

PONDICHERRY UNIVERSITY

(A Central University)

DIRECTORATE OF DISTANCE EDUCATION

BUSINESS LAW

Paper Code:

BCOM1004/BBA1004



Bachelor of Commerce - B.Com

Bachelor of Business Administration -B.B.A

I Year

DDE – WHERE INNOVATION IS A WAY OF LIFE

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UNIT I

Law: Rights, Duties and Liabilities – Legal Personality – Law and Fact – Cases and Legislation Mercantile Law and commercial Law – Sources.

UNIT – II

Law of Contracts – Contracts – Essentials of a valid Contract – Proposal – Acceptance Communication Revocation – Consideration – Capacity of Parties – Consent – Misrepresentation – Fraud – Undue Influence – Coercion – Mistake – Void and Voidable Contract – Discharge of Contract – Breach.

UNIT – III

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Law of Sales of Goods – Contract of Sale – Conditions and Warranties – Transfer of Property and Title to Goods – Rights and Duties of Seller and Buyer – Rights of Unpaid seller. Law relating to Negotiable Instruments: Important Provisions regarding Cheque – bill of exchange and Promissory Note.

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UNIT – VII

Memorandum, Articles of Association and Prospectus – Contents of Memorandum – Doctrine of ultra-vires – Contents of Articles of Association – Difference between Articles and Memorandum – Prospectus – Need – Issue of Prospectus – Contents – Exemptions from disclosure – Liability for misstatement – Civil Liability – Rights of Indemnity – Criminal Liability for misrepresentation.

UNIT – VIII

Dividends, Bonus and Interest: Payment of dividends – Interim Dividends – Payment of Interest on Capital – Capitalisation of Profits.

TEXT BOOK:

Kapoor N.D., Elements of Mercantile Law & Elements of Company Law

REFERENCES:

Bagrial A.K., Company Law

Kuchal M.C., Mercantile Law

Sreenivasan M.R., Business Laws.

Singh Avtar, Company Law

UNIT – I

CONCEPT OF LAW

Unit Structure:

Lesson – 1.1 - Law and its origin

Lesson – 1.2 - Mercantile Law and its Sources

LESSON – 1.1

LAW AND ITS ORIGIN

Some knowledge of law is necessary for all persons. The day-to-day survival of each member of our society must proceed to a greater extent in conformity with recognized rules and principles. Just as a game of football or cricket could not be played judiciously without rules and regulations to govern the players, life in general and the business world in particular could not survive without law to regulate and the conduct of people and to protect their property and rights. Without law, life and business would become a matter of the survival of the fittest. So, to protect the individuals from exploitation, sufficient amount of rules and regulations are necessary.

WHAT IS LAW?

It is not possible to give one complete accurate definition of law. In the legal sense ‘Law’ includes all the rules, regulations and principles which regular our relations with other individuals and with the State. The State regulates the conduct of its people by a set of rules. Such rules of conduct, if recognized by the State and enforced by it on people, are termed as ‘Law’.

In this sense, *Holland*, a jurist/defines law as “rules of external human action enforced by the State.”

According to Anson, rules regarding human conduct are necessary for peaceful living as well as for progress and development. Anson observes as follows:

“The object of law is order, and the result of order is that men are enabled to look ahead with some sort of security as to the future. Although human action cannot be reduced to the uniformities of nature, men have yet endeavoured to reproduce by law something approaching to this uniformity”.

SOCIETY AND LAW

The term 'society' is used to mean a community or a group of persons living in any region, who are united together by some common interest (or) bond. The word common bond can otherwise be called as social rules (or) rules of social behavior. These rules are made by the members of the society. Disobedience of these rules is followed by punishment in the form of social disapproval.

According to Salmond, "Law is the body of principles recognized and applied by the state in the administration of justice".

Woodrow Wilson has defined law as "that portion of the established habit and thought of mankind which has gained distinct and formal recognition in the shape of uniform rules backed by the authority and power of the government." Law in this sense, is a bundle of rules and regulations and also a social machinery for securing justice in the community.

Law is not too rigid. As the conditions in a society change, laws are modified to fit the needs of the society. At any point of time, law prevailing in a society must be in conformity with the general feelings, customs, traditions and aspirations of its people.

In the changing economic scenario, the main object of law is considered to be "to establish socio-economic justice and remove the existing imbalance in the socio-economic structure". Law, in this sense, has to play a crucial role in the task of achieving the various Socio-economic objectives as enacted in our constitution.

In a social set up like ours, a great part of law is designed primarily to bring about all-round improvement and well-being of the public individually and collectively from material and cultural view points, But 'Law' unlike social rules is enforced by the State, The objective of law is to bring order in the society with a view to enable its members to progress and develop with some sort of security regarding the future.

The State makes laws. Disobedience of state laws involves penalty which is enforced by the government through the sovereignty of the State. Whatever is not

enforceable is not law. Law of the state are applicable to all without exception in identical circumstances. There can be only one law within the State.

RULE OF LAW

In earlier times, certain classes and individuals possessed special privileges and were governed by special law. The modern view is to apply the same law over all persons in the State, and to give all persons equal rights and privileges for the protection of their human liberties. Democracy can remain only in a society of equals.

The concept of equality of all persons before law is the basis of what is called the Rules of laws. The Rules are summarized as follows:

1. No one shall be punished except for definite breach of law.
2. No man is above law.
3. Rule of law is the result of statutes and judicial decisions determining the rights of private persons.

MEANING OF LEGAL PERSONALITY

A person in law means any entity which is accepted by law as having certain defined rights and obligations. Such persons may be natural (human beings) or artificial (companies or corporations).

Example: The Company can be sued in its own name and sometimes be prosecuted for criminal offences like tax evasion etc. Similarly it can sue others in its own name.

LAW AND FACT

Lawyers always distinguish between the law involved in a case and the facts which the court has to consider in reaching its decision.

Example: In a situation, the fact may be a murder. But the judge decides on points of law i.e. whether the conduct of accused amounts to murder in the eyes of the law. Hence, it is the duty of the prosecutor to prove before the court such fact to show

- (i.) that a murder has been committed, and
- (ii.) That the accused was the person who committed the murder.

LESSON – 1.2

MERCANTILE LAW OR COMMERCIAL LAW AND ITS SOURCES

Definition

The laws of a country relate to many subjects e.g .inheritance and transfer of property, relationship between persons, crimes and their punishment, as well as matters relating to industry, trade and commerce.

The term commercial law is used to include only the rules relating to industry, trade and commerce.

Commercial law or Mercantile law may therefore be defined as that part of law which regulates the transactions of the mercantile community.

The scope of commercial law is large. It includes the laws relating to contract, partnership, negotiable instruments, sale of goods, companies etc.

SOURCES OF INDIAN COMMERCIAL LAW

The commercial law of India is based upon statutes of the Indian legislature, English mercantile law and Indian maritime usages, modified and adapted judicial decisions.

We are stating below the sources from which the rules of commercial law of India have been derived.

1. Statutes of the Indian legislatures

The Statute law means Acts of Parliament. These are the most efficient and the most usual way of bringing about changes in law today. The legislature is the main sources of law in modern times. In India, the Central and State legislatures possess law making powers and have exercised the powers extensively. The greater part of Indian Commercial Law is statutory. The Contract Act, 1872 , the Sale of Goods Act, 1930, the Partnership Act, 1932, the Companies Act, 1956, are instances of the Statute law.

2. English Mercantile Law

Many rules of English Mercantile law have been incorporated into Indian Law through statutes and judicial decisions. Indian mercantile law is, in the main, an adaptation of the English Law. It is incorporated in a number of Acts, which follow to a considerable extent the English mercantile law with some reservations and modifications necessitated by the peculiar conditions prevailing in India. To ascertain the sources of Indian Mercantile law, we have, therefore, to trace the sources of the English Mercantile law. The

sources of English Mercantile law are (a) Common Law (b) Equity (c) The Law Merchant, and (d) The Statute Law.

(a) The Common Law: The common law consists of principles based on immemorial customs and principles enforced by courts. It is traditionally unwritten law, developed in English courts during the period beginning with the thirteenth century and brought to our country by the British rule of India. In simple, we can say Common Law is nothing but Rules developed by custom in England.

(b) Equity: Equity Law is also unwritten and grew as a system of Law supplementary to the Common Law. It is based upon concepts of justice developed by judges. As the Common Law was too stereotyped and very harsh the Law of Equity was developed in English courts. In a sense, Equity covered the deficiencies of Common Law, especially where the Common Law worked very rigidly.

(c) The Law Merchant: The Law Merchant or 'Les Mercatoria' was independent body of customs and usages governing commercial transaction of the Merchants and Traders of 14th and 15th centuries, which have been ratified by the decisions of the Courts of Law. During this period the body commercial usages was practically uniform throughout Europe. In its earliest stages, therefore, the Law Merchant was a kind of Private International Law administered by tribunals consisting principally of the merchants themselves. The Law Merchant is the origin of much of the law relating to negotiable instruments, trademarks, partnerships, contracts of Insurance etc. In India the Law Merchant is codified, and the courts are left only with the task interpreting the languages of the Acts. But where some principles of the Law Merchant (Indian trade customs and usages) are not covered by those Acts, the Indian courts generally apply the English Law on the subject.

(d) Statute Law: The Statute Law refers to the Law passed in the Parliament. It is superior to any rule of the Common Law of Equity. The authority of the Parliament being supreme. It can pass any law it pleases, and is not bound by any of its previous Acts.

The other sources of the English Mercantile Law are:

(i) Roman Law: If for any particular case the existing law fails to suit, a reference to Roman law is made.

(ii) Case Law: This law is build upon previous judicial decisions. i.e. on the principle that what has been decided in an earlier case is binding in a similar future case, unless there is a change in the circumstances.

3. Judicial Decision or Precedents

This is source of law based upon previous judicial decisions which have to be followed in similar future cases. Judges interpret and explain statutes. Rules of equity and justice are incorporated in law through judicial decision. Whenever the law is silent on a point, the judge has to decide the case according to his idea of what is equitable.

4. Customs and Usages

A customary rule is binding where it is ancient, reasonable, and not opposed to any statutory rule. A custom becomes legally recognized when it is accepted by a court and is incorporated in a judicial decision.

QUESTIONS

1. Define “Law” and discuss the theory of “Rules of Law”.
2. “Change of Law depends upon the change of society”. Discuss.
3. What do you understand by Rule of Law?
4. “All are equal in the eyes of law”. Discuss.
5. Discuss the relationship between law and society.
6. What are the sources of commercial law in India?
7. What is meant by legal personality?
8. Distinguish between law and fact.

UNIT – II
LAW OF CONTRACTS

Lesson – 2.1- The Indian Contract Act

Lesson – 2.2 - Offer and Acceptance

Lesson – 2.3 - Consideration and Capacity of Parties

Lesson – 2.4 - Free Consent

Lesson – 2.5 - Discharge of Contracts and Void Agreements

LESSON – 2.1
THE INDIAN CONTRACT ACT

Introduction

The Indian Contract Act which was passed on 25th April, 1872, came into effect from 1st Sep. 1872. It was passed with an object to define and amend certain portions of the laws relating to contracts. It lays down general principles of law relating to contracts. It applies to the whole of the country except the State of Jammu and Kashmir. It does not affect the provisions of any Statute, Act or Regulation. Originally, the Act contained provisions relating to sale of goods and partnership. In 1930, rules relating to sale of goods were taken out from this Act and incorporated in a new Act, namely “Sale of Goods Act”. Similarly in 1932, provisions relating to partnership were codified as a separate Act and The Indian Partnership Act, 1932 was passed in the parliament. The Indian Contract Act in its present status contains the general principles of contracts, (Section 1 to 75) and special types of contract (Sec 124-238)

Object and Scope

Law of Contract constitutes the most important branch of mercantile law. It is the nerve centre of trade and commerce. It is not only the business community which is concerned with the law of contract, but it plays its role on every one’s walks of life. Every one of us enters into a number of contracts from dawn to dusk. When a person brings newspaper or rides a bus or goes to a hair-cutting saloon or purchases vegetables or borrows a loan from a friend etc., he enters into a contract though he may not be conscious of it. Such contracts create legal rights and obligations.

The object of the law of contracts is to introduce definiteness in commercial and other transactions. How this is done can be illustrated by an example, X entered into a

contract to deliver 10 tons of iron ore on a particular date. Since such a contract is enforceable by the courts, Y can plan his activities on the basis of getting iron ore on the fixed date. If the contract is broken, Y will get damages from the court and will not suffer any loss.

Sir William Anson observes in this regard that the law of contract is intended “to ensure that what a man has been led to expect shall come to pass and what has been promised to him shall be performed”.

Agreement and Contract

The Law deals with agreements which can be enforced through court of law. A contract has been defined by Sir John Salmond as “an agreement creating and defining obligations between the Parties”.

Sec.2(h) of the Indian Contract Act, provides that “An agreements enforceable by law is a contract. “An agreement is thus regarded as a contract only when it is enforceable by law. There are various social religious and moral obligations which are not enforceable by law as contracts.

Example: A husband promised to pay his wife a household allowance of \$30 every month. Later, the parties separated and the husband stopped the payment. The wife sued for the allowance, Held, agreements such as were termed, are mere social obligations and do not create legal relationship. As such they are not contracts. (Balfour Vs Balfour- 1919 ; 2 K.B.571)

In the words of **Lord Ackin**, “the most usual forms of agreements which do not constitute a contract are the agreements between husband and wife. They are not contracts because the parties do not intend that they should be attended by legal consequences”.

A Contract must specify two conditions (1) there shall be an agreement and, (2) such an agreement should be enforceable by law which creates legal obligation.

An agreement is defined under Sec.2(e) as “every promise and every set of promises, forming consideration for each other”. A promise is defined under Sec.2(b) thus: “When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. A proposal when accepted, becomes promise” In a nutshell, an agreement is an accepted proposal. Therefore, to form an agreement, there must be a proposal or offer by one party and acceptance by the other.

Definitions

The word contract is derived from the Latin word *contractum* meaning “drawn together”. It therefore denotes a drawing together of two or more minds to form a common intention giving rise to an agreement.

According to Sir John Salmond, a contract means “An agreement creating and defining obligations between parties”.

Sir William Anson defines a contract as “A Legal binding agreement between two or more persons by which rights are acquired by one or more acts or forbearance on the part of the other or others”.

According to *Pollock*, an “Every agreement and promise enforceable at law is contract”.

The Indian Contract Act 1872, Sec 2(h) defines a contract as follows:

“An agreement enforceable by law is a contract”.

ESSENTIALS OF A VALID CONTRACT

We have seen that all agreements are not contracts. The law of contract is the law of those agreements which create legal relationships and not simply moral or social ones. An agreement, which creates legal obligations in order to be valid and binding must possess certain basic essentials.

Sec.10 of the Contracts Act has laid down certain basic essentials for a valid contract. According to this Section, “All agreements are contracts if they are made by the free consent of parties, competent to contract, for a lawful consideration and with a law object and are not hereby expressly declared to be void”.

From the rule stated in Sec.10 the essential elements necessary constitute a valid contract are the following:

- (i.) Free consent of Parties (S.13)
- (ii.) Competency of Parties (S.11,12)
- (iii.) Lawful consideration (SS.23,24)
- (iv.) Lawful object (SS.23,24)
- (v.) Not declared to be void by any law(24,30)
- (vi.) They should also fulfill legal formalities presented by another law if any, viz., writing, registration etc.

According to English law, there is further requirement, namely “an intention to create legal obligation. “This principle is followed in India also. This may be treated as the seventh requisite element.

Now we shall discuss in detail the various essential elements of a valid contract.

1. Proposal or offer by one party and acceptance of the proposal or offer by another party resulting in an agreement.

A contract is a legally binding agreement. This agreement results when one person, the offeror or promisor, makes a proposal or offer and a person to whom the offer is made, the offered or promisee, accepts it. For an agreement to arise, there must be two or more parties to the transaction. As it is imperative that there be a concurrence of at least two minds, it is impossible for one person to make an agreement with himself.

Example: When a person in his official capacity as general manager of a company makes a promise to himself as an individual, no agreement is formed by an acceptance in the latter capacity. That there must be more than one person is an essential characteristic of an agreement. These persons must come to an understanding with a view to creating a right in one party and a corresponding duty on the other.

Consensus-Ad-Idem (or) Meeting of Minds: To constitute an agreement or a contract, there must be a meeting of the minds of the parties and both must agree to the same thing in the same sense. If in a particular agreement we find a meeting of minds or identity of wills of the parties in full and final then we can conclude that there must be consensus-ad-idem.

Example: Mr.Aravind who owns two Maruti cars of different colours namely red and white intends to sell his red car. But Miss, Athiral thinks she is purchasing the white car. In this situation, there is no consensus-ad-idem and consequently there is no contract.

The terms of the offer and acceptance must be legal which means that they should conform to the rules laid down in the Contract Act regarding the valid offer and valid acceptance i.e. the terms of the offer must be definite and the acceptance of the offer must also be absolute and unconditional. The acceptance must also be according to the mode prescribed and must be communication to the promisor.

2. Intention to create Legal Relationship:

The parties to the agreement must intend to create legal relations between them. Mere social or domestic agreements are not contracts because they are not intended to be

binding i.e., an agreement to have a cup of tea at a friend's house is simply a social obligation.

Example: "X" offers to play cards with "Y" for pleasure and "Y" accepts. If later on, "X" refuses to do so, "Y" cannot go to the court for enforcing the promise.

3. Lawful Consideration:

Subject to certain exceptions an agreement legally enforceable only when each of the parties to it gives something and gets something. An agreement to do something for nothing is generally not enforceable at law. The something given or obtained is called consideration. The Consideration may be an act (doing something) (or) forbearance (not doing something) or a promise to do or not to do something. Consideration may be past, present or future. But it must be real and lawful.

Example:

"X" agrees to sell his car to "Y" for Rs.1,00,000.

For "X"'s promise, the consideration is Rs.100,000.

For "Y"'s promise the consideration is the car.

4. Capacity of Parties:

The parties to an agreement must be legally capable entering into an agreement; otherwise it cannot be enforced by a court. Want of capacity arises from minority, lunacy, idiocy, drunkenness are similar other factors. If any of the parties to the agreements suffers from any such disability, the agreement is not enforceable by law, except in some special cases.

5. Free Consent:

The two parties to a contract must have agreed as to the particular subject matter in the same sense. By Section 13 "two or more sections are said to consent when they agree upon the same thing in the same sense "Such a meeting of minds creating an identity of opinion or will is carried to by using the term 'Consensus-ad-idem'. The consent of parties not be affected by any flaw. The consent is said to be free when it is not used by coercion, undue influence, fraud, mistake or misrepresentation.

Example: 'A' threatens to beat "B" if he does not sell his land for a low price agrees to do so. The agreement has been brought about by coercion.

6. Legality of Object:

An agreement is unlawful and therefore unenforceable when the object for which the agreement is made is forbidden by law, or if permitted would defeat the provisions of any of the existing law or is fraudulent or involves an injury to the property of another or in the eyes of the court, is immoral, or opposed to public policy (Sec.23).

Thus an agreement will not become a contract or will remain unenforceable, if it is made for an unlawful consideration and with an unlawful object.

Example: 'A', 'B' and 'C' enter into an agreement for the division among them of gains acquired or to be acquired by them by fraud. The agreement is void.

7. Certainty of the Terms of the contract:

The terms of the agreement must be definite and certain and it must not contain any ambiguous information.

Example: 'A' agrees to sell to 'B' a hundred tons of oil". There is nothing whatever to show what kind of oil was intended. The agreement is void for want of certainty.

8. Possibility of Performance:

The terms of the agreement must also be such as are capable of performance. An agreement to do an act which is impossible in practice cannot be enforced.

Example: When A agrees with B to find a treasure the agreement is void as it is impossible of performance.

9. Void agreements:

The agreements must not have been expressly declared to be void. Following agreements are expressly declared to be void under the Indian Contract Act:

- a. Agreement in restraint to marriage (Sec.26)
- b. Agreement in restraint to trade (Sec.27)
- c. Agreement in restraint to legal proceedings (Sec.28)
- d. Agreement having uncertain meaning (Sec.29)
- e. Wagering agreement (Sec.30)

10. Legal formalities:

The agreement may either be oral or in writing. But there are certain agreements which are required to be in writing e.g., lease, gift, sale, mortgage of immovable property, negotiable instruments, certain matters under the Companies Act, 1956. Such agreements must be in

writing, attested and registered, if so required by law. Registration of agreements or deeds is compulsory in cases of documents falling within the scope of Sec. 17 of the Indian Registration Act, 1980. If the agreement does not comply with these legal formalities it cannot be enforced by law.

CONTRACTUAL RIGHTS AND OBLIGATIONS

The law of contract consists of a number of limiting factors subject to which the parties may create rights and duties for themselves which the law will enforce.

It deals with two rights:

- (1) Rights in Personam
- (2) Rights in Rem

RIGHTS IN PERSONAM

Example: If 'X' has a right to get back a sum of Rs.5000 from 'Y' that right can be exercised only by 'X' but not by others because the right 'X' has against 'Y' is a right in personam. 'X' cannot enforce that right against anyone else except 'Y'.

RIGHTS IN REM

If 'A' owns a plot of land and 'B' is the adjacent owner, the right of 'A' to have uninterrupted possession and employment of that land is available not only against 'B' but against every member of the public. Similarly everyone except 'A' is under an obligation not to interfere with 'A's' possession or enjoyment, because the rights of 'A' in respect of that land are Rights in rem. The rights to property are all "Rights in Rem".

CLASSIFICATION OF CONTRACTS

For the sake of convenience we can classify contracts according to their (1) Validity, (2) Formation and (3) Performance. Let us examine them in detail.

1.Classification according to validity: When we closely analyse the definition of a contract, it is found that the contract is based on agreement. An agreement enforceable at law is a contract. To make the agreement enforceable at law. The essentials stipulated in Sec. 10 of the element is missing then the contract may either be void, voidable, illegal, or unenforceable.

a. void agreements: “An agreement not enforceable by law is said to be void”- Sec. 2(g). A void agreement has no legal effect. It confers no rights on any person and creates no obligations.

Examples: An agreement made by a minor, agreements without consideration (except certain cases). Certain agreements against public policy; etc., are void from the beginning.

Void Contract: There are certain agreements which are valid in the beginning and subsequently it becomes void due to impossibility of performance, change of law or other reasons. When it becomes void the agreements ceases to have legal effect. This we call as void contract as per Sec 2(j) **Example:** A contract to export coffee to USSR. It may subsequently become void if the exporting country bans the product from being exported.

Illegal agreement: An illegal agreement is one which is against a law in force in India.

Example: An agreement to commit murder, theft or cheating.

Voidable contract: A voidable contract is one which can be avoided by some of the parties to the agreement. Until it is avoided, it is a good contract. An agreement which is enforceable by law at the option of one or more of the parties thereto, but not at the option of the other or others, is a voidable contract as per Sec.2(i) **Examples of voidable contracts:** Contracts brought about by coercion, under undue influence, misrepresentation etc.

Illustration: ‘P’ threatens ‘Q’ to enter into a contract for the sale of ‘Q’s landed property to ‘P’. This contract can be avoided by ‘Q’. ‘P’ cannot enforce the contract. But ‘Q’, if he so desires, can enforce it against ‘P’.

Unenforceable agreement: The term unenforceable agreement is used in English law. It means an agreement which cannot be forced in a court of law by one or both of the parties, because of some technical defect. E.g. want of registration or non-payment to requisite stamp duty or for want of written form.

Difference between void and voidable contract

	Void	Voidable
1	Not enforceable by law	Enforceable by law at the option of one of the parties to the contract.
2	It has no legally binding effect	It continues to be legal unless avoided by the party.
3	In a void contract, the defects are incurable	In a voidable contract, the defect is curable
4	A third party who purchased goods which had been the subject of a void contract will not acquire good title	But in voidable contract third party will acquire good title.

Difference between void contract and illegal contract

	Void	Illegal
1	All void contracts are not necessarily illegal	All illegal contracts are void
2	All collateral contracts to a void contract are not void	But all collateral contracts to a illegal contract are void
3	Ground for the voidness has to proved.	Court will, of its own motion, in be case of an illegal contract, refuse to enforce it, even though the illegality has not been pleaded.

Valid contract: An agreement enforceable at law is a valid contract. An agreement becomes a contract when all the essentials of a valid contract stipulated in Sec. 10 are complied with.

2. Classification on the basis of Formation: A contract may be created in three different methods:

1. It may be in writing.
2. It may be made orally, and
3. It may be inferred from the circumstances of the case.

Contracts can be classified according to the mode of their formation as Express, Implied and Quasi contracts

Express contracts are those in which the fact of the agreement can be proved by words written or spoken which express the intention of the parties. Thus contracts in writing and oral (by spoken words) can be collectively called “express contracts.”

In case of implied contracts or tacit or inferred contracts agreements would be inferred from conduct of the parties and the general circumstances of each case.

Examples: Mr. A takes a public bus or enters into a restaurant for a cup of coffee or obtains a ticket from an automatic machine.

Unlike other contracts, the quasi-contract does not fulfil such requirements and in that strict sense, is not a contract at all. It rests on the ground of equity that,

“A person shall not be allowed to enrich himself unjustly at the expense of another.” In such a contract, rights and obligations arise not by any agreement between the parties but by operation of law.

Example: ‘A’ a shopkeeper supplied groceries to ‘B’ by mistake. ‘B’ used the items as his own. ‘B’ is bound to pay.

In the above case there is no consensus, no offer, no acceptance; still the law implies a contract. This is known as quasi-contract.

3. Classification according to performance: Contracts can again be classified depending upon the extent to which it has been performed i.e. Executed and Executory contracts.

An executed contract is one wherein both the parties have performed their obligations under the contract.

Example: ‘A’ agrees to sell his motorbike to ‘B’ for Rs.20,000. In this situation ‘A’ has given the motorbike and got the money from ‘B’. When both the parties perform their part of the obligation under the contract the contract is said to be executed.

An executor contract is one where both the parties are yet to perform their obligations. Thus in the above example, if ‘A’ has not yet delivered his motorbike and ‘B’

has not paid the price, the contract is executed as to 'A' and executory as to 'B'. Another classification of contracts on the basis of performance is as follows:

Unilateral or one-sided and Bilateral or two sided contract: In case of a unilateral or one-sided contract, one party to the contract has performed his part even at the time of its formation and an obligation is outstanding only against the other.

Example: The promise to give a reward to the person who finds out a lost thing forms a unilateral contract when the thing is actually found out. It creates an one-sided obligation.

In the Bilateral contract at the time of its formation, there are two outstanding obligations.

Example: 'A' promises to paint a picture in one month in return for which 'B' promises to pay Rs. 1000. Here there are two promises and each party is a promisor in respect of one promise and a promisee in respect of the other and as such each can hold the other liable for the breach of his promise.

LESSON – 2.2

OFFER (PROPOSAL) AND ACCEPTANCE

Introduction

As discussed earlier, a contract is defined as a promise or agreement enforceable by law. So, two elements namely, agreement and enforceability are essential for a valid contract. All contracts are made by the process of a lawful offer by one party and the lawful acceptance of the offer by the other party.

Example: If ‘X’ says to ‘Y’ “will you buy my house for Rs. 5,00,000”? It is an offer. If ‘Y’ says “Yes”, the offer is accepted and a contract is formed.

An ‘offer’ involves the making of a proposal. The term proposal is defined under Sec 2(a) in the Contract Act as follows: “when one person signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal”

A proposal is also called an offer. The promisor or the person making the offer is called the offeror. The person to whom the offer is made is called the offeree.

Promise and Acceptance: Sec.2(b) of the Act defines promise as “when the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. A proposal when accepted becomes a promise” Promisor and promise are defined under Sec 2(c) as “The person making the proposal is called the ‘promisor’ and the person accepting the proposal is called the ‘promisee’ – Sec. 2(c).

A proposal or acceptance may be made in any of the following manners:

- By express words spoken,
- In writing.
- By conduct.

Examples:

1. When A says to B: “will you buy this building for Rs.20 lakhs”? It is an express oral offer.
2. When A writes to B stating the above offer, then it is an express written offer.
3. When a transport company runs a bus on a particular route, it is termed as an implied offer or an offer by conduct.

RULES REGARDING VALID OFFER

- 1. An offer may be express or may be implied from the circumstances:** In so far as the proposal or acceptance of any promise is made in words, the promise is said to be express. In so far as such proposal or acceptance is made otherwise in words, the promise is said to be implied (Sec. 9).
- 2. An offer may be made to a definite person; to some definite class of persons; or to the world at large:** An offer made to a definite persons or a definite class of person is called a specific offer. An offer sent to all persons (the world of public at large) is called a General offer or Public offer.

Examples: Specific offer: 'X' offers to sell his motor cycle to 'Y' for Rs.10,000. This is a specific proposal. This proposal is specifically given to 'Y'. Only 'Y' can accept this proposal.

General offer: Carlill Vs Carbolic Smoke Ball & Co (1893) The patent medicine company advertises that it would give a reward of \$100 to anyone who contacted influenza after using the medicine namely smoke ball of the company for a certain period according to the specifications. Mrs. Carlill purchased the smoke ball and contacted influenza in spite of using it as per the specifications. She claimed the reward of \$100. The claim was refused by the company on the ground that the offer was not made to her and that in any case she had not communicated her acceptance of the offer. She filed a suit for the recovery of the reward.

It was held that she could recover the reward as she had accepted the general offer made by the company after complying with the terms of the offer.

3. Offer must be capable of creating legal relationship: The offer must be one which is capable of creating a legal relationship. An invitation to a birthday party or an invitation to play cards will not crate legal relationship. Therefore an offer for such social events will not constitute a contract.

