be to draw attention towards those provisions of the Companies Act, 1956 which are incorporated for protecting public interest indirectly i.e. by implication and not expressly.

(I) SECTION 4 A READ WITH SECTION 224A :

The financial institutions specified in Section 4A have been declared as a financial institutions for the purposes of the Companies Act, 1956 particularly for those provisions of the Act which deals with accounts and audit of the company. Section 224 A is one of them. Now-a-days the financial institutions have become a special class of shareholders. They play very important part in the management of companies through the nominee directors. Directly or indirectly, the public is interested, in these financial institutions, as they managed the public fund. Section 224 A provides that in the case of a company in which not less than 25 percent of the subscribed capital is held ~~was~~ by a public financial institutions, a Government company, or Central Government or State Government or a nationalised bank or a general insurance company or in any combination thereof, the appointment or re-appointment

of an auditor shall have no effect unless made by a special resolution passed at each annual general meeting of the company. The object of these provisions seems to protect public interest by having an independent audit of those companies in which public financial institutions have made investment.

It may be noted that the Section provides 25 percent of the subscribed capital and not equity share capital only'. This means that in the case of a company, if Public Financial Institutions holds the Preference Share capital of the company and such holding is 25 percent or more of the total subscribed capital, the mode of appointment of the auditors of such company will be governed by the provisions of Section 224 A.

(II) SECTION 6 - MEANING OF THE TERM "RELATIVE".

The definition of "relative" as given in section 6 is important for the following Sections :

Section 2(3) and (4) where 'Associate' includes a relative.

Section 204 A which deals with restrictions on the appointment of former managing agents or secretary and treasurer to any office except with the previous approval of the company in general meeting and the Central Government.

Section 224 AA which empowers the Central Government to prohibit the appointment of sole-selling agents in certain cases.

Section 295 (1) (b) which lays down the restriction on making any loans to directors.

Section 297 (1) which provides for obtaining sanction of the Board of Directors for certain contracts in which particular directors are interested.

Section 314 which prohibits directors from holding office of profit.

Section 370 (1-B) (v) which deals with loans etc. to companies under the same management.

The object of all these provisions is to put restrictions on the relatives of directors and former managing agents and secretaries and treasurers of companies, holding office of profit in the companies or having contractual and other business dealings with them and ensure that the powers of directors are not abused to the detriment or loss of the companies in their charge and improper gain or other pecuniary advantage made by directors themselves and/or of their relatives.

The Sacher Committee has recommended for the re-drafting of Section 2 (41) with an explanation to the effect that if one is related to the other within the meaning of this clause, the latter shall also be deemed to be related to the former, and inclusion of brothers and sisters of mother and father in the schedule. It has also recommended for the deletion of Section 6.

SECTION 7 : INTERPRETATION OF 'PERSON IN ACCORDANCE WITH WHOSE DIRECTIONS OR INSTRUCTIONS DIRECTORS ARE ACCUSTOMED TO ACT :

This section provides that except where this Act expressly provides otherwise, a person shall not be deemed to be, within the meaning of any provision in this Act, a person in accordance with whose directions or instructions the Board of Directors of a company is accustomed to act, by reason only that the Board's acts on advice given by him in a professional capacity. The object of this section is to protect or safeguard the position of professional advisers and to limit their liability. It is enacted in order to make it clear that such person, by reason only of giving advice in their professional capacity, do not come within that category. This section lays down very important rule of interpretation, because in the following sections prohibitions and restrictions, duties and liabilities are imposed on person in accordance with whose directions or instructions the directors of a company are accustomed to act and penalties are also imposed on them for contravening certain provision. As it is not the intention of the Act to bring within this category of person, professional advisers, such as solicitors and auditors, etc.

Section 162 (1) & (2) which provides penalty for non compliance of the provisions of sections 159, 160 or 161 which deals with annual return etc.

Section 239 (1) (c) which deals with the power of Inspector to carry on investigation into affairs of related companies etc.

Section 248 (2) (c) which deals with information regarding persons having an interest in company.

Section 295 (1) (e) which deals with loans to directors etc.

Section 303 (1) explanation (1) which deal with Register of directors etc.

Section 305 which deals with duty of directors etc. to make disclosure.

Section 307 (10) (a) and (b) (i) which deals with the register of director's shareholdings etc.

Section 308 which lays down duty of directors and persons deemed to be directors to make disclosure of shareholdings.

Section 370 which deals with loans, guarantee etc. to companies under the same management.

Section 538 (3) which deals with the offences by officers of companies in liquidation.

It may be noted that the words 'by reason only' show that a solicitor, lawyer or other professional advisers will not come within the expression 'person in accordance with whose directions or instructions the Board of Directors of a company is accustomed to act' only when his advice is



professional advice, i.e. advice given in his professional capacity. If he gives any extra professional advice or instructions and the Board is accustomed to act according to his advice or instructions, he will come within the expression.

The idea underlying the provisions seems to be to hold responsible those persons who truly control the company and are able to pull the strings by appointing their own pup<sup>p</sup>ets or subservients as directors of a company.

The persons covered by this section will get exemption from the provisions of the above mentioned sections of the companies *Act*.

(IV) SECTION 11 -- PROHIBITION OF ASSOCIATION AND PARTNERSHIP EXCEEDING CERTAIN NUMBER :

The Section is intended to prevent the mischief arising from large trading undertaking being carried on by large fluctuating bodies, so that persons dealing with them did not know with whom they were contracting and so might be put to great difficulty and expence. This was public mischief to be redressed.<sup>78</sup>

It may be noted that the section will apply only where a company, association or partnership carries on a business and has for its objects the acquisition of gain either by itself or by any of its members.

In one of the case it was held by the Court<sup>71</sup> that 'both the expressions 'business' and 'acquisition of gain' are, however, to be given the widest possible meaning, charitable, religious, scientific and other association not having for their object the acquisition of gain being alone excluded.

In another case<sup>72</sup> it was held that the expression indicate undertaking of a commercial nature as distinguished from literary, social and other associations and clubs. The test is whether what is done will be considered by ordinary person as carrying on business. In all cases, the ordinary businessman's point of view has to be adopted.

It may be noted that the application of the section is confined to 'companies' and does not extend to body-corporate. The prohibition has, therefore, no application to corporation, incorporated under any special laws or to foreign companies or other bodies corporate.

The Sachar Committee not satisfying with the present position relating to Foreign Company<sup>73</sup> has recommended for the rationalisation of law relating to foreign company as per its recommendation.<sup>74</sup>

(V) SECTION 13 (1) (c) and (d). THE CONTENTS OF MEMORANDUM OF ASSOCIATION : (OBJECTS CLAUSE)

Sub-Section (1) (c) provides that 'the memorandum of association of every company shall state in the case of

company in existence immediately before the commencement of the Companies (Amendment) Act, 1965 the objects of the company :

Sub-Section (1) (d) provides that in the case of a company formed after such commencement -

(i) the main objects of the company to be pursued by the company on its incorporation and objects incidental or ancillary to the attainment of the main objects;

(ii) other objects of the company not included in Sub-clause (i),

Sub-Section (1) (e) in the case of companies (other than trading corporation) with objects not confined to one State, the States to whose territories the objects extend.

In place of clause (c) of sub-section (1), clauses (c), (d) and (e) have been substituted by Section 5 of the Companies Amendment Act, 1965.

The purpose of the amendment was to provide clear definition of the main and the subsidiary objects of a company in its Memorandum of Association, so as to enable shareholders and others interested i.e. creditors and persons dealing with the company, to have a clear idea of the main objects and other objects of the company. This combined with the amendment of Section 149 inserting a new provision therein requiring that both at the initial

stage and at later stages, whenever a company embarks on any kind of business activity sanction of the company by special resolution should be obtained, will afford an opportunity to shareholders to inform themselves of the actual business or businesses in which the company is engaged or proposes to engage.<sup>75</sup>

It may be noted that by this amendment, the Legislature has tried to put an end to practice of making the objects of a company's Memorandum of Association as wide as possible, in order to (i) obviate the necessity of applying to the Court (now Company Law Board) when new venture is contemplated and (ii) avoid the doctrine of Ultra Vires.

(VI) SECTION 17 : ALTERATION OF MEMORANDUM OF ASSOCIATION-  
SPECIAL RESOLUTION AND CONFIRMATION BY COMPANY LAW  
BOARD REQUIRED IN CASE OF ALTERATION OF REGISTERED  
OFFICE AND OBJECTS CLAUSES :

The objects clause and registered office clause can doubtless be altered, but is subject to a number of restrictions. These restrictions are intended to protect the interest of the shareholders, creditors of the company and also public interest.<sup>76</sup> Section 17 lays down the procedural and substantive limits on the power of alteration to the object clause and change of registered office from one State to another State, particularly in case of alteration

of objects clause. The idea is that the company is incorporated for the conditions contained in the memorandum and should not be allowed to make alteration of the objects clause a routine affairs.

#### Difference between the English and Indian Laws

Under the English Act, it is left to specified number of shareholders or debenture holders objecting to any alteration of the memorandum of association to take the initiative of making an application to the Court, whereas under the Indian Act, an application for confirmation of the alteration requires to be made by the company and be subjected to scrutiny by the Company Law Board. The alteration is not to effect until confirmed by the Company Law Board.

Further section 17 provides that a company change its objects clause or change its Registered Office only in so far the alteration is necessary for any of the purpose specified in the section.

#### SACHER COMMITTEE'S OBSERVATION AND RECOMMENDATIONS IN RESPECT OF SECTION 17 :

Section 17(1) provides for the alteration of memorandum of association of the company inter alia with respect of the objects of the company. This alteration required approval from the Company Law Board. The object clause of a company is normally drafted so broadly that little, if at all any,

objection can be raised to the change of the objects when an application is made by a company. As a matter of fact, after the commencement of the Amendment Act, 1974, the total number of applications received by the Company Law Board for changing the objects of the company as on 31st January, 1978 was 524 of which 53 were dismissed in default or non-compliance of the rules. Among the 471 effective applications considered by the Board, as many as in 298 cases alterations were allowed (either in whole or/in part) and only in 3 cases were rejected. The remaining 170 cases were pending before the Board. This clearly shows that practically no objection is raised to the alteration in the objects clause. The law is well-settled and, therefore, there does not seem to any reason to follow this detailed procedure. We, therefore, suggest that there is no necessity for making application either to the Company Law Board or to any other authority and the company can, on its own, alter the objects clause of the memorandum by passing the necessary special resolution. We would, however, suggest that in case any member or members holding not less than five percent of the total voting power of the company are aggrieved by such an alteration, such member or members should have a right to apply to the Company Law Board which shall look into the grievance,

if any, and pass such orders as it may deem fit. As a measure of protection of the shareholders, a right may also be given to the Registrar and Government of the State in which the registered office of the company is situated to move the Company Law Board. As it is, the Registrar has to be heard at present before any alteration in the memorandum is approved, and, therefore, no greater right is being given to him. Adoption of section 5 of the English Act, 1948 with necessary modification will be suitable.<sup>78</sup>

It may be submitted that, if this recommendation is implemented, it will give company's management free hand to change its objects clause at its will. The object of the existing provisions of the section 17 is to afford protection not only to the shareholders of the company but also to outsiders dealing with the company. Further this recommendation will provide a qualified right to the shareholders of the company. In fact, there is nothing new in this recommendation, the Committee simply recommends for the adoption of Section 5 of the English Companies Act, 1948 with necessary modifications.

(VII) SECTION 20 : COMPANIES NOT TO BE REGISTERED WITH UNDESIRABLE NAME :

A company is legal entity and it must have a name to establish its independent identity. Name clause in the

memorandum of association confers protection against violation of name of the company. It secures to the company De Facto monopoly of corporate trading under a particular name. Generally no company can trade with a name identical or similar to that of an existing company, or a name which in the opinion of the Central Government is undesirable. But mere similarity of name is not in itself enough to give a right to an injunction or other remedy as there is no right of property in a name. As pointed by the Court<sup>79</sup> that the law does not recognise the absolute right of a person to a particular name to the extent of entitling him to prevent the use of the name by another person. In the case of company, however, registration will be refused if there is likelihood of deception or confusion.

A name can be 'calculated to deceive' when it suggests that the corporation adopting it is in some way connected or associate with the existing corporation.

Further a company cannot adopt a name which attracts the provisions of the Names and Emblems (Prevention of Improper use) Act, 1950.

Sacher Committee's Observation and Recommendations in Report of Section : 20 -

Section 20 prohibits registration of a company under a



name considered undesirable by the Central Government or under a name identical or similar to the name of an existing company. The Department of Company Affairs has issued guiding instructions for deciding cases with regard to availability of names for registration under the Act. To obviate any substantial legislative amendment, we are of the view that statutory rules should be framed under section 642 (1) of the Act for this purpose. We, therefore, recommend that section 20 should be amended so that it empowers the Central Government to lay down the guidelines as may be prescribed. The guidelines which are currently being followed by it could then be issued as statutory rules.

**(VII-B) SECTION 31 : ALTERATION OF ARTICLES OF ASSOCIATION:**

The proviso added to sub-section (1) of section 31 by the Companies (Amendment) Act, 1960 provides that 'no alteration made in the articles under this sub-section which has effect of converting a public company into a private company, shall have effect unless such alteration has been approved by the Central Government. A copy of such alteration is also required to be filed with the Registrar within the specified time. It was held by the Court<sup>80</sup> that the notice of meeting for alteration of articles should disclose full facts and be accompanied by a copy of the proposed amendment.

Sacher Committ's Recommendation :

It has recommended that the proviso to sub-section (1) of section 31 be deleted and it be made clear that it will not be permissible for a public company to convert itself into a private company.<sup>81</sup>

(VIII) SECTION 34 : EFFECT OF REGISTRATION :

One of the essential characteristic of a company is that it is incorporated. Now the meaning of this is that it is constituted by distinct and independent person in law and is endowed with special rights and privileges. It is in point of law a person distinct from its members. This characteristic has far-reaching consequences, and offers to a company and its share holders many special advantages and privileges; in particular it enables the company to contract with its shareholders, to use a common seal, and to acquire and hold property in its corporate name.

Section 34 provides that on registration company becomes a body corporate with a perpetual succession and common seal, but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is mentioned in this Act.

The property of the company belongs to the company and not individual shareholder. It was held by the Court<sup>92</sup>

that a member of a company has no lucus standi to challenge any decree passed against the company or the execution there of unless his rights as such shareholders are affected nor can such challenge be raised by the guarantor of a loan taken by the company.

(IX) TRUE LEGAL POSITION OF COMPANY AND LIFTING OF THE CORPORATE VEIL :

As regards the true legal position of a company or corporate body and the circumstances under which its entity as a corporate body will be ignored and the corporate veil lifted, so that the individual shareholder may be treated liable for its acts, the Supreme Court<sup>83</sup> has expressed itself as follows :

"The true legal position in regard to the character of a corporation or a company which owes its incorporation to a statutory authority is not in doubt or dispute. The corporation in law is equal to a natural person and has a legal entity of its own. The entity of the corporation is entirely separate from that of its shareholders; it bears its own name and has a seal of its own; its assets are separate and distinct from those of its members; it can sue and be sued exclusively for its own purpose; its creditors cannot obtain satisfaction from the assets of its members; the liability of the members or shareholders is

limited to the capital invested by them; similarly the creditors or the members have no right to the assets of the corporation. This position is well established ever since the decision in case of *Solomon V. Solomon & Co.* 1897 A.C. 22 was pronounced in 1897 and indeed, it has always been the well recognised principle of common law. However, in the course of time, the doctrine, that a corporation or company has a legal and separate entity of its own has been subjected to certain exceptions by the application of the fiction that the veil of the corporation can be lifted and its face examined in substance. The doctrine of the lifting of the veil thus marks a change in the attitude that law had originally adopted towards the concept of the separate entity or personality of the corporation. As a result of the impact of the complexity of the economic factors, judicial decisions have sometimes recognised exceptions to the rule, about the juristic personality of the corporation. It may be that in course of time these exceptions may grow in number and to meet the requirement of different economic problems, the theory about the personality of the corporation may be confined more and more".