Example: Balfour Vs Balfour (1919): A husband promised to send money to his wife, so long as she remained away from him. It was held that if the husband fails to pay, the wife

could not sue for the amount on the ground that the promise made by the husband was never intended to give rise to legal consequences.

4. The terms of the offer must be definite and certain: The terms of the offer must be definite, unambiguous and certain and not loose and vague. To constitute a valid contract, it is essential that the proposal must be so certain, that the rights and obligations of the parties arising out of the contract can be exactly fixed. If the terms of an offer are uncertain, its acceptance cannot create any contractual relationship. According to Sec. 29 of the Act, agreements, the meaning of which is not certain or capable of being made certain are void.

Example: ‘X’ says to ‘Y’ “I will give you some money if you marry ‘Z’”. This is not an offer which can be accepted because the amount of money to be paid is not certain.

5. A mere statement of intention is not an offer: Every expression of willingness to enter into a contract may not amount to an offer in the legal sense. It may be only a first and preliminary step in the formation of a contract. Thus it becomes necessary to distinguish between the offer on the one hand and (i) a mere declaration of intention (ii) an invitation to make an offer, and (iii) auction sale, on the other hand.

A distinction is usually made between an ‘offer’ and “a statement of intention”. Price lists and catalogues and enquiries from customers are merely statements of intention. They are not regarded as offers but as invitation to others to make offers.

Harvey Vs Facey: Harvey telegraphed to Facey asking to inform him whether he would sell Bumper Hall pen and if so at what price? Facey informed Harvey that the lowest price was \$900 but did not say that he was willing to sell at that price. Harvey telegraphed that he would buy at that price. Facey gave no reply to the telegram. Held, there was no contract because facey did not say that he was willing to sell or not. Mere mentioning of price is not an offer.

Similarly, in an auction sale, articles displayed in auction sale are displayed with an intention that the bidders present during the auction sale may bid for them. i.e. may make an offer for them. In an auction sale, a bid is an offer. It can therefore, be taken back at any time before acceptance is made by the auctioneer is effected by the fall of the hammer.

6. An offer must be communicated to the offeree: A person cannot accept an offer unless he knows of the existence of the offer.

Example: 'P' offers a reward to anyone who finds his lost dog. 'Q' on finding the dog brings it to 'P' without having heard of the offer. Held he was not entitled to the reward.

Lalman Vs Gauri Dutt: 'G' sent his servant 'L' in search of his missing nephew, subsequently 'G' announced a reward for information concerning the boy. 'L' brought back the missing boy, without having the knowledge of the reward. Held, there was no contract between L and G and the reward cannot be claimed.

7. An offer may have certain conditions: A proposer is at liberty to make an offer subject to certain conditions. It is immaterial if the terms are hard or ridiculous. Conditions attached to the offer must clearly be communicated to the offeree. The offeree must fulfil all the conditions mentioned in the offer.

8. Offer must not thrust the burden of acceptance: Offer should not contain the term "the non-compliance of which may be assumed to amount to acceptance". Thus a man cannot say that if he fails to hear from the other party within a week he would consider the offer as being accepted. Similarly, if 'A' writes to 'B'. "I will sell you my house for Rs.5 lakhs. If you do not reply. I shall assume that you have accepted the same. There is no contract even if 'B' does not reply.

LEGAL RULES AS TO ACCEPTANCE

An offer unless accepted cannot become an agreement. Acceptance is essential to convert an offer into an agreement. The acceptance of an offer to be legally effective must satisfy the following requirements:

1. It must be absolute and unqualified: An acceptance to be effective must be absolute and unqualified of all the terms of the offer. A conditional acceptance is not an acceptance at all. If there is any variation, even of an unimportant point, there is no contract. An acceptance with a variation is no acceptance but is a mere "counter offer" which is for the original offeror to accept or not.

Example: Mr.'X' informed 'Y' his willingness to buy 'Y's' car for Rs.75,000. On receipt of the offer 'Y' informed 'X' that he is willing to sell his car for Rs.1,00,000. In this

example, 'Y's' acceptance is not unconditional or unqualified. This is not an acceptance. It is only a counter offer. If 'X' accepts for Rs.1,00,000, then it will become a contract.

2. The mode of acceptance must be in some usual manner: Except where the offer prescribed a particular mode of acceptance, the acceptance must be made in such manner that it may come to the knowledge of the proposer. If the proposer prescribes a mode of acceptance, the acceptance must be given accordingly.

Example: If the proposer says "Telephonic reply" and the reply was sent by post, then there is no acceptance of the offer.

If the offeree fails to follow the prescribed mode of acceptance, the offeror may, within a reasonable time alter the acceptance as communicated to him, insist that the proposal be accepted in the prescribed manner. If he does not inform the offeree he is deemed to have accepted the acceptance although it is not in the desired manner [Sec. 7.(2)].

3. Acceptance must be by the party named in the offer: An offer made to a particular person is to be accepted by him only. It cannot be assigned to anybody else. It cannot be accepted by another without the consent of the offeror. However, in case of general offer, any member of the public may accept it.

4. An acceptance must be communicated to the offeror: Just as the offer should be communicated to the acceptor should do something to inform his intention to accept. In certain cases the offeror may prescribe a particular mode of acceptance, then all that the acceptor has to do is to follow that mode.

5. Acceptance must be within a reasonable time: The acceptance must be made while offer is still in force. (i.e) before the offer lapses. Acceptance made after the offer has been withdrawn is invalid. If any time limit is prescribed in the offer, it should be accepted within that time. But if no time is prescribed it must be accepted within "a reasonable time". What is a 'reasonable time' depends upon the circumstances of each case.

6. Acceptance cannot be made in ignorance of the offer: Acceptance cannot precede the offer nor does an acceptance in total ignorance of an offer result in a contract.

7. Clarification: The seeking of clarification of offer neither amounts to the acceptance of the offer nor to the making of a counter offer.

8. Mental acceptance or uncommunicated assent does not result in a contract: No contract is formed if the offeree remains silent and does nothing to show that he has accepted the offer.

Example: F offered to buy 'B's horse for \$30 saying. "If I hear no more from you, I shall consider the horse as mine at \$30." 'B' did not reply. Held there was no contract because the other party was not informed (Felthouse Vs Bindley)

9. When acceptance is complete: Sec. 4 of the contract act lays down that the communication of an acceptance is complete as against the proposer, when it is put in a course of transmission to him; so as to be out of the power of the acceptor; and as against the acceptor, when it comes to the knowledge of the proposer.

Examples

- (i) 'A' proposes by letter to sell a house to 'B' at a certain price. The communication of the proposal is complete when 'B' receives the letter.
- (ii) 'B' accepts 'A's proposal by a letter sent by post. The communication of the acceptance is complete as against 'A'. When the letter is posted, as against 'B', when the letter is received by 'A'.

COMMUNICATION OF OFFER AND ACCEPTANCE

An offer may be communicated to the offeree or offerees by word of mouth, by writing or by conduct. A written offer may be contained in a letter or a telegram.

Sec. 4 states: "The communication of a proposal is complete when it comes to the knowledge of the person to whom it is made."

The acceptance must be expressed in some usual or reasonable manner. The offeree may express his acceptance by word of mouth, telephone, telegram or by post.

Mr. G applied for shares in a company. A letter of allotment was posted but the letter did not reach 'G'. held there was a binding contract and 'G' was shareholder of the company (Household Fire Co. Vs. Grant)

REVOCAION OF OFFER AND ACCEPTANCE

Revocation of an offer: An offer comes to an end and is no longer open to acceptance under the following cases-Sec.6

1. Lapse of time.
2. After expiry of reasonable time.
3. An offer lapses by the failure of the acceptor to fulfil a condition precedent to acceptance, where such a condition has been prescribed.
4. An offer lapses by the death or insanity of the proposer, if the fact of his death or insanity comes to the knowledge of the acceptor before acceptance.
5. When the counter-offer is given, the original offer lapses.
6. A proposal once refused is dead and cannot be revived by its subsequent acceptance.

Example: 'A' offers to sell his farm to 'B' for Rs.1,00,000.'B' replies offering to pay Rs.90,000. 'A' refuses. Subsequently 'B' writes accepting the original offer. There is no contract because the original offer has lapsed.

7. By notice: If the offeror gives notice of revocation to the other party, an offer may be revoked anytime before acceptance but not afterwards. Once an offer is accepted there is a binding contract.

The acceptance of an offer becomes binding on the offeror as soon as the acceptance is put in course of communication to the offeror so as to be out of the power of the acceptor. But anytime before this happens, the offer may be revoked.

Example: A proposal is sent by 'X' to 'Y' and accepted by 'Y' by letter. The proposal might have been revoked anytime before the letter of acceptance was posted but it cannot be revoked after the letter is posted.

The notice of revocation does not take effect until it comes within the knowledge of the offeree.

Revocation of Acceptance: An acceptance may be revoked at any time before the communication of the acceptance is complete as against the acceptor but not afterwards.

Example: 'A' proposes by a letter sent by post to sell his house to 'B'. 'B' accepts the proposal by letter sent by post. 'A' may revoke his proposal at any time before or at the moment when 'B' posts his letter of acceptance but not afterwards. 'B' may revoke his acceptance at any time before or at the moment when the letter communicating it reaches 'A' but not afterwards.

LESSON - 2.3

CONSIDERATION AND CAPACITY OF PARTIES CONSIDERATION

Meaning

Consideration is an essential element in a contract. It is the sign and symbol of every bargain subject to certain exceptions. An agreement made without consideration is void. Consideration is the necessary evidence required by law of the intention of the parties to effect their legal relations. All contracts require consideration to support them. Consideration means the valuable considerations (i.e) the price paid for the other party's promise. Contract results where one party promises to do in exchange for something in return. Consideration is otherwise known as "something in return." In a nutshell, consideration is the price paid by the promisee for the obligation of the promisor.

Example

- (i) 'P' agrees to sell his land for Rs.2,00,000 to 'Q'. for 'P's promise, the consideration is Rs.2,00,000. For 'Q's promise, the consideration is the house.
- (ii) 'X' promises not to file a suit against 'Y' if 'Y' pays him Rs.10,000 on a particular date. 'X's act of not filing a case against 'Y' is the consideration for 'Y' and Rs.10,000 is the consideration for 'X'. if there is no consideration there is no contract.

In an Allahabad case, a person subscribed Rs.500 to rebuild a mosque. It was held that the promise was without consideration and the subscriber was not liable. (Abdul Aziz V. Masum Ali)

Definitions

Sec. 2(d) of contract act defines consideration as follows:

"when at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or to abstains from doing, such act or abstinence or promise is called a consideration for the promise."

In the English case Currie V. Misa (1875) consideration was defined as, "some right, interest, profit or benefit accruing to one party for some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other."

Example: 'X' engages 'Y' as a steno in his office for Rs.2000 per month. The monthly wage is the consideration received by 'Y'. the services of 'Y' is the consideration for 'X'.

The consideration may consist of either:

- (i) An act (which one is legally bound to perform)
- (ii) An abstinence or forbearance from doing
- (iii) A return promise.

TYPES OF CONSIDERATION

Consideration may be classified as

1. Past consideration
2. Present consideration, and
3. Future consideration.

Past consideration: When the consideration of one party was given before the date of the promise, it is said to be past.

For Example, ‘X’ does some work for ‘Y’ in the month of January and ‘Y’ promised him to pay some money during February. The consideration of ‘X’ is past consideration. Under English law past consideration will make the contract invalid. But under Indian law a past consideration is good consideration because the definition of consideration in Sec.2(d) includes the words “has done or abstained from doing.”

Present consideration: Consideration which moves simultaneously with the promise is called present consideration or executed consideration.

Future Consideration: When the consideration is to move at a future date it is called future consideration or executory consideration.

ESSENTIALS OF VALID CONSIDERATION

1. Consideration Must Move at the Desire of the Promisor: The act done or loss suffered by the promise must have been done or suffered at the desire of the promisor. An act done without any request is a voluntary act and does not come within the definition of consideration.

The collector of a district asked ‘D’ to spend money on the improvement of a market and he did so. ‘D’ cannot demand payment from the shopkeepers using the market for having improved the market. (Durga Prasad Vs Baldeo)

2. It must be a real consideration: The consideration must have some value in the eyes of law. It must not be illusory. The impossible acts or non-existing goods cannot

support a contract. A contribution to charity is without consideration. A promise to pay an existing debt within due date if the creditor gives a discount is without consideration and the discount cannot be enforced.

- 3. Public Duty:** “Where the promise is already under an existing public duty, an express promise to perform or performance of that duty will not amount to consideration.

Example: A contract to pay a sum to a witness who has already received some money to appear at a trial is invalid.

- 4. Promise to a stranger:** A promise made to a stranger to perform an existing contract, is enforceable because the promisor undertakes a new obligation upon himself which can be enforced by the stranger.

‘X’ wrote to his nephew ‘B’, promising to pay him an annuity of 150 pounds in consideration of his marrying ‘C’. ‘B’ was already engaged to marry ‘C’. Held that the fulfilment of B’s contract with ‘C’ was consideration to support X’s promise to pay the annuity. (Shadwell Vs Shadwell)

- 5. Consideration need not be adequate:** Explanation 2 under Sec. 25 provides that “An agreement to which the consent of the party is freely given is not void merely because the consideration is inadequate.” Law requires the presence of consideration, but does not inquire into the adequacy.

Example: ‘P’ agrees to sell a house worth Rs.5,00,000 for Rs.1,00,000. P’s consent to the agreement was freely given. The agreement is valid in spite of inadequate consideration.

- 6. The consideration must not be illegal, immoral or opposed to public policy:**

If the consideration of the object of the agreement is illegal, immoral or opposed to public policy, the agreement to contract is invalid.

Example: ‘X’ agreed to pay Rs.50,000 to ‘Y’ if he kills ‘C’.

- 7. The consideration may be past, present and future**

In the past promise, consideration has already been taken place. In the present consideration, it simultaneously moves with promise. In the future consideration, it passes subsequently.

8. The consideration may move from the promisee or from any other person:

A person has given some properties to his wife 'C' directing her at the same time to pay an annual allowance to his brother 'R'. 'C' also entered into an agreement with 'R' promising him to pay the allowance. This agreement can be enforced by 'R' even though no part of consideration received by 'C' moved from 'R'

“NO CONSIDERATION NO CONTRACT” – EXCEPTIONS TO THIS RULE

Consideration is essential for the validity of a contract. “A promise without consideration is a gift; one made for a consideration is a bargain” (Salmond and Windfield)

A promise without consideration is a gratuitous undertaking and cannot create a legal obligation. Under Roman law an agreement without consideration was called a 'nudum pactum' and was unenforceable. Under English law simple contracts must be supported by consideration but special contracts require no consideration. Under Indian law, the presence of consideration is a rule essential to the validity of contracts.

Exceptions:

- 1. Natural love and affection:** An agreement without consideration is valid under Section 25(1) only if the following requirements are complied with:
 - (i) The agreement is made by a written document
 - (ii) The demand is registered according to the law relating to registration in force at that time.
 - (iii) The agreement is made on account of natural love and affection.
 - (iv) The parties to the agreement stand in a near relation to each other.

Examples: An agreement entered into by a husband with his wife during quarrels and disagreement, whereby the husband promised to give some property to his wife. The agreement is void because, under the circumstances, there is no natural love and affection between the parties. (Rajlukhy Debee V. Bhootnath ;1900)

- 2. Voluntary Compensation:** Sec.25(2) applies when there is a voluntary act by one party and there is a subsequent promise (by the party benefited) to pay compensation to the former. The term 'voluntary' signifies that the act was done, “otherwise than at the desire of the promisor.” This kind of promise without any

consideration is valid. **Example:** 'D' finds B's baggage and gives it to him. 'B' promises to give 'D' Rs.100. this is a valid contract.

3. **Time-barred debt:** 'A's promise to pay, wholly or in part, a debt which is barred by the law of limitation can be enforced if the promise is in writing and is signed by the debtor or his authorised agent. [Sec. 25(3)] **Example:** 'D' owes 'B' Rs.10,000 but the debt is barred by the limitation act. 'D' signs a written promise to pay 'B' Rs.5000 on account of the debt. This is contract.
4. **Agency:** No consideration is required to create an agency. (Sec. 185).
5. **Completed Gift:** According to Sec. 25 'No consideration no contract' rule does not apply to completed gifts.

If a person transfers certain property to another by a written and registered deed according to the provisions of Transfer of property Act, he cannot subsequently claim back that property on the ground of lack of consideration.

Can a person who is stranger to consideration sue upon it? Normally, the rule is that the consideration must move from the promisee and the party to a contract can sue. In other words, a stranger to a consideration cannot sue. Under English law, a stranger to a consideration cannot sue.

Examples: Suppose 'A', a doctor, agrees to treat 'B', but as 'A' will not accept payment, 'B' promises 'C' (A's son) that he will pay him Rs.5,000, 'C' cannot maintain a suit on the promise because he is a stranger to the consideration and the fact of C being the son of A will not alter the position.

Under Indian law consideration may move from the "promisee or any other person". So it is clear that the consideration can move from any person.

There are certain differences between the rights of a stranger to a contract and stranger to consideration. A stranger to contract i.e. one who is not a party to it, cannot file a suit to enforce it. A contract between 'P' and 'Q' cannot be enforced by 'R'.

But a stranger to consideration can sue to enforce it provided he is a party to the contract. A contract between 'P', 'Q' and 'R' whereby 'P' pays money to 'Q' for delivering goods to 'R' can be enforced by 'R' although he did not pay any part of the consideration.

CAPACITY OF PARTIES

Capacity defined: According to

. 10, an agreement becomes a contract if it is entered into between the parties who are competent to contract. 'capacity' referred to here, means competence of the parties to enter into a valid contract. Capacity includes physical and mental capacity.

According to Sec.11: Every person is competent to contract who is of the age of majority, according to the law to which he is subject, and who is of sound mind, and is not disqualified from contracting by any law to which he is subject.

From this definition we come to the conclusion that the following are not competent to contract:

1. A person who has not attained the age of majority.
2. A person who is of unsound mind, e.g. lunatic or an insane person.
3. Any other person who has been disqualified from contracting under any law, e.g. a person who has been adjudicated an insolvent.

Minor: Under Section 3 of the Indian Majority Act, 1875, a minor is one who has not completed eighteenth year of age. It may be stated here that a minor whose property has been entrusted to a guardian by a court, attains the age of majority when he completes twenty one years of life. In England, minority continues up to the completion of 21st year.

THE LEGAL RULES REGARDING MINOR'S AGREEMENT

1. Minor's agreement is Void-ab-initio: (void from the very beginning):

Today an agreement with or by minor is void and inoperative. Formerly, the position was not clear. The Indian Contract Act, does not expressly state whether a contract made by a minor is void or voidable. Sec.11 of the Act simply states that a minor is not competent to contract. Following the English law, it was held formerly that a minor's contract was voidable but not void. The issue came up again in the case of *Mohori Bibee Vs Dharmadas Ghose* (1903)

In this case, a minor executed an agreement for Rs.20,000 and received Rs.8,000 from a mortgagee by way of earnest money. He sued for setting aside the mortgage. The lender wanted refund of the sum which he had actually paid. Held an agreement by a

minor was absolutely void and therefore, the question of refunding the money did not arise. Had the agreement been only voidable, the benefit received would have been refunded under Sections 64 and 65 of the Act.

2. A Minor can be a Promisee or a Beneficiary: During his minority, a minor cannot bind himself by a contract, but there is nothing in the contract act which prevents him from making the other party to the contract to be bound to the minor. Thus, a minor is incapable of making mortgage, or a promissory note. But he is capable of becoming a mortgagee, a payee or endorsee. He can derive benefit under the contract.

3. A minor's Agreement cannot be Ratified by the Minor on his attaining Majority: A minor cannot ratify the agreement on attaining the age of majority as the original agreement is totally void from the beginning, and, therefore, validity cannot be given to it later on.

Example: Indira Ramasamy V Anthiappa Chettiar. 'A' a minor makes a promissory note in favour of 'B'. on attaining majority, he makes out a fresh promissory note in place of the old one. Neither the original nor the fresh promissory note is valid.

4. If a Minor has Received any Benefit Under a Void Contract he Cannot be Asked to Refund the same: We have already mentioned the facts in Mohiri Bibee's case. In that case, the lender could not recover the money paid to the minor. Also the property mortgaged by the minor in favour of the lender could not be sold by the latter for the realisation of his loan.

5. A Minor is Always Allowed to plead Minority: He is not prevented from this right even where he had procured a loan or entered into some other contract by falsely representing that he was of full age. Thus, an minor who has deceived the other party to the agreement by representing himself as of full age is not prevented from later asserting that he was minor at the time he entered into agreement.

Examples: Leslie V Shiell (1914) In this case 'S', a minor, borrowed £ 400 from L, a money lender, by fraudulently misrepresenting that he was of full age. On default by 'S', 'L' sued for return of £ 400 and damages for the crime. Held, 'L' could not recover £ 400, and his claim for damages also failed. Even on equitable grounds, the minor could not be asked to refund £ 400, as the money was not traceable as the minor had already spent it.

In the case of a fraudulent misrepresentation of his age by the minor, inducing the other party to enter into a contract, if money could be traced. The court may award compensation to that other party under Sections 30 and 33 of the Specific Relief Act, 1963.

6. A Minor Cannot be a Partner in a Partnership Firm: He cannot become a partner but for the benefit of the partnership with the consent of all the partners he can be admitted as a partner. Other partners cannot file a case against the minor partner if the latter commits any offence.

7. A Minor's Estate is Liable to a Person Who Supplies Necessaries of Life to a Minor: However there is no personal liability on a minor for the necessaries of life supplied.

The term 'necessaries' is not defined in the Indian Contract Act, 1872. but the English Sale of Goods Act defines necessaries as "goods suitable to the condition in life of the minor and to his actual requirements at the time of sale and delivery".

From the above definition it is very clear that in order to entitle the supplier to be reimbursed from the minor's estate, the following conditions must be fulfilled:

- The goods are necessaries for that particular minor having regard to his status. For example, Purchase of a car may be a necessity for a particular minor and may not hold good for the other person.
- The minor needs the goods both at the time of sale and delivery.

Example: Nash V Inman (1908): A minor, was studying B.C.S., in a college. He ordered 11 fancy coats for about £ 45 with N, the tailor. The tailor sued him for the price. His father proved that his son had already number of coats and had clothes suitable to his condition in life when the clothes made by the tailor were delivered. Held, the coats supplied by the tailor were not necessaries and therefore, tailor cannot get the price.

The minor's estate is liable not only for the necessary goods but also for the necessary services rendered to him. The lending of money to a minor for the purpose of defending a suit on behalf of a minor in which his property is in jeopardy or for defending him in prosecution, or for saving his property from sale in execution of decree is deemed to be a

service rendered to the minor. Other examples of necessary services rendered to a minor are: provision of education, medical and legal advice, provision of a house on rent to minor for the purpose of living and continuing his studies.

8. Minor's parents or guardians are not liable to a minor's creditors for the breach of contract by the minor, whether the contract is for necessities or not. But the parents are liable where the minor is acting as an agent of the parents or the guardian.
9. A minor can act as an agent and bind his principal by his acts without incurring any personal liability.
10. **No specific performance:** An agreement by a minor being void, the court can never direct specific performance of such an agreement by him.
11. **No Insolvency:** A minor cannot be declared insolvent even though there are dues payable from the properties of the minor.
12. **Company' shares to a minor:** A minor cannot apply for and be a member of a company. If a minor has, by mistake, been recorded as a member, the company can rescind the transaction and remove the name from the register. But where a minor was made a member and, after attaining majority, he received and accepted dividends, he will be stopped from denying that he is a member. (Fazalbhoy V The Credit Bank of India)

PERSONS OF UNSOUND MIND

Definition of "Sound Mind" for a valid agreement it is necessary that each party to it should have a sound mind. What is sound mind for the purpose of contracting is laid down in Sec. 12 of the Indian contract act.

Section 12: A person is said to be of sound mind for the purpose of making a contract if at the time when he makes it, he is capable of understanding it and of forming a rational judgement as to its effect upon his interests.

A person usually of sound mind, but occasionally of unsound mind, may not make a contract when he is of unsound mind. However, when he is of sound mind he is capable of becoming a party to a contract.

Illustrations

- (a) A patient in lunatic state of mind, who is at intervals of sound mind, may make a contract during these intervals.
- (b) A sane man who is delirious from fever, or who is so drunk that he cannot understand the terms of a contract, or form a rational judgement as to its effect on his interests, cannot contract whilst such delirium or drunkenness lasts. Unsoundness of mind may arise from insanity or lunacy, idiocy, drunkenness and similar factors.

Idiocy: The term idiot is applied to a person whose mental powers are completely absent. Idiocy is a congenital defect caused by lack of development of the brain.

Insanity or Lunacy: This is a disease of the brain. A lunatic is one whose mental powers are so deranged that he cannot form a rational judgement on any subject. Lunacy can sometimes be cured. Idiocy is incurable.

Drunkenness: Drunkenness produces temporary incapacity. The mental faculties are clouded for sometime, so that no rational judgement can be formed.

Effects of Agreements Made by Persons of Unsound mind

Agreements by persons of unsound mind are void. But an Agreement entered into by a lunatic or a person of unsound mind for the supply of necessaries for himself or for persons whom he is bound to support (e.g. his wife, children) is valid as a quasi-contract under Section 68 of the Act. Only the estate of such a person is liable. There is no personal liability.

The guardian of a lunatic can bind the estate of the lunatic by contracts entered into on his behalf. The mode of appointments of such a guardian and his powers are laid down in the Lunacy Act.

Example: Inder Singh V Parmeshwardhari Singh (1957)

A person agreed to sell a property worth Rs.25,000 for Rs.7000. his mother proved that he was a congenital idiot and she pleaded for cancellation of the contract. The court held the agreement to be null and void.

DISQUALIFIED PERSONS

Aliens: An alien means a citizen of a foreign state. Contracts with aliens are valid. An alien living in India is free to enter into contracts which citizens of India. But the government may impose certain restrictions. Certain types of transactions with aliens may be prohibited. A contract with an alien becomes unenforceable if war breaks out with the country of which the alien concerned is a citizen.

Foreign Sovereigns: Foreign sovereigns or governments cannot be sued unless they voluntarily submit to the jurisdiction of the local court (Mighell V Sultan of Johore)

Professional Persons: in England, barristers and members of the Royal College of Physicians are prohibited by the etiquette of their profession from suing for their fees. But they can sue and be sued for all the claims other than their professional fees. In India, there is no such restrictions on barristers and physicians.

LESSON – 2.4

FREE CONSENT

Definition of free consent

An agreement is valid only when it is the result of free consent of all the parties to it. Sec. 13 of the Act defines the meaning of the term ‘consent’ and Sec. 14 of the Act specifies under what circumstances consent is “free”.

Sec. 13 “Two or more persons are said to consent when they agree upon the same thing in the same sense”.

Consent involves a union of the wills and an accord in the minds of the parties. When the parties agree upon the same thing in the same sense, they have consensus-ad-idem. For a valid contract the parties must have “identity of mind”.

Sec. 14 lays down that consent is not free if it is caused by

1. Coercion.
2. Undue influence,
3. Fraud,
4. Misrepresentation and
5. Mistake.

COERCION

Definition: Coercion is defined by Sec. 15 of the Act as follows: “Coercion is (1) the committing or threatening to commit, any act forbidden by the Indian penal code, or (2) Unlawful detaining, or threatening to detain, any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement.

Examples:

1. A Hindu widow is forced to adopt ‘X’ under threat that her husband’s dead body would not be allowed to be removed unless she adopts ‘X’. the adoption is voidable as having been induced by coercion. (Ranganayakamma Vs Alwar setti)
2. ‘A’ threatens to kill ‘B’ if he does not transfer all his property in ‘A’s favour for a very low price. The agreement is voidable for being the result of coercion.

It is not necessary that coercion must have been exercised against the promisor only, it may be directed at any person.

Examples:

1. 'A' threatens to beat 'B' (C's son) if 'C' does not let his house to 'A' the agreement is caused by coercion.
2. 'X' threatens to kill 'Y' if he does not sell his house to 'B' at a very low price. The agreement is caused by coercion though 'X' is a stranger to the transaction.

Further, it is immaterial whether the Indian penal code is or is not in force in the place where the coercion is employed.

Example: 'A' on board an English ship on the high seas, causes 'B' to enter into an agreement by an act amounting to criminal intimidation under the Indian penal code. 'A' afterwards sues 'B' for breach of contract at Calcutta. 'A' has employed coercion, although his act is not an offence by the law of England, and although the Indian penal code was not in force at the time or place where the act was done.

Threat to commit suicide – is it coercion?

As per Section 15 “committing or threatening to commit any act forbidden by the Indian Penal Code is coercion.” As the act of suicide is forbidden by the IPC, a threat to commit suicide must be treated as coercion.

Example: Ammiraju Vs Seshamma

In this case, 'A' obtained a release deed from his wife and son under a threat of committing suicide. The transaction was set aside on the ground of coercion.

Duress: The English equal of coercion is Duress. Duress has been defined as causing, or threatening to cause, bodily violence or imprisonment, with a view to obtain the consent of the other party to the contract. Duress differs from coercion on the following points:

1. 'coercion' can be employed against any person whereas 'duress' can be employed only against the other party to the contract or members of his family.
2. 'Coercion' may be employed by any person, and not necessarily by the promisee. 'Duress' can be employed only by the party to the contract or his agent.
3. 'Coercion' is wider in its scope and includes unlawful detention of goods also. 'Duress' on the other hand does not include unlawful detention of goods. Only bodily violence or imprisonment is duress.

Consequences of coercion: Sec.19: When consent to an agreement is caused by coercion the agreement is contract voidable at the option of the party whose consent was so

obtained. In other words, the affected party can have the contract cancelled or if he so desires to insist on its performance by the other party.

Sec. 72: A person to whom money has been paid or anything delivered under coercion must repay or return it.

Example: A railway company refuses to deliver certain goods to the consignee, except upon the payment of an illegal charge for carriage. The consignee pays the sum charged in order to obtain the goods. He is entitled to recover so much of the charge as was illegally excessive.

UNDUE INFLUENCE

Definition: A contract is said to be induced by undue influence where,

- (i) One of the parties is in a position to dominate the will of the other, and
- (ii) He uses the position to obtain an unfair advantage over the other Sec. 16(1)

Sec. 16(2) provides that undue influence may be presumed to exist in the following cases:

1. Where one party holds a real or apparent authority over the other or where he stands in a fiduciary relationship to the other. Fiduciary relationship means a relationship of mutual trust and confidence, such a relationship is supposed to exist in the following cases – father and son; guardian and ward; solicitor and client; doctor and patient; saint and disciple; trustee and beneficiary etc.
2. Where a party makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness or mental or bodily distress.

Example: ‘F’ having advanced money to his son ‘B’ during his minority, upon B’s coming of age obtains by misuse of parental influence, a bond from B for a greater amount than the sum advanced. ‘F’ employs undue influence.

Consequences of Undue influence: An agreement caused by undue influence is a contract voidable at the option of the party whose consent was obtained by undue influence (Sec. 19-A).

Example: a money-lender, advances Rs.100 to 'B' an agriculturist, and by undue influence induces 'B' to execute a bond for Rs.200 with interest at 6 percent per month. The court may set the bond aside, ordering 'B' to repay Rs.100 with such interest as may seem just.

Burden of proof [Sec. 16(3)]: If a party is proved to be in a position to dominate the will of another and the transaction appears on the face of it or on the evidence adduced to be unconscionable, the burden of proving that the contract was not induced by undue influence, lies on the party who was in a position to dominate the will of the other.

Undue Influence is suspected in the following cases.

1. Inadequacy of consideration.
2. Fiduciary relationship between the parties.
3. Inequality between the parties as regards age, intelligence, social status, etc.
4. Absence of independent advisors for the weaker party.
5. Unconscionable bargains: Unconscionable bargain is one which is against the conscience of reasonable persons and what shocks the public. If excessive profit is made it will also fall within this term.

High rates of Interest: It is usual for money lenders to charge 'High rates of interest' from needy borrowers can the court presume the existence of undue influence in such cases?

Illustration: 'A' applies to a banker for a loan at a time when there is an acute shortage in the money market. The banker declines to sanction the loan at the prevailing rate of interest. 'A' accepts the loan for a very high interest rate Held, this is a transaction in the ordinary course of business and the contract is not induced by undue influence.

So a transaction will not be set aside merely because the rate of interest is high. But if the rate is so high that the court feels it is unconscionable, the burden of proving that there was no undue influence lies on the creditor.

Pardanishin Women: Women, who observe the custom of Parda i.e. seclusion from contact with people outside her own family, are peculiarly susceptible to undue influence. Therefore, Indian courts have held that a contract made by or with a pardanish in lady may be set aside by her unless the other party to the contract satisfied the court that the terms of the contract were fully explained to her and that she understood their implications.

Difference between Undue Influence and Coercion: In both undue influence and coercion, one party is under the influence of another.

1. In coercion the influence arises from committing or threatening to commit an offence punishable under the IPC or detaining or threatening to detain property unlawfully. In undue influence, the influence arises from the domination of the will of one person over another.
2. Cases of coercion are mostly cases of the use of physical forces. But in undue influence it is a question of mental pressure.

MISREPRESENTATION

Representation is a statement or assertion, made by one party to the other, before or at the time of the contract, regarding some fact relating to it. Misrepresentation arises when the representation made is inaccurate but the inaccuracy is not due to any desire to defraud the other party. There is no intention to deceive.

Sec.18 of the Contract Act classifies cases of misrepresentation into three groups as follows:

1. The positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true.

Example: ‘X’ learns from ‘A’ that ‘Y’ would be director of a company to be formed. ‘X’ tells this to ‘B’ in order to induce him to purchase shares of that company and ‘B’ does so. This is misrepresentation by ‘X’ though he believed in the truthiness of the statement and there was no intent to deceive as the information was derived not from ‘Y’ but from ‘A’ and was mere hearsay.

2. Any breach of duty which, without an intent to deceive, gives an advantage to the person committing it, (or anyone claiming under him) by misleading another to his prejudice or to the prejudice of anyone claiming under him. Under this heading would fall cases where a party is under a duty to disclose certain facts and does not do so and thereby misleads the other party. In English law such cases are known as cases of “constructive fraud”.
3. Causing however, innocently, a party to an agreement to make a mistake as to the substance of a thing which is the subject of the agreement.

Consequence of Misrepresentation: In cases of misrepresentation the party aggrieved can,

1. Avoid the agreement, or
2. Insist that the contract be performed and that he be put in the position in which he would have been if the representation made had been true.

Example: 'A' informs 'B' that his estate is free from encumbrance. B' thereupon buys the estate in fact unknown to 'A', the estate is subject to mortgage. 'B' may either avoid the contract or may insist on its being carried out and the mortgage debt be redeemed.

In case of misrepresentation the aggrieved party cannot claim compensation or damages from the other person. This however, is subject to certain exceptions.

These are:

1. **Breach of Warranty of authority by an agent:** Where an agent believes that he has the authority to represent his principal while in fact he has no such authority, the agent is liable for damages even though he is only guilty of innocent misrepresentation. (Collen V. Wright)
2. **Misstatement in prospectus:** The directors of a company are liable for damages under Sec. 62 of the companies Act, 1956 for innocent misrepresentation made in the prospectus.
3. **Negligent representation** made by one person to another between whom confidential relationship exists. E.g. solicitor and client.

However, if the aggrieved party whose consent was caused by misrepresentation had the means of discovering the truth with ordinary diligence, he has no remedy.

FRAUD

Definition: The term 'fraud' includes all acts committed by a person with a view to deceive another person. To "deceive" means to "induce a man to believe that a thing is true which is false"

Sec. 17 of the contract act states that 'Fraud' means and includes any of the following acts committed by a party to a contract (or with his connivance or by his agent) with intent to deceive another party thereto or his agent; or to induce him to enter into a contract.

1. **False statement:** "The suggestion as to a fact, of that which is not true by one who does not believe it to be true." If a false statement is intentionally made it is fraud.

2. Active concealment: “The active concealment of a fact by one having knowledge or belief of the fact.” Mere non-disclosure is not fraud where the party is not under any duty to disclose all facts. But active concealment is fraud.

Examples

(i) ‘B’ having discovered a vein of ore on the estate of ‘A’ decided to conceal the existence of ore from ‘A’ with ‘A’s ignorance, ‘B’ contracted with ‘A’ to buy the estate at an under value. The contract is voidable at the option of ‘A’.

(ii) ‘A’ sells by auction to ‘B’ a horse which ‘A’ knows to be unsound. ‘A’ says nothing to ‘B’ about the horses’ unsoundness. This is not because ‘A’ is under no duty to disclose the fact to ‘B’ but if between ‘A’ and ‘B’ there exists a fiduciary relationship (if ‘B’ is ‘A’ daughter) here arises the duty to disclose and non-disclosure amounts to fraud.

3. Intentional non-performance: “A promise made without any intention of performing it” (e.g. purchase of goods without any intention of paying for them) is fraud.

4. Any other act fitted to deceive

5. Fraudulent act or omission: “Any such act or omission as the law specially declares to be fraudulent”. This clause refers to provisions in certain acts which make it obligatory to disclose relevant facts. E.g. under **Sec. 55** of the Transfer of Property Act, the seller of immovable property is bound to disclose to the buyer all material defects. Failure to do so amounts to fraud.

From the analysis of the above we can say that for fraud to exist there must be:

- (a) A representation or assertion, and it must be false.
- (b) The representation or assertion must be of a fact.

Example: ‘A’ a seller of a horse says that the horse is a ‘Beauty’ and is worth Rs.5000. it is merely ‘A’s opinion. It is not a matter of fact.

- (c) The representation or statement must have been made with a knowledge of its falsity or without belief in its truth or recklessly.

Example: Reese River silver Mining Co., Vs Smith

A company issued a prospectus giving false information about the unbounded wealth of Nevada. A share broker who took shares on the faith of such information wanted to avoid the contract. Held he could do so since the false representation in the prospectus amounted to fraud.

(d) The representation must have been made with the intention of including the other party to act upon it.

(c) The representation must in fact be to deceive.

Example: 'A' by misrepresentation leads 'B' erroneously to believe that 500 kilos of indigo are made annually at 'A's factory. 'B' examines the accounts of the factory, which shows that only 400 kilos have been made. After this 'B' buys the factory. The contrast is not voidable on account of 'A's misrepresentation.

(d) The party subjected to fraud must have suffered some loss.

Can Silence be Fraudulent?

1. The general rule is that mere silence is not fraud.

Example: Ward Vs Hobbs

'H' sold to 'W' some pigs which were to his knowledge suffering from swine fever. The pigs were sold "With all faults" and 'H' did not disclose the fever to 'W' held, there was no fraud.

2. Silence is fraudulent "if the circumstances of the case are such that regard being had to them, it is the duty of the person keeping silence to speak." Whenever there is a duty to disclose, silence amounts to fraud.

3. Silence is fraudulent where the circumstances are such. Silence is in itself equivalent to speech.

Consequences of fraud

A party who has been induced to enter into an agreement by fraud has the following remedies open to him: (Section 19)

- i. He can avoid the performance of the contract.
- ii. He can insist that the contract shall be performed and that he shall be put in the position in which he would have been if the representation made had been true.
- iii. The aggrieved party can sue for damages.

Distinction between Fraud and Misrepresentation

1. In case of fraud the party making a false representation makes it with the intention to deceive the other party to enter into a contract. Misrepresentation on the other hand is innocent i.e., without any intention to deceive or to gain an advantage.
2. In case of fraud, the aggrieved party can sue the person who made the false statement, for damages. But in case of misrepresentation except in certain cases, the only remedy is rescission and restitution.

3. In case of fraud the person who made the false statement cannot argue that the aggrieved person had the means of discovering the truth or could have done so with ordinary diligence.

MISTAKE

Definition: Mistake may be defined as an erroneous belief concerning something. Consent cannot be said to be 'free' when an agreement is entered into under a mistake.

Mistake is of two kinds:

1. Mistake of law
2. Mistake of Fact

Mistake of law: Mistake on a point of Indian law does not affect the contract. Mistake on a point of law in force in a foreign country is to be treated as mistake of fact

Example: 'A' and 'B' make a contract based on the erroneous belief that a particular debt is barred by the Indian law of limitation. This is a valid contract. The reason is that every man is presumed to know the law of his own country and if he does not he must suffer the consequence of such lack of knowledge. But if in the above case, the mistake is related to the law of limitation of a foreign country, the agreement could have been avoided (Sec. 20)

Mistake of Fact: An agreement induced by mistake of fact is void. Mistake of fact may be

1. a bilateral mistake
2. a unilateral mistake

Bilateral Mistake: When both the parties to the agreement are under a mistake of fact essential to the agreement, the mistake is called a bilateral mistake of fact and the agreement is void (Sec. 20). For the application of Sec. 20 the following two conditions are to be fulfilled.

- (i) The mistake must be mutual
- (ii) The mistake must relate to a matter of fact essential to the agreement.

Example: (1) and example (2)

1. 'A' agrees to buy from 'B' a horse. It turns out that, the horse was dead at the time of bargain, though neither party was aware of the fact, the agreement is void.
2. 'A' agrees to sell to 'B' a specific cargo of goods supposed to be on its way from England to Bombay. It turns out that, before the day of the bargain, the

ship carrying the cargo has been washed away and the goods lost. Neither party was aware of the fact. The agreement is void.

Mistake so as to render the agreement void, must relate to some essential matter, some typical cases of mistake invalidating the agreement are given below:

1. Mistake as to the subject matter:

(a) Mistake as to the Existence of Subject-matter: If both the parties believe that the subject-matter of the contract to be in existence, which in fact at the time of the contract is non-existent, the contract is void.

Example: 'A' agreed to purchase 'B's car which was lying in 'B's garage. Unknown to either party the car and the garage were completely destroyed by fire a day earlier. The agreement is void.

(b) **Mistake as to identity of the subject-matter:** where the parties agree upon different things, i.e. one party intends to deal in one thing and the other intends to deal in another.

Example: 'A' who owns three maruti cars of different colours, other to sell his white colour car Rs.1,00,000. 'B' accepts the other thinking 'A' is selling his green colour car. There is a mistake as to the identity of the subject-matter and hence no contract.

(c) **Mistake as to Title to the Subject Matter:** where the parties believe that the seller is the owner of the thing which he purports to sell, but in fact, he has no title to it, the contract is void on the ground of mistake.

Example: A person took a lease of a fishery which, unknown to either party already belonged to him. Held, the lease was void [Cooper V. Phibbs.(1861)]

(d) **Mistake as to the quality of the Subject-matter:** If the subject matter is something different from what the parties thought it to be, the agreement is void.

Example: Table napkins were sold at an auction by a description, "with the crest of Charles I and the authentic property of that monarch." In fact napkins were Georgian. Held, the agreement was void as there was a mistake as to the quality of the subject-matter [Nicholson Venn V. Smith Marriott].

(e) **Mistake as to the quantity of the subject-matter**

Example: Henkel V. Pape (1870)

'P' wrote to 'H' enquiring the price of rifles and suggested that he might buy as many as 50. On receipt of the information, he telegraphed "Send three rifles". But because of the mistake of the telegraph authorities the message

transmitted was “send the rifles”. ‘H’ despatched 50 rifles. Held, there was no contract between the parties. However, ‘P’ could be held liable to pay for three rifles on the basis of an implied contract.

- (f) **Mistake as to the price of subject-matter:** Where a contract of lease of a house was agreed to at a lease of \$230 but in written agreement, the figure \$130 was inserted by mistake, the contract was held to be void.

But an erroneous opinion as to the value of the subject matter of the agreement is not to be deemed a mistake as to a matter of fact.

Example: ‘A’ buys an article thinking it is worth Rs.10,000 while it is actually worth Rs.500 only. The agreement cannot be avoided on the ground of mistake

2. Mistake as to the possibility of performing the contract :

If both the parties believe that an agreement is capable of being performed when in fact this is not the case. The agreement, in such a case is void on the ground of impossibility.

Impossibility may be

- (i) **Physical impossibility:** Example: A contract for the hire of a room for witnessing the coronation procession of Edward VII was held to be void because, unknown to the parties the procession had already been cancelled [Griffith V. Braymer(1903)].
- (ii) **Legal Impossibility:** A contract is void if it provides that something shall be done which cannot, as matter of law, be done.

Unilateral Mistake: In case of unilateral mistake i.e where only one party to a contract is under a mistake, the contract, generally speaking is not invalid. Sec. 22 reads, “A contract is not voidable merely because it was caused by one of the parties to it being under a mistake as to a matter of fact.”

Exception: To the above rule, there are certain exceptions.

- (a) **Where the unilateral mistake is as to the nature of the contract:** A contract is void when one of the parties to it does not intend to enter into it, but through the fault of another and without any fault of his own, makes a mistake as to the nature of the contract. *Example: Foster Vs V. Mackinnon (1869)* An old illiterate man was made to sign a bill of exchange by means of a false representation that it was a guarantee. Held, the contract was void.
- (b) **Mistake as to quality of the promise:** In *Scriven Vs Hindley* case an auction was held for the sale of some lots of hemp (quality natural fibre) and some lots of tow

(broken inferior fibre). Mr. B thinking that hemp was being sold, bid for a lot of tow for an amount which was not of proportion to it, and was only fair price for hemp. Held, contract could be avoided.

- (c) **Mistake as to the identity of the person contracted with:** where 'A' intends to contract with 'B' but by mistake enters into a contract with 'C' believing him to be 'B' the contract is void on the grounds of mistake. *Example: Cundy Vs Lindsay & Co (1878):* Mr. 'X' of Blenkarn, by imitating the signature of a reputed firm called Blenkiron and Co, induced another firm 'Y' to supply goods to him on credit. The goods were then sold to 'X' of Blenkarn. Held, there was no contract between 'X' of Blenkarn and 'Y' because 'Y' never intended to supply to Blenkarn. Therefore 'X' of Blenkarn obtained no title to the goods. But if the goods are sold for cash then that is a valid contract.

Consequences of Mistake: Mistake renders a contract void and as such in case of a contract which is yet to be performed the party complaining of the mistake may avoid it, i.e. need not perform it. If the contract is executed, the party who received any advantage must restore it or make compensation for it, as soon as the contract is discovered to be void.

LESSON – 2.5

VOID AGREEMENTS AND DISCHARGE OF CONTRACTS

VOID AGREEMENTS

The contract act specifically declares certain agreements to be void. A void agreement is one which is not enforceable by law [Sec.2 (g)]. Such an agreement does not give rise to any legal consequences and is totally void from the very inception.

The different kinds of void agreements under the Indian Contract Act, 1872 are given below:

1. Agreements made by incompetent persons.(Sec. 11)
2. Agreements made where there is a mutual mistake as to a matter of fact (Sec.20)
3. Agreements made where there is a mistake as to any law in force in India(Sec.21)
4. Agreements of which consideration or object is unlawful (Sec.23)
5. Agreements of which consideration or object is partly unlawful (Sec. 24)
6. Agreements without consideration (Sec. 25)
7. Agreements in restraint of marriage (Sec. 26)
8. Agreements in restraint of trade (Sec. 27)
9. Agreements in restraint of legal proceedings (Sec. 28)
10. Agreements the meanings of which are uncertain or not capable of being made certain (Sec. 29)
11. Agreements by way of wager (Sec. 30)
12. Agreements contingent on the happening of an event (Sec. 32)
13. Agreements contingent on the impossible events (Sec.36)
14. Agreements to do an impossible Act (Sec. 56)
15. In case of reciprocal promises to do things legal and also to do other things illegal, the first set of promises is a contract, but the second set of reciprocal promises is a void agreement (Sec. 57)

It may be stated here that the agreement from 1 to 13 are void ab-initio. i.e., from the very inception while the remaining 14 to 15 become void by subsequent events.

WAGERING AGREEMENTS OR WAGER (Sec. 30)

Definition of Wager: “A contract between two parties to the effect that if a given event is determined in one way, one of them shall pay a sum of money to the other, and in the contrary event the later shall pay to the former.” It is a promise to give money or money’s worth upon the determination or ascertainment of an uncertain event. (Sir William Anson)

Example: ‘A’ and ‘B’ may wager regarding an uncertain event as to whether it would rain or not on a particular day. ‘A’ promising to pay ‘B’ Rs.100 if it rains and ‘B’ promising

Rs.100 if it does not rain. Such agreements are void and are not enforceable at law. No suit can be initiated for recovering anything alleged to be won on any wager (Sec. 30)

Essential Elements of a Wager:

1. Intention of both the parties to the wagering contract is to gamble.
2. The gain of one party is the loss of the other party.
3. Neither party should have any interest in the happening or non-happening of the event other than the sum he will win or lose.
4. The event on the happening of which the amount is to be paid is uncertain.
5. The mind of the parties to the agreement may be uncertain in regard to the fact.
6. The event on which the betting is placed should not necessarily be unlawful.

The following contracts are not wagers:

1. A crossword competition involving a good measure of skill for its successful solution.
2. Games of skill e.g. picture puzzles or athletic competitions.
3. A subscription towards any prize or sum of money of the value of Rs. 500 or above to be awarded to any winner of a horse race.
4. Share market transactions
5. Contracts of insurance is not a contract of wager because of the following reasons:
 - a. In case of Insurance the assured has an insurable interest in the subject-matter.
 - b. Both the parties are interested in protection of the subject matter.
 - c. Except life insurance, the other contracts of insurance is a contract of indemnity.
 - d. It is beneficial to the public.
 - e. It is based on scientific and actual calculation of risks.

Effects of Wagering Agreements: Wagering agreements have been expressly declared to be void in India. In certain States in India, they have been declared to be illegal. No suit can be initiated for recovering anything alleged to be won on any wager.

Since the wagering agreements are void, transactions are void, transactions collateral to them are not affected. So excepting in the states of Maharashtra and Gujarat collateral transactions are valid.

CONTINGENT CONTRACTS

Definition: [Sec.31]: A Contingent Contract is a contract to do or not to do something, if some event, collateral to such contract does or does not happen.

Example: 'A' contracts to pay 'B' Rs. 10,000 if B's house is burnt. This is a contingent contract.

Essentials of a Contingent Contract:

1. The performance of a contingent contract is made dependent upon the happening or non-happening of some event.
2. The event on which the performance is made to depend is an event collateral to the contract. i.e it does not form part of the reciprocal promises which constitute the contract.
3. The contingency is uncertain. If the contingency is bound to happen, the contract is due to be performed in any case and is not therefore a contingent contract.

Examples

- i. Life insurance, indemnity and guarantee are examples of contingent contract.
- ii. Where 'A' agrees to deliver 100 bags of rice and 'B' agrees to pay the price only afterwards, the contract is a conditional contract and not contingent, because the event on which B's obligation is made to depend is a part of the promise itself and not a collateral event.

4. The contingent event should not be the mere will of the promisor.

Example: 'A' promises to pay 'B' Rs.1000. if he so choose, it is not a contingent contract. If the event is within the promisor's will but not merely his will, it may be a contingent contract.

Example: 'A' promises to pay 'B' Rs.10,000, if 'A' left Delhi or Bombay; it is a contingent contract, because going to Bombay is an event, no doubt within A's will but is not merely his will.

Rules Regarding Enforcement of Contingent Contracts:

1. Contracts contingent upon the happening of a future uncertain event cannot be enforced by law unless and until that event has happened. And if the event becomes impossible such contract becomes void (Sec. 32)

Examples

- (i) 'A' makes a contract with 'B' to buy 'B's house if 'A' survives 'C'. This contract cannot be enforced by law unless 'C' dies in A's life-time.
- (ii) 'A' contracts to pay 'B' a sum of money when 'B' marries 'C' 'C' dies without being married to 'B'. the contract becomes void.

2. Contracts contingent upon the non-happening of an uncertain future event can be enforced when the happening of that event becomes impossible, and not before (Sec. 33)

Example: 'A' agrees to pay 'B' a sum of money if a certain ship does not return. The ship is sunk. The contract can be enforced when the ship sinks.

3. When the event to be deemed is impossible

Examples: 'A' agrees to pay 'B' a sum of money if 'B' marries 'C'. 'C' marries 'D'. the marriage of 'B' to 'C' must now be considered impossible although it is possible that 'D' may die and that 'C' may afterwards marry 'B'.

4. **a. The happening of an event within a fixed time:** Contracts contingent upon the happening of an event within a fixed time become void if, at the expiration of the fixed time, such event has not happened or if before the fixed time, such event becomes impossible. **Example:** 'A' promises to pay 'B' a sum at a certain ship returns within a year. The contract may be enforced if the ship returns within a year, and becomes void if the ship is burnt within the year.

b. The non-happening of an event within a fixed time example: 'A' promises to pay 'B' a sum of money if a certain ship does not return within a year. The contract may be enforced if the ship does not return within the year, or is burnt within the year.

5. **Impossible event:** Contingent agreements to do or not to do anything if an impossible event happens, are void, whether the impossibility of the event is known or not to the parties to the agreements at the time when it is made (Sec. 36)

Example: 'A' agrees to pay 'B' Rs.10,000 if two straight lines should enclose a space. The agreement is void.

Difference between Contingent Contract and Wagering Agreements

1. A contingent contract is valid, a wagering agreement is void.
2. When a contingent contract depends on the happening or non-happening of an event, the contract is valid, but the wagering agreement is void.
3. Contingent contract may not contain reciprocal promises; wagering agreement consists of reciprocal promises.
4. In contingent contract both parties may have an interest in the subject matter; in a wagering agreement the parties have no interest except getting or paying money.
5. In a contingent contract the future event is only collateral and valid; a wagering agreement is void.

QUASI-CONTRACTS

'Quasi' is a Latin word which means "to resemble". Contracts which are not full-fledged contracts are called quasi contracts. i.e., when all the essentials of a valid contract are not there they are called quasi-contracts.

According to Dr. Jenks, quasi-contract is "a situation in which law imposes upon one person, on grounds of natural justice, an obligation similar to that which arises from a true contract, although no contract express or implied has in fact been entered into by them".

Example: 'X' supplies goods to his customer 'Y' who receives and consumes them. 'Y' is bound to pay the price. 'Y's acceptance of the goods constitutes an implied promise to pay. This kind of contract is called a tacit contract.

In the above example, if the goods are delivered by the servant of 'X' to 'Z' mistaking 'Z' for 'Y', then 'Z' will be bound to pay compensation to 'X' for the value. This is Quasi-contract (or) Implied contract (or) Constructive contract.

The principle underlying a quasi-contract is that no one shall be allowed unjustly to enrich himself at the expense of another, and the claim based on a quasi-contract is generally for money.

Sec. 68-72 of the Contract Act describes the cases which are to be deemed Quasi-contracts.

1. Claim for necessities supplied to a person incapable of contracting on his own account. **Example:** 'A' supplies 'B' a lunatic (or) to his family with necessities suitable to his condition in life. 'A' is entitled to be reimbursed from B's property.
2. Reimbursement of person paying money due by another in payment of which he is interested. **Example:** 'B' holds land in Bengal on a lease granted by 'A' the Zamindar. The revenue payable by 'A' to the government being in arrear, his land is advertised for sale by the government. Under the revenue law, the consequence of such sale will be the cancellation of B's lease. 'B', to prevent the sale and the consequent cancellation of lease, pays the government the sum due from 'A'. 'A' is bound to make good to 'B' the amount so paid.
3. Obligation of a person enjoying benefits of non-gratuitous act: **Example:** 'A' a tradesman, leaves goods at B's house by mistake. 'B' treats the goods as his own. 'B' is bound to pay for them.

4. **Responsibility of Finder of goods:** Generally, a person is not bound to take care of goods of others, left on a road or other public places by accident or negligence, but if he takes them into his custody, an agreement is implied by law. The finder is for certain purposes, deemed in law to be a bailee and must take care of the goods. As per Sec. 71. "A person who finds the goods belonging to another and takes them into his custody, or anything delivered by mistake or under coercion, must pay for it."
- Example:** 'A' and 'B' jointly owe Rs.10,000 to 'C'. 'A' alone pays the amount to 'C' and 'B' not knowing this fact pays Rs.10,000 again to 'C'. 'C' is bound to repay the amount to 'B'.

DISCHARGE OF CONTRACT

When the obligation created by a contract comes to an end, the contract is said to be discharged or terminated.

A contract may be discharged in any of the following ways:

1. **By performance of the promise or tender:** The common mode of discharge of a contract is by performance i.e. where the parties have done whatever was expected under the contract, the contract comes to an end. Thus where 'A' contracts to sell his car to 'B' for Rs.75, 000 as soon as the car is delivered to 'B'. As soon as he delivered the car he received the price from 'B'. The contract comes to an end by performance.

The offer of performance or tender has the same effect as performance. If a promisor tenders performance of his promise but the other party refuses to accept, the promisor stands discharged of his obligations.

2. **By Mutual Consent cancelling the agreement or substituting a new agreement in place of the old:** By agreement of all parties, a contract may be cancelled or its terms altered or a new agreement substituted for it. Whenever any of these things happen, the old contract is terminated.

"If the parties to a contract agree to substitute a new contract for it, or to rescind or alter it, the original contract need not be performed" (Sec. 62)

Termination by mutual agreement may occur in any one of the following ways:

a. **Novation:** Novation occurs when a new contract is substituted for an existing contract, either between the same parties or between different parties. Novation may occur by two ways, i.e., change of parties and a substitution of a new contract in place of the existing one.

Example

- 1) 'A' is indebted to 'B' and 'B' is indebted to 'C'. by mutual agreement B's debt to 'C' and A's debt to 'B' are cancelled and 'C' accepts 'A' as his debtor. It is Novation.
- 2) 'P' lent 'D' Rs.20,000. afterwards the parties agreed that 'D' will repay to 'P' Rs.10,000 and certain grams of gold at a particular date. The former agreement is replaced by the latter. There is Novation.

b. **Rescission:** Rescission means cancellation of all or some of the terms of the contract. Where parties mutually decide to cancel the terms of the contract. The obligations of the parties there under terminates.

c. **Alteration:** If the parties mutually agree to change certain terms of the contract, it has the effect of terminating the original contract. There is, however, no change in the parties.

d. **Remission Sec. 63 deals with remission:** Remission is the acceptance of a lesser sum than what was contracted for or a lesser fulfilment of the promise made. **Example:** 'A' owes 'B' Rs.5000. 'A' pays to 'B' who accepts in satisfaction of the whole debt Rs.2000 paid at the time and place at which the Rs.5000 were payable. The whole debt is discharged.

e. **Waiver:** Waiver means relinquishment or abandonment of a right. Where a party waives his right under the contract, the other party is released of his obligations. **Example:** 'A' promises to paint a picture for 'B'. 'B' afterwards forbids him to do so. 'A' is no longer bound to perform the promise.

f. **Merger:** A contract is said to have been discharged by way of 'Merger' where an inferior right possessed by a person coincides with a superior right of the same person. **Example:** A man, who is holding certain property under a lease, buys it. His rights as a lessee vanish.