"The doctrine of the lifting of the veil has been applied in the words of Palmer, in five categories of cases;

where companies are in relationship of holding and subsidiary (or Sub-Subsidiary) companies where a shareholder has lost the privilege of limited liability and has become directly liable to certain creditors of the company on the ground that, with this knowledge, the company continued to carry on business six months after the number of its members was reduced below the legal minimum, in certain matters pertaining to the law of taxes, death duties and stamps, particularly where the question of the "controlling interest" is the issue in the law relating to exchange control, and in the law relating to trading with the enemy where the test of control is adopted (Palmer's Company Law, 20th Edn. page 136). In some of these cases judicial decisions have no doubt lifted the veil and considered substance of the matter."

"Gower has similarly summarised this position with the observation that in a number of important respects, the Legislature has rent the veil woven by the Solomon case. Particularly is this so, says Gower, in the sphere of taxation and in the step which have been taken towards the recognition of enterprise - entity rather than corporate entity. It is significant, however, that according to Gower the Court have only constructed statutes as 'cracking open

the corporate shell' when compelled to do so by the clear words of the statute, indeed, they have gone out of their way to avoid this construction whenever possible. Thus, at present the judicial approach in cracking open the corporate shell is somewhat cautious and circumspect. It is only where the legislative provision justifies the adoption of such a course that the veil has been lifted. In exceptional cases where the Court have felt "themselves able to ignore the corporate entity and to treat the individual shareholders as liable for its acts", the same course has been adopted. Summarising his conclusions, Gower has classified seven categories of cases where the veil of a corporate body has been lifted. But it would not be possible to evolve a rational consistent and inflexible principle which can be invoked in determining the question as to whether the veil of the corporation should be lifted or not. Broadly where fraud is intended to be prevented, or trading with enemy is sought to be defeated, the veil of corporation is lifted by judicial decision and the shareholders are held to be "person who actually work for the corporation".

In U.S.A. also the judicial review is that the Courts will be willing to lift the corporate veil where it is used "to defeat public convenience, justify wrong, protect fraud or defend crime." <sup>84</sup>

In short the Court will lift the corporate veil where it is essential to secure justice, where it is in the public interest to do so or where it is for the benefit of revenue. But it must <sup>be</sup> kept in mind that a separate legal entity is still the general rule. The corporate entity will be disregarded only in exceptional cases.

These cases may be divided in two :

- (1) Under express statutory provisions.
- (2) Under judicial interpretation, i.e. Judicial activism.

(IX-A) The following instances may be included under (1) :

- (a) Reduction of membership below the statutory Minimum : When the company carries on business for more than six months after its number of members is reduced in the case of a public company, below seven, or in the case of a private company, below two, every person who is cognizant of the fact and is a member during the time the company so carries on business after these six months, is severally liable for all the debts of the company contracted during that time and may be severally sued therefore <sup>35</sup> It may be noted that this section

enables creditors to look beyond the company ~~to~~ to its members in satisfaction of their money.

Further, it may be noted that this section does not affect private companies consisting of less than seven members becoming public companies by virtue of Section 43A. In the case of Section 43A company there is no question of the number of members being reduced below the legal minimum and this section applies only to case of public companies which originally had seven or more members but whose number became reduced subsequently.

However, recently the Supreme Court<sup>86</sup> has observed that if a private limited company having 3 members becomes a deemed public company by virtue of Section 43A and retains in its articles of association, the restrictions of Section 3 (1) (iii), it will "attract the rigour of Section 45" if it continues to function with 3 members. The Court further observed that such a company would also liable to be wound up under the provisions of Section 433 (d). It may be submitted that the learned judges seem to have proceeded on the basis that certain sections such as Sections 174 (1), 220 and 252(1) make specific exemptions in favour of Section 43A companies while this section and Section 433 (d)



do not. These observations are apparently inconsistent with what has been stated earlier at page 224, viz... the number of members of a public company cannot fall below 7 without attracting the serious consequences provided for by Section 45 (personal liability of members for the company's debts) and Section 433 (d) (winding up in case the number of its members falls below). A section 43A company can still maintain its separate corporate identity qua debts even if the number of its members is reduced below seven and is not liable to be wound up for that reason.

(b). Fraudulent Trading :

If in the course of the winding up of a company, it appears that any business of the company has been carried on with an intent to defraud creditors of the company or any other persons or for any fraudulent purpose, the court may, if it thinks it proper so to do, declare that any persons who were knowingly party to the carrying on the business in the manner aforesaid, shall be personally liable for all or any of the debts of the company without any limitation of liability.<sup>87</sup> It may be noted that this section and sections 540 and 541 are new and they deal with matters which were not covered by the Indian Companies Act, 1913 and refer to transactions which disclose frauds by officers of companies which have gone into liquidation.

The scope and import of this section, which adopts the provisions of section 332 of the English Act, 1948 corresponding to section 275 of the previous English Companies Act, 1929 are discussed in two English cases.

In the *Re William C. Leith Bros.*,<sup>88</sup> Maugham J. held that "if a company continues to carry on business and to incur debts at a time when there is, to the knowledge of the directors, no reasonable prospect of creditors ever receiving payment of those debts, it is in general a proper inference that the company is carrying on business with intent to defraud". "However, a gloss was placed on this principle by the same Judge in another case<sup>89</sup> wherein it was held that" the words 'defraud' and 'fraudulent purpose' where they appear in the section are words which cannot actual dishonesty involving, according to current notion of fair trading among commercial men, real moral blame", and the onus of proof was on those alleging fraud.

In India, the Kerala High Court<sup>90</sup> held that it is necessary to be proved under Section 542 (1) that the business was being carried on with fraudulent intent or for a fraudulent purpose and that the person or persons sought to be charged were knowingly parties to it.

(c) Misdescription of the Company's Name :

Section 147 requires that the name of the company be fully and properly mentioned on all documents issued by it. Where the name of the company is not properly indicated as required by Section 147, persons who have committed the act or made the contract shall be personally liable for it. Thus where a bill of exchange is accepted by an officer of the company and the name of the company is not properly indicated as required, the officer shall be personally liable to the holder of the bill if the company fails to pay it.

The object of insisting on the proper publication of the name of the company as detailed in the section is to make the company itself continually to bring to the notice of all those having any dealing with it the fact of its being a company with 'limited' liability.

(d) In Case of an Investigation of the Affairs of the Company :

Section 239 provides that where an inspector is appointed to investigate the affairs of a company, he shall also have the power to investigate the affairs of any other body corporate which is, or has at any relevant time been, the company's subsidiary or holding

company or a holding company or any of its subsidiary, if he thinks that it is necessary for the satisfactory completion of the task. In order to determine whether the relation of holding and subsidiary company exist it be necessary to look behind to the persons who control them. However, the separate corporate personality will be duly respected.

(e) In Case of an Investigation of the Ownership of a Company :

Where it appears to the Central Government that there is good reason to do so, it may appoint one or more inspectors to investigate and report on the membership of any company and other matters relating to the company, for the purpose of determining the true persons (a) who are or have been financially interested in the success or failure, whether real or apparent, of the company; or (b) who are or have been able to control or materially influence the policy of the company. This will be done by lifting the veil so as to ascertain the real persons controlling it.<sup>91</sup>

(IX-B) LIFTING OF VEIL-JUDICIAL INTERPRETATION-JUDICIAL ACTIVISM :

(a) For Determining the Character of the Company :

"A company may assume an enemy character when persons in de facto control of its affairs are resident in an enemy country or where residents are acting under the control of enemies."<sup>92</sup> Thus

whenever it is suspected that the company is owned or controlled by enemies, the court may lift the corporate veil and examine the characters of the persons constituting it. It becomes necessary to do so because the company can neither be loyal or disloyal, it can neither be a friend nor an enemy as it is an artificial person. It is the persons behind the corporate fiction who determine its loyalty or disloyalty, or its character. This is based on a principle that it would be against public policy to allow alien enemies to trade under the corporate facade. But a company registered in England and carrying on business in an enemy country is not necessarily an alien enemy.<sup>93</sup>

(b) In Case of Fraud or Misconduct :

The court shall also lift the corporate veil where it finds that the company has been formed to defraud creditors or to defeat the provisions of any law or to avoid any legal obligations. In short the corporate veil will be pierced where the company has been formed for any fraudulent or unlawful purpose. This was well illustrated by the case of Gilford Motor Co. V. Horne.<sup>94</sup>

In this case Horne was appointed Managing Director of Gilford Motor Co.. The appointment was made on the

condition that he would not solicit or entice away the customers of the company while in office. He, in the course of time, formed a company to carry on his own business and this company solicited the customers of Gilford Motor Co. It was held "that the company was a mere cloak or sham for the purpose of enabling the defendant to commit a breach of his promise against solicitation. In this case the evidence as to the formation of the company and as to the position of its shareholders and directors leads to that inference.

Similarly in *Jones v. Lipman*<sup>95</sup> the vendor had agreed to sell his house to a buyer. In order to avoid having to complete the sale to the buyer, he conveyed the house to the company formed for the purpose. The court ordered the vendor and the company specifically to perform the contract.

(c) For benefit of revenue or piercing the veil in Tax matters :

The court may also lift the corporate veil in the interests of revenue. The court will not hesitate to look behind the corporate facade where it is found that the company has been formed for evasion of taxes. A clear illustration is provided by the case of *In re Sir Dinshaw Maneckjee Petit*.<sup>96</sup>

In this case the assessee was enjoying a huge dividend and interest income from investments held by him. Four private companies were formed by him and each private company would transfer a part of his investments to them. However, the actual transfer was to take place only when the company called upon him to do so, something that was never done. It may also be noted that the entire issued capital of the company was held by him and his nominees, while he also held investments as a trustee of the company.

Later, as soon as the interest and dividends were received, the amount was credited to the company, and on the same day was withdrawn as a loan from the company to the assessee; this was never paid back by him. In this way, the income of the assessee was divided into four companies and his tax liability was henceforth reduced. The court held that the company was, in fact, not carrying on any business. It was being used as a tool to reduce Petit's tax liability. Company and assessee were held to be one and the same. However, the court may refuse to identify the shareholders with the company if this results in loss of revenue to the Government or if it is not beneficial for the revenue of the State.<sup>97</sup>

In applying the principle to matters of assessment to income-tax, the Supreme Court<sup>98</sup> has thus observed in a recent case, "The income tax authority are entitled to

pierce the veil of corporate entity and to look at the reality of the transaction. It is true that from the juristic point of view the company is a legal personality entirely distinct from its members and the company is capable of enjoying rights and being subjected to duties, which are not the same as those enjoyed or borne by its members. But in exceptional cases the Court is entitled to lift the veil of corporate entity and to pay regard to the economic realities behind the legal facade". The corporate entity will be disregarded if it is used for tax evasion or to circumvent tax obligation. However in another case the Supreme Court<sup>96</sup> refused to lift the veil in the case of a company whose share capital was owned entirely by the Government of India and held that the company was a distinct legal entity and that the land and buildings owned by the company were the property of the company, not of the Government of India. The company, therefore, could not escape liability to pay property tax under a statute which exempted 'buildings and lands owned by or vesting in the Union Government', from such tax.

(IC-C) PIERCING THE VEIL IN HOLDING SUBSIDIARY RELATIONSHIP:

The principle of lifting or piercing the veil is also applicable to cases of holding-subsidary relationships, where in spite of their being separate legal personalities, the facts and circumstances show that they are in



reality parts of one concern, owned by a parent company or a group as a whole. Section 212 of the Indian Companies Act, 1956 also provide group accounts. It provides that there shall be attached to the balance sheet, profit and loss account directors' report and auditors' report of each subsidiary, and a statement of the holding company's interest in every such subsidiary. Sections 150, 151, 152 and Schedule VIII, para 15(4) and (5) of the English Act also provides the same thing.

Inspite of the rigid rule in *Solomon V. Solomon & Co.*<sup>100</sup> as regards the independent corporate existence of a company, the courts especially in U.S.A. have developed a body of law governing the instances in which the corporateness of companies as separate legal entity may be disregarded.

Where the corporate formalities are not substantially observed the broader business entity comprising the holding company and subsidiary as a whole may be held liable for the debts and other liabilities of either or both of them under following circumstances :

- (a) Where the business affairs of both the parent company and the subsidiary are intertwined and the business transactions, property, bank and other accounts, employees, management etc. are intermingled.

- (b) Where the subsidiary is inadequately financed as a separate business as regards meeting its normal obligations.
- (c) Where the parent company and the subsidiary are operating portions of a single business and financing as well as managerial activities come from the holding or parent company.
- (d) Where the enterprises of both the companies are not held out to the public as separate.
- (e) Where the subsidiary is being operated in an 'unfair' manner i.e. not in its interest of primarily but in the interest of the parent company so as to funnel its profits to that company.

Failure to delineate between the operation of both may mislead the creditors and the public into believing that they are dealing with the broader corporate entity and not with the subsidiary as a separate business. Where the subsidiary, being under-capitalised, is operating only some portions of the business of the parent or holding company, there is no reason why it is not to be treated so far as the liabilities incurred by it are concerned, as an agent of the parent company.

Such is the law in U.S.A. There is no reason why the same principles should not be applied to holding subsidiary relationship in this country. Where the separate corporate entity of subsidiary is put to improper use, such as to defraud creditors, or evade the law or escape any legal obligation, there is no reason why for achieving the ends of justice the Courts in this country should not disregard the separate corporate entity of subsidiary and make the larger business entity comprising the parent company, and the subsidiary or subsidiaries as single business entity answerable for all the obligations of the group as a whole. As Sanborn J. of the Supreme Court of the U.S.A. stated " Where the nation of legal entity is used to defeat public convenience, justify, wrong, protect fraud or defend crime, the law will disregard the corporate entity and treat it as an association of persons".<sup>102</sup>

Even in England the application of the rigid rule in Solomon's case has been departed for in several cases where the circumstances showed that the company were mere facade concealing the true facts. It was observed<sup>103</sup> "that tendency of the Courts is to recognise 'entity' rather than 'corporate entity' and readily lift the veil where fraud or improper conduct is involved."<sup>104</sup> The modern tendency is that in the case of groups of companies in the group, especially where

they are related as holding company and wholly owned subsidiary or subsidiaries, to ignore their separate legal entity and look instead at the economic entity of the whole group.<sup>105</sup>

In the case of I.C.I. v. E.C. Commission, the European Court of Justice observed as followed :

The fact that the subsidiary has a distinct legal personality does not suffice to dispose of the possibility that its behaviour might be imputed to the parent company. Such may be the case in particular when the subsidiary, although being a distinct legal personality, does not determine its behaviour on the market in an autonomous manner but essentially carries out the instructions given to it by the parent company. When the subsidiary does not enjoy any real autonomy in the determination of its course of action on the market, the prohibition, imposed by Article 85 (1) may be considered inapplicable in the relations between the subsidiary and the parent company with which it then forms one economic unit. In view of the unity of the group thus formed, the activities of the subsidiaries may, in certain circumstances, be imputed to the parent company.

In these circumstances, the formal separation between these companies arising from their distinct legal personality, cannot, for the purpose of application of the competition rules, prevail against the unity of their behaviour on

the market. Thus it is indeed the applicant (I.C.I. which was the holding company) which carried out the concerted practice within the Common Market.

On the whole, as regards the holding company- subsidiary relationship, the true legal position is that, though according to the trend of decision of English Courts (our Supreme Court and High Courts generally follow them), the rule in Solomon's case is not departed from except in special circumstances, there is no reason why Courts in this country should worship at its altar and not take to the more vindicable course followed by the courts in U.S.A., of disregarding the operative veil, when-ever necessary to achieve a just and equitable result".

(X) DEFINITION OF 'MEMBER': Section 41 (2) :

Sub-Section (2) of Section 42 provides that 'every person who agree in writing to become a member of a company and whose name is entered in its register of members, shall be a member of the company'.

The words 'in writing' have been added by the Company (Amendment) Act, 1960. While making recommendation the Companies Amendment Committee observed that "it has been brought to our notice that in some cases on the verge of liquidation entries are made in the register

of the names of person who have never applied for shares, in order to fasten liability on these persons as contributors. To avoid this contingency, we suggest the addition of the words, 'in writing' after the word 'agree' in Section 41 (2)<sup>106</sup>

This amendment has its own significance from the point of view of public interest. Henceforth, no one can become a member of a company, unless he has agreed in writing to become a member. An agreement to become a member can no longer be inferred or implied from conduct. Under the English Law no such writing is required.

Convertible Debenture and Section 41 (2) :

The companies have been issuing debentures with a conversion clause, the company being under an obligation to issue fully paid equity shares for part of that amount with the condition that without any further act or application by the debenture holder the company is obliged to issue and allot such shares to the debenture holder. It is also stated in the application form for issue of debentures that the applicant agrees to accept the debentures applied for and such other number as may be allotted to him subject to the terms of the conversion. But the terms of conversion would in effect seek to override the provisions of Section 41 (2), unless there is adequate compliance with

Sub-Section (2) of Section 41, there would be an irregularity committed by the company in allotting equity shares under the conversion clause without any further act or application by the debenture holders. The requirement of Sub-Section (2) must also be fulfilled in cases of conversion in pursuance to the conversion clause in the debenture. When the company implements its obligation to allot shares under the prospectus and the application for allotment of debentures authorising the company ~~the company~~ also contains ~~no~~ recitals, it may serve as an agreement in writing by the holder to become a shareholder on allotment of shares otherwise the allotment may be challenged as contrary to the terms of Section 41(2).

In one of the case the Madras High Court<sup>107</sup> observed that "the provisions of the Companies Act no where provide that there must be a written application for allotment of shares and, therefore, there can be an oral application for the purpose and an allotment made on the basis of an oral application" apparently has not taken note of the words 'in writing' inserted by the Companies (Amendment) Act, 1960.

(XI) CONVERSION OF A PRIVATE COMPANY INTO PUBLIC COMPANY DEEMED PUBLIC COMPANY (Section 43 A) :

Section 43A is a new section inserted by the Companies (Amendment) Act, 1960 with an object that "private

companies, which employ public money to an appreciable extent, should be subject to the same restrictions and limitations as to disclosure and otherwise, as apply to public companies".

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The Companies Act Amendment Committee stated that "private companies are exempted from the operation of several sections of the Act and enjoy certain privileges, principally on the ground that they are family concerns in which public is not directly interested. It is however, well known that there are many private companies with large capital doing extensive business and controlling a number of public companies. This is made possible because of funds of other companies, public or private, are invested in such private companies. As public money invested in such companies, there is no reason for treating such companies as private companies. The problem of private companies has always been somewhat difficult. On the otherhand, there are genuine private companies which are nothing but glorified partnerships and on the other, there are private companies whose operations, financial and industrial, are far wider than those of many public companies. To meet this problem, the Cohen Committee created the category of exempted private companies but the relevant provisions in the English Act are very complicated. It was strongly urged upon us that the several exemptions granted



to and the privileges enjoyed by private companies should be withdrawn, as they are abused. But to withdraw them from all private companies may cause hardship to genuine private companies. At the same time, there is no doubt that private companies, which employ public money directly or indirectly to a considerable extent, should be subject to the same restrictions and limitations as to disclosures and otherwise as apply to public companies. This section was once again amended and Sub-Sections (1-A), (1-B) clause (c) of Sub-Section (8), Sub-Section (9) and the explanation at the end have been added by the Companies (Amendment) Act, 1974.

The Sacher Committee has made several recommendations in respect of Sections 43A and Section 31.<sup>109</sup>

(XII) MATTERS TO BE STATED AND REPORTS TO BE SET OUT IN PROSPECTUS (Section 56) :

This section provides that 'every prospectus issued by or on behalf of a company, or by or on behalf of any person who is or has been engaged or interested in the formation of a company shall state the matters specified in Part I of Schedule II and set out the reports specified in Part II of that Schedule; and the said Parts I and II shall have effect subject to the provisions contained in Part III of that Schedule. This section provides for the disclosures

of certain matters for the benefit of the prospective investors and other persons dealing with the company.

(XIII) EXPERT'S CONSENT TO ISSUE OF PROSPECTUS CONTAINING STATEMENT BY HIM (Section 58)

This section adopted from Section 40 of the English Act, 1948 enacts "a wholesome rule intended to protect the interest of an intending investors by making the experts a party to the issue of the prospectus and making him liable for untrue statement. However, by consenting to the issue of prospectus the expert does not undertake liability in respect of anything in the prospectus except his own statement."<sup>110</sup>

(XIV) PROVISIONS RELATING TO DEPOSITS

(A) DEPOSITS NOT TO BE INVITED WITHOUT ISSUING AN ADVERTISEMENT (Section X 58-A)

(B) PROVISIONS RELATING TO PROSPECTUS TO APPLY TO ADVERTISEMENT (Section 58-B)

These two sections are new and added by the Companies (Amendment) Act, 1974.

The object of these two provisions is to control the companies inviting deposits from the public and make it obligatory for such company to disclose its financial position and other matters to the public.

(XV) REGISTRATION OF PROSPECTUS (Section 60)

Section 60 provides for the registration of prospectus. It provides that a copy of every prospectus must be signed by every director or proposed director and filed with the Registrar of Companies for registration before it is issued to the public.

The objects of this section are (a) to keep an authentic record of the issue of prospectus, and (b) to pinpoint the responsibility for the mis-statement made in the prospectus.

Sub-Section (4) prohibits the issue of a prospectus more than 90 days after it had been filed with the Registrar. The English Act contains no such restriction. The reason for this provision is that 'If the Issue is too long delayed, conditions may alter and what appears in the prospectus when registered may no longer be valid at the end of such a long period.'

(XVI) PENALTY FOR FRAUDULENTLY INDUCING PERSONS TO INVEST MONEY (Section 68) :

This section corresponds to Section 12 of the British Prevention of Fraud (Investment) Act, 1939, now section 13 of the Prevention of Fraud (Investment) Act, 1958 which provides that any person who, by any promise or forecast

which he knows to be misleading, false or deceptive or by any dishonest concealment of material facts, or by the reckless making (dishonestly or otherwise) of any statement, promise or forecast which is misleading, false or deceptive, induces or attempts to induce another persons to enter into any agreement for acquiring, disposing, subscribing or underwriting any securities or speculating in them or in other property. is guilty of an offence and liable to imprisonment for seven years". This section is expected to serve 'as a sufficient deterrent to unscrupulous company promoters against making untrue and deceptive statement in prospectus with a view of obtaining capital from the public.

The punishment prescribed under Section 68 is imprisonment for a term which may extend to five years, or with fine which may extend to ten thousand rupees or with both, whereas English Act provides for imprisonment for seven years.

(XVII) PERSONATION FOR ACQUISITION OR SUBSCRIBING ETC.  
OF SHARES (Section 68 A) :

This section makes it an offence to make applications for shares in the name of or induce the allotment of shares to fictitious persons. Under this section a person who has subscribed shares in a fictitious name or has induced company to allot shares in a fictitious name

can also be held liable for an imprisonment upto the term of five years. It may be noted that punishment to the guilty person is certainly a potent protection to the public but is a poor consolation to the individual investor who has been cheated.

This section is new and added by the Companies (Amendment) Act, 1965 on the recommendation of Vivian Bose Commission/Daphatry Sastri Committee.

The Vivian Bose Commission said "that an instance came to the notice of the commission where shares of a public company to the extent of Rupees 16 lakhs were applied for, on behalf of 114 non-existing shareholders. Although, it cannot be stated that this practice is of wide spread usage, still any instance of such practice should be dealt with severly . . ."

After examining several alternative the Commission recommended that :

- (i) A provision should be made in the Companies Act, whereby any person who, either makes an application to the Company to allot or transfer its shares in the names of fictitious or non-existent person, shall be punishable with imprisonment which may extend to five years.

(ii) The penal provision suggested in item (i)

above shall be inserted at a prominent place

(a) in every prospectus issued by a company;

and

(b) in every form of application for shares that is issued to any person".<sup>11</sup>

Daphtary-Sastr Committee observed<sup>12</sup> that "bennami shareholding and shareholding in the names of fictitious or non-existing persons are common. The object is to avoid tax and defraud the revenue in cases where the super-tax limit is reached, and recommended that a provision should be made in the Companies Act making it a punishable offence for a person to apply for or get an allotment of shares or get a transfer of shares registered in the names of fictitious or non-existing persons or benamidars and clause to this effect should be inserted in every prospectus issued by the company and applications for shares or registration of transfer of shares.

(XVIII) STATUTORY RESTRICTIONS ON ALLOTMENT OF SHARES (Sections 69 to 75) :

According to Law of Contracts, allotment of shares amounts to an acceptance of a proposal of the investors to purchase the shares or debentures of the company, and being a contract it will be subjects to all the provisions of the

Indian Contract Act, 1872. In addition to the provisions of the Indian Contract Act, the Indian Companies Act, 1956 also lays down certain restrictions on the powers of the company to allot shares or debentures. These restrictions are laid down under sections 69 to 75 of the Act.

(a) Prohibition of Allotment unless Minimum Subscription is received (Section 69) :

This section lays down very important condition in respect of allotment of shares by the company. It provides that 'no allotment shall be made of any share capital offered to the public for subscription unless the amount stated in the prospectus as the minimum amount which must be raised by the issue of shares capital in order to provide for the matters specified in clause 5 of Schedule II has been 1/4 subscribed, and the sum payable on application for the amount so stated has been paid to and received by the company, whether in cash or by a cheque or other instrument which has been paid.'

It may be noted that the conditions laid down in this section apply only to share and not to debentures. The purpose of these provisions is to curtail the promotion of under capitalised companies.

Here attention may be drawn to the Circular letter of Ministry of Finance, Department of Economic Affairs<sup>13</sup>

on the subject of allotment of shares in the event of over-subscription of public issues.

According to the circular in the event of over-subscription of public issues, especially where the issues are heavily over subscribed, the scheme of allotment should be framed in such a manner that the interests of the genuine small investors are promoted and widest possible dispersal of the shareholding takes place. It has, therefore, been decided that in the event of over-subscription of a public issue offer for sale intended for the listing of the shares on the stock exchange, the scheme of allotment is inter alia settled by the stock exchange in the following manner:

- (a) The allotment is predominantly in favour of the applicants in the lower categories of 50 to 200 shares of the face value of Rs. 10 each. The allotment by drawal of lots, wherever necessary, should begin with 25 shares and should be increased progressively in multiple thereof. It should be the endeavour to have about 200 shareholders for every Rs. 1 lakh of share capital issued/offered for sale especially in the event of issues over-subscribed by more than 10 times.
- (b) The allotment per applicant does not in any event exceed 500 shares of the face value of Rs. 10 each.



In cases of excessively heavy oversubscription say issues over subscribed by more than 20 times, the ceiling could even be reduced to 250 shares per applicant.

- (c) It further provided, that if, for any reason, allotment of more than 500 shares per applicant becomes unavoidable, the prior approval of the Government in this department should be obtained for the scheme of allotment.

Public interest require that small investors should be encouraged to invest their saving in shares of the companies and at the same time it also requires that the investors indulging into gambling and other transactions in respect of shares should be stopped. The purpose of the above circular is to have widest dispersal of shareholdings in joint stock companies.

- (b) Prohibition of Allotment in certain cases unless statement in lieu of prospectus delivered to Registrar (Section 70) :

It may be stated that a public company may invite the general public to subscribe to capital of the company, and for this purpose it must issue a prospectus. However, if the promoters are confident of raising the required capital from relatives and friends, it need not issue a

prospectus in such a case a statement in lieu of prospectus may be filed with the Registrar of Companies. In this connection ~~the~~ section 70 provides that a company with share capital, which does not issue a prospectus of which has issued such a prospectus but has not proceeded to allot any of the shares offered to the public for subscription shall not allot any of its shares or debentures unless, at least three days before the first allotment of either shares or debentures, there have been delivered to the Registrar for registration a statement in lieu of prospectus. It shall contain the particulars set out in Schedule III.

The object of this section is <sup>to</sup> preserve an authoritative record of terms and conditions of issues of shares or debentures. The provisions of this section is applicable to both issue of shares and debentures where the provisions of section 69 is applicable to shares only. A private company is neither required to issue a prospectus nor to file a statement in lieu of prospectus.

An allotment made by a company to an applicant in contravention of the provisions of sections 69 or 70 will be irregular allotment. An irregular allotment is voidable at the option of the applicant within two months (under the previous Act it was one month) of the statutory meeting of the company or in any case where the company is not

required to hold a statutory meeting or where the allotment is made after holding such a meeting, within two months of the date of the allotment.<sup>14</sup>

The allotment shall be void, notwithstanding that the company is in the course of being wound-up.<sup>15</sup> It was held<sup>16</sup> that the allottee must inform the company that he avoids the allotment within two months. It is not necessary that the allottee should commence legal proceedings within the said period provided he has given notice of avoidance within two months. But legal proceedings should be reasonably prompt thereafter if they are to be brought. In another case<sup>17</sup> it was held that 'unless the allotment is ab initio void, where an allottee wants to avoid an irregular allotment, he must do so in the manner and within the time limit provided by this section. If he does not take any steps in time and waits and after the expiry of time when winding up proceedings against the company are taken, he applies under this section or applies to the Court for rectification of the Register under Section 155, the Court will not exercise its discretion in his favour.'.

(c) Irregular allotment and Rectification :

In one of the case<sup>18</sup> it was held that an irregular allotment of shares made by the directors in excess of their powers may be subsequently rectified by the shareholders at a general meeting.

It may be stated that this section applies only in the case of applicants i.e. those who have made applications for share. It does not effect the position of those to whom shares have been allotted surrepticiously or without their applying for them. For in such case any allotment made will be ab initio void, as there is no power to allot shares to persons who have not applied thereof. An agreement in writing is necessary for any person becoming a member of <sup>a</sup> company<sup>19</sup>.

Further no allotment shall be made of any shares in or debentures of a company in pursuance of a prospectus issued generally, and no proceedings shall be taken on application made in pursuance of a prospectus so issued, untill the beginning of the fifth day after that on which the prospectus is first issued or such later time, if any, as may be specified in the prospectus.<sup>120</sup> The object of this provision is to give applicant sufficient time to study the prospectus and to withdraw their offer to subscribe for shares or debentures in case they are not satisfied with the prospectus.