3. **By subsequent impossibility (Sec. 56):** Impossibility in a contract may either be inherent in the transaction or it may happen later by the change of certain circumstances

material to the contract. If it happens at a later stage we call it subsequent impossibility. In England this is referred to as 'Doctrine of Frustration'. A contract is deemed to have become impossible of performance and thus void under the following circumstances:

- i. Destruction of subject-matter of the contract.
- ii. By death or disablement of the parties.
- iii. Subsequent illegality (e.g.) 'A' contracts to supply 'B' 100 bottles of wine. Before the contract is executed, dealings in all sorts of liquor are declared prohibited by the Government; the contract becomes void.
- iv. Declaration of war.
- v. Non-existence or Non-occurrence of particular state of things. When certain things necessary for performance cease to exist, the contract becomes void on the grounds of impossibility.

Example: 'A' and 'B' contract to marry each other. Before the marriage, 'A' goes mad. The contract gets discharged.

Exceptions:

- a) difficulty of performance does not amount to impossibility.
- b) Commercial impossibility does not render a contract void.
- c) Strikes, lock-outs and civil disturbances do not terminate contracts unless provided for in the contract.
- d) Failure of one of the objects does not terminate the contract.
- e) Non-performance of third party does not exonerate the promisor from his liability.

4. By Operation of Law: *Discharge under this head may take place as follows:*

- a) The death of the promisor results in termination of the contract in cases involving personal skill and ability.
- b) The insolvency Act provides for discharge of contracts whenever the promisor becomes insolvent.
- c) By merger.
- d) By material alteration without seeking the consent of the other party

BY BREACH OF CONTRACT

A contract terminates by breach of contract. Breach of contract may arise in two ways:

- a) Anticipatory Breach
- b) Actual Breach.

Anticipatory breach of contract occurs when a party repudiates it before the time fixed for performance has happened or when a party by his own act disables himself from performing the contract. **Example:** 'A' Contracts to marry 'B'. Before the agreed date of marriage he marries 'C'. 'B' is entitled to sue 'A' for breach of promise.

Consequences of Anticipatory Breach: In case of anticipatory breach, the promisee may either;

- a) rescind the contract and treat the contract as at an end, and at once sue for damages, or
- b) he may elect not to rescind but to treat the contract operative and wait for the time of performance and then hold the other party liable for the consequences of non-performance.

Example:

'A' agreed to load a cargo of wheat on 'B's ship at Odessa by a particular date but when the ship arrived 'A' refused to load the cargo. 'B' did not accept the refusal and continued to demand the cargo. Before the last date of the loading had expired the Crimean war broke out, rendering the performance of contract illegal. Held, the contract was discharged and 'B' cannot sue for damages. [Avery V. Bowen]

b) Actual Breach of Contract: Actual breach of contract occurs when during the performance of the contract or at the time when the performance of the contract is due; one party either fails or refuses to perform his obligations under the contract. The refusal of performance may be express or implied. **Example:** 'D' agrees to deliver to 'B' 50 kilos of Ghee on 1st June. He fails to do so on 1st June.

Cort V. Ambergate Railway Co. (1851)

'A' contracted with a Railway Co., to supply it certain quantity of railway chairs at a certain price. The delivery was to be made in instalments. After four instalments had been supplied, the railway company asked 'A' to deliver no more. Held, A could sue for breach of contract.

REMEDIES FOR BREACH OF CONTRACT

When a breach of contract occurs, the aggrieved party or the injured party becomes entitled to the following remedies or reliefs:

1. Rescission of the Contract: When a breach of contract is committed by one party, the aggrieved party is relieved from all his obligations under the contract. **Example:** 'A' promises 'B' to supply 10 bags of sugar on a certain date and 'B' promises to pay the price

on receipt of the goods. 'A' does not deliver the goods on the appointed day. 'B' needs not pay the price.

Party Rightfully Rescinding the Contract Entitled to Compensation (Sec. 75): A person who rightfully rescinds the contract is entitled to compensation for any damage which he has sustained through the non-fulfilment of the contract.

2. Damages for the Loss Suffered: Damages, generally speaking, are of four kinds.

- i. **Ordinary damages:** Ordinary damages are those which naturally arose in the usual course of things from such breach. The measure of ordinary damages is the difference between the contract price and the market price on the date of breach. **Example:** 'A' contracts to deliver 100 bags of wheat at Rs.800 a bag on a future date. On the due date he refuses to deliver; the price on that day is Rs.900 per bag. The measure of damages is the difference between the market price on the date of breach and the contract price i.e Rs.10,000.

The ordinary damages shall be available for any loss or damage which arises naturally in the usual course of things from the breach and as such compensation cannot be claimed for any indirect loss by reason of breach.

Example: A railway passenger's wife caught cold and fell ill due to her being asked to get down at a place other than the railway station. In a suit by the plaintiff or affected person against the railway company, held, that damages for the personal inconvenience of the plaintiff alone could be granted, but not for the sickness of the plaintiff's wife, because it was a very indirect consequence.

- ii. **Special Damages:** Special damages are claimed in case of loss of profit etc. when there are certain special or extraordinary circumstances present and their existence is communicated to the promisor, the non-performance of the promise entitles the promisee to not only the ordinary damages but also damages that may result from it.

Example: 'A' a builder, contracts to erect and finish a house by the 1st of January so that 'B' may give possession of it at that time to 'C'. to whom 'B' has contracted to let it. 'A' is informed of the contract between 'B' and 'C'. 'A' builds the house so badly that, before the 1st January, it falls down and has to be rebuilt by 'B' who in consequence loses rent which he was to have received from 'C', and is obliged to make compensation to 'C' for

the breach of his contract. 'A' must make compensation to 'B' for the cost of rebuilding the house, for the rent lost, and for the compensation made to 'C'.

Notice of the Communication of the Special Circumstances is a Pre-requisite to the Claim for Special Damages.

Example: Hadley V. Baxendale (1854)

'X's Mill was stopped due to the breakdown of a shaft. He delivered the shaft to 'Y' a common carrier, to be taken to a manufacturer to copy it and make a new one. 'X' did not make known to 'Y' that delay would result in a loss of profits. By some negligence on the part of 'Y' the delivery of the shaft was delayed in transit beyond a reasonable time. As a result the mill remained idle for a longer time than otherwise would have been, had the shaft been delivered in time.

Held: 'Y' was not liable for loss of profits during the period of delay as the circumstances communicated to 'Y' did not show that a delay in the delivery of shaft would entail loss of profit to the mill.

c) Vindictive (or) Punitive or Exemplary Damages: These damages are awarded to punish the defaulter than to really compensate the plaintiff and have no place in the law of contracts. But in the following cases vindictive damages are awarded.

- i) Breach of a contract to marry and
- ii) Wrongful dishonour of a cheque by a banker.

d) Nominal Damages: This kind of damages is awarded when the injured party does not suffer any damages. Yet this damage consisting of a very small amount, say, a rupee or two, is awarded for violation of a legal right.

3. Specific Performance: Where damages are not an adequate remedy, the court may direct the party in breach to carry out his promise according to the terms of the contract. This is called 'Specific performance' of the contract some of the instances where court can direct specific performance are: a contract for the sale of a particular house or some rare article or another thing for which monetary compensation is not enough because the injured party will not be able to get an exact substitute in the market.

Specific performance will not be granted where:

- a. Monetary compensation is an adequate relief.
- b. The contract is of personal nature, e.g. a contract to marry

- c. Where it is not possible for the court to supervise the performance of the contract, e.g. a building contract.
- d. The contract is made by a company beyond its objective as laid down in its Memorandum of Association.

4. Injunction: Injunction means an order of the court. Where a party is in breach of a negative term of a contract (i.e. where he does something which he promised not to do) the court may, by issuing an order, prohibit him from doing.

Example: (i) Metropolitan Electric Supply Company V. Ginder (1901)

G agreed to buy the whole of the electricity required for his house from a certain company. He was therefore, restrained by an injunction from buying electricity from any other person.

(ii) N, a film star, agreed to act exclusively for a particular producer, for one year. During the year she contracted to act for some other producers. Held, she could be restrained by an injunction.

5. Quantum Meruit: The phrase 'Quantum Meruit' means 'as much as merited' or 'as much as earned'. The general rule of law is that unless a person has performed his obligations in full, he cannot claim performance from the other. But in certain cases, when a person has done some work under a contract, and the other party repudiated the contract, or some event happened which makes the further performance of the contract impossible, then the party who has performed the work can claim remuneration for the work he has already done.

Example: 'A' contracts with 'B' to deliver to him 500 kilos of butter before 1st May. 'A' delivers 200 kilos only before that date and none after. 'B' retains the 200 kilos after the 1st May. 'B' is bound to pay 'A' for them

QUESTIONS

1. When is an offer completed? How and when may an offer be revoked?
2. Define offer and acceptance. When are the offer and acceptance deemed to be complete if made through post?
3. Define consideration. Critically discuss the essential elements of consideration.
4. "A stranger to the consideration may sue on a contract but not a stranger to the contract"- Explain.
5. State the circumstances in which a contract without consideration may be treated as valid.
6. Who are competent to contract under the Indian law of Contract?
7. Explain the legal rules regarding contracts with a Minor.
8. When a consent is said to be free? Distinguish between coercion and undue influence.
9. Define and distinguish between misrepresentation and fraud. What remedies are available to the aggrieved party?
10. Explain the different types of mistake and give the relevant rules regarding contract with mistake.
11. When is an agreement said to be against public policy? Give examples of agreements which are against public policy.
12. Explain contingent contract and their rules.
13. State the circumstances under which a contract is said to be discharged.
14. What do you understand by Novation? What is the difference between Novation and Alteration?
15. Define Special damages; Exemplary damages and Nominal damages.
16. What are the consequences of breach of contract?
17. State the remedies allowed to the aggrieved person in case of breach of contract.
18. What is a quasi-contract? Give some examples of quasi-contract.

UNIT – III
SPECIAL CONTRACTS

Lesson – 3.1 Indemnity and Guarantee

Lesson – 3.2 Bailment and Pledges

LESSON – 3.1

INDEMNITY AND GUARANTEE

CONTRACTS OF INDEMNITY

Definition

Section 124 of the Indian Contract Act defines a contract of indemnity as a contract by which one party promises to save the other party from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person.

Example: ‘A’ contracts to indemnify ‘B’ against the consequences of any proceedings which ‘C’ may take against ‘B’ in respect of a certain sum of 1000 rupees. This is a contract of indemnity.

In the above example, ‘A’ is called the indemnifier and ‘B’ the indemnity-Holder or Indemnified.

There are a few requisites for a valid contract of indemnity. They are:

1. A contract of indemnity must satisfy all the essentials of a contract.
2. A contract of indemnity may arise either,
 - (i) by an express promise or
 - (ii) by operation of law, e.g., the duty of a principal to indemnify an agent from consequences of all lawful acts done by him as an agent. Similarly, on a transfer of shares, the transferee, in law, undertakes to indemnify the transferor against all future loss.
3. Under contract of indemnity loss to promisee is essential. Unless promisee has suffered a loss, he cannot hold the promisor liable on the contract of indemnity.
4. As per Indian Contract Act, the loss must have been caused either by the conduct of the promisor or any other person. But this any other person does not include promisee and an act of god such as accidents, death, disability, destruction by fire, cyclone, etc.
5. As the Indian Contract Act is not exhaustive, at present Indian courts are following English law which covers promises to save a harmless person from loss caused by events such a accidents, death, disability destruction by fire, cyclone etc.

Rights of indemnity-holder or indemnified: The Indemnity-holder is entitled to recover from the promisor:

1. All damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies;
2. All costs of suit which he may have to pay to a third party, [provided he acted prudently or with the authority of the indemnifier];
3. All sums which he may have paid upon compromise of such suit, (provided such compromise was prudent and was authorised by the indemnifier).

Rights of Indemnifier: The Act makes no mentions of the rights of an indemnified. It has been held in *Aswant Singhji Vs State of Bombay* case that, the indemnifier enjoys rights similar to the rights of a surety under Section 141, i.e., he becomes entitled to the benefit of all the securities which the creditor has against the principal debtor, whether he was aware of them or not.

CONTRACT OF GUARANTEE

Definition [Section – 126]: A contract of guarantee is a contract to perform the promise or discharge the liability of a third person in case of his default

Example: ‘P’ lends Rs.50,000 to ‘Q’ and ‘R’ promises to ‘P’ that if ‘Q’ does not pay the money ‘R’ will make the payment to ‘P’. This is contract of guarantee.

- The person who gives the guarantee is called the “Surety” – It is ‘R’ in the above example.
- The person for whom the guarantee is given is called the “principal Debtor” – It is ‘Q’ in the example.
- The person to whom the guarantee is given is called the “Creditor” It is ‘P’ in the example.
- In a contract of guarantee there are three parties namely, the creditor, the principal debtor and the surety.

Kinds of Guarantees

1. A contract of guarantee may either be oral or in writing (Sec.126), though a creditor should always prefer to put in writing to avoid any disputes regarding the terms etc. in case of an oral agreement the existence of the agreement itself is very difficult to prove.

2. From the point of view of the scope of guarantee a contract of guarantee may either be specific or continuing.

Specific Guarantee: A guarantee is a 'specific guarantee', if it is intended to be applicable to a particular debt and comes to an end on its repayment. A specific guarantee once given is irrevocable.

Example: 'A' guarantees the repayment of a loan of Rs.1,00,000 to 'B' by 'C' (a banker). The guarantee in this case is a specific guarantee.

Continuing Guarantee [Sec. 129]: "A guarantee which extends to a series of transactions is called a continuing guarantee".

Example: Mr. 'P' guarantees payment to Mr. 'B', a tea-dealer, to the amount of Rs.1000 for any tea he may from time to time supply to Mr. 'C'. Mr. 'B' supplies Mr. 'C' with tea to the value of Rs.1000 and Mr. 'C' pays Mr. 'B' for it. Afterwards Mr. 'B' supplies Mr. 'C' with tea to the value of Rs.2000. Mr. 'C' fails to pay. The guarantee given by Mr. 'P' was a continuing guarantee, and he is liable to Mr. 'B' to the extent of Rs.1000.

A continuing guarantee is revoked under the following circumstances:

1. By notice of revocation by the surety.
2. By the death of the surety. The estate of the surety is liable for all transactions entered into prior to the death of the surety. It is not necessary that the creditor must have notice of the death.
3. By variation in contract.
4. Creditor's act of omission.
5. Novation.
6. By discharge of principal debtor.

Essentials of a valid contract of guarantee

1. All the three parties [i.e., the principal debtor, the creditor and the surety] must agree to make such a contract. A contract of guarantee may be oral.
2. The surety must make a clear promise that if the principal debtor does not perform his promise, he (surety) will perform that promise. So, the liability of the surety is secondary, i.e., the creditor must first proceed against the principal debtor and if the latter does not perform the promise, then only, he can proceed against the surety.

3. There must be consideration between creditors and the surety to make the contract enforceable.
4. The liability of the surety must be legally enforceable.

RIGHTS AND LIABILITIES OF SURETY

1. Rights of surety can be discussed under three sub-divisions, namely,

- a) As against the Principal debtor
- b) As against the creditors and
- c) As against the co-sureties.

a) Rights against the Principal debtor [Sec. 140-141]

- i. **Right of subrogation:** After paying the amount due to the creditor, the surety is subrogated to the right of the creditor, i.e., he has the same rights as those of the creditor and he can therefore, sue the principal debtor to exercise those rights.
- ii. **Right of indemnity:** The surety is entitled to be indemnified against all payments properly made by him. The surety is entitled to receive only that amount which he had paid rightfully to the creditor (Sec. 145).
- iii. **Right to be relieved earlier:** A surety can, even before making any payment, compel the debtor to relieve him from liability by paying off the debt, provided the liability is an ascertained and subsisting one.

(b) Right against the creditor

1. In case of fidelity guarantee, i.e., guarantee regarding good conduct, honesty etc., of the principal debtor, the surety can ask the creditor or the employer to dispense with the services of the principal debtor or the employee in case the latter is proved to be dishonest or has committed any act of dishonesty.
2. After the debt has become due, and before the surety is called upon to pay, the surety may ask the creditor to sue the debtor and collect the amount. But the surety must undertake to indemnify the creditor any risk, delay or expense, resulting from such a suit. In no circumstances, the surety can compel the creditor to sue the principal debtor before suing him (surety).
3. The surety can, after payment of the debt or performance of the promise of the principal debtor, recover all the securities which the creditor had either before or

after the contract of guarantee was entered into [Sec. 141]. It is immaterial whether the surety was aware of such securities or not. He is entitled to all of them.

(c) Right against the co-sureties [Sec. 146-147]

1. Where there are two or more sureties for the same debt either jointly or severally and, whether under the same or different contracts and, sureties were aware of such debts and if one of them is called upon to pay the debt of the principal debtor to the creditor, then such a surety is entitled to recover the excess of the amount over and above his share which he had to pay, from his co-sureties, in equal amount.
2. If the sureties agreed to stand as sureties in different amounts for the same debt, in case the principal debtor commits default and one of the co-sureties is asked to clear the debt, he is entitled to recover the amount from the co-sureties but not exceeding the amount which he had agreed originally to pay in the event of the default by the principal debtor.

2. Liabilities of a surety [Sec. 128]

Unless the contract provides otherwise, the liability of the surety is co-extensive with that of the principal debtor. In other words, the surety is liable for all those amounts, the principal debtor is liable for.

Example: 'A' guarantees to 'B' the payment of a bill of exchange by 'C', the acceptor. The bill is dishonoured by 'C'. 'A' is liable not only for the amount of the bill but also for any interest and charges which may have become due on it.

The liability of a surety is called as secondary or contingent, as his liability arises only on default by the principal debtor. But as soon as the principal debtor defaults, the liability of the surety begins and is co-extensive of the principal debtor, i.e., the surety will be liable for all those sums for which the principal debtor is liable. The creditor may file a suit against the surety without suing the principal debtor. Further, where the creditor holds securities from the principal debtor for his debt, the creditor need not first exhaust his remedies against the securities before suing the surety, unless the contract specifically so provides. The creditor is not bound to give notice of the default to the surety, unless it is expressly provided for.

WHEN A SURETY IS DISCHARGED FROM LIABILITY

The liability of a surety under a contract of guarantee comes to an end under any one of the following circumstances:

1. **Notice of Revocation:** In case of a continuing guarantee, a notice by the surety to the creditor stating that he will not be responsible, will revoke his liability as regards all future transactions. He will remain liable for all transactions entered into prior to the date of the notice [Sec. 130]
2. **Death of Surety:** In case of continuing guarantee the death of a surety discharges him from all liabilities as regards transactions, after his death unless there is a contract to the contrary [Sec. 131]
3. **Variation of Contract:** Any variance, made without the surety's consent in the terms of the contract between the principal debtor and the creditor, discharges the surety as to transactions subsequent to the variance [Sec. 133]. **Example: 'C'** contracts to lend Rs.10,000 on the 1st March. 'A' guarantees repayment 'C' pays Rs.10,000 to 'B' on the 1st January. 'A' is discharged from his liability, as the contract has been varied in as much as 'C' might sue 'B' for the money before 1st March.
4. **Release or Discharge of Principal Debtor:** The surety is discharged by any contract between the creditor and the principal debtor, by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor.[Sec 134]
5. **Arrangement with Principal Debtor:** A contract between the creditor and the principal debtor, by which the creditor makes a composition with (or) promises to give time to or not to sue, the principal debtor, discharges the surety, unless the surety assents to such contract [Sec. 135].
6. **By Creditor's Act or Omission Impairing Surety's Eventual Remedy [Sec. 139]:** If the creditor does any act which is his duty to the surety, and the eventual remedy of surety himself against the principal debtor is thereby impaired, the surety is discharged.
7. **Loss of Security:** If the creditor loses or parts with any security given to him by the principal debtor at the time the contract to guarantee was entered into, the surety is discharged to the extent of the value of the security, unless the surety consented to the release of such security [Sec. 141].

Difference between Indemnity and Guarantee

- 1) **Number of Parties:** There are two parties in a contract of indemnity i.e., indemnifier and indemnified, while in the case of a contract of guarantee, there are three parties, i.e., the principal debtor, the creditor and the surety.
- 2) **Contract in writing or oral:** Contract of indemnity need not be in writing but a contract of guarantee should be in writing.
- 3) **Number of contract:** In case of contracts of indemnity there is only one contract, i.e., a contract between the indemnifier and the indemnified while in the case of guarantee there are three contracts, i.e., one between principal debtor and the creditor and the second between the surety and the creditor, and the third one is between the principal debtor and the surety.
- 4) **Object:** The object of a contract of indemnity is to save the indemnity holder from a contingent risk while in a contract of guarantee the surety undertakes to discharge the liability of the principal debtor which is an existing one and is not contingent.
- 5) **Nature of liability:** In case of contract of indemnity, the liability of the indemnifier is primary while in the case of contract of guarantee, the liability of the surety is secondary, i.e., surety is liable only when the principal debtor commits a default.
- 6) **Right of indemnifier and surety:** In the case of contract of indemnity, the indemnifier after paying the indemnity, cannot sue the third party on whose conduct the loss was caused in his own name unless the right of the indemnity holder was assigned to him, while the surety after paying the creditor, can sue the principal debtor for the reimbursement in his own name.

LESSON – 3.2 BAILMENT AND PLEDGES

Definition of Bailment [Section 148]

Bailment is the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished be returned or otherwise disposed of according to the directions of the person delivering them.

The person delivering the goods is called the “Bailor”. The person to whom they are delivered is called the “Bailee”. The transaction is called “Bailment”.

Example

1. ‘P’ lends his book to ‘Q’
2. ‘P’ delivers a pen to ‘Q’ for repair.
3. ‘P’ gives ‘Q’ his watch as security for a loan.

In all these cases ‘P’ is the bailor and ‘Q’ is the bailee.

Requisites of a valid contract of Bailment

- 1) **Contract:** Bailment is the result of a contract between the owner of the goods and the other to whom they are delivered temporarily with condition that they shall be returned or disposed of according to the discretion of the person delivering them. Sometime the bailment arises from implied contract i.e., finder of goods.
- 2) **Delivery of goods:** The delivery of goods is made to convert the transaction into a contract of bailment. Sometimes, if the goods are already in possession of a person who agrees to hold them on behalf of the owner, a contract of bailment is thereby entered into although the goods were never delivered. In this case it is called constructive delivery. If the key of the gudown where the goods are lying given to the buyer, it will also amount to constructive delivery of goods

The goods are not delivered permanently but are returnable or disposed of according to the directions of the person delivering them.

- 3) **Purpose:** The goods are delivered to another person for some specific purpose. The bailee will have to complete the purpose for which it is given to him before returning it to her bailor.

- 4) **Ownership:** In bailment the bailor continues to be the owner of the goods. Therefore bailment does not cause any charge of ownership.
- 5) **Movable goods:** Bailment is concerned with only movable goods. Money is not included in the category of movable goods i.e., a deposit of money is not bailment. The relationship between depositor and the bank is that of borrower and the lender.
- 6) **Possession:** A person already in possession of the goods becomes a bailee by subsequent agreements, express (or) implied.

Different kinds of Bailment: Bailment may be classified into

1. Voidable Bailment
2. Gratuitous Bailment and
3. Bailment for Reward.

Voidable Bailment [Sec. 153]: A contract of bailment is voidable at the option of the bailor if the bailee does any act, with regard to the goods bailed, inconsistent with the conditions of the bailment.

Example: 'A' lends to 'B', on hire, a horse for his riding. 'B' drives the horse in his carriage. This contract can be terminated at the option of 'A'.

Gratuitous Bailment: A gratuitous bailment is one when the goods are delivered to another without any charge or consideration on the condition that they shall be returned to the bailor. In such cases, the following points must be considered:

1. The bailor may at any time ask the bailee to return the goods even though they might have been bailed for a specific time or purpose [Sec. 159].
2. The bailor must indemnify the gratuitous bailee, if the bailee is asked to return the goods before the expiry of the specified period or before the fulfilment of the purpose, for which the goods were bailed provided the bailee in such a case suffers a loss greater than the benefit which he has derived from the gratuitous bailment for the goods (Sec. 159).
3. A gratuitous bailment is terminated by the death either of the bailee or of the bailor (Sec. 162).

Bailment for Reward: A bailment for reward is one where either the bailor or the bailee is entitled to remuneration.

Example: Motor car let out for hire; goods given to a carrier for carriage for a price; articles given to a person for being repaired for a remuneration etc.

Bailment can also take the form of any one of the following:

- a. Deposit
- b. Gratuitous
- c. Hire
- d. Pledge
- e. Carriage
- f. Given to complete a work

DUTIES AND LIABILITIES OF THE BAILOR

(1) Bailor's Duty to Disclose Faults in Goods Bailed: "The bailor is bound to disclose to the bailee faults in the goods bailed, of which the bailor is aware, and which materially interfere with the use of them, or expose the bailee to extraordinary risk, and if he does not make full disclosure, he is responsible for damages arising to the bailee directly from such faults [ssec. 150].

In case of bailment for reward (or) non-gratuitous bailment, the bailor is responsible for such damage, whether he was or was not aware of the existence of such faults in the goods bailed".

Example:

1. 'A' lends a horse which he knows to be vicious, to 'B'. He does not disclose the fact that the horse is vicious. The horse runs away. 'B' is thrown and injured. 'A' is responsible to 'B' for damages sustained.
2. 'A' hires a carriage of 'B'. The carriage is unsafe, though 'B' is not aware of it, and 'A' is injured. 'B' is responsible to 'A' for the injury.

(2) To repay expenses to the bailee: In case of gratuitous bailment all ordinary expenses are to be borne by the bailee while extraordinary expenses are to be borne by the bailor and if the bailee has incurred such expenses, the bailor must repay to the bailee all such expenses. On the otherhand, in the case of non-gratuitous bailment, the bailor must repay even the ordinary expenses incurred by the bailee [Sec. 158].

(3) To indemnify the bailee: If the bailee has suffered any loss which arose from defective title of the bailor, the bailor has to compensate the bailee [Sec. 164].

Example: 'A' gives B's car to 'C' for use without B's knowledge or permission. 'B' sues 'C' and receives compensation. 'C' is entitled to recover the losses from 'A'.

(4) In the case of non-gratuitous bailment, if the bailor demands back the goods bailed before the specified time or the purpose for which they were bailed, he must indemnify the bailee for any loss which the bailee has suffered.

Rights of the Bailor

1. To get back the goods after expiry of the time for which they were bailed (or) after the accomplishment of the purpose of bailment.
2. To get back the goods from the bailee at any time if it is a gratuitous bailment. Even if the goods are bailed for a specific period, the bailee will have to be indemnified for any loss which might be more than the benefit he derived out of the gratuitous bailment and which he might suffer due to early termination of the contract of bailment [Sec. 159].
3. To terminate the contract of bailment if the bailee is guilty of an act in respect of the bailed goods that is inconsistent with the terms of bailment.
4. If the bailee has not been able to recover any compensation from the wrong doer of the goods bailed, the bailor shall be entitled to proportionate compensation according to the loss suffered by the bailor.
5. The bailor may enforce the duties of the bailee.

DUTIES AND LIABILITIES OF THE BAILEE

(1) Not to Make Unauthorised Use of Goods: The bailee is responsible to the owner if he uses the goods bailed in a manner inconsistent with the conditions of the bailment and ask the bailor to return the goods [Sec.153].if the bailor has suffered any loss on account of any unauthorised use, the bailee must indemnify the bailor[Sec.160].

(2) To Return the Goods Bailed (Sec. 160): The bailee must return the goods bailed on the expiration of time or accomplish of the purpose for which the goods were bailed. The goods must be returned to the bailor or disposed of according to his direction. Moreover, the goods must be returned without any demand from the bailor.

Example: 'A' hires a horse in Calcutta from 'B' to march to Benaras. 'A' rides with lot of care, but marches to cuttack instead. The horse accidentally falls and is injured. 'B' is liable to make compensation to 'A' for the injury to the horse.

(3) Indemnity: If the bailee does not return the goods according to the terms of the bailment, the bailee must indemnify the bailor for any loss, destruction or deterioration of the goods from the date of expiry of the time for which the goods were bailed.

(4) To Take Reasonable Care of the Goods Bailed: In all cases of bailment, the bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quality and value as the goods bailed [Sec. 151]. In spite of enough care, if the goods are destroyed or spoiled, in the absence of any special contract, the bailee is not liable for the loss [Sec. 152]. A bailee is liable for damages caused by negligence of the servants.

(5) To deliver any Accretion to the Goods Bailed: In the absence of a contract to the contrary, the bailee must return to the bailor any addition or profit accruing from the goods [Sec. 163]. **Example:** 'X' leaves a cow in the custody of 'Y' to be taken care of. The cow has a calf. 'Y' is bound to deliver the calf as well as the cow to 'X'.

(6) Not to Mix Bailor's Goods With his Own Goods [Sec. 155-157]: The bailee must not mix his own goods with those of the without the consent of the bailor. If such mixed goods can be separated, the cost of separation will have to be borne by the bailee. If the goods so mixed cannot be separated, all the damages and the cost of the goods must be paid by the bailee. **Example:** 'D' bails superior flour worth Rs. 10,000 to 'B'. without 'D's consent, 'B' mixes the flour with inferior quality flour of his own, worth only Rs. 2000. 'B' must compensate 'D' for the loss.