The purpose underlying this section is thus explained by the Company Law Committee :

"Under the existing law, a company is not required to keep its subscription list open for any period. An applicant for shares is also at liberty to withdraw his application

before the allotment is made. The state of law has set in motion two unhealthy tendencies to which our attention has been called by certain witnesses. It has been pointed out that in some cases the subscription list is closed on the very day it is open; consequently the public have no time to digest the contents of the prospectus, much the less to obtain independent advice, such precipitate action is evidently not in accord with the intentions of the Legislature which by prescribing detailed particulars to be inserted in a prospectus, must be presumed to have expected the intending investor to consider the informations contained in it before he risked his money in the particular venture. Further a class of persons, colloquially known as 'stage' in the investment world, has arisen who prefer to make applications on a large scale with a view of reaping quick profit on resale at a premium while the going is good, but who would be quick to withdraw the applications of the slightest prospect on the issue being found unpopular. Both these tendencies to ~~the~~ which the Cohen Committee has also drawn attention in paragraph 19 & 20 of its Report are attributable to the present unsatisfactory state of the law and call for some action. A remedy is provided by the new section 50 of the English Act under which the subscription list is to be kept open for three days after publication of the prospectus. Having regard to distances in this

country in the section proposed by us, we have increased this period to five days. In the English section, a provision has been made preventing applicants from withdrawing their applications unless any person who is a party to the issue of the prospectus, e.g. an expert has withdrawn his consent by advertisement as provided by section 43 of the English Act, which corresponds to the proposed section 97 and item 20 of the Addendum to the Annexure of our Report. We have retained this provision in the section proposed by us. We have, however, suggested as addition to Sub-Section (7) to the effect that the closing of the subscription list should be announced by the company and that the allotment should be made and the notice of allotment given not later than the tenth day after such closing. This additions appears to us desirable.<sup>121</sup>

As per notification<sup>122</sup> subscription list should be kept open for a maximum period of 21 days from the date of opening in case where the public issues are not underwritten by the public financial institutions.

(d) Allotment of Shares and Debentures to be Dealt with on Stock Exchange (Section 73) :

Section 73 lays down specific provisions for allotment of shares and debentures to be dealt with on stock exchange. It provides that where a prospectus states that an application

has been made or will be made for permission of share or debentures offered thereby to be dealt in one or more recognised stock exchange, such prospectus shall state the name of the stock-exchanges or, as the case may be, each such stock exchange. It further provides that any allotment made on an application in pursuance of such a prospectus shall be void if the permission has not been applied for before the tenth day after the issue of the prospectus or where such permission has been applied for before that day, if the permission has not been granted before the expiry of ten weeks from the date of the closing of subscription lists.

This section is based on section 51 to the English Act and incorporated on the recommendation of the Company Law Committee<sup>123</sup> which observed that "it is usual for a company to state prominently on the face of the prospectus that an application has been made or will be made to a stock exchange for quotation of the shares or debentures offered by subscription. The object underlying this statement is to give an assurance to the intending investor that the share will become marketable and to induce him to subscribe. Our attention has been drawn to the facts that in many cases in spite of this statement contained in the prospectus the necessary permission is not sought or sought only after

considerable delay. ... We have tried to follow section 51 of the English Act, ... where the permission has been refused the company has to repay the moneys to the applicants."

It may be submitted that the provision that even if one stock exchange does not grant listing or refuse listing, the subscription received should be refunded, is too onerous a responsibility and may result in dissuading public companies from getting listed in more than one stock exchange.

(e) Return as to Allotment (Section 75) :

Whenever a company with a share capital makes any allotment of its shares, it must, within thirty days thereafter, file with the Registrar a return, known as 'return as to allotment'. It must contain the matters specified in the section.

(XIX) RESTRICTION ON PURCHASE BY COMPANY, OR LOANS BY COMPANY FOR PURCHASE OF ITS OWN OR ITS HOLDING COMPANY'S SHARES (Section 77) :

As per the provisions of section 77, no company having share capital can buy its own shares unless (a) the consequent reduction of capital is effected and sanctioned in accordance with provisions of sections 100 to 104 or (b) where the Court makes an order for the purchase of its own shares by the company under section 402 for prevention



of oppression or mismanagement. Similarly no public company or private company which is a subsidiary of a public company can give financial assistance in the form of loan or guarantee or provision of security to any person for the purchase of its own share or the shares of its holding company except, in the cases exempted from the purview of the section.

The reason for this restriction is that such purchase either amounts to 'trafficking' in its own shares thereby enabling the company, in an unhealthy manner, to influence the price of its own shares in the market, or it operates as a reduction of authorised capital which can only be affected with the sanction of the Court, and in the manner laid down under section 100 to 102.<sup>24</sup>

Further restriction as regards financing the acquisition of a company's own shares is to prevent improper use of its assets by speculators in management of a company, who, by such acquisition may seek to obtain control of the Company for their own advantage.

It may be noted that the section does not apply to the case of any holding company purchasing the shares of or lending money to any person for purchasing shares of its subsidiaries.

Although a company cannot purchase or holds it own shares, a bequest of his shares by a shareholder to the company is not illegal. The company may have the shares transferred to a nominee in trust for itself, the nominee being a person qualified to hold shares under the company's Articles of Association.<sup>125</sup>

It may be noted that what sub-Section (1) prohibits is the buying of its own shares by a company. It does not prohibit the receiving by way of gift, or surrender, if any, of such shares. But while holding of its own shares by a company, in whatever manner acquired, will have the effect of a reduction of capital, the holding of them by a nominee or trustee will not have that effect, though the nominee or trustee will be obliged to vote as the company may, from time to time, direct.<sup>126</sup>

(XX) REDUCTION OF CAPITAL (Sections 100 to 104)

It may be stated that the issued capital represents a fund available to meet the debts and obligations of the company. Companies do not generally call the full value of shares at one time. The uncalled capital acts as a future security for the company's creditors. Therefore, any reduction of capital, called up or uncalled reduces the security of the creditors. It is for exactly these reasons

that a company is not allowed to buy its own shares as this would amount to reduction of capital. Similarly there are a number of restrictions on the power of the company to forfeit shares or to accept surrender of shares, as this would also reduce its capital. Thus all safeguards have been provided for in the Companies Act to conserve the capital of a company. However in genuine cases a company limited by shares or a guarantee company with a share capital is permitted to reduce its capital by section 100 of the Act. In order to reduce capital the company is required to follow procedures laid down under the other sections of the Act, particularly section 100 to 104 of the Act. The object of all these provisions is to protect the interest of the shareholders and the creditors of the company. As per section 100 the company is required to pass special resolution at the meeting of the company, under section 101 an application is required to be made to the court for confirmation of reduction of capital, section 102 lays down the power of the court and it also lays down duty of disclosure, under section 103 the order of the court and minute are required to be registered with the Registrar of companies and section 104 lays down the liability of members in respect of reduced shares.

(XXI) TRANSFER OF SHARES IN OR DEBENTURE OF THE COMPANY NOT TO BE REGISTERED EXCEPT ON PRODUCTION OF INSTRUMENT OF TRANSFER (Section 108 (1-A), (1-B), (1-C), & (1-D)).

Sub-Sections (1-A), (1-B), (1-C) and (1-D) were inserted by section 13 of the companies (Amendment) Act, of 1965, but again, Sub-Section (1-A), (1-B) and (1-C) were amended in their present form by the companies (Amendment) Act of 1966 with provisions that they shall be deemed to have come into effect on 1st April, 1966.

Sub-Section (1-A) seek to impose restriction on the period of currency of blank transfer form on the lines of recommendation in para 19 of the Commission's report. The restrictions imposed by this sub-Section are :

- (a) that every instrument of transfer shall be in the prescribed form (Form No. 7-B given in Appendix I) bearing the date of issue stamped by the prescribed authority, and
- (b) that the said instrument is required to be delivered to the company (i) in the case of shares dealt or quoted on a recognised stock exchange, at any time before the date on which the register of members is closed, in accordance with law, for the first time after the date of presentation of

the prescribed form to the prescribed authority under clause (a) or within two months from the date of such presentation, whichever is later; (ii) in any other case, within two months from the date of such presentation. These restrictions are designed to curb the abuse inherent in the system of blank transfer. However, the above time limits shall not apply to any shares held or deposited in any body corporate etc. as specified in Sub-Section (1-C) or Section 108.

Sub-Section (1-D) empowers the Central Government to extend, on an application made to it in that behalf, the period mentioned above by such further time as it may deem fit in order to avoid hardship in any particular case.

Amendment Act of 1965 -

As soon as the new provisions came into operation, question arose as to whether the effect of these new provisions was only to regulate and control the currency of blank transfer of shares or to prohibit them altogether. As views were divergent on this point, it was thought that in order to maintain the smooth functioning of the stock exchange and capital market it should be made clear that the object underlying the new provisions was not to prohibit blank transfer altogether but only to restrict their currency.

- (a) The System of Blank Transfer - A Legislative Attempt to Control it (Sub-Section (1-A), (1-B), (1-C), and (1-D) of Section 108 :

What is blank transfer? It means to transfer the document without writing the name of the buyer. Usually in the case of blank transfer the seller only fill in his name and signature. Neither the buyer's name and signature nor the date of sale are filled in, in the transfer form. The advantage of this system is that the buyer will be at liberty to sell and transfer it again without filling his name or signature to a subsequent buyer, thereby he can avoid the payment for the transfer stamp and new deed of transfer in favour of the buyer. The process of purchase and sale can be repeated any number of times with the blank deed and ultimately when it reaches the hands of one who wants to retain the shares he can fill in his name and date and get it registered in the company's book. For this ultimate transfer and registration, the first seller will be treated as the transferor or even if it happens years after his death.<sup>127</sup>

Blank transfers are common, not only in cases of sale of shares but also where shares are offered as security by way of mortgage and otherwise. The important features of a blank transfer is that the transfer instrument is signed only by the transferor, neither the transferee's name

and signature, nor the date of sale are filled, in the transfer form, and then delivered to the transferee along with the certificate of the shares so that the transferee or any other person to whom it has been transferred, may complete the instrument by putting his name and signature and lodge them with the company for registration of the shares in his name in the register of members. The advantage of this system is that it saves the trouble of complying with the formalities of transfer every time and it also saves the payment of stamp duty on each successive transfer.

Validity of Blank transfer :

The blank transfer is one of the recognised mode of transferring documents from one person to another. The object of the new Sub-Sections of section 108 is to control and regulate the currency of blank transfer and not to prohibit blank transfer altogether. The Supreme Court,<sup>28</sup> recognised the validity of 'blank transfer' where the name of transferor is entered and the transferor, signs the transfer with the share scrip annexed, and hands it over to the transferee who, if he chooses, may complete the transfer by entering his name and then apply to the company to register his name in the place of that of the transferor.

(b) The Position of Transferee in the Case of Blank Transfer :

A transfer in blank, when accompanied by the share certificate or scrip carries, to the transferee both the legal and equitable right in the shares and also the right to call upon the company to register the transfer. In the words of Lord Watson, "the person to whom it i.e. the blank transfer along with the certificate is delivered, can effectually transfer his interest by handing his certificate to another, and the document may thus pass from hand to hand until it comes into the possession of a holder who thinks fit to insert his own name as transferee, and to present the document to the company for the purpose of having his name entered in the register of shareholders and obtaining a new certificate in his own favour."<sup>129</sup> It is to be noted, in order to complete the blank transfer, the share certificate should also be delivered along with the blank transfer.

The question, whether a blank transfer can be completed by the transferee by inserting his name and signature and presented to the company for registration after the death of the transferor recently arose in an appeal before the Company Law Board under section 111 of the Act<sup>130</sup> and Mr. P.B. Menon of the Board following the decision in Bengal



Silk Mills Ltd.<sup>131</sup> has "correctly expressed the view that a blank transfer instrument can be completed by filling the name and signature of the transferee even after the death of the transferor, and the company cannot refuse to register the transfer on the ground that the signing by the transferee after the death of the transferor would not be valid." In another case<sup>132</sup> it was held that "where shares in blank transfer forms signed by the transferor are gifted to a donee and the share certificate relating thereto are also handed over along with it, the transfer will be completed on the signing the Form as transferee; and the death of the transferor subsequent to his signing and handing over the blank transfer form and the share certificate will not affect its validity".

A transfer, when accepted, relates back to the date of execution of the instrument.<sup>133</sup>

Where shares are transferred whether under a regular or in blank transfer form, but the transfer is not registered either because the company has refused to register or the transfer deed has not yet been delivered to it, the rights of the transferor and transferee in respect of the shares are thus summarised by the Supreme Court.<sup>134</sup>

"that the transferee of shares transferred by way of blank transfer has not the benefit

of a legal title until his name is entered in the register of members, although the completion of the transaction by having the name entered in the register of members relates back to the time when the transfer is made. During the period that the transfer exists between transferor and transferee without emerging as a binding document upon the company, equities exist between them, but not between the transferee and the company. The transferee can call upon the transferor to attend the meeting, vote according to his directions, sign documents in relation to the issuance of fresh capital, call for emergent meetings and inter alia also compel the transferor to pay such dividend he may have received. But these rights, though they, no doubt, cloth the transferee with an equitable ownership, are not sufficient to make the transferee a full owner, since the legal interest vis-a-vis the company still outstands in the name of the transferor and also calls upon him to make payment of any unpaid, capital, which in a company under the blank transfer and in whose name the shares have not been registered in the books of the company is not a 'shareholders' in respect of such shares within the meaning of Sec. 18 (5) of the Income Tax Act, notwithstanding his equitable right to the dividend on such shares."

(c) Transfer of Shares and Foreign Exchange Regulation Act, 1973

Before any transfer of shares by or in favour of non-resident is considered, it is necessary to see whether it contravenes any provision of the Foreign Exchange Regulation Act, 1973. In particular, it must be noted that no transfer of shares can be made or registered in favour of a person not resident in India, unless Reserve Bank permission has been obtained (Section 19 (1) and (4) of the Foreign Exchange Regulation Act, 1973) And as per Sub-Section (5) no transfer by a non-resident to a resident or non resident can be valid, unless the transfer is confirmed by the Reserve Bank or exempted by the Central Government.

(XXII) RESTRICTION ON THE ACQUISITION OF SHARES  
(Section 108 A)

Section 108 A provides that except with the previous approval of the Central Government, no individual, group, constituent of a group, firm, body corporate, or bodies corporate under the same management, shall jointly or severally acquire or agree to acquire, any equity share in a public company or in a subsidiary thereof, if the total holdings exceed, because of these acquisitions, by more than twenty five percent of the paid up equity share

capital of such a company.

Object of the section :

This section is intended to meet the cases of 'take over' bids by group of companies. Such a take overs are apt to adversely affect the interest of non-controlling shareholders, particularly public financial institutions who are kept in the dark while secret negotiations are entered into with those having control of a company. The former are deprived of the opportunity of having any share in a bargain that may prove profitable and are forced to continue with their shares in the company while management passes into unknown or undesirable hands. Stock exchanges have complained about the inadequacy of the existing provisions to prevent such anonymous and clandestine take over. Suggestions have been received from other knowledgeable quarters as to the need for urgent action to prevent or regulate such a take overs. It is therefore, proposed to provide for the requirement of Governmental approval before completion of any take over either in one transaction or a series of transactions resulting in the acquisition of shareholding in the aggregate of over twenty-five per cent by a "group" or combine having the common intention of acquiring control over the company concerned. The proposed restrictions will apply to companies having total

paid up capital of not less than Rs. 25 lakhs and private companies which are subsidiaries of such public companies (clause 10).

It may be mentioned that the Sacher Committee has recommended transfer of this section to Monopolies and Restrictive Trade Practices Act.<sup>135</sup>

(XXIII) TRANSFER AND TRANSMISSION OF SHARE-REFUSAL TO REGISTER A TRANSFER (Section 111 (5-A)):

Although the right to transfer shares is a statutory right confirmed by section 82 of the Act, yet it is common for articles to provide that director shall have power to refuse to register a transfer on reasonable ground. The directors in exercising their discretion while refusing to register a transfer are not bound to give reasons for their refusal. However, under Sub-Section (5-A) as amended by the Companies (Amendment) Act, 1967 the Central Government may require the company to disclose to it the reasons for such refusal and, on the failure or refusal of the company to disclose such reasons, the Central Government may presume that the disclosure, if made, would be unfavourable to the company. The Central Government may either reverse the decision of the company or confirm it.

In case of private company, the very definition of private company<sup>36</sup> requires that it should, by its articles, restrict the transfer of its shares, and its total number is also limited. Under the circumstances a very wide discretion is vested in the directors.<sup>37</sup>

In addition to this section, section 155 of the Act confirms right on the members of the company to apply for the rectification of the register of members.

(XXIV) DECLARATION AS TO SHARE AND DEBENTURES HELD IN TRUST :

Section 153 B provides that where any shares in or debentures of a company are held in trust by any person. i.e. trustee, the trustee shall within a specified time make a declaration to the public trustee.

As regards the object and scope of these sections, i.e. section 153 A and 153 B and of section 187A, the following extract from the Finance Minister's statement at various stages of the Bill are sufficiently explanatory.

"While Government have no intention to interfere with the position of trust's equities, it has often happened that certain types of trust hold large amount of equities and the people who are in management of these trust use those equities for the purpose of having control...

Direct Taxes Administration Enquiry Committee has drawn attention to this fact of trust funds being invested and

utilised for furthering donor's business interests...

The intention is only this-that the holding of securities by trusts should not be used by a group of persons for the purposes of augmenting their own voting rights. That is the main intention. It is not a question of divesting anybody of any rights. I do not see how the identification of the rights of the person who exercise the right to vote and that of the trust can be equated. Here nothing is sought to be taken away, except that you do not exercise the vote direct but exercise through public trustee... The overall intention of the Government is that the aggregate of the voting right of an individual who control the trust and the property of the trust was such which he handles, is not used for some purpose not wholly necessary in the interests of the trust... We do not want to interfere with the ordinary right of a person who is managing a trust as a shareholder.... The votes in regard to equity holdings of trust are misused for the purpose of concentration of economic power".<sup>138</sup>

It may be noted that while Section 153 says that no notice of any trust shall be entered into in the register of members, section 153 B requires, that every person to whom the section applies, holding shares or debentures in trust for any other person or for any charitable or other purpose, should make

a declaration to the public trustee appointed under section 153A, and should also send a copy of such declaration, to the company concerned, within twenty or days after making of the declaration. Thus though no notice of any trust shall be entered in the register, the company must be given notice of the trust. Non-compliance is made punishable.

Section 153B read with Section 187B does not apply to any trust (i) implied or constructive trust or to obligations in the nature of trust. It applies only where shares are held under an express trust created in writing.<sup>139</sup> (ii) Unless the amount of the trust's monies invested in the shares or debentures of any single company exceeds one lakh of rupees and even where it exceeds one lakh of rupees if it does not exceed five lakhs of rupees or twenty five per cent of the paid up shares capital of the company, which is less.

The object of the new provisions as explained by the Finance Minister is to stop the mis-use of the voting rights by the person who control the trust and trust property. Debentures does not carry voting rights and therefore it is not clear why it has been incorporated in the new provision. The Sachar Committee<sup>140</sup> has rightly recommended "for the deletion of the word 'debenture' from the section. It has also recommended for the consolidation of Sections 153, 153A, 153 B and 187 B as this sections relate to the appointment



of public trustee, declaration to made to Public Trustee and the exercise of voting rights by him. Further it has recommended for the inclusion of constructive trust within the meaning of the expression instrument in writing, it has recommended for single criteria in for computing the value of the shares in place of two criteria."<sup>40</sup>

(XXV) EXERCISE OF VOTING RIGHTS IN RESPECT OF SHARES HELD IN TRUST (Section 187-B) :-

The public trustee is entitled to exercise the rights and powers of a member (including the right to vote by proxy) at the company's meetings in respect of shares held in trust and regarding which a declaration has been given to it under section 153 B. However, the public trustee may abstain from exercising these powers if, in his opinion, the objects of the trust or interests of the beneficiaries of the trust are not likely to be adversely affected by such abstention.<sup>41</sup>

The object of this section is to prevent the use of voting right attached to shares held by trust for the advancement of personal interests of the donor, it is considered necessary to regulate the exercise of such right in suitable cases, with a view to securing proper management of the company in the interests of the shareholders and the company at large.

(XXVI) DECLARATION BY PERSON NOT HOLDING BENEFICIAL  
INTEREST IN ANY SHARES (Section 187-C) :

The Companies (Amendment) Act, 1974 has also added two other sections i.e. sections 187 C and 187 D making it obligatory that all benami holdings of shares in existence at the commencement of (Amendment) Act must be declared both by the benamidar and beneficial owner and the failure to do so, will be punishable. Investigation has also been proposed for the purpose of ensuring compliance with section 187B. It is expected that these provisions will be helpful as a check upon any possible evasion of the provisions relating to take over bid. However, Sacher Committee has recommended for the deletion of this section on the ground that no particular advantage has resulted from the operation of the section and has led to considerable paper work both at the end of the company and at the end of the Registrar, besides making the law little harsh on the general members of the public owing small or insignificant number of shares. In place of section 187 C it has recommended for the incorporation of provisions like Section 12 (3) of the Banking Regulation Act, 1949 which make a presumption of title in favour of the registered holder of shares.<sup>42</sup>

(XXVII) POWER OF THE CENTRAL GOVERNMENT TO CALL ANNUAL GENERAL MEETING (Section 167)

As per the provisions of section 167, if the company fails to call an annual general meeting within the time limits prescribed, Central Government may call or direct the calling of a general meeting of the company, on the application of any member of the company who has a right of voting. The Central Government can give any ancillary or consequential directions which it thinks expedient in relation of calling and conducting of the meeting. The meeting so held shall be deemed to be an annual general meeting of the company.

So far as this section is concerned, the underlying policy is to exercise the power only where the management is found to be unwilling to convene an Annual General Meeting of the company with a view of keeping the share-holders in dark about the affairs of the company or where the management is unable to convene the meeting on account of party faction or other like reason. Under the previous Act this power was with the Court. Under the present Act, the power to call meeting other than Annual General Meeting is now vested not in the Court but in the Company Law Board.<sup>143</sup>

Can an individual member constitute a valid meeting?

Ordinarily, a single member cannot constitute a valid meeting. A meeting means the coming together of more than one person. Further, one of the requirements of a valid meeting is the presence of quorum<sup>144</sup>.

However, when the Central Government calls or directs the calling of an annual general meeting it has a statutory authority to direct that one member present in person or by proxy shall be deemed to constitute a valid meeting.<sup>145</sup>

(XXVIII) PROHIBITION OF TAX-FREE PAYMENTS (Section 200):

A company is not allowed to make any tax-free payment of remuneration to its officers or employees. The intention underlying this provision is to prevent creation of a class of persons who are immune from any future increase in taxation. This provision corresponds to section 189 of the English Act, 1948. In England Cohen Committee pointed out the principal objection to the practice of making tax-free payment is that it creates a class of persons who are immune from any future increase in taxation. Further, this practice has the effect of making it difficult for shareholders to assess the burden imposed on a company by its salaries and wages bill.

(XXIX) MANAGERIAL AND EXECUTIVE REMUNERATION (Sections 198, 309 to 311)

The regulation of managerial appointment and remuneration is a special feature of the Company Law in this country. So far as the appointment of managerial personnel, particularly directors are concerned detail provisions are laid down under sections 252 to 270 and 274 to 279 and 283 and 284 of the Act. In case of remuneration sections 198 to 200 and 309 to 311 lays down detail provisions, in that respect. The present section 198 provides an overall ceiling of 11 percent of the net profits as the maximum managerial remuneration that can be paid by a company. Within this ceiling, a single managing director or a whole time director as per section 309 can be paid managerial remuneration upto 5 per cent of the net profits and if there are more than one managing director or whole time director, upto 10 per cent of the net profits. These maximum percentages present a kind of sub-ceiling within the overall ceiling of 11 per cent. The present law also permits the directors other than the managing or whole time director to receive by way of remuneration, for all of them together, a remuneration upto 1 percent of the net profits. Where the company has not appointed any managing or whole-time director, the directors of the company may be paid collectively a remuneration not exceeding 3 percent of the

net profits. It is also permissible within the existing law to pay remuneration beyond these ceilings provided the payment of such remuneration is by way of minimum remuneration and is also approved by the Central Government. The ceiling for minimum remuneration which is payable in case of loss or inadequacy of profits is fixed at Rs. 50,000. for all managerial personnel together and the payment of minimum remuneration whether within or beyond this ceiling is required to be approved by the Central Government. The present provisions of the Act and the rules also require the Central Government to take into account the size of the company's capital, its operations and its profitability on the one hand and the qualifications and experience as well as the integrity of the individual to be appointed as managing or whole-time director, on the other.

Within the statutory limits laid down by the provisions of the Act, the Central Government has also laid down certain administrative guidelines prescribing the monetary ceilings in respect of salary, commission and perquisites.<sup>146</sup>

The object of all these restrictions on the managerial remuneration is to safeguard the public interest and the protection of consumers from exploitation. Here it may be mentioned that in India a higher price is paid by the

consumers more often because of shortages rather than because of high 'cost of production'. Regulating the remuneration of one or a few individuals cannot be justified even if one were to imagine that 'cost of production' is the only factor that determines the price. After all, the element of cost of production is total managerial remuneration, which is regulated by section 198, and not what an individual gets within this overall ceiling. Further lack of adequate remuneration results in the managerial personnel leaving the country in large numbers and depleting this scarce resources at a time when the country is about to make rapid strides in its economic activities. Another undesirable effect of such artificial restriction, which in particular begs the remuneration at a given level, is that having reached the level-there is no incentive for further efforts. This has resulted in hordes of managers doing a job which could otherwise be done by a single manager properly motivated and remunerated. It may be stated that though some limitations in public interest may be desirable, the existing limits which already operate today are totally insufficient to attract competent persons/ professional managers whom the company with the consent of the shareholders wish to engage this inhibits the growth of the corporate sector. Any ceiling that may be provided

has to be such that Indian Manager are not lured by higher salary which they are liable to obtain abroad. The argument; that ou~~r~~ is a Socialist Republic - a R public in which there should be a freedom from all forms of exploitation, social, political and economic, and when more than half of our population lives below poverty line and therefor<sup>there</sup><sub>L</sub> is no justification for the top executives of any company being so lavishly fed is not tenable. Because it is these persons who bring about growth in an enterprise of a combined effort and for this effort they have to be rewarded for their skill. The whole approach to the managerial remunerations has to be looked at in the overall context of the prevailing situation and the times to come when industries will be wholly manned by professional managers.

The relevance of section 198 no longer exists. This was incorporated as a hang over of the managing agency, system. This should be deleted.

(XXX) PREVENTION OF MANAGEMENT BY UNDESIRABLE PERSONS  
(Sections 202 to 204 A) :

Section 202 lays down that an undischarged insolvent not to manage companies, section 203 empowers the Court to restrain fraudulent persons from managing companies, i.e. those persons who are disqualified on account of any fraud committed in the promotion, formation, management or winding



up of the company. The object of section 202 is to prevent an undischarged insolvent from discharging the functions of a director, or manager, whether he is or is not styled as a director, etc. and also from taking part in the formation etc. of a company. Here attention may be drawn to section 267 (a) & (b) according to which an undischarged insolvent or any person who has at any time been adjudged an insolvent or a person who had suspended payment or compounded with his creditors cannot be appointed as a managing or whole time director.

Section 203 is very wide and order passed under it may even disqualified a person starting a private company of his own, consisting of none but himself and a nominee of his as member. It may be noted that an order under this section will not only disqualify a person for the office of director<sup>147</sup> but also where he is already a director, vacate him from the office.<sup>148</sup>

Recently it has been held in England<sup>149</sup> that a disqualification imposed under this section (Section 188 of the English Act) on the occasion of the conviction of a person must date from the date of the conviction and not from the date of the discharge of the person from prison or any other date.

Section 204 lays down restriction on appointment of firm or body corporate to office or place of profit under a company. The only notable point is the contravention of the section is now punishable under section 629-A a new provision introduced by the Companies (Amendment) Act, 1960 but no employment or appointment is rendered void by reason of contravention, and, further, it is not clear what legal consequences such contravention will have except that in the event of resorting to a Court of Law any rights or liabilities arising out of it may not be legally enforceable.

Section 204 A inserted by the Companies (Amendment) Act, 1974 lays down restrictions on the appointment of former managing agent or secretaries and treasurers to any office.

Here it may be mentioned that the Companies (Amendment) Act, 1969 abolished the system of management of companies by managing agents and Secretaries and treasurer with effect from 3rd April, 1970. Consequent on such abolition, it is noticed that Many erstwhile Managing Agents or Secretaries and treasurers are trying to continue their control over the managed company by entering into service agreements in various forms like Secretary, Consultant or advisor to any other office. The section 204 A was inserted to provide for scrutiny and regulation of such agreements to prevent their continuing control in some guise or form without

rendering any real services for the benefit of the company. This section provides that all agreements between the erstwhile Managing agent or Secretary and Treasurer entered into within five years of their ceasing to Managing Agent or Secretary and Treasurer shall require approval of the Central Government, and shall be subject to such verifications, in the opinion of the Central Government, is necessary in the interest of the company.

Is this Section Violates Art. 14 of the Constitution of India ?

It was held<sup>150</sup> that it is not violative of Art. 14 of the constitution of India. Its object is to prevent erstwhile managing agents, secretaries and treasurers from continuing their control and management of the Company. The section provides for scrutiny and regulation of service agreements by the Central Government in order to ensure that appointments of Directors are in the interest of the company and not a mere device to circumvent the provisions of the Act. The Central Government has to exercise its discretion lawfully by inviting its attention to all relevant matters before coming to conclusion as to whether or not the proposed appointment was with the object of continuing control over the Company by the persons mentioned in the section.

(XXXI) UNPAID DIVIDEND TO BE TRANSFERRED TO SPECIAL  
ACCOUNT - PAYMENT OF UNPAID OR UNCLAIMED  
DIVIDEND (Sections 205 A and 205 B) :

Section 205 A introduced by the Companies Amendment) Act, 1974 makes it obligatory for the company, to transfer, within seven days after expiry of forty-two days from the date of declaration of dividend, any unpaid dividend or dividends in respect of which dividend warrants have not been posted, to special account, called 'Unpaid Dividend Account'. It further provides that in case any amount transferred to such account remains unpaid or unclaimed for a period of three years from the date of such transfer, it shall be transferred by the company to the general revenue account of the Central Government, with such information as prescribed under the section. In case company fails to comply with this provisions, it shall be liable to pay interest at the rate of 12 per cent per annum from the date of default on the relevent account, and every officer of the company who is default shall be punishable with fine.

Under Section 205 B introduced by the Companies (Amendment) Act, 1974 any person claiming to be entitled to any money transferred to the general revenue account of the Central Government, may apply to it for the refund of money due to him. The Central Government will pass orders

for the payment of such money to the claimant after taking such security as it may think fit. The object of these sections is thus stated in the notes on clause :

It has been observed that large established companies have been in the practice of declaring dividends even in the year in which profits are not adequate for payment of large dividends out of reserves accumulated in previous years. Such accumulated reserves, which should have been normally available as a ploughback for furtherance of the company's business, are thus used in a manner prejudicial to public interest. ... to prevent companies from declaring dividends when no profits in the shape of liquid funds are readily available... to prevent the misuse of the money due to shareholders by management... to empower the Central Government to pay individual claimants as and when the claims are preferred... to make it obligatory for the company to deposit in the general revenue account unclaimed dividends... (Clause 16).