(7) To Compensate for Setting up of Adverse Title: The bailee must not set up an adverse title to the goods of the bailor. If he does so, he must compensate for the same.

Rights of the Bailee

Generally, the bailee can, by suit, enforce the duties of the bailor.

1. The bailor is entitled to be rewarded if the goods were bailed to be worked upon by him [Sec. 148].
2. The bailee has a right to be compensated if he has suffered any loss from the defect in the goods which he bailed and which he did not disclose [Sec. 150].
3. The bailee has a right to be compensated if he has suffered any loss from the fact that the bailor was not entitled to bail the goods [Sec. 164].” If the bailor has no title to the goods, and the bailee, in good faith, delivers them back to or according to directions of the bailor, the bailee is not responsible to the owner in respect of such delivery” [Sec 166].
4. The bailee is entitled to recover reasonable expenses incurred by him in connection with the goods bailed.
5. If the bailee is deprived of the goods bailed by a third person, he has a right to sue such a person to recover goods from him as if the goods belonged to him. If he has incurred any expense in such a case, he can recover the amount from the bailor.
6. “If several joint-owners of goods bail them, the bailee may deliver them back to, or according to the directions of, one joint-owner without the consent of all, in the absence of any agreement to the contrary” [Sec. 165].
7. The bailee has a right to exercise lien. The right of a person to retain the property of another person till he satisfies the right of a person, who is in possession of the goods of another, to retain such possession until the debt due to him has been discharged. This right is sometimes called a ‘Possessory Lien’.

This lien may be of two types, namely

- a. Particular lien
- b. General lien

PARTICULAR LIEN OR SPECIFIC LIEN

Particular lien means the right to retain particular goods until claims on account of those goods are paid.

Example: If 'X' gives a piece of cloth to 'Y', a tailor, for making a suit, and if 'X' does not pay the lawful charges to the tailor, the tailor has a right to refuse the delivery of the suit. Unlike general lien, the tailor has no right to retain any other items of cloth of 'X' other than the suit, for the pending charges from 'X'.

The right of 'Particular lien' can be exercised by the bailee under the following circumstances only.

1. The particular lien is available only if the service rendered by the bailee is one involving the "exercise of labour and" in respect of the goods bailed. There is no lien for custody charges or other charges for work not involving labour or skill.
2. The right of lien cannot be exercised until the services have been performed in full. When a bailee has done only a part of the work contracted for, he cannot claim lien for part payment.
3. The lien cannot be claimed if there is an agreement to pay the money on a future date.
4. The lien can be exercised only so long as the goods are in the possession of the bailee. If possession is lost for any reason, the lien is also lost.

Persons entitled to exercise particular lien

- a. The bailee (Sec. 170), e.g., a carrier, mechanic, repaiers, tailors, watch-makers, etc.
- b. Unpaid seller of goods under Sec. 47 of the Sale of Goods Act.
- c. Agents in respect of their claims against their principals under sic. 221 of Indian Contract Act.
- d. A partner of a firm, under Sections 46 and 52 of the Partnership Act.
- e. Finder of the goods, uner Sec. 168 of the Indian Contract Act.
- f. Pawnee and pledgee under Sec. 173 of the Indian Contract Act.

GENERAL LIEN

The 'general lien' is a right to retain the goods belonging to another, not only for the discharge of a debt or liability incurred in connection with those goods but also for a general balance of account between the owner and the person detaining the goods. Bankers, factors, harbingers, attorneys of the High Courts, policy-brokers may, in the absence of a contract to the contrary, exercise the general lien and retain as a security for a general balance of account any goods bailed to them but no other person has a right to retain as a security for such balance, goods bailed to them, unless there is an express contract to that effect [Sec. 170].

FINDER OF GOODS

Rights and Responsibilities of a person who finds the goods belonging to another and takes them into his custody

Responsibility (or) Duties

1. If the finder of goods takes the goods that he has found into the custody he must try to find out the owner of the goods and incur necessary expenses.
2. He must take as much care of the goods found as he would have taken care of his own goods of the same bulk, quality and value till he finds the owner. He is considered to be the bailee though no formal contract has been entered into between him and the owner.
3. He must incur expenses to preserve the goods, e.g., if he finds a cow, he must properly feed it to keep it alive.
4. If there is an accrual to the goods found, he must return it to the true owner.

Rights of a Finder of Goods

- a. He can retain the goods till his lawful charges in finding the owner and preserving it are paid to him by the owner.
- b. If the owner of the lost goods had announced a reward the finder can sue the owner for the reward and he can exercise the right of lien on the goods till the announced reward is paid to him

c. The finder of the goods may sell them.

- (i) If the owner of the goods cannot be found after reasonable efforts; or
- (ii) If the owner refuses to pay the lawful charges
- (iii) If the goods are in danger of perishing or losing the greater part of their value and
- (iv) His lawful charges amount to two-third of the value of the goods.

TERMINATION OF BAILMENT

A contract of bailment terminates under the following circumstance:

- (1) **Expiry of time:** if the bailment's is for a stipulated period, the bailment terminates as soon as the stipulated period expires.
- (2) **Fulfilment of purpose:** If the bailment is for a specific purpose, the bailment terminates as soon as the purpose is fulfilled.
- (3) **Act Inconsistent with the Terms:** If the bailee does any act, with regard to the goods bailed, which is inconsistent with the terms of the bailment, the bailment terminates [Sec. 153].
- (4) **Goods lent Gratuitously:** A gratuitous bailment can be terminated anytime. But if premature termination causes any loss to the bailee the bailor must compensate the loss.
- (5) **Death:** A gratuitous bailment terminates upon the death of either the bailor or the bailee.

CONTRACT OF PLEDGE OR PAWN

Definition: The bailment of goods as security for payment of a debt or performance of a promise is called pledge or pawn. The bailor in this case is called pledgor or pawnor. The bailee is called the pledgee or the pawnee [Sec. 172].

Essentials of a valid Pledge

1. There must be a debt or a promise to perform some act.
2. Goods are bailed by way of security for the repayment of the debt or the performance of the promise.
3. Goods to be pledged must be delivered to the pledgee.
4. Only movable goods can be pledged.
5. Legal Possession is necessary in case of pledge and therefore, mere physical possession cannot be considered to be a pledge, e.g., a servant cannot pledge the goods belonging to his master because legally he is not the owner of those goods.

Rights of Pledgee or Pawnee

- (1) **Right of Retainer:** “The pawnee can retain the goods pledged not only for payment of the debt or the performance of the promise, but also for the interest of the debt and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged” [Sec. 173]. The pawnee enjoys only particular lien. If the pawnee makes fresh advances to the same debtor it will be presumed that the debtor has agreed to create lien on the goods already pledged for the fresh advance [Sec. 174].
- (2) **Rights to sell:** The pawnee may sell the goods by giving reasonable notice to the pawnor if the principal debt and the interest is not paid to him even if the pawnor’s title to the goods was defective. If the sale results in deficit, he can recover the remaining amount by filing a suit against the pawnor.
- (3) **Rights to Sue the Pawnor:** If the pawnor does not repay the debt or perform the promise after the expiry of the period, he may sue the pawnor for the same without losing his right of lien or the right to sell the goods pledged.

Rights of Pledgor or Pawnor

- (1) **Defaulting Pawnor’s Right to Redeem [Sec. 177]:** A pawnor who has committed default in the payment of the debt or in the performance of the promise within the stipulated time, may redeem (take back) the goods pledged, before the pawnee has sold the goods by giving a reasonable notice.

- (2) **Preservation and Maintenance:** The pawnor can enforce the preservation and proper maintenance of the goods pledged.
- (3) **Protection of Debtors:** The pawnor as a debtor has various rights given to him by statutes enacted for the protection of debtors e.g., Money Lender's Acts.

When Can a Non-owner make a Valid Pledge?

The owner of goods can always make a valid pledge. In the following cases, one who is not an owner can make a valid pledge.

- (1) **Mercantile Agent [Sec. 178]:** A mercantile agent who is in possession of goods, with the consent of the owner, can make a valid pledge provided the pawnee acts in good faith and has not noticed at the time of the pledge that the pawnor has no authority to pledge.
- (2) **Person in possession of goods under voidable contract:** When a person has obtained possession of goods under voidable contract, he can make a valid pledge before the contract has been revoked provided the pawnee acts in good faith and without any notice of any defect in the title of the pawnor.
- (3) **Pawnor with a Limited Interest [Sec. 179]:** A person who has only limited interest in the goods can make a valid pledge to the extent of that interest.
- (4) **Possession with Co-owner:** If one of several co-owners is in sole possession of the goods with the consent of the other owners. He can make a valid pledge of the goods [Sec. 28 of Sale of Goods Act]
- (5) **Seller in Possession of Goods after Sale:** A seller in possession of the goods after the sale, and the buyer to whom the possession had been delivered before payment of the price, may make a valid pledge, provided the pawnee acted in good faith and had no prior notice of this effect. [Sec. 30(1) of Sale of Goods Act]

DISTINCTION BETWEEN PLEDGE AND BAILMENT

- a. In case of Pledge something is delivered to the pledge as security against a loan or for the performance of the promise, whereas, in the case of bailment, the goods are delivered to the bailee for some purpose, say, for safe custody or use or conversion of goods into another form, etc.
- b. In case of pledge the same goods are to be returned to the pawnor after payment of the debt with interest, whereas, in the case of bailment, the identical goods may or may not be returned to the bailor (e.g.) Piece of cloth given to the bailee may be returned to the bailor as a suit.
- c. In case of pledge, the pawnee does not become the owner but has a right of possession, whereas, in the case of bailment the bailee has no right in respect of the things bailed and he holds those things for some purpose.

QUESTIONS

1. Define a contract of indemnity. Distinguish between a contract of guarantee and a contract of indemnity.
2. Discuss the nature and extent of the liability of a surety.
3. State the law relating to continuing guarantee.
4. What are the rights of a surety against the principal debtor and against the co sureties.
5. When is a surety discharged from liability?
6. What are the rights of the indemnity holder?
7. Define bailment. State the degree of care to be taken by a bailee.
8. What is a pledge? What are the rights of a pledgee?
9. Can a person other than the true owner make a valid pledge of goods?
10. Explain the rights and duties of the bailor and the bailee.
11. State the rights and duties of a finder of goods.
12. Explain the differences between pledge and bailment.

UNIT –IV AGENCY AND LAW OF SALE OF GOODS

Lesson - 4.1 Contract of Agency

Lesson - 4.2 Law of Sale of Goods

LESSON - 4.1 CONTRACT OF AGENCY

Definition of an Agent (Sec. 182)

An agent is defined by the Act as “a person employed to do any act for another or to represent another in dealings with a third person. In other words, an agent is a person who acts in place of another. The person for whom or on whose behalf he acts is called ‘Principal’. For example, ‘X’ appoints ‘Y’ a broker to sell his house on his behalf. ‘X’ is the principal and ‘Y’ is his agent. The relationship between ‘X’ and ‘Y’ is called Agency.

The functioning of an agent is to bring about contractual relations between the principal and third parties. Thus, an agent is merely a connecting link between the Principal and the third party. Acts of the agent within the scope of the instructions by the principal bind the principal as if he has done them by himself. In simple words, the act of an agent is the act of the Principal.

Any person who is of the age of majority according to the law to which he is subject to, and who is of sound mind, may employ an agent (Sec. 183).

According to Sec. 184 “as between the Principal and the third persons any person may become an agent, but no person who is not of the age of majority and of sound mind can become an agent, so as to be responsible to his Principal according to the provisions in that behalf”.

Creation of Agency:

A contract of Agency may be created by

1. Express agreement.
2. Implied agreement, and
3. By ratification.

1. **Express Agency:** A person may be appointed as an agent, either by word of mouth or by writing. No particular form is required for appointing an agent. The usual form of a written contract of agency is the power of attorney on a stamped paper.
2. **Implied Agency:** Implied agency arises from the conduct, situation or relationships of parties. Implied agency therefore includes agency by estoppels, agency by holding out, and agency of necessity.
 - i. **Agency by Estoppel:** When a person has by his conduct or induced others to believe that a certain person is his agent, he is stopped from subsequently, denying it. Example: 'P' allows 'A' telling 'C' that 'A' is 'P's agent. Lat on, 'C' supplies certain goods to 'A' thinking him to be 'P's agent. 'P' shall be held liable to pay the price to 'C'.
 - ii. **Agency by Holding out:** Though it is an extension of Agency by estoppels, some affirmative conduct by the principal is necessary in creation of agency by holding out. Example: 'P' allows his servant 'A' to buy goods for him on credit from 'C'; and pays for them regularly. On one occasion, 'P' pays his servant cash to purchase the goods. The servant purchased goods on credit pocketing the money 'C' can recover the price from 'P' since through previous dealings 'P' has held out his servant 'A' as his agent.
 - iii. **Agency of Necessity:** This arises where there is no express or implied appointment of person as agent for another but he is forced to act on behalf of a particular person. Example: A horse was sent by rail and at the destination it was not taken delivery of by the owners. The station master had to feed the horse. Held, station master became the agent by necessity and hence, the owner must compensate him.
3. **Agency by Ratification (Sec. 196-200):** Where an agent does an act for his Principal but without knowledge of authority, the principal is not held bound by the transaction. However, Sec. 196 permits the principal, if he so desires, to ratify the act of the agent. If he so elects, it will have the same effect as if the act was originally done by this authority. Agency in such a case is said to be created by ratification. In other words, the agency is taken to have come into existence from the moment the agent first acted

and not from the date of Principal's ratification. **Example:** The case of Bolten Partners V. Lambert (1881) is a good illustration on the point. In this case, 'L' made an offer to 'X' Managing Director of a company 'L' subsequently withdrew the offer, but the company ratified 'X's acceptance. Held 'L' was bound. The ratification related back to the time 'X' accepted the offer, thus rendering the revocation of the offer inoperative. An offer once accepted cannot be withdrawn. Requisites of a valid Ratification Ratification may be expressed or implied (Sec. 197).

The following are the requisites of a valid ratification:

- i. The agent must contract in the capacity of agent and not as principal
- ii. The Principal must have been in existence at the time the agent originally acted. He must have contractual capacity both at the time of the contract as well as at the time of ratification.
- iii. Ratification may be made within a reasonable time. what is reasonable time shall vary from case to case.
- iv. The act to be ratified must be a lawful one.
- v. According to Sec. 198 of the Act, "No valid ratification can be made by a person whose knowledge of the facts of the case is materially defective. "So, the principal should have full knowledge of the facts.
- vi. Ratification cannot be made for a portion of the contract. The principal cannot reject the discomforts and accept only comforts.
- vii. Ratification of acts not within the Principal's authority is ineffective. For example: Acts of directors which are ultravires the powers of the company cannot be ratified.
- viii. Ratification if it results in, loss to a third party or terminating any right of interest of a third person is not valid (Sec. 200). Example: 'A' holds a lease from 'B' which can be cancelled on three months' notice. 'C', an unauthorised person, gives notice of termination to 'A'. The notice cannot be ratified by 'B' which will cause a great loss to 'A'.

DUTIES OF AGENT

The duties of an agent towards his Principal are

1. To run the business of agency as per the directions of the principal (Sec. 211): The duty of the agent must be not to deviate from the directions of the Principal even for the principal's benefit. If he resorts to any deviation, any loss occurred shall have to be borne by the agent, whereas, any surplus must be accounted for to the Principal. **Example:** Lilley V. Douleday (1881) 'A' was directed by his Principal to store the goods in a particular warehouse. 'A' stored a portion of the goods in a different place, equally good but cheaper. Those goods were destroyed by fire. Held, the agent was liable to make good the loss.
2. In the absence of instructions from the Principal, the agent should follow the customs of the business in the place where it is conducted (Sec. 214). **Example:** 'A' an agent engaged in carrying on for 'B' a business in which it is the custom to invest from time to time, at interest, the moneys which may be in hand, omits to make such investment. 'A' must make good to 'B' the interest usually gained by such investment.
3. The agent should run the business with the skill and diligence that is generally possessed by persons engaged in similar business, except where the principal knows that the agent is lacking in skill (Sec. 212). **Example:** Where a lawyer proceeds under a wrong Section and thereby the case is lost, he shall be liable for the loss.
 - a. **To render Proper accounts (Sec. 213):** Rendering accounts does not mean the showing of accounts but of the accounts supported by vouchers. If the agent fails to keep proper account of the principal's business, the agent is personally liable for the default.
 - b. **In cases of difficulty to communicate with the Principal (Sec. 214):** It is the duty of the agent, in case of difficulty, to use all reasonable tactfulness, in communicating with his principal, and in seeking to obtain his instructions. In case of emergency, the agent can do all that a reasonable man would do under similar circumstances with regard to his own goods.

- c. ***Not to make any secret profits***: An agent, except the lawful deductions towards his remuneration and expenses should deliver to the principal, all moneys including secret commissions received by him.
 - d. ***Not to deal on his own account***: An agent shall not deal on his own account without obtaining consent of his Principal. If he acts without the consent, the principal can claim from the agent any benefit which the agent has received.
Example: 'P' directs 'A' his agent, to buy a particular house for him. 'A' tells 'P' it cannot be bought, and buys the house for himself. 'P' may, on discovering that 'A' as bought the house, compel him to sell it to 'P' at the price he bought.
4. Agent not entitled to remuneration for business misconduct: An agent who is guilty of misconduct in the business of the agency is not entitled to any remuneration in respect of that part of the business which has misconduct. (Sec.220).
 5. An agent should not disclose confidential information supplied to him by the principal.
 6. When an agency is terminated by the death or insanity of the principal, the agent is bound to act on behalf of the representatives of the late principal, and take all reasonable steps for the protection and preservation of the interest contrasted to him (Sec. 209).

RIGHTS OF AN AGENT

1. **Right to Receive Remuneration (Sec. 219 - 220)**: An agent is entitled to his agreed commission or remuneration and if there is no agreement, to a reasonable remuneration.
2. **Right of Retention (Sec. 217)**: In agent may retain, out of any sums received, or account of the Principal in the business of the agency, all moneys due to himself in respect of advances made or expenses properly incurred by him in conducting such business, and also such remuneration as may be payable to him for acting as an agent.
3. **Right of Lien (Sec. 221)**; An agent is entitled to retain goods, papers and other property, whether movable or immovable of the principal received by him, until the due amount towards commission, remuneration etc. has been paid by the Principal.

4. Right of Stoppage in Transit: This right is available to the agent in the following cases:

- a) Where he has purchased goods on behalf of the principal either with his own funds, or by incurring a personal liability for the price, he stands towards the principal in the position of an unpaid seller. Like an unpaid seller, he enjoys the right of stopping the goods in transit if in the meantime the principal has become insolvent.
- b) Where an agent holds himself liable to his principal for the price of the goods sold; for example, del credere agent; he may exercise the unpaid seller's right of stopping the goods in transit in case of buyer's insolvency.

5. Right of Indemnification (Sec. 222-224): The principal is bound to indemnify the agent against consequences of all lawful acts done by the agent in exercise of authority conferred upon him. However, the agent cannot claim indemnification for an unlawful act, even though the principal had agreed to do so.

6. Right to Compensation for Injury Caused by Principal's Negligence (Sec.225): The principal must make compensation to his agent in respect of injury caused to such agent by the principal's neglect or want of skill. **Example:** 'A' employs 'B' as a bricklayer in building a house and he failed to provide enough support systems and safety measures. Consequently 'B' met with an accident 'A' must make compensation to 'B'.

SCOPE OF AGENT'S AUTHORITY

Express and Implied Authority: The authority of an agent may be express or implied [Sec. 186]. The authority is said to be express when it is given by words or written. The authority is said to be implied when it is to be inferred from the circumstances of the case. The inference as to implied authority may be drawn from things spoken or written or ordinary course of dealing between the parties and others. (Sec. 187). **Example:** 'A' owns a shop in Serampur, himself living in Calcutta and visiting the shop occasionally. The shop is managed by B, and he is in the habit of ordering goods from 'C' in the name of 'A' for the purposes of the shop, and of paying for them out of A's funds with A's knowledge. 'B' has an implied authority from 'A' to order goods from 'C' in the name of 'A' for the purposes of the shop.

Extent of agent's authority (scope)

An agent having an authority to do an act has authority to do every lawful thing which is necessary in order to do such act (Sec. 188).

Authority in an emergency: An agent has authority, in an emergency, to do all such acts for the purpose of protecting his principal from loss as would be done by a person of ordinary prudence, in his own case, under similar circumstances" [Sec. 189]. **Examples:**

- a) An agent for sale may have goods repaired if it is necessary.
- b) 'A' consigns provisions to 'B' at Calcutta with directions to send them immediately to 'C' at Cuttak. 'B' may sell the provisions at Calcutta, if they will not bear the journey to Cuttack without any damages.

Consequences of Agent Exceeding his Authority

- a) **When the authority is separable:** "When an agent does more than he is authorized to do, and when the part of what he does which is within his authority, can be separated from the part which is beyond his authority, so much only of what he does is within his authority, is binding as between him and his principal". (Sec. 227). **Example:** 'A' being owner of a ship and cargo, authorises 'B' to procure insurance for Rs. 4,000 on the ship. 'B' procures a policy for 4000 rupees on the ship, and another for the like sum on the cargo. 'A' is bound to pay the premium for the policy on the ship, but not the premium on the cargo.
- b) **When the authority cannot be separated:** "When an agent does more than he is authorised to do and what he does beyond the scope of his authority cannot be separated from what is within it, the principal is not bound to recognise the transaction" [Sec. 228]. **Example:** 'A' authorises 'B' to buy 500 sheep for him. 'B' buys 500 sheep and 300 cows for a fixed sum of Rs. 1,00,000. 'A' may repudiate the whole transaction.
- c) **The principal is bound for the unauthorised acts of the agent during the following situations:**
 - (i) Where by the rule of estoppels the principal is prohibited from denying the authority of the agent.
 - (ii) Where an agency gets terminated, but notice of termination has not been received by the other party.

DUTIES AND RIGHTS OF THE PRINCIPAL

Principal's Duties to Agent: The rights of an agent are in fact the duties of the principal.

Thus a Principal is

- i.** bound to indemnify the agent against the consequences of all the lawful acts done by such agent in exercise of the authority conferred upon him (Sec. 222).
- ii.** Liable to indemnify an agent against the consequences of an act done in good faith, though it causes an injury to the rights of third persons. (Sec. 223).
- iii.** not liable for acts which are criminal in nature though done by the agent at the instance of the principal. (Sec. 224).
- iv.** to make compensation to his agent in respect of injury caused to such agent by the Principal's neglect or for want of skill (Sec. 225).

Principal's Liability to Third Persons:

1. An agent being a mere link binds the principal for his acts done within the scope of his authority.
2. The principal is liable for the agent's acts which fall not only within the actual authority but also within the scope of his apparent authority.
3. Where an agent exceeds his authority and the part of what he does which is within his authority, the principal is liable to the third parties.
4. Misrepresentations by Agent. The Principal is liable for misrepresentations made or frauds committed, by an agent in the business of agency for his own benefit. But, misrepresentations made or frauds committed, by agents in matters beyond their authority, do not affect their principals. (Sec. 238).
5. The principal is bound by any notice or information given to the agent in the course of business transacted by him.
6. The liability of the principal continues even in cases where agent is personally held liable. Sec. 233 provides an option to the third parties to either sue the principal or agent or both.

Agency coupled with interest: Agency is said to be coupled with interest when authority is given for the purpose of securing some benefit to the agent. In other words, where the agent has himself an interest in subject matter of the agency, the agency is one coupled with interest. *Example:* Where an agent is appointed to sell properties of the principal and to pay himself out of such sale proceeds, the debt due to the agent.

CLASSIFICATION OF AGENTS

Agents are classified as follows: One way of classifying the agents is:

1. General
2. Specific (or) Special.

A general agent is one who is appointed to represent the principal in all matters concerning a particular business e.g. manager of a firm or managing director of a company.

A special agent is a person appointed to do some particular act or enter into some particular contract. A special agent, therefore, has only a limited authority to do the specified act. If he does anything beyond the specified act, he runs the risk of being held personally liable since the principal may not ratify the same. According to another view point, agents may be classified as;

1. Mercantile agents and
2. Non-mercantile agents.

Mercantile or commercial agents

A mercantile or commercial agent may assume any of the following forms.

1. **Broker:** A broker is a mercantile agent engaged to buy and, or sell property or to make bargains and contracts between the engager and a third party for a commission (called brokerage). He cannot have the possession of goods. He is merely a connecting link between the person who engages him and a third party.
2. **Factor:** A factor is a mercantile agent who is entrusted with the possession of goods with an authority to sell the same. He can even sell the goods on credit and in his own name. He is also authorised to raise money on their security. A factor has a general lien on the goods in his possession. A factor cannot delegate his authority.

- 3. Commission agent:** A commission agent is an agent who is engaged to buy and sell goods or transact business. The remuneration that he gets for the purpose is called the commission. A commission agent is not liable in case the third party fails to carry out the agreed obligation. A commission agent may have possession of the goods or not. His lien is a particular lien.
- 4. Del Credere Agent:** Del Credere Agent is one who, in consideration of an extra commission, called a delcredere commission, guarantees the performance of the contract by the other party. A delcredere agent occupies the position of a guarantor, as well as of an agent. A delcredere agent is mostly appointed in case of deals with foreign nationals, about whom the principal knows nothing.
- 5. Auctioneer:** An auctioneer is one who is authorised to sell goods of his principal by auction. He has a particular lien on the goods for his remuneration. He has the goods in his possession and can sue the buyer in his own name for the purchase price up to the moment of sale. He acts as an agent for the seller. After the sale he acts as an agent for the buyer. An auctioneer has an implied authority to sell the goods without any restriction.
- 6. Banker:** Though the relationship between a banker and customer is ordinarily that of debtor and creditor, he acts as his agent when he buys and sells securities on his behalf. Likewise, when he collects cheques, bills, interest dividends etc. or when he pays insurance premium out of customer's account as per customer's request, he acts as his agent.
- 7. Indentor:** An indentor is a commission agent, who, for a commission procures a sale, or, a purchase on behalf of his principal, with a merchant in a foreign country. According to a custom judicially recognised in Bombay. Such agent can charge commission at the rates mentioned in the indent.

Non-mercantile agents

Wife as the agent: If the wife and husband are living together and the wife is looking after necessaries, she is an agent. But in certain cases the husband may escape liability if he can prove that

- a) He had expressly forbidden his wife from purchasing anything on credit or from borrowing money.
- b) He had given sufficient money to his wife for Purchasing necessaries: and
- c) The goods purchased were not necessaries.
- d) The trader had been expressly told not to give credit to his wife.

Where the wife lives apart from the husband, through no fault of hers, the husband is liable to provide for her maintenance. If he does not provide for her maintenance, she has an implied authority to bind the husband for necessaries. But if the wife lives apart under no justifiable circumstances, she is not her husband's agent and him for necessaries.

Besides, estate agents, advocates, Attorneys etc., are other instances of non-commercial agents.

Sub-Agents and Substituted Agents (Sec. 190-195): The general rule is that an agent cannot appoint an agent. Sec. 190 of contract act deals with circumstances as to when and how far an agent can delegate his duties.

Sub-Agent: Sec. 191 of the act states that a sub-agent is a person employed by, and acting under the control of the original agent in the business of agency. There is no privity of contract between the sub-agent and the principal. So, the sub-agent, cannot sue the principal for remuneration and similarly, the principal cannot sue the sub-agent for any moneys due from him.

Substituted Agent: Where an agent appoints another person for being appointed as an agent in his place, such person is called as a substituted agent. According to Sec. 194 of the Act, "Where an agent, holding an express or implied authority to name another person to act for the principal in the business of the agency has named another person accordingly, such person is not a sub-agent but an agent of the principal for such part of the business of the agency as is entrusted to him".

TERMINATION OF AGENCY

Section 201 of the Indian Contract Act, 1872 mentions the circumstances under which an agency terminates or comes to an end. It reads, “An agency is terminated by the principal revoking his authority; or by the agent renouncing the business of the agency being completed; or by either the principal or agent dying or becoming insolvent or becoming of unsound mind under the provisions of any act for the time relief of insolvent debtors.”

1. By Revocation by the Principal: The principal may, by notice, revoke the authority of the agent at anytime. Where the agent is appointed to do a single act, agency may be revoked anytime before the commencement of the act. In case of continuous agency, notice of revocation is essential to the agent as well as to the third parties who have acted on the agency with the knowledge of the principal.

Where an agency is for a fixed period of time, and the contract of agency is revoked without sufficient cause, compensation must be paid to the agent. The agency is revocable in the following cases:

- i. Where the authority of the agent is one which is coupled with interest.
- ii. The principal cannot revoke the authority given to his agent after the authority has been partly exercised so far as regards such acts already in the agency (Sec. 204).

2. On the Expiry of Fixed Period of Time: When the agency is for a fixed period of time, it comes to an end on the expiry of that time.

3. On the Performance of the Specific Purpose: where an agent is appointed to do a particular act, it terminates when that act is done or when the performance becomes impossible.

4. Insanity or Death of the Principal or Agent: Death or insanity of the principal or the agent terminates the agency. But, an agent in such a case, should take all reasonable steps for the preservation of property on behalf of the legal representatives of the principal.

5. An Agency shall also terminate in Case Subject-matter is either Destroyed or becomes Unlawful.

6. If the Principal Becomes Insolvent the Agency Get Terminated.

7. By Renunciation of Agency by the Agent: If Principal can cause termination of agency by revocation, an agent may renounce his agency by giving a sufficient notice

to that effect. Where an agency is fixed for a particular period and the agency is renounced without a sufficient notice, and cause, the principal must be compensated. (Sec. 205).

When termination of agency takes effect:

1. The termination of the authority of an agent does not, so far as regard the agent, take effect until it becomes known to him.
2. As regards third parties, they can continue to deal with the agent, as such, till they come to know of the termination of the authority. (Sec. 208.)
3. The termination of the authority of an agent causes the termination of all sub-agents appointed by him.

Undisclosed Principal: Where an agent, though discloses the fact that he is an agent working for some principal, conceals the name of the principal, such a principal is called an undisclosed principal.

Concealed principal: Where an agent not only conceals the name of the principal, but the very fact that there is a principal, the principal is called as a concealed principal.

UNIT- V

Unit Structure

Lesson 5.1 Law of Sale of Goods

Lesson 5.2 Negotiable Instruments Act

Lesson 5.3 Classification of Negotiable Instruments

Lesson 5.4 Parties to a Negotiable Instrument

Lesson 5.5 Endorsement

LESSON - 5.1 LAW OF SALE OF GOODS

LAW OF SALE OF GOODS - DEFINITIONS

The law relating to the sale of movable goods is contained in the sale of Goods Act, 1930. The Act came into force on 1st July, 1930. It clearly follows the English Act on the subject. Unless otherwise mentioned the sections mentioned in this chapter pertain to Sale of goods Act, 1930.

Buyer, Seller and Goods

Buyer [Sec. 2(1)]: Buyer means a person who buys or agrees to buy goods.

Seller [Sec. 2(13)]: Seller means a person who sells or agrees to sell goods.

Goods [Sec. 2(7)]: The term 'goods' includes every kind of movable property except

- (i) Actionable claims, and
- (ii) Money.

An actionable claim means a debt or a claim for money on which a person may have against another and which he may recover by suit. And money means legal tender money.

These two types of movable property are not included in the definition of the term goods as used in the sale of goods Act.

Movable articles like furniture, clothing etc and shares, debentures are goods. Things attached to the earth are not movable. But growing crops and grass, which can easily be separated from earth before sale, and fruits which can be severed from trees, are included with the definition of 'Goods'.

The goods are classified into three types, namely:

- a. Existing goods
- b. Future goods and
- c. Contingent goods.

a. Existing Goods: Existing goods are goods which are already in existence and which are physically present in some person's possession and ownership [Sec. 6(1)] Existing goods may be either,

- (i) specific and ascertained, or
- (ii) generic or unascertained

- (i) Specific goods are goods which can be clearly defined and recognised as separate things e.g. a particular picture by a painter; or a ring with distinctive features.
- (ii) Generic goods are goods indicated by description and not separately identified. If a merchant agrees to supply one bag of wheat from his godown to a buyer, it is a sale of unascertained goods because it is not known which bag will be delivered. As soon as a particular bag is separated out and marked and identified for delivery, it becomes specific goods.

b. Future goods: Future goods are goods which will be manufactured as produced as required by the seller after the making of the contract of sale Sec. 2(6). **Example;** P agrees to sell to Q all the mangoes which will be produced in his garden next year. This is an agreement for the sale of future goods.

C. Contingent goods: There may be a contract for the sale of goods and the acquisition of which by the seller depends upon a *contingency* which may or may not happen [Sec. 6(2)]. In such cases the goods sold are called contingent goods. **Example:** 'X' agrees to sell to 'Y' a ring provided he is able to purchase it from 'Z'. This is an agreement for the sale of contingent goods.

Definition and Essentials of Contract of Sale (Sec. 4): "A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price".

ESSENTIALS OF A CONTRACT OF SALE

- 1. There Must be At least Two Parties:** A sale has to be bilateral because the property in goods has to pass from one person to another. The seller and the buyer must be different persons. A person cannot buy his own goods. *Example:* [Bell Vs Lever Bros Ltd]. Supposing 'X' is the owner of certain goods but he does not know that 'A' pretends to be the owner of the goods and sells them to 'X'. There is no sale. 'X' cannot buy goods which are already his own.
- 2. Transfer or Agreement to Transfer the Ownership of Goods:** contract of sale mere transfer of possession is not enough. Transfer of ownership is a must.
- 3.** The subject-matter of the contract must necessarily be 'goods'. Sale of immovable property is not covered In this Act.
- 4. The Consideration is Price:** In a contract of sale, the consideration must be money only. If for instance, goods are offered as the consideration for goods, it will not amount to sale. It will be called a 'barter'. Similarly, in case there is no consideration, it amounts to gift and not sale. Where goods are sold for a definite sum and the price is paid partly in terms of valued up of goods and partly cash, that is sale. *Example: Aldridge V. Johnson:* In this case, fifty-two bullocks, valued at £6 a piece, were exchanged for 100 quarters of barley at £2 per quarter, the difference to be made up in cash, the contract was treated as one of sale.
- 5. The terms of the contract:** The parties may agree upon any term concerning the time, place and mode of delivery. The terms may be of two types namely, essential and non-essential terms. Essential terms are called conditions and non-essential terms are called warranties. The sale of goods act provides that in the absence of a contract to the conditions and warranties are to be implied in all contracts of sale,
- 6. All Other Essentials of a Valid Contract Must be Present:** Being a segment of contract, sale must conform to all other essentials of a valid contract. For example, parties to the transaction must be competent contracting, consent of the parties must be free, etc.

Sale and “Agreement to Sell” Distinguished

A contract for the sale of goods may be either a sale or an agreement to sell (Sec. 4).

Sale: Where under a contract of sale the ownership is transferred from the seller to the buyer the contract is called a sale. The transaction is a sale even though the price is payable at a later date or delivery is to be given in the future, provided the ownership of the goods is transferred from the seller to the buyer.

Agreement to sell: When the transfer of ownership is to take place at a future date or subject to some condition to be transferred are fulfilled later, the contract is called agreement to sell.

When an agreement to sell becomes a sale: An agreement to sell becomes a sale when the prescribed time elapses or the conditions, subject to which the property in the goods is to be transferred, are fulfilled.

Example:

- (i) P agrees to buy from B a haystack on B's land with liberty to come on 'B's land to take it away. This is a sale because the property in the goods has passed to the buyer.
- (ii) 'P' agrees to buy a quantity of soda to arrive by a certain ship. This is an agreement to sell because the property in the goods will pass to the buyer when the goods come and the agreement is naturally subject to the condition that the ship arrives in port with the goods.

Points of Distinction

Sale	Agreement to sell
1. A sale is an executed contract.	1. An agreement to sell is an executory contract.
2. In a sale, since the property has passed to the buyer, the seller can sue the buyer for the price of the goods.	2. In an agreement to sell, in case of breach, the seller can only sue for damages, unless the price was payable on a particular date.
3. A sale creates a right 'in rem' (i.e.) right against the whole world	3. An agreement to sell creates a right 'in Personam' in (i.e.) right against a particular person.
4. In case of loss of goods, the loss will fall on the buyer, even though the goods are in the possession of the seller.	4. The loss in these cases shall be borne by the seller, even though the goods are in the possession of the buyer.
5. In case buyer pays the price and seller thereafter becomes an insolvent, the buyer can claim the goods from the official receiver.	5. In these circumstances, the buyer cannot claim the goods but only a rateable dividend for the money paid
6. If the buyer becomes an insolvent without paying the price, the ownership having passed to the buyer, the seller shall have to give the goods to the official receiver.	6. In these circumstances, the seller can refuse to deliver the goods to the official receiver.

CONDITIONS AND WARRANTIES [Sec. 11-17]

In a contract of sale, parties make certain stipulations i.e. agree to certain terms and conditions. All stipulations cannot be treated with same amount of seriousness. Some conditions may be of fundamental nature, [e.g. quality of goods to be supplied] the breach of which, therefore, will be regarded as a breach of the whole contract. Some conditions may be of less importance, [i.e. time of payment], so that a breach of these stipulations will not put an end to the contract but will make the party committing the breach, liable for damages. The former are called 'conditions' and the latter 'warranties'. **Section 12(2)** defines a "condition as a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat contract as repudiated." **Section 12(3)** defines a "warranty as stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not to reject the goods and treat the contract as repudiated".

Distinction between a condition and warranty

Condition	Warranty
<p>1. A condition is a stipulation which is essential to the main purpose of the contract.</p> <p>2. A breach of condition gives the aggrieved party a right to sue for damages as well as right to repudiate the contract.</p>	<p>1. A warranty is a stipulation which is only subsidiary to the main purpose of the contract.</p> <p>2. A breach of warranty gives him only the right to sue damages. The damages cannot be repudiated.</p>

The Distinction between the two may be illustrated as follows: A man buys a particular horse, which is warranted quiet to rid and drive. If the horse turns out to be vicious, the buyer's only remedy is to claim damages. But if instead of buying a particular horse, a man asks a dealer to supply him with a quiet horse and the horse turns out to be vicious, the stipulation is a condition and the buyer can reject the horse and claim damages.

Implied Condition and Warranties

A stipulation in a contract of sale of goods may be express or implied. Express terms are those which have been expressly agreed upon by the parties. Implied terms are those which have been enacted in Sections 14 to 17 of the sale of Goods Act.

Implied Conditions

- 1. Conditions as to title:** There is an implied condition on the part of the seller that in the case of a sale he has the right to sell the goods, and in the case of an agreement to sell, he will have the right to sell the goods at the time when the property is to pass [Sec. 14(a)]. *Example: Rowland V. Divell* 'R' bought a motor car from D and used it for four months. D had no title to the car. 'R' was forced to return the car to the true owners. Held, there is a breach of the implied condition as to title and 'R' is entitled to get back the purchase money paid, notwithstanding the fact that he had used the car for four months.

2. **Sale by description:** When there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description [Sec. 15]. *Example:* Sale of 50 boxes of X brand soap or of 100 tons of Y brand of coconut oil, is a sale of goods by description. In such cases the goods supplied must be the same as the goods described.
3. **Sale by sample:** When goods are to be supplied according to a sample agreed upon, the following conditions are implied:
 - a. The goods shall correspond with the sample in quality.
 - b. The buyer shall have a reasonable opportunity of comparing the goods with the sample.
 - c. The goods shall be free from any defect rendering them unmerchantable which would not be visible on reasonable examination of the sample. If the defect is easily discoverable on inspection and the buyer takes delivery after inspection, he has no remedy.
4. **Condition as to fitness or quality (Sec.16):** There is an implied condition as to fitness or quality for the purpose of the buyer, where the buyer, expressly or by implication, makes known to the seller the particular for which the goods are required, so as to show that the buyer relies on the seller's skill, or judgement, and the goods are of a description which it is in the course of the seller's business to supply.

Implied Warranties

1. The buyer must get quiet possession: [Sec. 14(b)]
2. The goods must be free from encumbrance [Sec. 14(c)]

The Doctrine of 'CAVEAT EMPTOR': Caveat Emptor is a Latin expression which means "let the buyer beware of". The doctrine of caveat emptor means that ordinarily a buyer must buy goods after satisfying himself of their quality and fitness. If he makes a bad choice he cannot blame the seller or recover damages from him.

The following are certain exceptions to the above mentioned rule:

- a. Where the buyer relies upon the skill and judgement of the seller.
- b. Where by custom an implied condition of fitness is annexed to a contract of sale.
- c. Where there is a sale of goods by description , there is an implied condition that the goods are fit for sale.
- d. Where the seller is guilty of fraud.

In cases not falling under any of the four exceptions noted above, the seller is not liable to any penalty if the goods purchased are found to be unfit by the buyer for the purposes he had in mind.

TRANSFER OF OWNERSHIP OR TITLE TO GOODS

Section 18 to 25 of the sale of Goods Act lays down the rules which determine when ownership of property passes from the seller to the buyer. The rules are listed below:

1. **Unascertained Goods (unidentified goods):** When there is a contract for the sale of unascertained goods, property in the goods (ownership) is not transferred to the buyer unless and until the goods are ascertained (or) identified.

Example: An agreement to sell 50 kilos from a large quantity of rice in a godown does not make the buyer the owner of 50 kilos of rice. He can become the owner of 50 kilos of rice only after this quantity of rice has been separated out from the other rice in the godown.

2. **The Intention of the Parties:** In a contract for the sale of specific or ascertained goods the property passes at such time as the parties to the contract intend it to pass. For the purpose of finding out the intention of the parties regard shall be had to the terms of the contract, the conduct of the parties and the circumstances of the case (Sec. 19).

3. **Specific Goods (Sec. 20) :** In case of specific goods, the property in the goods passes to the buyer when the contract's made and it is immaterial whether the time of payment of

the price or the time of delivery of the goods or both is postponed.

Property (or) ownership passes at the time of entering into the contract of sale if the following conditions are fulfilled:

- (i) The goods are specific goods
- (ii) The goods can be immediately delivered
- (iii) The contract of sale is without any condition
- (iv) The parties themselves have not fixed a different time for the passing of property.

4. Specific Goods put into deliverable state : Where there is a contract for the sale of specific goods and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done and the buyer has notice thereof [Sec. 21].

5. When Goods are to be Measured, Tested etc.: Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done and the buyer has notice thereof [Sec. 22]

6. Delivery to the Carrier: As per the terms of the contract, when the seller delivers the goods to a carrier for being taken to the buyer, the ownership passes to the buyer. But if the seller reserves the “right of disposal” of the goods, the ownership does not pass to the buyer.

7. Goods Sent on Approval or “On Sale or Return” basis [Sec. 24]: when goods are delivered to the buyer on approval or sale or return basis the property passes to the buyer only

- (i) When he signifies his approval to the seller or does any other act accepting the transaction;
- (ii) If he does not signify his acceptance to the seller but retains the goods without giving notice of rejections then, if a time has been fixed for the return of the goods, on the expiration of such time and if no time has been fixed on the expiration of a reasonable time.

TRANSFER OF TITLE BY NON-OWNER [Sections 27 to 30]

The general rule is that only the owner of goods can transfer a good title. No one can give a better title than he himself has. As per Section 27, “Subject to Provisions of the Act and of any other law at the time in force, where goods are sold by a person. who is not the owner there of and who does not sell under the authority or with the consent of the owner, the buyer acquires no better title to the goods than what the seller had unless the owner is precluded by his conduct from denying the seller’s authority to sell”.

To the above rule there are certain exceptions that are laid down in Section 27 to 30 and are as follows. In each if the following cases, a person who is not an owner can give to the transferee a valid title to the goods.

1. Estoppel: Under certain circumstances the true owner may be prevented, by his conduct, from denying the seller’s authority to sell. Suppose that ‘X’ is the owner of certain goods. ‘X’ acts in such a manner that ‘Y’ is induced to believe that the goods belong to ‘Z’. on that belief ‘Y’ buys goods from ‘Z’. Under these circumstances, the court will not allow ‘X’ to prove his ownership. Thus ‘Y’ gets a good title to the goods even though he has purchased them from ‘Z’ who is not the owner.

2. Sale by Mercantile Agent: In case of sale by a mercantile agent who is in possession of either the goods or documents of title to the goods with the consent of the owner and sells the goods in the ordinary course of business as a mercantile agent, the buyer gets a good title to the goods provided he buys them in good faith for value.

3. Sale by a Joint-owner: Where one of several joint-owners of goods has the sole possession with the consent of other co-owners, the ownership is transferred to any person who buys them from such joint-owner provided the buyer acts in good faith and without notice that the seller had no authority to sell [Sec. 28].

4. Sale by the Seller in Possession of Goods After Sale: where a person, having sold goods, continues to be in possession of the goods or of the documents of title to the goods, a transfer of title by him or his agent by way of sale, pledge, gives a good title to the transferee provided the buyer was acting in good faith and had no knowledge of the seller’s want of title [Sec. 30]

The original buyer in such cases can obtain only damages from the seller but cannot recover the goods from the second buyer.

Example: J. Johnson V. Credit Lyonnais. 'M' has 50 bundles of tobacco at a warehouse on the dock. The dock warrant was issued to him. 'M' sells the tobacco to 'J' who leaves the dock warrant with 'M' and took no steps to have the tobacco transferred in his name, 'M' subsequently, pledges the tobacco and delivers the dock warrant to 'C'. Held, 'C' acting in good faith, will acquire good title against 'J'.

5. Sale of goods obtained under a voidable agreement: When the seller of goods has obtained possession under a voidable agreement but the agreement has not been revoked at the time of sale, the buyer obtains a good title to the goods.

Example: 'X' buys a ring from 'Y' at a low price by undue influence and sells it to 'Z' who is an innocent purchaser without the notice of 'X's defective title. 'Z' has a good title and 'Y' cannot recover the ring from 'Z' even if the agreement with 'X' is subsequently revoked.

6. Seller has some rights when the buyer is in possession of goods: When goods are sold subject to lien or right of the seller, the buyer may sell, pledge, or otherwise dispose of goods to a third party and give a good title [Sec. 30(2)]

7. An unpaid seller: An unpaid seller of goods Can, under certain circumstances, re-sell the goods (Sec. 54).

8. Sale under the Contract Act:

(a) A pawnee can sell the goods of pawnor if the latter makes a default of his dues. The purchaser under such a sale gets a good title.

(b) A finder of goods can sell the goods under certain circumstances.

DUTIES OF THE SELLER AND BUYER

a. Duties of Seller of Goods

1. Delivery: (i) It is the duty of the seller to deliver the goods and of the buyer to accept and pay for them, in accordance with the terms of the contract of sale [Sec. 31].
(ii) Unless and otherwise agreed, delivery of the goods and payment of the price are concurrent conditions, that is to say, the seller shall be ready and willing to give possession of the goods to the buyer in exchange of the price, and the buyer shall be ready and willing to pay the price in exchange of possession of the goods [Sec. 32].

2. Risk of deterioration in the goods: Where the seller of goods agrees to deliver them at his own risk at a place other than that where they are when sold, the buyer shall, nevertheless, unless otherwise agreed, take any risk of deterioration in the goods necessarily incident to the course of transit [Sec. 40]

3. Damages for non-delivery: Where the seller wrongfully neglects or refuses to deliver the goods to the buyer, the buyer may sue the seller for damages for non-delivery [Sec. 57].

4. Specific performance: Under certain circumstances, in any suit for breach of contract to deliver specific goods, the court may, if it thinks fit, on the application of the plaintiff, by its decree direct that the contract shall be performed specifically [Sec. 58].

b. Duties of Buyer of Goods

1. Payment of price: The buyer must pay the price of goods according to the terms of the contract.

2. Compensation: If the buyer wrongfully refuses to accept delivery, he must pay compensation to the seller.

3. Delivery: Unless otherwise agreed, the seller is not bound to deliver the goods without the application of the buyer for delivery [Sec. 35].

4. **Liability of buyer:** When the seller is ready and willing to deliver the goods and requests the buyer to take delivery and the buyer does not within a reasonable time after the request, take delivery of the goods he is liable to the seller for any loss caused by his refusal to take delivery, and also for a reasonable charge for the care and custody of the goods [Sec. 44].
5. **Interest and special damages:** The seller or the buyer may recover interest or special damages for the lapses on each other as per existing relevant laws.

RIGHTS OF BUYER AND SELLER OF GOODS

a. Rights of Buyer of Goods

- i. **Delivery:** The buyer has the right to have delivery of the goods according to the terms of the contract.
- ii. **Revocation:** Unless otherwise agreed, the buyer of goods is not bound to accept delivery by instalments. The buyer is not expected to accept the delivery of a wrong quantity [short delivery (or) extra delivery].
- iii. **Buyer's right of examining goods:** Where goods are delivered to the buyer which he has not previously examined, he is not deemed to have accepted them unless and until he has had a reasonable opportunity of examining them for the purpose of ascertaining whether they are in conformity with the contract [Sec. 4 1(1)].
- iv. **Buyer is not bound to return rejected goods:** Unless otherwise agreed, where goods are delivered to the buyer and he refuses to accept them, having the right to do so, he is not bound to return them to the seller, but it is sufficient if he intimates to the seller that he refuses to accept them [Sec. 43].
- v. **Damages for non-delivery:** Where the seller wrongfully refuses to deliver the goods to the buyer, the buyer may sue the seller for damages for non-delivery [Sec. 58].
- vi. **Specific performance:** Under certain circumstances, the court may permit the buyer to get specific relief from the defaulting seller [Sec. 58]

b. Rights of seller of goods

- i. **Remedies:** If the seller is not paid by the buyer he has certain remedies, namely,
 - Seller's Lien
 - Right of stoppage-in-transit
 - Right of re-sale and
 - Suit for the price
- ii. **Enforcement of liabilities of buyer:** The seller can enforce the liabilities of buyer for not taking delivery [Sec. 44]
- iii. **Other rights:** The seller has been given certain rights to aggrieved party for the following reasons:
 - Damages for non-delivery
 - Remedy for breach of warranty
 - Repudiation of contract
 - Interest and special damages
 - Increasing of the amount of duty imposed

RIGHTS OF THE UNPAID SELLER

A contract is comprised of return promises. In a contract of sale, if seller is under an obligation to deliver goods, buyer has to pay for it. In case buyer fails or refuses to pay, the seller, as an unpaid seller, shall have certain rights. Now we will discuss

- (i) Who is an unpaid seller?
- (ii) What are the rights of an unpaid seller?

(i) An unpaid seller of goods is a person who has not been paid the whole of the price or to whom the whole of the price has not been tendered. Sec. 45(1) provides that the seller of goods is deemed to be an "unpaid seller" if:

- (a) the whole of the price has not been paid or tendered;
- (b) when a bill of exchange or other negotiable instrument has been received as conditional payment, and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise.

The term seller includes any person who is in the position of a seller, example, the agent of the seller.

Suppose that goods worth Rs. 1,000 are sold. The seller is deemed to be an unpaid seller under any of the following circumstances:

- (a) If the whole of the purchase price (Rs. 1,000) is not paid on the due date.
- (b) If payment is made in the form of a negotiable instrument (bill of exchange or cheque) and the instrument is dishonoured.

(ii) Unpaid seller's rights: *Rights of an unpaid seller can be listed as follows:*

- 1. *Against goods*
 - a. Seller's Lien
 - b. Stoppage in transit, and
 - c. Re-sale
- 2. *Against the buyer personally*
 - a. Suit for price
 - b. Damages and Interest

1. (a) Seller's Lien or Vendor's Lien (Sec. 47-491: The unpaid seller of goods, who is in possession of them, is entitled to retain possession until payment or tender of the price is made in the following cases:

- (1) Where the goods have been sold without any stipulation as to credit.
- (ii) Where the goods have been sold on credit but the terms of credit has expired.
- (iii) Where the buyer becomes insolvent.

Other rules

(i) Lien can be exercised only for non-payment of the price, and not for other charges due against the buyer. For example, the seller cannot claim lien for godown charges for storing the goods in exercise of his lien for the price.

(ii) The lien of an unpaid seller is a particular lien. It is a personal right which can be exercised only by him and not by his assignees or his creditors.

(iii) The unpaid seller may exercise his lien even if he is in possession of goods as agent or bailee for the buyer.

Unpaid Seller's Lien is lost in the following circumstances:

- i. When the seller delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer, without reserving a right of disposal of goods to himself; example; takes R/R or Transport Receipt in the name of buyer or his agent.
- ii. Where the buyer or his agent lawfully obtains possession of the goods;
- iii. By waiving the right of lien
- iv. Where he assents to a sub-sale;
- v. Where he takes a security from the buyer for the payment of the price, in place of his lien.
- vi. Lien of an unpaid seller is lost, once the possession is lost.

In a Bombay case on a sale of certain shares the relevant share certificates and transfer forms duly signed were handed over by the seller to the buyer against payment of price by cheque. On the buyer becoming subsequently insolvent, it was held that the seller had no lien on the share certificate or transfer forms. His lien is lost when he parted with their possession. *Bharneha V. Wadilal*

1. (b) Right of stoppage-in-transit: (Sections 50-52): When the buyer of goods becomes insolvent and the goods are in course of transit to the buyer, the seller can resume possession of the goods from the carrier. This is known as the right of stoppage in transit.

Rules Regarding the Course of Transit:

1. The goods are deemed to be in course of transit from the time they are delivered to the carrier to the time they are delivered to the buyer or his agent.
2. The right of stoppage-in-transit comes to an end as soon as the goods are delivered to the buyer or his agent.
3. Where a part delivery has been made, the remainder of the goods may be stopped in transit unless It is shown that the part delivery was made under such circumstances as to show an agreement to give up possession of the whole of the goods.

1. (c) The right of re-sale [Sec. 54]. The unpaid seller who has retained possession of the goods in exercise of his right of lien or who has resumed possession from the carrier upon insolvency of the buyer, can re-sell the goods,

- a. If the goods are of perishable in nature, without any notice to the buyer, and
- b. In other cases after notice to the buyer, calling upon him to pay or tender the price within reasonable time, and upon failure of the buyer to do so.

If the money realised upon such re-sale is not sufficient to compensate the seller, he can sue the buyer for the balance. But if he receives more than what is due to him, he can retain the excess.

2. (a) Suit for the price (Sec. 55): Where under a contract of sale the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may sue him for the price of the goods.

2. (b) Suit for damages: Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages for non-acceptance [Sec. 56].

Claim for interest and damages: The seller may recover interest or special damages in any cases where by law interest or special damages may be recoverable. He may also recover the money paid where the consideration for the payment of it has failed [Sec.61].

QUESTIONS

1. Explain different modes of creating an agency.
2. When is a principal bound by the unauthorised acts of his agent?
3. State the respective rights and duties of a principal and a agent.
4. What are the different ways an agency can be terminated?
5. Explain the following terms:
 - a. del credere agent
 - b. sub-agent and substituted agent
 - c. undisclosed principal and concealed principal
6. Explain the respective rights and duties of a seller and a buyer in a contract of sale.
7. Who is an unpaid seller of goods and what are his rights against the goods? Has he any remedy against the buyer personally?
8. What are unascertained goods? When does the ownership pass in a contract for the sale of goods?
9. The general law is that no seller of goods can give the buyer of goods a better title to the goods than he himself has. explain
10. Define 'goods' and state the different types of goods.
11. Explain the points of differences of the following:
 - a. Sale and Agreement to sell
 - b. Conditions and warranty
12. What do you understand by 'Caveat Emptor'? are there any exceptions to its application to sale of goods?

LESSON 5.2 NEGOTIABLE INSTRUMENTS ACT

A Negotiable Instrument is a document which entitles a person to a sum of money and is transferable from one person to another by mere delivery or by endorsement and delivery. The Negotiable Instruments Act 1881 deals with the laws regarding negotiable instruments such as promissory notes, bills of exchange, cheques etc. This Act is based on the English law with certain changes to suit the Indian conditions.

Definition

The term 'negotiable instrument' is not defined in the Act. Section 13, of the Act states that "a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer". As this definition gives only the meaning, any instrument of these types can be included In the Act. According to Justice Willis, negotiable instrument can be defined as "One the property in which is acquired by anyone who takes it bonafide and for value notwithstanding any defect of title in the person from whom he took it".

It can. be seen from this definition that if one takes the instrument bona fide and he takes it for a value, he acquires a .good title, even when the transfer may be defective.

Characteristics

1.Freely Transferable: The property in a negotiable instrument can be passed on from one person to another by mere delivery if it is payable to bearer, by endorsement and delivery if it is payable to the order.

2.The Holder Gets a Perfect Title: A person taking an instrument bonafide (in good faith) and for value, is known as a holder in due course. He gets the instrument free from all defects in the title of the transferor. That means, even if the instrument was not stolen by a transferor it will not affect the title of the holder in due course.

3.Recovery of the Value: The holder in due course need not give notice of transfer to the prior parties who are liable to pay on the instrument. A holder in due course has the right to sue the party liable on the instrument for payment in case he fails to get payment on demand at the due date.

4. Some Presumptions: The following matters are presumed in the case of all negotiable instruments unless the contrary is proved. Hence anyone challenging any of these presumptions will have to prove his allegations.

a) *Consideration:* Every negotiable instrument is presumed to have been ‘made, drawn, accepted, endorsed, negotiated or transferred for Consideration

b) *Date:* It is presumed that the negotiable instrument was drawn on the date mentioned on it.

c) *Time of Acceptance:* When a bill of exchange is accepted it is presumed that it was accepted within reasonable time of its date and before maturity.

d) *Time of Transfer:* it is presumed that every transfer of the negotiable instrument is made before the maturity of the instrument.

e) *Holder is a Holder in Due Course:* Every holder of a negotiable instrument is presumed to have been done in the order in which they appear on the instrument.

f) *Order of Endorsements:* Every endorsement appearing on the instrument is presumed to have been done in the order in which they appear on the instrument.

g) *Stamp:* Every instrument is presumed to have been duly stamped.

h) *Proof of Protest:* In a suit against the dishonour of a negotiable instrument, the court presumes the fact of dishonour, unless it is proved.

There is no question of any of these presumptions if the instrument was obtained by any fraud, or unlawful consideration.

Types of Negotiable Instrument

Negotiable instruments can be divided into the following two types:

1. Negotiable by statute, and
2. Negotiable by custom or usage

1. Negotiable by Statute: Section 13 of the Negotiable Instrument Act states only three kinds of negotiable instruments viz. promissory notes, bills of exchange and cheques.

These are instruments by statute.

2. Negotiable of Custom of Usage: These are instruments which gained the character of negotiability by the usage or custom of trade. In India, Government promissory notes, banker’s drafts and pay orders, hundis, delivery orders and railway receipts for goods have been held to be negotiable by usage or custom.

PROMISSORY NOTE

According to Sec. 4 of the Act, a promissory note is an instrument in writing containing an unconditional undertaking, signed by the maker, to pay a certain sum of money, only to or the bearer of the instrument. The person who promises to pay in writing is called the maker of the instrument. The person to whom it is payable is called the payee.