The legal effect of section 205 A is that from the moment of declaration of the dividend the company has no legal or beneficial interest in the amount so declared, but is merely custodian in the nature of a trustee until the amount is paid or transferred into the special account as provided in the section.

The Payment of Dividend to Non-Resident Shareholders :

As regards the dividend to be paid to non-resident shareholders, the Company Law Department issued the following explanation:<sup>51</sup>

There is nothing in the section to say that the dividend remittable to non-resident shareholders which requires approval of the Reserve Bank of India is exempt from the provisions of Sub-Section (i) of Section 205 A. ... The concerned company after obtaining the necessary approval of the Reserve Bank of India can draw the amount from the unpaid dividend account for the payment to the non-resident shareholders.

Here attention may be drawn to the criticism<sup>52</sup> that "the expression" entitled to payment of dividend must in the context which is used mean a shareholder who has an unrestricted right to receive payment of dividend. A shareholder to whom dividend cannot be paid without obtaining sanction under any law such as the Foreign Exchange Regulation Act would not be deemed to be a shareholder entitled to payment of dividend and if there is no shareholder entitled to payment of dividend there is no corresponding obligation to transfer the dividend to the unpaid dividend account. It is submitted that this view is not correct. A dividend,

when declared, becomes a debt, and a shareholder is entitled to sue at law for recovery of the same, after the expiry of the period presented by section 207.<sup>153</sup> The person entitled to dividend is prima facie the person registered as shareholder in the register of members. So far as Sub-Section (1) is concerned a question has been raised as to what will happen to the dividend represented by such of the warrants which even though posted within the period of forty-two days remained uncashed. According to the Company Law Department,<sup>154</sup>

the amount of dividend which has not been actually claimed for whatever reasons, even though the warrant thereof had been posted within the statutory period of forty-two days, has to be deposited in the special unpaid dividend account of the company.

This view of the Company Law Department is contrary to the decision of the Supreme Court. The Supreme Court has held<sup>155</sup> that a dividend is deemed to be paid once the dividend warrant is posted. If this interpretation is applied to sections 205A and 205B, once the company has posted the dividend warrants within 42 days, the dividend is deemed to have been paid and it is under no obligation to transfer the amounts represented by warrants which

have been returned or not claimed to the separate account. In view of this decision the view taken by Department is not correct.

In order to settle this, the Sacher Committee<sup>156</sup> has rightly recommended that section 205A should be redrafted to provide for compulsory transfer of the dividends not yet received by shareholders:-

- (a) where dividend warrants have not been posted, within seven days of the expiry of the forty two days after date of declaration of dividend: and
- (b) where dividend warrants, though posted, are not yet collected, within ten days, after the expiry of six months from the last day on the which the dividend warrants should have been posted by the company.

(XXXII) PROVISIONS RELATING TO AUDITORS (Sections 224 to 234) :

The following sections which deals with the audit of the company's accounts and auditors, are incorporated with an object to have an independent audit of the company's account by an independent auditor and to bring to the notice of the members of the company the clear picture of the financial position of the company. The need for an independent audit cannot be over emphasized. As pointed out by Carey in



his professional Ethics of Public Accountings: "independence is the keystone in the structure of the accounting profession... Clearly there would be no great store by the certified Accountant's opinion or certificate if they (users of his published report) were not confident of his independence of judgement as well as his technical competence... The basic difference between privately employed accountants as professional practitioners is in their responsibilities, moral or legal, to the corporation or the public, and in the extent to which their relationship may tend to influence their judgement. In the last analysis, therefore, it is his independence which is the certified public accountants' <sup>eco</sup> <sub>L</sub> nomic excuse for existence."

Section 224 lays down provisions for the appointment and remuneration of auditors, which follow closely the provisions of section 159 and 160 of the English Act.

Section 224A inserted by the companies (Amendment) Act, 1974 lays down that 'auditor not to be appointed except with the approval of the company by special resolution in certain cases. This section is new and there is no corresponding section under the English Act. The object of the insertion of this section is to protect the interest of public financial institutions, nationalised bank or general insurance company in those companies in which they have invested their funds.

Section 225 lays down provisions for the appointment of person as auditor other than a retiring auditor and also for the removal of the auditor. This section lays down safeguards for the protection of independent auditor. The safeguards provided under the section makes the removal of independent and conscientious auditors difficult.

Section 226 corresponding to section 161 of the English Act, lays down qualifications and disqualifications of auditors. By this section the categories of persons to be disqualified for appointment as auditors are not enlarged. The object is to make the position of auditors as little dependent as possible on the companies whose affairs they audit. However, this section does not disqualify the relatives of a director or employee, if otherwise qualified. It may be stated that in actual practice, an auditor will be considered independent only if he avoids any relationship which might arouse the suspicion that such relationship had prevented an impartial attitude of mind. An auditor should not only be free from impropriety but also from the appearance of it.<sup>157</sup> But having regard to the newly inserted proviso to section 297 (1) it is clear that in the case of companies with paid up capital of rupees one crore or more, no relative of a director or a firm in which such relative is a partner or any other partner of such firm can be appointed

auditor without the previous approval of the Central Government. If under the Chartered Accountant Act, any further disqualification are added, they will also apply e.g. relatives of a director.

Section 227 lays down powers and duties of auditors. From the point of disclosure very important powers are given to the auditors under sub-Section (1) (1-A) to (4-A), inserted by the Companies (Amendment) Act, 1965. In addition to this powers additional powers are conferred on them by new section 45-MA of the Reserve Bank of India Act, inserted by the Reserve Bank Second Amendment Act, 1974.<sup>158</sup>

As regards his duty generally under section 227, he should not merely rely on the statement of the management as regards matters which are capable of direct verification by him from books and accounts and vouchers.<sup>159</sup>

Section 228 lays down provisions for the audit of accounts of branch office of the company.

Section 230 provides for the reading and inspection of auditor's report at the meeting of the company. /of

Section 233A added by the Companies (Amendment) Act, 1969 empowers the Central Government to direct special audit in certain cases, and section 233B empowers the Central Government to direct for audit of cost accounts

in cases, of companies engaged in production processing manufacturing of mining activities. So far as cost audit is concerned it may be stated that the real point about cost accounting is that it is an internal affairs which, if properly used, will assist forward looking management in cost control and cost reduction and improving efficiency so as to maximise production and profits, which would ultimately be beneficial to the consumers and the society at large.

Powers of Registrar to Call for Information, etc.  
(Sections 234 and 234A)

Section 234 empowers the Registrar to call for additional information or explanation in respect of any matter stated or explained in any document required to be submitted to him under any other provisions of the Act.

Section 234A added by the Companies (Amendment) Act, 1960 lays down power of the Registrar to order for the seizure of books and papers under certain circumstances in other words it empowers the Registrar to seize documents, books and papers of a company after obtaining the orders of a Magistrate where he has reason to believe that they may be destroyed or tampered with.

(XXXIII) INVESTIGATION :

It is plain fact that it is almost impossible for the shareholders to have effective control over the management of the company in which they hold shares. This

is because of a number of factors. Firstly, the doctrine of ultra vires, is no longer a significant check on corporate spending. Secondly, the shareholders are ill-equipped both financially as well as academically to challenge the wisdom and expertise of the company's officers. Thirdly, the remedies available under sections 397 and 398 for the prevention of oppression and mismanagement are beset with a variety of procedural and financial difficulties. Fourthly, due to great diffusion of share capital, shareholders

become indifferent to voting and controlling. All this made it necessary for the Government to arm itself with powers to take necessary steps against the company if there was a reason to suspect that the management was not acting in the interests of the general body of shareholders.

Sections 235 to 251 provide wide powers to the Government to investigate the affairs of any company. The investigation may be done at the request of the shareholders or the Registrar or at its own initiative. So far as these sections are concerned, the provisions of sections 164 to 175 of the English Act have been followed, except to the extent to which the special circumstances of this country required suitable changes.

Here it may be mentioned that the powers conferred on the Central Government for investigation into the affairs of

companies by section 235 are of discretionary, while those conferred by section 237 (a) and section 245 are obligatory.

#### Company's Management

A company is an artificial person, owned and managed by its members. But the number of members is so large that all of them cannot conveniently carry on the business of the company. Therefore, they select certain persons i.e. director from among themselves to look after the general administration of the company. The directors usually confine themselves to matters of general business policy and overall supervision of management on account of large size of corporate units and complexities of modern business. They leave day-to-day working of the company to other managerial personnel. In recent days the following patterns of company management have come into practices :<sup>60</sup>

- (a) Management by Board of Directors with executives working under the Board's directions.
- (b) Management by one or more Managing Directors under the supervision of the Board.
- (c) Management by a manager under the supervision of the Board.
- (d) Management by a Committee of Directors under the supervision of the Board.

- (e) Management by whole time directors with such functions as defined by the Board of Directors.

The following sections which deals with the appointment, removal and powers of the Board of Directors are incorporated for the protection of the interest of the company, the interest of the members of the company and also for the protection of the public interest.

Section 263, appointment of directors to be voted on individually. The object of this section is to prevent the putting forward a list of candidates to be elected and forcing the meeting to vote for the candidates in a batch and giving no discretion to the meeting as regards the rejection of a particular candidate in the list or not filling one or more of the vacancies, if the meeting so desired.

Section 265 which gives option to the company to adopt proportional representation for the appointment of directors.

The object of this section is to provide an opportunity to the minority shareholders to appoint their own nominee as a director in the Board of Directors. In the case of appointment of directors by ordinary method i.e. the method adopted by majority companies, majority shareholders are able to monopolise all the directorships with the result that even a respectable minority of the shareholders cannot get even one of their representatives into the Board. It is desirable in the public interests to give representation to

minorities on the boards of directors of large companies engaged in the production and distribution of essential commodities.

It may be submitted that though the Sacher Committee has devoted whole chapter<sup>161</sup> on shareholders' protection, it has not made any specific recommendation in respect of minority members right to appoint their nominee on the board of a company.

Section 267 lays down disqualifications for the office of managing director and whole time director. According to the provisions of the section, following persons cannot be appointed managing or whole-time directors :

- (a) a person who is not a director- since it is necessary for a person to be a director before he can be appointed as a managing director, all the disqualifications applicable to director will also apply to the appointment of a managing director;
- (b) an undischarged insolvent or any person who has at any time been adjudged an insolvent;
- (c) a person who suspends or has at any time made, a composition with them;
- (d) a person, who has at any time been convicted by a Court for any offence involving moral turpitude.



This section applies to all companies, public or private, without exception. It may be noted that this section disqualifies all persons convicted, for whatever term of imprisonment or fine of an offence involving moral turpitude. Even a Day's imprisonment or a mere fine of one rupee will do. Looking to the importance of the provisions of the section, this section was amended by the Companies (Amendment) Act, 1960, and the words "in India" was omitted from Sections 267 (c) and 274 (1) (d) after the word "court". The effect of this amendment is that conviction by a foreign court also, if it involves moral turpitude should disqualify. This suggest that the emphasis has been given to the nature of offence and not the punishment. The term moral turpitude used under sections 267 (c) and 274 (1) (d) means anything done contrary to justice, honesty, principle of good morals, an act of baseness, villainess or depravity in the private and social duties which man owes to his fellowmen or society in general, contrary to the accepted and customary rule of right and duty between man and man!<sup>62</sup>

In one of the cases<sup>63</sup> it was held that everything done contrary to justice, honesty or good morals if done with turpitude, so that embezzlement involves moral turpitude.

Further it may be mentioned that the disqualification in the case of a director or manager take account only of his

past five years, there is no time limit as regards a managing or whole-time director. He must be of good character throughout his life. The Central Government has no power to exempt any person from any of the disqualifications given in the section as it can do in case of appointment of a person as a manager, or director.

The object of this section and section 274 in laying down disqualifications is to see that the company is managed by those persons whose character is above any doubt. Public interest requires that companies in which interests of the members, creditors and society at large is involved, are managed by an honest person.

(XXXIV) VACATION OF OFFICE BY DIRECTORS (Section 283):

Section 274 lays down disqualification for the office of director and accordingly certain persons cannot be appointed as directors where<sup>as</sup> section 283 lays down events on the happening of which the director vacates his office automatically. This section is very general and applies to all directors by whomsoever appointed and for whatsoever period appointed. A life director also will come under the section.

(XXXV) REMOVAL OF DIRECTORS :

A Director can be removed from his office :

- (a) by the shareholders under section 284;

- (b) by the Central Government under sections 388-B to 388-E, and
- (c) by the Court under section 402.

According to the provisions of above sections directors are liable to be removed from their office before the expiry of their period of office. These sections lay down provisions for the removal of the directors but they also contain provisions for protecting public interests.

According to section 284, the shareholders may remove a director, but their power of removal is subject to the limitations laid down under the section. These limitations lay down an inbuilt framework for protection of public interest. According to these limitations, the shareholders cannot remove a director appointed by the Central Government under section 408 for the prevention of oppression and mismanagement. This is because the appointment of director under section 408 is for the protection of public interest. Similarly a director appointed under the system of proportional representation as per the provisions of section 265 cannot be removed by the company. The object of appointment of director under the system of proportional representation is to provide an opportunity to the minority shareholders to appoint one or more nominees in the board of a company. This provision is made for the protection of public interest.

and it cannot be allo<sup>w</sup>ed to be nullified by any other provision or act of other shareholders. Further the rule of natural justice requires that a person should not be punished without providing him an opportunity to be heard. This rule of natural justice is for the protection of public interest. In order to uphold this principle of natural justice, section 284 provides that 'on receipt of notice of a resolution to remove a director, the company shall forthwith send a copy thereof to the director, concerned. The director shall be entitled to be heard on the resolution at the meeting.

Sections 388B, 388C, 388D and 388 E give wide power to the Central Government to remove managerial personal from office. But this power of the Central Government is not an absolute power. As per the provisions of the section, the Central Government is required to refer the case of the managerial personnel to the High Court for inquiry where it is convinced of the existence of any of the circumstances specified in by the section and only on the recommendation of the High Court, managerial personnel can be removed from the office. This provision provides an opportunity to the affected person of a fair hearing by the Court.

(XXXVI) VALIDITY OF ACTS OF DIRECTORS (Sections 290):

This section provides that an act done by a person as director shall be valid notwithstanding that it may afterwards be discovered that his appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in the Act or in the Article. The object of the section is to protect person dealing with the company and also the members of the company. But this section will not apply where the act itself is not within the competence of the Board of Directors!<sup>64</sup>

(XXXVII) BOARD'S POWERS AND RESTRICTIONS THEREONDivision of powers between the General Meeting and the Board :

Until the celebrated judgement in *Solomon V. Solomon and Co. Ltd.*,<sup>65</sup> it was thought that there was no distinction between the rights and powers of the company and those of its shareholders. The real power to manage and control the affairs of the company vested in the shareholders, who could take any decision in their general meeting. Such decision was considered as an act of the company itself, final in all respect and binding on all concern. In the case of *Attorney General V. Davy*,<sup>66</sup> Hardwick L.C. observed :

It cannot be disputed that wherever  
a certain number are incorporated a

major part of them may do any corporate act... it is not necessary that every corporate act should be under the seal of the corporation.