Characteristics

1. In Writing: The instrument must be in writing. In this context, writing includes writing with pen, pencil, typewriting or print.

2. Promise to Pay: There should be an undertaking or promise to pay. A mere acknowledgment of indebtedness is not sufficient to constitute a promissory note. For example, a writes “I am liable to B a sum of Rs.10,000/-“. As there is no promise to pay, this is not a promissory note.

3. Unconditional: The undertaking or promise to pay must be unconditional. Any condition in promise will make it invalid. For example, if an instrument contains “I promise to pay Rs.5000 within two days after my marriage with X”. as this promise is conditional, it is not valid.

However if the condition is certain to take place and the promise has to pay after a specified time, it is not taken as conditional. For example, if ‘X’ promises to pay ‘Y’ a sum of Rs. 5000/- after the death of ‘A’, it is not a conditional promise because it is certain that ‘A’ shall die.

4. Signed by the Maker: If the instrument is not signed by the maker it is incomplete and is not valid. It is just not sufficient to have the signature. It is essential that the mind of the person signing should accompany the signature.

5. Certain Parties: The instrument must clearly show who the maker of the instrument is and who the payee is. A promissory note made payable to the maker himself is a nullity. But if it is endorsed by the maker to some other person or endorsed in blank it becomes a valid promissory note (Gay Vs Landal).

6. Certain Sum of Money: The amount payable on the promissory note should be certain and should be specified in the promise. For example, a promissory note stating “I promise to pay ‘A’ Rs. 2000/- and any other sums due to him” is not a promissory note because the sum payable is not certain.

7. Promise to Pay Money Only: An instrument containing a promise to pay something other than money or something in addition to money, cannot be a promissory note. For example, an instrument containing a promise that “I promise to pay ‘X’ Rs.3000 and a motor cycle” is not a promissory note.

8. Bank note or Currency Note is not a Promissory Note: Though there is a promise in the bank note or currency note it is not considered as a promissory note because it is money itself.

9. Formalities: Certain formalities like number, date place etc. are found in all instruments though they are not essential. But it is necessary that it should bear the stamp required under the Indian stamp Act 1899.

10. Payable on Demand or After a Definite Period of Time: The promissory note should state when it becomes payable. The term “On demand” means that it is payable immediately. The Reserve Bank Act 1934 prohibits the issue of promissory notes payable to bearer on demand by all, except the Reserve Bank of India or the Central Government.

BILL OF EXCHANGE

According to Section 5 of the Act “A bill of exchange is an instrument in writing, containing an unconditional order, signed by the maker directing a certain person to pay, a certain sum of money only to or to the order, of a certain person or to the bearer of the instrument.”

Parties

A bill of exchange has three parties viz. drawer, drawee and payee. A person who makes the bill is called “Drawer”. It is he who gives the order to pay. The person who is directed to pay is called the, “drawee”. when the drawee accepts the bill, he is called the “acceptor.” The person to whom the actual payment is to be made is called the “payee”. If the drawer does not pass on the instrument to somebody, he himself will be the payee. Whoever is in possession of the bill is called the holder. When the holder endorses the instrument to another he is called the endorses. The person to whom the instrument is endorsed is called the endorses

Characteristics

The characteristics of a Bill of exchange are similar to those of a promissory note. The important among them are as follows.

1. The bill must be in writing.
2. It must contain an order to pay.
3. The order contained must be unconditional.
4. The order must be to pay money.
5. The money payable must be certain.
6. It requires three parties viz. drawer, drawee and payee.
7. It must be signed by the drawer.
8. The formalities like number, date, consideration, signature, stamp etc. are similar like in the case of a promissory note.

Distinction between a Bill of Exchange and a Promissory Note

Bill	Promissory note
1. There are three parties viz. the drawer, the drawee and the payee.	There are only two parties viz. the maker and the payee.
2. It contains an unconditional order to pay.	It contains an unconditional promise to pay
3. The maker of a bill of exchange is a creditor.	The maker of a promissory note is a debtor.
4. The maker directs the drawer to pay.	The maker himself undertakes to pay.
5. The maker of a bill of exchange should give an unconditional order.	The maker of a promissory note is in the position of an acceptor. But as he originates the document, he can accept to pay conditionally.
6. The liability of the maker is secondary and is conditional.	The liability of the maker is primary and absolute.
7. Normally the drawer and the payee are one and the same.	A promissory note cannot be made payable to the maker himself.
8. The bill must be accepted by the drawee before it is presented for payment.	There is no need for acceptance
9. A drawer of a bill stands in immediate relation with the acceptor and not to the payee.	The maker is in immediate relation with the payee.

10. A bill cannot be made payable to the bearer.	A note can be made payable to the bearer .
11. Certain additional formalities like presentation for acceptance of the document etc. are required in the case of certain types of bills.	These formalities are not required in the case of a promissory note.
12. In case of dishonour of a bill due notice must be given to all the endorsers and the drawer.	No such notice is required to the maker of a promissory note.
13. A foreign bill must be noted and protested for dishonour as required by the law of the land where they are drawn.	No such protest is required in the case of dishonour of a note.

CHEQUE

According to Section 6 of the Negotiable Instruments Act "A cheque is a bill of exchange drawn upon a specified banker and payable on demand." Cheques belong to the specie of bills of exchange. It can be seen from the definition that all cheques are bills of exchange. But it should be noted that all bills of exchange are not cheques. A cheque has all the essential elements of a bill of exchange such as it must be signed by the maker, it must contain an unconditional order, the order must be on a specified Banker, it is to pay a certain sum of money to or to the bearer of the cheque. But like bill of exchange a cheque need not get acceptance.

A cheque has the following additional qualifications viz.

- (1) It is drawn on a specified banker
- (2) It is always payable on demand.

Distinction between Bill of Exchange and a Cheque

Bill of Exchange	cheque
<ol style="list-style-type: none"> 1. A bill of exchange may be drawn on any person. 2. A bill has to be accepted before it becomes payable. 3. A bill other than the one payable only demand is eligible for three days of grace. 4. A bill becomes payable only after the expiry of a certain period. 5. If a bill is not presented for payment to the acceptor within a reasonable time, the drawer of the bill will be discharged from his liability. 6. A bill of exchange cannot be crossed. 7. A bill has to be duly stamped. 8. The payment of a bill cannot be stopped by the drawer. 9. A bill may be noted or protested for the dishonour. 	<p>A cheque is always drawn on a banker.</p> <p>A cheque need not be accepted.</p> <p>A cheque is not entitled for any days of grace.</p> <p>A cheque is always payable on demand.</p> <p>A delay in presenting a cheque for payment will not relieve the drawer from liability.</p> <p>A cheque can be crossed.</p> <p>No stamp is required for a cheque.</p> <p>The payment of the cheque can at any time be stopped by the drawer.</p> <p>It is not required in the case of a cheque.</p>

Marking of cheques

A cheque may be marked as good by the drawee banker when requested by the drawer. Marking is done in writing by the drawee banker on the cheque that it is good. It is to show that it will be honoured when duly presented for payment; Payment on such a cheque cannot be stopped by the drawer later. Making is not practised in India.

Crossing of Cheque

When a cheque is not crossed, it is payable in cash across the counter of the bank. Such a cheque is called an open cheque. If it is lost by the holder, the finder can go to the bank and get payment. To protect against this risk the custom of crossing the cheque is practised. Two parallel transverse lines with or without the words, “& Co”, is drawn at the left hand top corner of the cheque for crossing it. It gives an indication to the drawee banker to pay money only through the banker to the person presenting it for payment. This helps to trace the party who obtains payment.

Types of Crossing

Crossing may be divided into three types viz. (1) General crossing (2) Special crossing and (3) Restrictive crossing.

1. General Crossing: In general crossing two parallel transverse lines are put on the face of the cheque at left hand corner at the top and in between the lines the words “and company” or its abbreviation “& Co” is written. The words “not negotiable” are also added in certain cases.

Specimens: Fig. in the next page .When a general crossing is done the drawee banker should not make payment unless it is presented through a banker.

2. Special Crossing: If a cheque bears across its face an addition of the name of a banker, either, with or without the words ‘not negotiable’, the cheque is deemed to be crossed specially (Sec. 124) Even transverse lines are not necessary in case of a special crossing.

Specimens: Fig. in the next page .In the case of specially crossed cheques payment can be obtained only through the particular banker whose name appears on the cheque.

3. Restrictive Crossing: This type of crossing has come into practice by commercial and banking usage. The words ‘A/C payee’ is added to general or special crossing, under this type.

Specimens: Fig. in the next page. This type of crossing gives an indication to the collecting banker that the amount collected on the cheque is to be credited to the bank account of the payee. It should be noted that account payee cheques are negotiable.

Not Negotiable Crossing: The words ‘not negotiable’ written in crossing does not restrict further transferability of the cheque. But it takes away the main feature of negotiability. That is, normally a holder with a defective title can give a good title to a subsequent holder in due course. But if it is crossed “not negotiable” on a cheque, the title of the transferee of such a cheque cannot be better than that of its transferor. It gives production to the drawer and holder against miscarriage or dishonesty in the course of transit.

Who can Cross a Cheque: A cheque can be crossed generally or specially by the (a) drawer (b) The holder or (c) . The banker. If the drawer has crossed it generally the holder or the banker can cross it specially.

SPECIMEN I

- 1 _____
- 2 _____ and company
- 3 _____ and Co
- 4 _____ not negotiable
- 5 _____ not negotiable and CO
- 6 _____ N/N & co

SPECIMEN II

- 1 _____ state bank of india
- 2 _____ state bank of india
- 3 _____ bank of india & co
- 4 _____ canara bank not negotiable
- 5 _____ bank of barod for A/C of payee

SPECIMEN III

- 1 _____ A/C payee
- 2 _____ A/C payee not negotiable
- 3 _____ canara bank A/C babu Rao

LESSON 5.3 CLASIFICATION OF NEGOTIABLE INSTRUMENTS

Negotiable instruments may be classified as follows:

- | | |
|------------------------|-----------------------------|
| 1. Bearer instruments | 8. Fictitious bill |
| 2. Order instruments | 9. Documentary bill |
| 3. Inland instruments | 10. Clean bill |
| 4. Foreign instruments | 11. Escrow |
| 5. Payable on demand | 12. Ambiguous instrument |
| 6. Time instruments | 13. Inchoate instrument |
| 7. Accommodation bill | 14. Undated bills and notes |
| | 15. Bills in sets. |

1. **Bearer Instrument:** when a negotiable instrument states it is payable to bearer or the last endorsement on the instrument is blank it is payable to the bearer. Hence it is a bearer instrument and anyone in the legal possession of it can enforce payment due on it. While receiving money he must sign of the instrument acknowledging the payment received. The restrictions imposed by the Reserve Bank of India Act 193 do not allow the making of a promissory note payable to the bearer.

2. **Order Instruments:** When a negotiable instrument states that it is payable to the order or when it is expressed to be payable to a particular person, it is said to be an order instrument.

3. **Inland Instruments (Sec. 11):** A promissory note, bill exchange or cheque which is both drawn and made payable in India or drawn upon any person resident in India, is deemed to be an inland instrument. Any bill of exchange drawn upon a resident in India is considered an inland bill irrespective of the place where it was drawn.

4. **Foreign Instrument:** According to Section 12, an instrument, which is not an inland instrument is deemed to be a foreign instrument. foreign instruments must be protested for dishonour if such a protest is required as per the law of the country where it was made.

Usance: Usance is a term used in foreign bills. It is the time fixed for the payment of bills drawn in one country and payable in another country. The length of the usance varies in different countries depending on their custom.

5. Payable on Demand: A promissory note or bill of exchange is payable on demand, when no time for payment is shown in it and it is expressed that it is payable on demand or at sight. But a cheque is always payable on demand.

6. Time Instruments: A time instrument may be a bill of exchange or promissory note which is payable after a fixed period mentioned on it or on the happening of an event which is certain to happen.

7. Accommodation Bill: A genuine trade bill is drawn, accepted and endorsed for consideration. But an accommodation bill is drawn, accepted or endorsed without any consideration. It is done by two parties accommodating each other.

Example: 'A' and 'B' are good business friends. Both are in need of money. 'A' draws a bill of exchange for Rs.2,00,000 to 'B'. 'B' accept it and returns it to 'A'. 'A', discounts it with his bank and gets Rs. 1,90,000. A gives Rs. 95,000 to 'B' and agrees to pay Rs. 1,00,000 at the time 'B' has to honour the bill. This is an accommodation bill.

7. Fictitious Bill: If the name of the drawer or the payee or both stated in the bill is fictitious, the bill is called a fictitious bill. Even when the names of the drawer and the payee are fictitious the holder in due course can claim the amount of the bill from the acceptor provided he got the instrument in good faith.

8. Documentary Bill: When documents relating to the goods like the document of title of the goods, certificate of origin, marine insurance policy etc. are attached to the bill it is called a documentary bill. These documents are normally delivered to the buyer only after accepting the bill or making payment for the bill.

9. Clean Bill: When no document relating to the goods is attached to the bill, it is called a clean bill.

10. Escrow: When a negotiable instrument is delivered for a special purpose of somebody or for safe custody without any intention of absolutely transferring the property therein, it is called an escrow. Between immediate parties, the liability in the case of an escrow arises only when the conditions agreed upon are fulfilled. However this does not affect the rights of a holder in due course when it comes to him.

Example: 'X' is the holder of a bill. He endorses the bill to 'Y' for the purpose of getting it discounted by 'Y'. but 'Y' negotiates the bill to 'A', who takes it bonafide and for value. 'A' is a holder in due course and he acquires a good title to the bill.

11. Ambiguous Instrument: An instrument interpreted as a promissory note or bill of exchange due to the faulty drafting is called an ambiguous instrument. In such a situation the holder has to elect whether he wants to treat it as a promissory note or a bill of exchange. Once he elects one, he cannot change it later.

Example: 'X' draws a bill on a fictitious name 'Y' and negotiates it. Since 'Y' is a fictitious name the holder of this bill can treat this bill as a promissory note made by 'X'. According to Section 18, if the amount undertaken to pay in the case of a promissory note or ordered to be paid in the case of a bill of exchange is written differently in figures and words, the amount stated in words is to be taken as correct.

12. Inchoate Instrument: When a person delivers an instrument to another signed and stamped by not filling up the amount, it is called an inchoate instrument. The holder in due course in such a case can complete the instrument for any amount not exceeding the amount covered by the stamp.

Example: 'X' owes 'Y' Rs.5,000/-. He gives 'Y' a blank acceptance on a bill which is sufficiently stamped to cover any amount up to Rs.6000/-. 'Y' endorses the bill to 'A', a holder in due course. 'A' who fills up the amount as Rs. 6000/- can recover the amount.

13. Undated Bills and Notes: A negotiable instrument cannot be made invalid for the reason that it is not dated, when it satisfies all other aspects. A holder in due course is empowered to insert the true date of acceptance. This insertion is not taken as a material alteration.

Bills in Sets: In foreign trade, sometimes a bill of exchange is prepared in sets of two or three to avoid problems resulting from losing one during the transit. These are called bills insets. If anyone from the set reaches the drawer for acceptance and comes back safe, without delay, the purpose is served. Each part of the bill in the set is called a “via”. As soon as any of the parts in the set is accepted and paid, the other parts become ineffective.

LESSON 5.4 PARTIES TO A NEGOTIABLE INSTRUMENT

Capacity of Parties

Any person competent to contract can become party to a negotiable instrument. One has capacity to incur liability on the negotiable instrument only when he has the capacity to enter into a contract. If one of the parties to a negotiable instrument does not have the capacity to enter into a contract, the agreement is void as against him. However this will not diminish the liability of the other parties.

Example: 'A', 'B' and 'M', a minor, executed a promissory note in favour of 'P'. Held, M's immunity from liability did not absolve 'A' and 'B'; other joint promisors' liability (Sulochna Vs Pandiyan Bank Ltd).

1.Minors: A minor is not competent to enter into a contract. however he may draw, endorse or deliver and negotiate a negotiable instrument so as to bind all parties except himself. Even on a bill not accepted by a minor for the necessaries supplied to him, only his estates will be liable and not he personally.

2. Persons of Unsound Mind: Bills or notes drawn or accepted by persons of unsound mind (lunatics, idiots, drunken persons etc.) are void as against them if it is proved that at the time of execution of the document they were incapable of forming a rational judgement as to the effects of such an instrument.

3. Corporations: Though corporations are entitled to enter into contracts generally, they have some limitations to execute a negotiable instrument. Any act done by a corporation beyond the powers conferred upon it by its Memorandum is void. If a corporation executes a negotiable instrument exceeding its powers even a bonafide holder in due course cannot make the corporation liable. A trading company, unless prohibited by the Memorandum or Articles of Association has implied power to bind itself by negotiable instruments.

4. Agents: Anyone competent to contract can by himself or through his authorised agents draw, accept or endorse a bill of exchange. An agent who executes a negotiable instrument for his principal can bind the principal provided that he states the principal's name and states that he is signing as an agent and he acts within the scope of his authority.

5. Partners: Each partner in a trading firm has the implied authority to bind his co-partners by drawing, endorsing, accepting or negotiating bills, notes and cheques. But a partner of a non-trading firm has no such implied authority.

6. Joint Hindu Families: In a joint Hindu family the eldest person viz. Karta alone has the capacity to contract on behalf of the family. Therefore an instrument executed by him binds all other members of the family.

7. Legal Representative: After the death of the holder of a negotiable instrument, the legal representative gets all the rights and liabilities on such instruments.

Holder and Holder In Due Course

Holder - (Sec-8): Holder of a negotiable instrument is any person entitled in his own name (i) to the possession of an instrument and (ii) to receive or recover the amount due thereon from the parties thereto.

Holder in Due Course (Sec-9): A holder in due course is any person who for considerations becomes a possessor of a negotiable instrument (if payable to bearer) provided he got possession before the amount mentioned in it became payable and without sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

Privileges of a Holder in Due Course

A holder in due course is at a privileged position. He is protected from certain risks to which an ordinary holder of the negotiable instrument is exposed to. The following are the special privileges of a holder in due course:

1. When the Instrument is Inchoate: A blank instrument stamped and signed without filling up the amount is called an inchoate instrument. If such an instrument is filled up by a holder in due course and presented when it is due, payment cannot be denied for the reason that the amount is filled up without the authority, so long as the amount does not exceed the amount covered by the stamp.

2. When the Payee is Fictitious: Even when the names of the drawer and the payee are fictitious in a negotiable instrument the holder in due course can claim the amount from

the acceptor. That is, the acceptor of a bill cannot avoid payment to a holder in due course for the reason that other parties to the bill were fictitious.

3. When the Instrument is Made without Consideration: A contract made without consideration is void. But if a negotiable instrument made without consideration gets into the hands of a holder in due course, the absence of consideration cannot be raised against him or subsequent holders deriving title from him.

4. When there are Prior Parties: Every prior party to a negotiable instrument is liable thereon, to a holder in due course, until the instrument is duly satisfied (Sec. 36).

5. When the Instrument was Escrow: When a negotiable instrument is delivered to a person for a special purpose without intention of transferring the property therein, it is called an escrow. If that person negotiates it and it finally comes into the hands of a holder in due course the parties to the instrument cannot avoid liability on the ground that it was an escrow.

6. When the Instrument is Defective Due to Fraud or Illegality: Where at any time the instrument was affected by fraud or illegality while passing through the previous parties, it gets cleaned up when it comes into the hands of a holder in due course. Any defect in the title of the instrument will not affect the rights of the holder in due course provided he himself was not a party to the fraud.

7. When the Instrument was Obtained for Unlawful Consideration or by Unlawful Means: The person liable to pay on a negotiable instrument cannot avoid payment to a holder in due course on the ground that the instrument was lost or that it was obtained from him by means of an offense or fraud or for an unlawful consideration.

8. When the Validity of the Instrument is Denied: The validity of an instrument cannot be denied when it is in the hands of a holder in due course. There is an estoppel against denying original validity of instrument when it is in the hands of a holder in due course.

9. When the Payee's Capacity to Endorse is Challenged: When the instrument is in the hands of a holder in due course, there is an estoppel against denying the capacity of payee to endorse.

10. When the Endorser denies the signature or capacity of any prior party: Endorser is not permitted to deny the capacity of prior parties and avoid payment to a holder in due course on any such grounds.

Liability of Parties

- 1. Liability of Drawer (Sec. 30):** The drawer of a bill of exchange or cheque is bound to compensate the holder, in case of dishonour by the drawer or acceptor thereof, provided due notice of dishonour has been given to or received by the drawer.
- 2. Liability of Drawee:** When a banker having sufficient funds of the drawer of a cheque fails to pay money when the cheque is duly presented must compensate the drawer for any loss or damage caused by such default.
- 3. Liability of Maker of a Promissory note and Acceptor of a Bill of Exchange:** The maker of a promissory note and the acceptor of a bill of exchange are liable for payment due on the instrument at the maturity of the instrument.
- 4. Liability of Endorser:** Normally the endorser of a negotiable instrument will be liable to all the subsequent holders in case of dishonour of the instrument.
- 5. Liability of Prior Parties:** Every prior party to a negotiable instrument will be liable to a holder in due course till the instrument

Negotiation

When a promissory note, bill of exchange or cheque is transferred to any person, so as to constitute that person as the holder there of, the instrument is said to be negotiated. If an instrument is payable to bearer it is negotiated by delivery. If an instrument is payable to order, it is negotiable by the holder by endorsement and delivery thereof.

LESSON 5.5 ENDORSEMENT

Endorsement means writing of a person's name on the face or back of a negotiable instrument or on a slip of paper annexed thereto, for the purpose of negotiation (Sec. 15). The person who signs the instrument is called the 'endorse'. The person to whom it is endorsed is called the 'endorsee'.

Essentials of Valid Endorsement

1. It must be on the instrument itself. If there is no place on the instrument, it must be on a slip of paper called "allonge" annexed to the instrument.
2. It must be signed by the endorser for the purpose of negotiation.
3. It must be made by the endorser either by signing on the instrument or by specifying the name of the person to whom the instrument is payable, in additions to his signature.
4. It must be completed by the delivery of the instrument.

Kinds of Endorsement

Endorsement can be divided into the following kinds, viz. 1. Blank or general 2. Full or special 3. Restrictive 4. Partial, and 5 Conditional or Qualified.

1. Blank or General Endorsement: An endorsement is said to be blank or general if endorser signs his name only on the face or back of the endorsement [Sec. 54]. In a blank endorsement endorsee's name is not written, with the result, the instrument becomes payable to bearer even though originally it was payable to order. After a blank endorsement even an instrument payable to order becomes one payable to bearer.

2. Full or Special Endorsement: If an endorser signs his name and adds a direction to pay the amount mentioned in the instrument to or to the order of a specified person, the endorsement is said to be in full [Sec.16 (1)].

3. Restrictive Endorsement: An endorsement restricting or prohibiting further transferability of the instrument is called a restrictive endorsement. The endorser restricts further negotiation by express words

Example: If 'A' while endorsing the negotiable instrument to 'X' writes on it "Pay the contents to 'X' only", 'X' cannot negotiate it further.

4. Partial Endorsement: When an endorsement is done only for one part of the amount of the instrument it is said to be a partial endorsement. A partial endorsement does not result in the negotiation of the instrument. But where one part of the endorsement is paid and is noted on the instrument, then the instrument can be negotiated.

5. Conditional Endorsement: An endorsement is conditional when it limits or removes the liability of the endorser. While a restrictive endorsement places restriction on the negotiability of the instrument a conditional endorsement limits or removes the liability of the endorser. The following are the different types of conditional endorsements.

(a) Sans Recourse Endorsement: When an instrument is endorsed by adding the words “Sans Recourse” to the Endorsement he does not incur the liability of an endorser to the endorsee.

Example: “Pay ‘X’ or order Sans Recourse”. After such an endorsement if the instrument is dishonoured the holder of the instrument cannot claim payment from the endorser.

(b) Contingency Endorsement : An endorsement, where the endorser gets the liability only on the happening of an event which may or may not happen, is called contingency endorsement.

Example: “Pay ‘X’ or order on his marriage with ‘C’.” In such an endorsement the liability of the holder as an endorser would arise only if ‘X’ marries ‘C’.

(e) Facultative Endorsement: The endorser by express words abandons some right or takes up some liability under this type of endorsement.

Example: “Pay ‘X’ or order, Notice of dishonour not required”. The endorser has a right to get notice of dishonour. But in this example he abandons the right.

(d) ‘Sans Frais’ Endorsement: An endorsement which does not make the endorsee or the holder of the instrument to incur any liability on account of the instrument, is called a sans frais Indorsement.

Cancellation of Endorsement: If the holder of an endorsement without the consent of the endorser destroys the remedies available to the endorser against any previous endorsers, the endorser is discharged from liabilities as if his endorsement is cancelled.

Example: 'X' is the holder of a bill of exchange payable to the order of 'A', which contains the following endorsements:

First endorsement 'A', Second endorsement 'B', Third endorsement 'C' and Fourth endorsement 'D'.

'X' directly files a suit against 'B' without the consent of 'D' and strikes out the endorsement card of 'B' without the consent of 'D'. This action destroys the remedies available to 'D' against 'C' and 'B'. Hence 'D' is relieved of all his liabilities as an endorser.

Negotiation Back: When a negotiable instrument after many negotiations comes back to an earlier endorser before its maturity it is called Negotiation back. In such a case none of the intermediate holders will be liable to him.

Example: 'A' negotiates a bill to 'B', 'B' to 'C', 'C' to 'D' and 'D' to 'A'. In this case 'B', 'C' and 'D' will not be responsible to 'A'.

Stolen and Lost Instruments: A person who steals or finds a lost negotiable instrument does not acquire a title to the instrument. He has no right to enforce payment on it against any party connected with the instrument. If he obtains payment on it, he is liable to return it to the owner. However if a negotiable instrument payable to bearer is negotiated by mere delivery to a bonafide transferee for value, the transferee becomes a holder in due course and gets a good title to it. But if the bill of exchange or promissory note payable to order is lost and the finder forges the endorsement the purchaser cannot acquire the rights of a holder in due course, even when he gets it for value in good faith.

Instruments Obtained by Coercion or Fraud: If a negotiable instrument is obtained by coercion or fraud, the person defrauding is not entitled to enforce payment on such instruments. But the defence of coercion or fraud shall be lost generally when it reaches the hands of a holder in due course.

Negotiable Instrument and Consideration: It is presumed that every negotiable instrument is made or drawn for consideration until otherwise is proved. The defence of failure of consideration is available only between immediate parties of the instrument and not between remote parties. Lack of consideration between original parties or between any subsequent negotiators cannot be raised as a defence against a holder in due course.

Presentment of a Negotiable Instrument

Presentment of a negotiable instrument means showing it to the drawer, acceptor or maker for any of the following viz. (1) Acceptance (2) Sight or (3) Payment.

1. Presentment for Acceptance: Only a bill of exchange payable after sight needs to be presented for acceptance. Through acceptance the drawee signifies his assent to the order of the drawer that he will honour the bill at the appropriate time. Only from the time of acceptance the drawee gets the liability on the instrument. The essentials of a valid acceptance are as follows:

- (1) It may be written on the bill “accepted”, across the face or on the back of the bill.
- (2) It must be signed by the drawee personally or by a duly authorised agent.
- (3) The accepted bill must be delivered to the holder.

A bill payable on demand or payable after a certain date or after some number of days need not be presented for acceptance. But, for a bill payable some period after sight, the bill on which there is a provision that it should be presented for acceptance before it is presented for payment, presentation for acceptance is required. Presentment for acceptance must be made at a reasonable hour on a business day and before the bill becomes overdue.

Modes of Acceptance

An acceptance may be classified into (a) General and (b) Qualified.

a) General acceptance: When the drawee while accepting the bill does not add any condition or qualification to it, it is called a general acceptance.

b) Qualified Acceptance: When the acceptance is subject to some qualification or conditions it is called a qualified acceptance. Qualified acceptance can be treated as non-acceptance or dishonour by the holder. Instead if he takes it as acceptance, it is at his own risk. Unless he obtains the consent of all the prior parties to this, all of them will be

relieved of from their liabilities on the instrument. A qualified acceptance may be in any of the following ways viz.

(1) Conditional (2) Partial (3) Qualified as to place (4) Qualified as to time, and (5) Acceptance by some of the drawees, but not all

Presentment for Acceptance to Whom?

The Bill payable after sight should be presented for acceptance to any of the following persons:

1. To the drawee or his duly authorised agent.
2. To his legal representative if the drawee is not alive.
3. To his assignee, if the drawee has been declared insolvent
4. To all the drawees if there are several drawees.
5. To the drawee in case of need.

When is Presentment for Acceptance Excused?

Presentment for acceptance for a bill payable after sight is excused under the following situations:

1. The drawee is a fictitious or incompetent person.
2. The drawee is dead or insolvent. It is enough if it is presented to the legal representative or the official assignee as the case may be.
3. The drawee is not found after a reasonable search.
4. Even when the presentment is irregular and acceptance is refused on some other ground

When the presentment for acceptance is excused the bill is deemed to be dishonoured on the due date.

Acceptor for Honour

A stranger to a bill normally cannot accept the bill. However when a bill payable after sight is dishonoured by non-acceptance, the holder of the bill can allow anyone to accept the bill on behalf of the drawer or any other party to the bill. A person so accepting the bill for somebody else is called 'acceptor for honour'.

Presentment for Sight

A promissory note payable after sight must be presented to the maker in order to fix its maturity. If the maker could not be found even after a reasonable search, presentment is

excused and the instrument may be treated as dishonoured. The presentment should be made on a business day during the business hours.