This position, according to Gower<sup>167</sup>, remained until at least the end of the 19th Century, when 'it seems to have been generally assumed that the principle remained intact that the general meeting was the company whereas the directors were merely the 'agents' of the company, subject to the control of the company in general meeting. In *Isle of Wight Railway V. Tahourdin*,<sup>168</sup> the court refused an application by the Directors of a statutory company for an injunction to restrain the holding of a general meeting, one of the purposes of which was to appoint a committee to reorganise the management of the company. Cotton L.J. observed

It is very strong thing in deed to prevent shareholders from holding a meeting of the company, when such a meeting is the only way in which they can interfere, if the majority of them think that the course taken by the directors, in a matter intra vires of the directors, is not for the benefit of the company.

In this age:

the management (directors) was thought of as a set of agents running business for a set of owners, while they could and did have wide powers than most agents, they were strictly accountable to shareholders. Although the directors were left in-charge of the business, it was legally considered that the directors were directly under the control of the shareholders and any of their decisions could have been voted by the shareholders.<sup>169</sup>

It may be said that there was fusion of Ownership, Management and Control. This period was rightly called as 'Golden age of the shareholder democracy'.

The shareholders' supermacy, however, did not last long. With the growth of public interest in corporate activities, specially due to the stock-exchanges, which popularised investment into shares, more and more persons became corporate members. This led to dispersion of stock-holdings. There was growing tendency of share-holdings getting smaller and smaller. Just about a year ago, the number of shareholders in the country was estimated at 7.5 million. Today 10 to 12 million investors mostly salary earners, professional housewives, pensioners and farmers are believed to have a stake in the nation's 1,180,00 joint-stock companies—public or private. With the result that individually no

shareholder remained an important constituent element of a company in contrast to its counter part in the earlier period.

The another reason for the decline of the shareholder supremacy was the rise of the Institutional Shareholders. Alongwith individuals shares started to be held by the institutions such as one company in another company, by registered societies, trustees of provident and pension funds. Now no individual can be supposed to have any personal interest in the affairs of the company, or its management or control. The change brought about by it was that active ownership of the shareholders turned into a passive one. The stock-holder who hitherto considered himself as a owner was left with just a symbolic ownership. The power and control having passed from his hands to a separate entity called 'management' which is essentially different from the old concept of Governors in Charter Companies or Managers. The other effect of this was that 'Ownership which upto 19th century was considered to belong to shareholders as a consequence of Salomon's case passed over to the juristic personality of the company. On the basis of the doctrine of division of power and other reasons the management came to be concentrated in the hands of the Board of Directors, who with the passage of time became more and



more powerful, as compared to the general meeting of the shareholders, while the control passed into the hands of the individual or group of persons or institutions, controlling the appointment of board of directors, either directly or indirectly. Bertrand Russel calls this divorce of control from ownership as 'The logical outcome of the twentieth century trend of power'.<sup>70</sup>

DIVISION OF POWERS BETWEEN THE ORGANS OF COMPANY i.e. BETWEEN BOARD AND GENERAL MEETING :

As a natural consequences of the dispersion of shareholdings and the dilution of the shareholders powers, the Board of Directors became more powerful. This gave rise to conflict between the general meeting and the board of directors. The courts<sup>71</sup> tried to demarcate the area of control between these two rivals. It was held that "the division of powers between the Board of Directors and the General Meeting in a company depended entirely on the construction of the Articles of Association and where powers had been vested in the Board, the general meeting could not interfere in the exercise of those powers of the Board,

In India the Madras High Court<sup>72</sup> did not allow the directors to exercise a power vested in the shareholders.

### Corporate federalism :

Today there is a total decline of the share-holders supermacy. The judicial committee of the Privy Council<sup>73</sup> rejected the concept of supermacy of shareholders in general meeting and upheld the new concept of supermacy of the Articles of Association. This new equilibrium between the two organs of the company has been described as 'Corporate Federalism'. The relative position of the General Meeting and Board of Directors can now be equalled to the division of powers between the State Legislature and Federal Legislature, in a federal constitution.<sup>74</sup>

### Position in India :

Section 291 of the Companies Act, 1956 also upholds the same trend when it declares that "subject to the provisions of the Act, the board of directors of a company shall be entitled to exercise all such powers and do all such acts and things as the company is authorised to exercise and do".

There are however, two important limitations upon the powers of the board. Firstly the Board is not competent to do what the Act, Memorandum and Articles required to be done by the shareholders in general meeting, and, secondly, in the exercise of their powers the directors are subject to the provisions of the act, Memorandum and Articles and

other regulations not inconsistent therewith, made by the company in general meeting.

Power cannot be usurped :

Powers of a company thus distributed between the Board of Directors and the shareholders in a general meeting. The general meeting cannot interfere with the decisions of the director, unless they are acting contrary to the provisions of the Act or the Articles. It will be interesting here to quote some extracts from important judgements.

In *Shaw & Sons (Standford) Ltd, V. Shaw*<sup>175</sup> Greer L.J. observed :

A company is an entity distinct alike from its shareholders and its directors. Some of its powers may, according to its articles, be exercised by directors, certain others-powers may be reserved for shareholders in general meeting. If powers of management are vested in the directors, they and they alone can exercise those powers. The only way in which the general body of shareholders can control the exercise of the powers vested by the articles in the directors is by altering their articles, or, if opportunity arises under the articles, by refusing to re-elect the directors of whose actions they disapprove. They cannot themselves usurp the powers which by the articles are vested in the directors any more than the

directors can usurp the powers vested by the articles in the general body of shareholders.

In another case Farwell, L.J.<sup>176</sup> observed :

Even a resolution of a numerical majority at a general meeting cannot impose its will upon the directors when the articles have confided to them the control of the company's affairs.

However, the inherent residuary and ultimate powers of a company lie with the general meeting of shareholders, and therefore, the general meeting, can act even in a matter delegated to the Board in the following exceptional cases :

- (1) Where the Directors' actions are found to be malafide. In Marshall's Valve Gear Co.Ltd v. Manning Warlde & C.Ltd<sup>177</sup> Neville J. observed :

It is obvious that in the position in which directors have placed themselves on this question their duty and their interests are in direct conflict. On the one hand it is their duty as directors to protect the interest of the original patent which is the property of the company; on the other hand, their personal interests are clearly to maintain the validity of the patent which belongs to them. And, therefore, the majority of the shareholders are entitled to decide whether or not an action in the name of the company shall proceed.

- (2) Where the Board becomes incompetent to act, e.g. all the directors are interested in a particular transaction. In one of the cases<sup>178</sup> the articles gave power to the company's board of directors to fill up any casual vacancy in the board. At some casual vacancies did occur but it was found that none of the directors constituting the Board was validly appointed. It was held that the shareholders in general meeting could validly fill up those casual vacancies.

(3) Deadlock in the Board :

A Co. Ltd. had only two directors on its Board. Its Articles did not provide for any increase or decrease in the number of directors by the shareholders in the general meeting. None of the directors was willing to act and co-operate with the other directors. It was held that where directors having certain powers are unable or unwilling to exercise them, are in fact a non-existence body for the purpose—there is always power in the company to do itself that which under other circumstances would otherwise be done by the directors.<sup>179</sup>

Powers to be exercised by Resolution passed at Board's Meetings :

According to section 292, the following power of the

company can be exercised only by means of resolutions passed at the meetings of the Board :

- (a) The power to make calls.
- (b) The power to issue debentures
- (c) The power to borrow money otherwise than on debentures.
- (d) The power to invest the funds of the company.
- (e) The power to make loan

Besides these powers, there are certain other powers also which can be exercised only at the meeting of the Board :

- (a) Sanctioning of a contract in which a director is interested (Section 297).
- (b) Receiving of notice of disclosure of interest of a director in a contract or arrangement (Section 299)
- (c) Receiving notice of disclosure of shareholding by directors and persons deemed to be directors (Section 308).

Power to be Exercised by Company in the General Meeting  
(Section 293) :

Section 293 lays down restrictions on powers of the Board of Directors. According to the section the board of directors cannot exercise following powers except with the consent of the company in general meeting .

- (a) Sale lease or disposal of the whole or substantially the whole of the undertaking of the company, except sale or lease of property by a company whose business ordinarily is to sell or lease properties.
- (b) Showing any concession regarding payment of debts owed by a director by remitting a part of the debt or giving him more time to repay the debt except in the case of renewal or continuance of an advance made by a banking company to its directors in the ordinary course of business.
- (c) Make investment of the amount of compensation received by the company in respect of the compulsory acquisition of the property otherwise than in trust securities.
- (d) Borrowing money which will make the total borrowings in excess of the aggregate of the paid-up capital and free reserves of the company except temporary loans obtained by the company from its bankers in the ordinary course of its business.
- (e) Contribution to charitable and other funds, not directly relating to the business of the company or the welfare of its employees, of amount exceeding Rs. 50,000 in the aggregate or five percent of the

average net profits.

It may be noted that though, as per the section, the board should not exercise the powers specified in clause (a) to (e) or Sub-Section (1) without the consent of the company in general meeting, the board is not however, bound to exercise the powers, even though the company passes resolutions in respect of the exercise of such powers.<sup>180</sup>

A private company which is not subsidiary of a public company is exempted from the purview of this section.

The provisions of Section 293 and the position of Committee of Management appointed by the Court in proceedings under Section 397 of the Act. Recently it was held by the Court that <sup>181</sup> "this section does not apply to a committee of management appointed by the Court in proceedings under section 397. Such a committee appointed to discharge the functions of the Board is not either a Receiver or a Manager and is not subject to the limitations which apply to a Receiver or Manager, but it must always act under the superintendence and direction of the Company Court.

#### Disability of Shareholders Control over Management :

The shareholders control over management having been reduced to the lowest web and the control having shifted



into the hands of Directors themselves or those few whose use of blocks of shares, enabled them to be or to appoint Directors or in the hands of Chief Executive Officers. This process required to be checked.

It is argued~~t~~ that the vacuume created by the lack of shareholders effective control over management has been filled by the Statutory and Governmental control. As such there is no need of any other control. Further, it is feared that, it would be detrimental to the growth of industry and professional administration.

Share-holders are not only beneficiaries of a modern company there are many other interests to be protected. In the words of Bhagwati J. (S.C.)<sup>182</sup> "the concept of company has undergone radical transformation in the last decade. The traditional view that the company is the property of the shareholders is now an exploded myth. Today, social scientists and thinkers regard a company as a living, vital and dynamic social organism with firm and deep rooted affiliation with the rest of the community in which it functions."

A company today is a social and economic institution that touches every aspect of our lives. The dependence of the Community as consumers of the goods and the responsibility of ensuring a decent life for their workers

and other employees, on these giant enterprises has increased the pressure of the social interest in their stability and efficiency as economic institutions. Then the modern states, especially one having a goal of socialistic pattern of society, as India has, can no more allow companies to remain as institutions for concentration of wealth, but would wish them to be turned into instruments of diffusion of wealth. It is accepted fact that self-interest is a human weakness, if power is left free, it is bound to be misused and company management is no exception to it. If previously, control was necessary in the shareholders, today it becomes all the more necessary in the general social interest or public interest which includes all other interests. The companies Act, 1956 is regarded as a progressive piece of legislation, and it has provided number of restrictions on the powers of the managerial personnel and sections 291 to 293 few of them.

In addition to these restrictions some supervisory control is necessary. It may be provided if shareholders becomes active members of the company rather than mere passive investors of capital. In order to do so, following suggestions are made :

- (a) The resignation of shareholders associations,
- (b) Increase in the frequency of ordinary general meetings of the company.

- (c) Common use of proxy be discarded, as it has done more harm than good to the common cause.

Today's general meetings have truned into proxy-war.

(XXXVIII) POWER OF CENTRAL GOVERNMENT TO PREVENT  
CHANGE IN BOARD OF DIRECTORS LIKELY TO  
AFFECT COMPANY PREJUDICIALLY (Section 409) :

Under this section, the Central Government has been given powers to prevent a change in the Board of Directors which would affect the affairs of the company prejudicially, if such change can be attributed to change in shareholdings in the company. The application is to be made by management viz. existing managing director or any other director, or manager. The power of the Central Government under the section is very wide. It may by order direct that no resolution passed after the date of the complaint and no action taken to effect the change e.g. registration of transfer of any shares shall have effect. However, the order of the Central Government will be directed to prevent the change in the Board of Directors and will extend no further.

The primary object of the section is to check the activities of raiders and speculators to gain control of public companies having substantial reserve and good profits with the view of superseding the management or

compelling the management to purchase their shares at extortionate prices in order to retain control. The other object is to prevent a company being made subsidiary of another by a change in the Board of Directors to prejudice the affairs of the company. The section does not apply to a private company unless it is subsidiary of a public company.

As the Second Annual Report of the Company Law Administration 1957-58<sup>183</sup> pointed out, swift action under this section has, in many cases, proved salutary, in as much as it has prevented abrupt changes in the management of companies, irrespective of the voting strength commanded by the different groups of shareholders and has prevented the control and management of well-run companies from passing into the hands of unscrupulous and ambitious financiers whose object has often been to traffic in the shares of well managed companies for their personal gain. Nevertheless, if Government are convinced that the persons who have newly acquired a substantial block of shares, in a company (and who, would, therefore, seek adequate representation on the Board of the company) are persons competent to manage the company efficiently, Government would not ordinarily invoke its powers under this section.

The powers of the Central Government under the section

is discretionary and therefore, in exercising its powers, Government should, however, be careful to see that any aggrieved complaining party does not use it as a lever in his negotiations for bargaining with the party in control of the company, for own private advantage.

Government's Policy as Regards Applications under this Section !<sup>84</sup>

(a) Where the existing management was not good and there was nothing specific against the incoming person, no order under section 409 need be issued but that the matter might be left to the decision of the shareholders of the company;

(b) Where both the existing as also the incoming management were reputedly good, there was no need for interference by Government under section 409;

(c) Where there was nothing unfavourable against the existing management or against the incoming persons in the records before the Commission, interim protection might be given to the existing management by issuing an interim order and further enquiries instituted immediately thereafter to enable a final decision to be taken :

(d) Where the existing management was good and nothing was known about the incoming persons, an interim order as

under (c) above might issue and further enquiries instituted thereunder;

(e) Even if any interim order was issued under section 409(1) of the Act the commission would advise Government to confirm that order only if the Commission was satisfied that the existing management proved positively that the incoming persons would not be able to manage the company;

(f) Where, in respect of a company in which action under Section 409 has been prayed for by the applicant, the Court was also seized of the matter and has issued injunction against any change in the Board of the company, the Commission would not advise any action under Section 409.

Circumstances in which Company may be wound up by Court (Section 433) :

One of the characteristics of a company is that it is a juristic person with a perpetual succession and common seal. As such it never dies. Its life does not depend on the life of its members. The death of a member leaves the company unmoved; members may come and go but the company can go on for ever. Even a hydrogen bomb cannot destroy it.<sup>185</sup> It is not in any manner affected by insolvency, mental disorder or retirement of any of its members. This is not to say that death or incapacity

of its human members may not cause the company considerable embarrassment; obviously this will occur if all the directors die or are imprisoned or if there are too few surviving members to hold a valid meeting, or if the bulk of the members or directors become enemy alien.<sup>186</sup>

A company is created by a process of law, i.e. by incorporation and can be put to an end by a process of law. It is brought into existence by registration and can be put to an end by any of the following three methods, viz.,

(a) If it transfers its undertaking to another company under a scheme for reconstruction or amalgamation, it may be dissolved without winding up, if the Court so direct (Section 394(1)(b) (iv)).

(b) If it is a defunct company, it may be struck off the register by the Registrar and then dissolved (Section 560).

(c) It may be wound up under Part VII of the Act. According to the scheme of Part VII of the Act there are three modes of winding up of a company, viz.,

- (1) Winding up by the Court; or
- (2) Voluntary winding up, This may be :

- (i) Members' voluntary winding up, or
- (ii) Creditors' voluntary winding up, or
- (3) Winding up subject to the supervision of the Court (Section 471).

Winding up is a proceedings by which a company is dissolved. The assets of the company are disposed of, the debts are paid off, out of the realised assets and surplus, if any, is then paid off to the members in proportion to their holdings in the company.

According to Gower<sup>187</sup>, winding up of a company is the process whereby its life is ended and its property administered for the benefit of its creditors and members. An administrator, called liquidator, is appointed and he takes control of the company, collects its assets, pays its debts and finally distributes any surplus among the members in accordance with their rights.

According to Pennington<sup>188</sup>, winding up is a process by which the management of a company's affairs is taken out of its Directors' hands, its assets are realised by a liquidator, and its debts are paid out of the proceeds of realisation and any balance remaining is returned to its members. At the end of the winding up the company will have no assets or liabilities and it will therefore be simply a formal



step for it to dissolve, i.e. for its legal personality as a corporation to be brought to an end.

The Act imposes much responsibility upon Courts to evaluate the facts of each case and order for compulsory winding up. According to Section 433 a company may be wound up by the Court if :

- (a) It has passed special resolution, or
- (b) Default is made in delivering the statutory report, or
- (c) It does not commence business within a year from its incorporation or suspends business for a year, or
- (d) Its minimum membership falls below the prescribed limit, or
- (e) It is unable to pay its debts, or
- (f) The Court considers it just and equitable.

On these grounds alone the Courts have to adopt their approaches to order for the suitability of the winding up of a company. Further, while exercising their powers under Section 433, the Courts are required to keep in mind that a company is no more regarded as the property of shareholders alone. A company is now considered as a living, dynamic social organisation having a firm and deep

rooted affiliation with and duties and responsibility towards the contemporary society. As far back as 1950 the Supreme Court proclaimed that "we should bear in mind that a corporation which is engaged in production of a commodity vitally essential to the community has a social character of its own, and it must not be regarded as the concern primarily or only of those who invest their money in it".<sup>189</sup> Now Supreme Court has held that "Law cannot stand still, it must change with the changing social concepts and values.....even workers should have voice or a right to be heard in the determination of the question whether the enterprise should continue to run or be shut down".<sup>190</sup>

In *M/s. Navjivan Trading Finance Pvt. Ltd., v. Registrar of Companies, Gujarat*,<sup>191</sup> D.A. Desai J. observed that "whilst the Court would be keen and quick to strive for evolving a scheme to resurrect a company so that the society does not lose a producing unit, the workers do not lose their source of livelihood and the State does not lose its revenue and order winding up of it only as a last desperate measure as a necessary evil, there are times when the Court may justify to feel that delaying winding up by a single day is crime for which no atonement is sufficient."

Out of six grounds enumerated in the section 433, the last ground requires special attention, i.e. if the Court is of the opinion that it is just and equitable that the company should be wound up.

Conceptually, the words 'just and equitable' are vague and incapable of precise definition. It confer on Courts a discretionary power of the widest import. But the Courts are not completely at large in the exercise of the discretion because it is to be exercised on a proper consideration of each case and in turn each case must depend on its own facts and circumstances and which can only be dealt with on its own merits. The Court may give due weightage to safeguard company's interest, its workers, creditors, consumers and even the interest of general public, in addition to the interest of the members of the company. The courts in India and England have treated the words 'just and equitable' differently in different times. The judicial dimension within which orders are generally made for winding up of a company on this ground may be pointed out as follows :

- (1) Disappearance of Company's substratum.
- (2) Complete deadlock in the management.
- (3) When it cannot carry on business except at losses.

- (4) Oppression of minority and mismanagement.
- (5) If it has been conceived and brought forth in fraud or for illegal purposes,

(1) Loss of Substratum :

Where the objects for which the company was constituted have either failed or become substantially impossible to be carried out, i.e. substratum of the company is lost.<sup>191</sup> However, a temporary difficulty which does not knock out the company's bottom shall not be permitted to become a ground for liquidation.<sup>192</sup>

Thus, whether there is a loss of substratum or not, is a question of fact which depends on the circumstances of each individual case. In *Seth Mohan Lal v. Grain Chambers Ltd.*<sup>193</sup> Shah J. observed;

"The substratum of a company is said to disappear when the objects have substantially failed or it is impossible to carry on business except at a loss or the existing liabilities are far in excess of existing and possible assets".

The substratum of the company is deemed to be gone :

- (i) When the object for which it was incorporated has substantially failed,<sup>194</sup> or the business for which the company was formed, had substantially ceased to exist.<sup>195</sup> or the very object for which the company was incorporated had failed.<sup>196</sup>

But the substratum of the company cannot be said to have gone even where its sole undertaking is sold so long as there is some other business coming within the objects stated in its memorandum which it can carry on.<sup>97</sup>

(ii) When it is carrying on the business at a loss and its remaining assets are insufficient to pay its debt, which means that is no reasonable hope that the object of trading at a profit can be attained.<sup>98</sup> However, 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, particularly, when majority of shareholders are against a winding up order.<sup>99</sup>

Further, if the assets of a company even when they are valuable are locked up in investments and the business is being carried on at a loss the company may be wound up. It was observed by the Court<sup>100</sup> that "if they are carrying on business at a manifest loss, and it is totally impossible to make any profit, it can scarcely be said that this Court will consider it just and equitable that the company should be allowed to continue when people who have embarked property to a considerable amount in it do not wish it to go on.... It is quite distinct from saying that it is an insolvent company, or that it cannot pay its debts, because the persons managing it will take care to have all the debts by making calls to meet them".

(iii) When the existing and probable assets are insufficient to meet the existing liabilities. Thus where a company is totally unable to pay off creditors and there is ever increasing burden of interest and deteriorating state of management and control of business owing to sharp differences between shareholder, the Court must order wind up.<sup>201</sup>

(2) Oppression of Minority :

In cases where those who control the company abuse their power to such an extent that it seriously prejudices the interests of minority shareholder, the Court may interfere and order for the winding up of the company. In this respect the observation made by the Madras High Court is noteworthy.<sup>202</sup>

Where the directors of a company were able to exercise a dominating influence on the management of the company and the managing director was able to outvote the minority of the shareholders and retain the profits of the business between members of the family and there were several complaints that the shareholders did not receive a copy of the balancesheet, nor was the auditors' report read at the general meeting and dividends were not regularly paid and the rate was diminishing, these constituted sufficient ground for winding up.

However, the Court will not make an order of winding up unless it is proved that :

- (a) Wrong has been done to the company by abuse of majority voting power,<sup>202</sup>
- (b) It is impossible for the business of the company to be carried on for the benefits of the company as a whole owing to the way in which the voting power is held and used.<sup>203</sup>

(3) Deadlock in Management :

Where there is complete deadlock in the management of the company in the sense that it is not possible for the company to carry out its objects for which it was formed. In the case of *Yeniöje Tobacco Co. Ltd., Re.*<sup>204</sup> A and B were the only two shareholders as well as the directors of a Private company. Subsequently some serious differences developed and became hostile to each other. They stopped even talking to each other. It was held that there was a complete deadlock in the management and the company should be wound up.

However, in one of the Indian case it was observed.<sup>205</sup> "The just and equitable clause... should not be invoked in cases where the only difficulty is the difference of view between the majority directorate and those representing the minority... In the absence of any evidence of

misappropriation of funds by the management, a company should not be wound up, merely on account of difference of views between the majority directorate and those representing the minority... Where nine or ten directors belonging to different communities unanimously and solidly take one view as against the minority of three holding that the company has been earning profit and has accumulated a goodwill, the mere in-compatibility of good relation between the rival factions in the directorate is not sufficient for ordering winding up".

(4) Where Public Interest is likely to be prejudiced :

In the case of Balichandra Dharmajee Makajee v. Alcook, Ashdown & Co. Ltd.<sup>206</sup> it was observed that : "Having regard to the provisions of Section 397, 398 and 402 (dealing with oppression and mismanagement) where the concept of prejudice to public interest is introduced, it would appear that the Court winding up a company will have to take into consideration not only the interest of shareholders and creditors but also public interest in the shape of needs of the community, interest of the employees, etc. Supreme Court has already conferred on the workers' right to be heard in cases of winding up petition.<sup>207</sup>

(5) Fraudulent Object :

When the company was formed to carry out fraudulent or illegal business or when the business of the company



becomes illegal. A winding order will be made under the just and equitable clause where the company was begotton in fraud and lived in fraud or illegal purposes. Where the whole object of the company is fraudulent, it would be just and equitable that it should be wound up.<sup>103</sup>

X In the case of Brinsmead (Thomas Edward) & Sons,<sup>209</sup> Re. T.E. Brinsmead and two of his sons were employed by John Brinsmead & Sons in the business of piano manufacturing. They left John Brinsmead & Sons and started a company called Thomas Edward Brinsmead & Sons Ltd. for carrying on a similar business. They were restrained by an injunction from using the name Brinsmead on the ground of fraud. A petition for the compulsory winding up of the company was presented. It was held that the company was initiated to carry out a fraud; and therefore it was just and equitable that it should be wound up.

In another case<sup>210</sup> the main object of the company was to conduct a lottery. Some of its other objects were philanthropic. It was held that the company would be wound up as being formed for illegal purpose.

However, the mere fact of there having been a fraud in promotion or fraudulent misrepresentation in the prospects, or fraud in the carrying on of the business, are not by themselves sufficient grounds for passing a winding up order, as the majority of shareholders may waive the fraud.<sup>211</sup>

(6) When the company is a mere bubble and it does not carry on any business or does not have any property.<sup>212</sup> It may be submitted here that the 'just and equitable' ground of winding up has its own place and importance in the company law, particularly in the present socio-economic conditions which prevails in our country. The phrase is of flexible nature and the Courts are left with the maximum discretion and is exercised only for some specific grounds, such as loss of substratum, deadlock in management, mismanagement, oppression of minority etc. The major thrust of the Courts has been on the primary clauses and the secondary clauses have not been looked into. It is no doubt true that the modern trend is against winding up of a company and will refuse winding up when alternative remedy is available. The Courts are not keen to wind up a company but would be slow if there is any possibility of keeping the company going concern to protect interest of shareholders, creditors, employees and also public interest. The remedy as applied by the Courts both in India and England bears the traces of principle laid down by the English Court in the cases of the Frustration of Contracts on the grounds that the object of contract can no longer be achieved or non-existing or non-occurrence of a particular state of things.<sup>213</sup>

Effect of winding up on Antecedent and other Transactions (Sections 531 to 537):

Section 531 lays down provisions relating to fraudulent preference in the case of company. The law relating to fraudulent preference is contained in Section 56 of the Presidency Town Insolvency Act, 1909 and Section 54 of the Provincial Insolvency Act, 1920. The object of these provisions is to afford protection to the creditors of the company.

Section 531A added by the Companies (Amendment) Act, 1960 deals with the voluntary transfer. The substance of the section is that any transfer of property or goods made by a company otherwise than in the ordinary course of business will be void, if it had been made within one year before the presentation of a winding up petition or the passing of a resolution for voluntary winding up. In the case of individual Section 55 of the Presidency Towns Insolvency Act and Section 53 of Provincial Insolvency Act deals with the voluntary transfers.

Section 532 lays down that transfers for the benefit of all creditors is void. The object of this section is to prevent evasion of the winding up procedure with its strict rules of supervision.<sup>214</sup>

Section 533 lays down provisions relating to the liabilities of fraudulently preferred persons. The object of the section is to give protection to the

creditor of a company which is being wound up, where the creditor has been paid by the company with a fraudulent motive on the part of the company to relieve from liability or reduce the liability of a person who has stood surety or guarantee to the creditor on behalf of the company.

In Buckley's Companies Act,<sup>215</sup> the Section 321 of the English Companies Act, corresponding to Section 533 is explained as follows :

This section which is new is apparently designed to give relief to any person who has to repay to the liquidator of an insolvent company sums paid to that person under circumstances making the payment a fraudulent preference of a third party. Thus, if someone has secured the company's overdraft at the bank, either with or without a covenant giving rise to a personal liability, on his part, the company by paying its trade debts in the ordinary reduction of the overdraft instead of paying of its trade debts in the ordinary course of business may fraudulently prefer the person in question. In such circumstances, even if the bank has not been fraudulently preferred, it may have to repay those money to the liquidator in consequence of the fraudulent preference of the third party. In such a case the bank would now be able not only to sue the third party, as surety to the extent mentioned in sub-section (1) notwithstanding the absence of any express

covenant on his part giving rise to a personal liability, but could also raise any question relating to the liability of the surety or guarantor and have it determined in the winding up under sub-section (3) instead of having to bring separate proceedings.

Section 534 lays down provisions relating to floating charge created by a company which is in insolvent condition. The object of the section is to prohibit companies which are in insolvent condition from creating any floating charges on their assets, with a view to secure past liabilities. The section does not however, affect companies which can prove that after the creation of the floating charge, they were in solvent condition. The test of solvency is whether a company has been able to pay its debts as and when they become due, after the creation of the floating charge. The prohibition applies even though the charge may not be fraudulent.<sup>216</sup>

However, in the case of *Re. Parkes Garge (Swadlincote) Ltd.*,<sup>217</sup> it was observed that "while the effect of the section is to nullify the floating charge created within twelve months before the winding up, if the company had paid any monies to the holder of the charge before the date of the winding up the liquidator cannot recover back the amount so paid except in the case of fraudulent preference.

Section 535 deals with the disclaimer of onerous property in case of a company which is being wound up. The object of the section is to save an insolvent company's assets from further losses and enable the liquidator to get rid of onerous property by disclaiming it.

It was held by the Court<sup>218</sup> that "the disclaimer may extend to any kind of property-stocks, shares, unprofitable contracts or any other property which is unsaleable, because of obligation attached to it. The Court will not allow disclaimer where it will prejudice the interest of third parties, e.g. lessor entitled to sue another party on a guarantee of the rent".

In a recent case<sup>219</sup> it was held that "a disclaimer will not, however, affect the liability of any surety, guarantor or the original lessee where company is sub-lessee from him of any property or any other party liable under the disclaimed contract or other obligation in respect of the property disclaimed".

Section 536 deals with avoidance of transfer etc. after commencement of winding up proceedings. Sub-section (1) of the section deals with the transfer of shares and not the debentures. It prevents transfer of shares, but does not prevent transfers of debentures or release the company from any obligation it may be under in respect of transfer of debentures.<sup>220</sup>

In respect of Sub-section (2) of the section, it was observed <sup>221</sup> that "The object of the Sub-section (2) is to prevent improper disposition or dissipation of property so as to affect the assets otherwise available for distribution among the creditors of a company in winding up. But the Court has a discretion to uphold all proper transaction. Accordingly, in the event of a winding up order being made all transactions since the commencement of the winding up will be subjected to scrutiny by the liquidator who will take appropriate proceedings to have them declared void or valid by the Court. The Court usually validates transactions which are honest and in the ordinary course of a company's business. Payment to a creditor by assigning an assets to him is void, where it is not a bonafide transaction carried out or arising in the ordinary course of business". Any payment made can be ordered to be refunded and there is no time limit for making such order.<sup>222</sup>

Section 537 lays down provisions for avoidance of certain attachments, executions, etc. in winding up by or subject to supervision of Court. This apply only to winding up by or subject to the supervision of the Court.

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Where, in the case of non-banking institution, being a company, the auditor has made, or intends to make, a report to the Bank under Sub-Section (2) of Section 227 of the Companies Act, 1956, the contents of the report which he has made, or intends to make, to the Bank".

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