Presentment for Payment

Promissory notes, bills of exchange and cheques have to be presented for payment to the maker, acceptor or drawee as the case be or on behalf of the holder. If default is made, the parties other the parties primarily liable are discharged of their liability (Sec. 64).

Payment for Honour

When a bill is accepted by the drawee and later dishonoured by non-payment it can be paid by any other party for the honour of the drawee or the drawer, after declaring before a Notary Public, as to whose honour he is paying. This is called payment for honour.

Dishonour of a Negotiable Instrument

A bill of exchange may be dishonoured by non-acceptance or by non-payment, whereas a promissory note can be dishonoured only by non-payment.

Notice of Dishonour

When a negotiable instrument is dishonoured, the holder has to give a notice of dishonour to all the parties liable on the instrument. In case of failure to give a notice of dishonour all the prior parties liable thereon are discharged of their liability (Sec. 93). The notice is to be given by the holder or any of the parties liable to the instrument to the prior parties.

But such notice need not be given to the maker of a promissory note, acceptor of a bill or drawee of a cheque.

Noting and Protesting

Noting means the recording of the fact of dishonour by a Notary Public on a dishonoured bill or upon a paper attached thereto or party upon each (Sec. 99). The formal certificate issued by the Notary Public showing the dishonour of a negotiable instrument is called protest. the holder of a promissory note or bill of exchange can sue any or all prior parties liable thereon only after the dishonour is authenticated by a Notary Public as stated above. The Notary Public issues a notice of protest to the party concerned.

Rules as to Compensation

1. *Amount of Compensation:* The amount of compensation payable to the holder of a negotiable instrument includes the principal amount interest due, expenses of noting and protesting, etc.
2. *Compensation to Endorser:* An endorser who paid the amount of the instrument is entitled to get back the amount with interest at the rate of six percent per annum from the date of payment until realisation thereof. He is also eligible to get back all the expenses incurred by him in connection with the dishonour of the instrument.
3. *Re-draft:* Compensation can even be given in the form of a 're-draft'. The party eligible for compensation may draw a bill upon the party liable to compensate for the amount due to him with interest and other expenses incurred by him. Such a bill is called "re-draft". The re-draft should be accompanied by the instrument dishonoured and the protest, if any.

Discharge of Negotiable Instrument

A negotiable instrument is said to be discharged when all rights of action under it are completely extinguished and it ceases to be negotiable. All the rights of action are considered to be completely extinguished only when all the parties liable on the instrument are discharged of their liabilities.

HUNDIES

The term 'hundi' is derived from the Sanskrit word hund which means 'to collect'. Hundies are negotiable instruments similar to promissory notes and bills of exchange. But they are written in a vernacular language. They are governed by local usages and customs. But when there is no customary rule on a certain point, the provisions of the Negotiable Instrument Act apply.

Kinds of Hundies

Hundies can be broadly divided into two types viz.

- (2) Darshni hundi which is payable at sight, and
- (3) Muddati or Miadi hundi which is payable after a specific period.

The following are the commonly known hundies:

1. Shah-jog hundi
2. Nam-joghundi
3. Dhani-jog hundi
4. Firman-jog hundi
5. Jawabee hundi
6. Jokhami hundi

1. Shah-Jog Hundi: Shah means a respectable person. A hundi which is payable only to a respectable person is called Shah-jog hundi. Such hundies are freely transferable from person to person by mere delivery.

2. Nam-Jog Hundi: Nam means name. It is a hundi payable to or to the order of a specified person named in the hundi. It can be negotiated like a bill of exchange.

3. Dhani-Jog Hundi: Dhani means a 'Holder'. A dhani-jog hundi is a hundi which is payable to the holder or bearer. It can be negotiated by mere delivery like a bearer instrument.

4. Firman-Jog Hundi: Firman means order. A firman-jog hundi is one which is payable to order. It can be negotiated by endorsement and delivery like instruments payable to order.

5. Jawabee Hundi: Jawab means reply. Jawabee hundies are used for remitting money from one person to another. When the person who should get the money receives it, sends a reply to the sender.

6. Jokhami Hundi: In this type of hundies money is payable by the buyer of goods who is the drawee of the instrument only in the event of safe arrival of goods against which the bill is drawn. It protects the buyer who is liable to pay, only when he receives the goods.

QUESTIONS

1. What is a negotiable instrument? Explain its special characteristics?
2. What are the types of negotiable instruments?
3. What is a promissory note? What are its essential elements?
4. Distinguish between (a) a bill and a promissory note and (b) a bill and a cheque.
5. What is meant by crossing a cheque? Who can cross a cheque? What is the difference between a general crossing and a special crossing?
6. Explain the significance and legal implications of marking a cheque.
7. In what respects does an accommodation bill differ from other bills?
8. What is the effect of the words 'not negotiable' written in the crossing of a crossed cheque?
9. Write short note on;
(a) a bill in sets, and (b) a holder in due course.
10. What are the liabilities of (a) the drawer and (b) the endorsers (assuming there are more than one) in case of a bill of exchange.
11. A holder in due course gets a title free from equities; comment.
12. Explain clearly what is meant by negotiation. How is it effected and in what way does it differ from an ordinary assignment?
13. Explain the meaning and effect of (a) endorsement in blank (b) special endorsement (c) restrictive endorsement.
14. What is the effect of fraud, forgery and absence of consideration on a negotiable instrument?
15. Write notes on: (a) endorsement sans recourse (b) allonge (c) negotiation back.
16. What is meant by acceptance of a bill of exchange? When must a bill be accepted? If acceptance is refused, what steps should the holder take?
17. Define acceptance for honour; Can the drawer of a bill of exchange accept it for honour?
18. When is a negotiable instrument considered as dishonoured? what are the duties of a holder upon such dishonour?
19. When is a negotiable instrument said to be discharged? What is the difference between discharge of an instrument and discharge of a party to an instrument?
20. What is a hundi? What are its various kinds?

UNIT – VI

Unit Structure:

Lesson – 6.1 Company – Nature and Features

Lesson – 6.2 Classification of Companies

Lesson – 6.3 Company Incorporation

LESSON – 6.1 COMPANY – NATURE AND FEATURES

Introduction

The origin of Indian company law can be traced back to the year 1850, when the first Indian companies Act providing for the registration of joint stock companies was passed in the year 1850, on the lines of English Companies Act of 1844. During 1857 another Act was passed on the lines of the English Companies Act of 1856. The principle of limited liability was first introduced in England by the Limited Liability Act of 1855 under which a company was entitled to obtain certificate of registration with limited liability. The English Companies Act, 1856 replaced both the Acts of 1844 and 1855. The concept of limited liability is not alien to India.

The growth of trading, commercial and later industrial activities in India in the later half of the nineteenth century led to several changes in company legislation. The first Comprehensive Act providing for the incorporation, regulation and winding up of companies was passed in India in 1866, in the lines of English Companies Act, 1862. This Act was recast in 1882 to bring the Indian Company Law in conformity with the various amending Acts were passed in 1887, 1891, 1895 and 1910, till we had a consolidating Act – the Indian Companies Act 1913 – which brought our law almost at par with the English Companies for the first time. Thereafter, some minor amendments to the Act were carried out in 1914, 1915, 1920, 1926, 1930 and 1932. Extensive amendments were made by the ‘Indian Companies (Amendment) Act of 1936’ which not only brought our law at par with the English Companies Act of 1929, but which went a step further. This amending Act, for the first time, introduced various provisions relating to the powers and limitations of Managing Agents and devoted a separate chapter for Banking Companies. This chapter was later taken out and incorporated in a separate Banking Companies Act. From 1936 to 1946, the Act was amended several times with minor changes arising out of specific needs.

After the independence, some formal amendments were made by the Adaptation of laws order, 1950 which came into force on the 26th January, 1950, the date on which the constitutional status of India was changed into Sovereign Democratic Republic.

The growth of industrial activity during and after the second world war brought about a spurt in the formation of companies in India. Many changes had taken place in the organization and management of joint stock companies. Need was felt for a thorough revision of the existing Act and enactment of a Comprehensive Companies Act and provide for the changed situation. In the meantime, the English Companies Act, 1948 was passed providing far-reaching changes recommended by the Cohen Committee. The government of India appointed on 25.10.1950, a committee of 12 members representing various interests under the chairmanship of Mr. H.C. Bhalha. The Bhalha committee reported in 1952, made a thorough enquiry into the development of joint stock companies in the country, the abuses of the Managing agency system, the loopholes in the existing legislation and the social and economic requirements of the fast changing society after the independence. A bill based mainly on the recommendations of the Bhalha Committee was introduced in Parliament in 1953 and after consideration by a joint select committee of parliament, was passed in 1955. The Companies Act, 1956 came into force with effect from April 1, 1956.

THE COMPANIES ACT, 1956

The Companies Act, 1956 is a consolidating and amending act. It contains 658 sections, 12 schedules and numerous forms. While Schedule XIII has been later added by the Amendment Act of 1974, Schedule XIV has been inserted by the Companies (Amendment) Act, 1988.

This Act is based largely on the report of the company law committee, 1952. The Act applies to the whole of India, except Jammu and Kashmir where it applies only in respect of banking, insurance and financial corporations. As regards Nagaland, it applies subject to modifications, if any, notified by the Central Government. The Act was amended first in 1960 and later in 1963, 1965 and 1969. The Amendment Act of 1969 brought a far-reaching change in that the managing agency system and the institution of Secretaries and treasurers was abolished altogether with effect from April 3, 1970. The 1974 amendment brought about far-reaching changes in the 1956 Act to plug the loopholes left over, to give

greater power to the Government to regulate and control company activities in public interest. Since then the Act has been further amended in 1977, 1985, 1988, 2000 and 2006.

The main objectives underlying the companies act, 1956 may be briefly stated as under:

- (1) To protect the interests of a large number of shareholders as there exists separation of ownership from management in a joint stock company.
- (2) To safeguard the interests of creditors in view of the limited liability feature of a joint stock company.
- (3) To help the growth of companies on healthy business lines.
- (4) To help the attainment of the ultimate ends of the social and economic policy of the Government, namely, establishing a socialistic pattern of society.
- (5) To equip the Government with necessary powers to intervene directly in the affairs of company in the public interest so that the interests of consumers, laborers and suppliers of raw materials may be protected from unscrupulous management.

Machinery for the Administration of the Companies Act, 1956

The Central Government is charged with the overall responsibility for administration and enforcement of the Companies Act. It acts through the Department of Company Affairs. Till recently the task of looking after the Department of Company Affairs was entrusted to the Ministry of Law, Justice and Company Affairs. On reshuffling of the Ministry in 1985, the Department of Company Affairs now forms a part of the Ministry of Industry and Company Affairs.

THE COMPANY

Literally the word 'Company' means a group of business, charity, sports, research etc. a company, in common parlance, means a group of persons associated together for the attainment of a common end, social or economic. The dictionary meaning of the word, "Company", includes a number of persons united for performing or carrying on anything jointly. In this sense the word is applicable to ordinary partnerships. However, when the word is used in connection with 'Company Law' it has a somewhat different meaning. The word then refers to an association of persons who have formed themselves into a

corporation or a body corporate. Quite often the word, “company” is used as part of partnership firm name, but that does not make the firm a company in the sense in which the word is used in Company Law.

In the ordinary sense, ‘Company’ means a voluntary association of persons for some common purpose. Such an association of persons may be registered or incorporated or it may be unincorporated. If it is incorporated under the Companies Act, it acquires a legal personality of its own distinct from the individuals comprising the association.

After incorporation or registration, a company becomes a ‘body corporate’. Corporation or body corporate means an association of persons formed and authorised by law to act as a single person. One of the most important conceptions of jurisprudence is the corporation, a legally recognized person. Consisting of a group of persons acting in combination. The type of corporation or company may be a corporation aggregate as distinguished from a corporation sole.

A corporation sole is comprised of one person, who is the holder for the time being of a perpetual office, or such an individual has a dual personality, one corporate and the other human or natural. The rights and liabilities which attach to him in his corporate capacity are entirely distinct from those which attach to him in his capacity of a natural person. A corporation aggregate consists of a number of individuals who become contemporaneously associated in a group, so that in the eyes of law they enjoy the status of a single person, e.g., a limited company, municipality, municipal corporation.

Company – Definition

Section 3(1)(i) of the Companies Act defines a company as, “a company formed and registered under this Act or an existing company”. As per Sec 3(1)(ii) an existing company means a company formed and registered under any of the former Companies Acts.

Section 2(7) of the Indian Companies Act, 1956 defines a body corporate to include a company incorporated outside India, but does not include (a) a corporation sole (b) a co-operative society registered under any law relating to co-operative societies and (c) any other body corporate (not begin a company as defined in this Act) which the Central Government may. By notification, specify in this behalf.

In the words of Linsly, L.J. a company is defined as, “an association of many persons who contribute money or money’s worth to a common stock and employ it in some common trade or business and who share the profit or loss arising there from. The common stock so contributed is denoted in money and is the capital of the company. The persons who contribute it or to whom it belongs, are members. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted”.

According to Prof. Haney “a company is an artificial person created by law, having separate entity, with a perpetual succession and a common seal”.

It is thus quite obvious from the aforesaid definitions that a company comes into existence only when it is registered under the Act , An unregistered company has no such separate legal existence. A company which is created by law, will be dissolved only by law.

Characteristic features of A Company

A careful scrutiny of the aforesaid definitions would reveal the following essential characteristics of a company:

1. Incorporated Association: A company must necessarily be incorporated and registered under the companies Act. Registration creates a joint stock company and it is compulsory for all associations or partnerships, having a membership of more than 10 in banking and more than 20 in any other trading activity, formed for carrying on a business with the object of earnings profits.

2. Corporate Personality: A company is in law different from its members. It has an independent corporate existence. It has a legal personality of its won. It can make contracts open a bank account, can sue and be sued by others: it can own property in its own name. Unlike a partnership firm, which has no existence apart from its member, a company is a juristic person independent of its members.

The law has recognized that even if a person holds virtually all the shares, the rights and obligations of the company shall be different from its members. The company’s

money and property belong to the company and not to the shareholders. The member's personal property cannot be held liable to pay the creditors of the company. In *Solomon V. Solomon & Co.Ltd.*, it was held that company is a different person altogether from its members. It is this feature of corporate personality that distinguishes it from other forms of business organizations.

3. Perpetual Succession: Section 34(2) of the Act states that an incorporated company has perpetual succession. The life of a company is not related to the life of its members. Law creates the company and the law alone can dissolve it. The existence of a company is not affected by death, insolvency, retirement or transfer of shares of members. Members may come and members may go, the company continues until it is dissolved. Gower, L.C.B in his book has given an interesting example. He says "During the war all the members of one private company, while in general meeting, were killed by a hydrogen bomb. But the company survived, not even a hydrogen bomb could have destroyed it."

4. Limited Liability: It is the most important advantage of a corporate form of business organization. It means that the liability of a member shall be limited to the nominal value of the shares held by him. Once he has paid the full amount on the shares held by him, he cannot be called upon to bear the loss from his personal property. In the case of a company limited by guarantee, the liability of members is limited up to the amount guaranteed by a member. In case of partnership the liability of members is unlimited. It may, however, be noted that the benefit of limited liability accrues only to members and not to the company as such. A company, in fact, incurs unlimited liability.

5. Transferability of Shares: The shares of a joint stock company are freely transferable except in the case of a private company. A shareholder can transfer his shares to any person without the consent of other members. A company cannot impose absolute restrictions on the rights of members to transfer their shares. However, the articles shall lay down the procedure of transfer of shares and it may also contain bonafide and reasonable restrictions on the rights of members to transfer their shares.

6. Separate Property: Because of its corporate personality, a company can own and transfer property in its own name. Although the shareholders have contributed to the capital of the company, they do not become the part owners of its property. Property of the

company should not be treated as members' property or vice versa. The property of the company should be used for the company's business and not for the personal benefit of any shareholders. In *Gramophone & Typewriter Co. Ltd., V. Stanley*, it was held that the property of the company is not the property of the shareholders; it is the property of the company. Also in *Bacha F. Guzdar V. The commissioner of Income Tax Bombay and in perumal V. John Deauin* the courts held that "no member can claim himself to be the owner of the company's property during its existence or on its winding up."

7. Capacity to Sue: A company being a juristic person, it can sue in its own name and be sued by others. In *Abdul Haq V. Das Mal*, an employee was not paid his salary for several months. He filed a suit against the directors of the company for the recovery of the amount of salary due to him. It was held that he will not succeed because the remedy lies against the company and not against the directors or members of the company.

Advantages of incorporation

- 1. Perpetual succession:** A company is a legal person having perpetual succession (Section 34). The death or insolvency of individual members does not in any way affect its existence or continuity.
- 2. Limited liability:** In a limited company the liability of the members is limited. No member is bound to contribute anything more than the nominal value of the shares held by him.
- 3. Transferable shares:** The shares in a company as per Section 82 of the Act, are a movable property transferable in the manner provided by the Articles of the company, shares of public company can be listed on stock exchanges which makes the selling or purchasing of shares extremely easy. This encourages investment of funds in shares.
- 4. Public participation in growth:** There is no upper limit on the number of shareholders in a company. Thus by making large number of shareholders, the company can grow to the size of a giant as in the case of, say Hindustan Lever Ltd. And can contribute a lot to the country's growth.

5. ***Funds can be arranged from public:*** Funds can also be arranged from public by issue of debentures or by way of fixed deposits by a public company.
6. ***Capacity to sue:*** Being a legal person a company can sue and be sued in its name. The directors or shareholders cannot be sued for the dues against a company.
7. ***Flexibility and autonomy:*** A company has an autonomy and independence to form its own policies. This form of organization dislocates the ownership from the control of business and thus helps promote professional management and efficiency.
8. ***Separate property:*** A company as a legal entity is capable of owning its funds and other assets. Even a member holding majority shares or a managing director of a company is liable for criminal misappropriation of the funds of the company or its property.
9. ***Preference by creditors:*** Persons who want to deal; with the company can have full information about its set-up, directors, shareholders, working results etc. by inspecting the file of the concerned company in the office of the Registrar of Companies by paying a nominal fee of Rs. 10. Thus a company is preferred over a firm in this regard. Even banks and financial institutions prefer a company while giving credit.

Corporate Veil

A company has a separate legal personality quite distinct from its members. The famous Solomon case well established the existence of the 'veil of corporate personality' through which the identity of the members cannot be perceived. However, there are exceptions to the fundamental principle of separate corporate personality where the veil is Lifted or Pierced and the identity of the members is revealed. Thus, where the law disregards the corporate entity and pays regard instead to the individual members behind the legal façade. It is known as lifting the veil of corporate personality. The decisions on which the law will lift the corporate veil may be broadly study under the following heads.

- A. Under Judicial interpretation
- B. Under statutory Provisions

A. Under Judicial Interpretation

(1) For determining the character/status of a company: When it is suspected that the company is owned or controlled by enemies of the country. The courts may lift the corporate veil and examine the character of persons in the real control of the company [*Daimler Co. Ltd., Vs. Continental Tyre & Rubber Co. Ltd.*].

(2) For the protection of revenue: when a company is used as a means to evade tax, the courts may disregard the corporate veil. In *Commissioner of Income tax Vs Sri Meenakshi Mills, Madurai*, it has been held that the court is empowered to lift the corporate veil if a company is used as a means to circumvent the obligations.

(3) To prevent fraud/improper conduct: The court may also lift the corporate veil of a company where it appears that the company was formed only for some fraudulent purpose to defraud creditors or to avoid legal obligations [*Tata Engg. & Locomotive Co. Ltd., Vs. State of Bihar*].

(4) Company acting as agent of the shareholders: Where a company is acting as the agent of the shareholders under an express or implied agreement. The corporate entity of the company will be disregarded and shareholders will be held liable for the acts of the company. [*Smith, Store & Knight Ltd., Vs Birmingham Corporation*].

(5) Where the doctrine conflicts with public policy: where the corporate veil conflicts with public policy, the court lifts the veil for protecting the public policy. [*Connors Bros. Vs. Coonors*].

B. Under Statutory Provisions

The Companies Act, 1956 itself has provided for certain cases making the members or directors personally liable.

(1) Reduction in membership [Sec. 45]: If a company carries on business for more than 6 months after the number of members has been reduced below 7 in the case of a public company and 2 in the case of private company, every person who was a member during that time and knew of this fact. Shall be held severally liable for the debts of the company contracted after 6 months.

(2) Misdescription of the company: If any officer of a company or any other person acts on its behalf and enters into a contract or signs a negotiable instrument without fully writing the name of the company. Then such officer or person shall be personally liable. [Sec. 147].

(3) Failure to refund application money [Sec. 69]: If the application money of those applicants to whom no shares have been allotted is not repaid within 130 days of the date of issue of the prospectus, then the directors shall be jointly and severally liable to repay that money with interest @ 15% p.a. as per the guidelines issued by SEBI.

(4) Fraudulent trading [Sec. 542]: Where it appears that in the course of winding up of a company that it had carried on business with the intent to defraud the creditors, the court may declare that persons who were knowledgeable parties to such fraud will be personally liable for the debts of the company.

(5) Ultra vires acts: Directors of a company shall be personally liable for all such acts which they have done on behalf of the company. If they are ultra vires the company or ultra vires the directors and the company does not ratify their acts.

Questions

1. What are the main features of the Companies Act, 1956?
2. Stat the history of company law in India.
3. Define a 'Company'
4. Mention the characteristic features of a company.
5. What is a corporate veil? When can it be lifted?
6. "A company is a legal person distinct from its members" – Explain.
7. What is meant by (i) Corporation sole and (ii) Corporation aggregate.
8. What is meant by limited liability?
9. What are advantages of incorporation of a company?
10. Under what circumstance veil is pierced?

LESSON – 6.2 CLASSIFICATION OF COMPANIES

Joint stock companies may be of various kinds of the most common type is company limited by shares. On the basis of incorporation, there are three types of companies:

- (i) *Chartered Companies*
- (ii) *Statutory Companies*
- (iii) *Registered Companies*

(1) Chartered Companies

A chartered company is one which is incorporated under a special charter granted by the King or Queen of England. The East India Company and the Bank of England are examples of chartered companies incorporated in England. The powers and nature of business of chartered company are defined by the charter which incorporated it. After independence such companies find no place in India.

(2) Statutory Companies

These companies are incorporated by a special Act of Legislature (i.e., by the Act of Parliament or State Legislature). Reserve Bank of India, Life Insurance Corporation of India, Union Trust of India, Food Corporation of India, MMTC are examples of such companies. The special enactment contains its constitution, powers and scope of its activities. Such companies do not have any Memorandum or Articles of Association. They derive their powers from the Acts which constitute them, change in its structure or powers is possible only by a legislative amendment. Such companies are generally formed to carry on the works of some special public importance. The main objective of such companies is to serve public interest.

(3) Registered Companies

Companies registered under the Indian Companies Act, 1956 or under any of the previous Companies Acts are called 'registered companies'. A registered company comes into existence when it is registered under the Companies Act and a certificate of incorporation is issued by the Registrar of Companies. Such companies derive their powers from the Companies Act and from the Memorandum of Association. These are the companies commonly found in India. A registered company may either be a private company or a public company.

These companies may be:

- (a) Companies limited by shares;
- (b) Companies limited by guarantee; or
- (c) Unlimited companies.

(a) Companies limited by shares: Where the liability of the members of a company is limited by the Memorandum to the amount, if any, unpaid on the shares, such a company is known as a company limited by shares [Sec. 12(2) (a)]. If the shares are fully paid, then the liability of the member is nil. On the other hand, in case of partly paid-up shares, his liability will extend to the amount unpaid on shares held but him. The liability of the members to pay the unpaid amount can be enforced during the existence of the company found in India.

(b) Companies limited by guarantee: Where the liability of the members of a company is limited by the Memorandum to a fixed amount which the members undertake to contribute to the assets of the company in case of its winding up, the company is called a company limited by guarantee [Sec. 12(2)(b)].

Such companies are generally non – trading companies, and they are not formed for the purpose of earning profits, rather they are formed for the promotion of art, science, sports, culture etc. Such companies may be registered with or without a share capital. The Articles of such a company must state the number of members with the company is to be registered [Sec. 27(2).]

(c) Unlimited companies: A company not having any limit on the liability of its members is termed as an unlimited company [Sec. 12(2) (c)]. The members are personally liable for the debts of the company. It should, however, be noted that because of separate legal entity of the company. The creditors of an unlimited company cannot sue the members directly. The creditors will have to ask the court for the winding up of the company and then the members have to contribute their property and then the Liquidator shall use the funds in the discharge of the debts of the company. Such companies may or may not have share capital.

The Articles of an unlimited company must state the number of members with which the company is to be registered and if the company has a share capital, the amount of share capital with which the company is to be registered [Sec. 27(1)]. The unlimited companies may also be either 'private' or public' companies.

Sec. 32 (1) (a) says that a company registered as unlimited may register under this Act as a limited company. However, a special resolution must be passed to this effect,. The re- registration shall not affect any debts, liabilities, obligations or contracts of the company before or at the time of re- registration [Sec. 32(3)].

Such Companies are very few. Besides the above, the companies may also be classified as:

- (a) Associations not for profit having license under Section 25 of the Act; or licensed companies;
- (b) Government companies;
- (c) Foreign Companies;
- (d) Holding and subsidiary companies.

Some other types of companies which are referred to under the Companies Act are as follows:

1. Licensed Companies

Popularly known as Section 25 companies, these companies are also registered under the Companies Act like any other Company but before they are registered, a license may be obtained from the Central Government. Any association formed for promoting commerce, art, science, religion, charity or any other useful object and which has no intention to distribute dividends to members but instead to apply its income in promoting its objects, can obtain a license from the Government and can get itself registered as a company with limited liability. On registration, it enjoys certain exemptions and privileges as compared to an ordinary limited company, such companies may exclude the words 'limited' or 'private limited' from their names. They are registered without paying any stamp duty on their memorandum and articles. These companies are also exempted from complying with the provisions of Sections 147, 160(1)(aa), 166(2), 171(1), 209(4)(a), 257, 264(1), 285, 287, 299, 301 and 302(2) of the Companies Act either wholly or in part, as per

Government of India Notification No. S.O.1578 dated 8 July 1961. The license may at any time be revoked by the Central Government, if the fundamental conditions of the license are contravened; such companies may be public or private companies and may or may not have share capital.

It is worth nothing that a partnership firm may be a member in a licensed company in its firm name and it is only on the dissolution of the firm that its membership shall cease [Sec. 25(4)].

2. One-man Company or Family Company

Where one man holds Practically the whole of the share capital of a company and takes a few more dummy members (usually family members) simply to meet the statutory requirement of the minimum number of persons (6 more persons in case of a public company), such a company is known as “one-man company”, such a company is perfectly in order in the eyes of law and is regarded to have a separate entity, as distinct from the majority shareholder (Salomon us. Salomon & Co. Ltd.).

3. Foreign Company

A foreign company means a company incorporated outside India but having a place of business in India [Sec. 591(1)].

Within 30 days of the establishment of the business in India, a foreign company has to furnish to the Registrar, the following documents as per Section 592;

- (1) A certified copy of the Charter, Statute, Memorandum and Articles of the company, containing the constitution of the company. If the instrument is not in English language, a certified translation thereof.
- (2) The full address of the Registered, or Principle Office of the company.
- (3) A list of directors and secretary of the Company giving name in full, usual residential address, nationality of origin, his business and particulars of other directorships held by him.
- (4) The names and address of any person or persons resident in India, authorized to accept service of legal process and notices on behalf of the company.
- (5) The full address of that office of the company in India which is to be deemed as its principal place of business in India.

When any change occurs in the above particulars the Registrar must be notified accordingly within the prescribed time (Sec. 593).

Obligation regarding accounts: The obligations of a foreign company in respect of accounts are almost the same as those of a company registered under the Indian Companies Act. Section 594 provides that every foreign company, unless exempted by the central Government, is required to file with Registrar every year three copies of its Balance Sheet and profit and Loss A/c and other documents, required under the Act, Along with these documents, it must also send to the Registrar three copies of a list in the prescribed form of all the places of its business in India [Sec. 594(3)].

Other obligations [Sec. 595]: Every foreign company shall:

- (i) State the name of the country of its incorporation in every prospectus inviting subscriptions in India for its shares or debentures. It may be noted, however, that a foreign company may issue a prospectus even if it has no place of business in India (Sec. 603).
- (ii) Conspicuously exhibit on the outside of every office or place of business, its name and the country of incorporation in English and in the regional language;
- (iii) Give the name of company and the country of incorporation in English language in all business letters, bill heads and letter paper and in all notices and other official publications of the company; and
- (iv) State in every prospectus and in all official publications and exhibit outside every office or place of business, whether the liability of the members is limited.

Office where Documents to be delivered [Sec. 597]; Any document which any foreign company is required to deliver to the Registrar of Companies shall be delivered to the Registrar having jurisdiction over New Delhi and also to the Registrar of the State in which the principle place of business of the company is situated. If any foreign company ceases to have a place of business in India, it must forthwith give notice of the fact to the Registrars referred to above, and as from the date on which notice is so given, the obligation of the company to deliver any document to the Registrars shall cease.

Penalties: If any foreign company fails to comply with any of the foregoing provisions, the company and every officer or agent of the company, who is in default, shall be punishable with fine extending upto Rs. 1,000 and in the case of continuing offence with

an additional fine which may extend to Rs. 100 for every day during which the default continues (Sec. 598). Further, any such defiant foreign company shall not be entitled to enforce any contract by way of a suit or set – off or counter claim though it will be liable to be sued in respect of any contract it may have entered into (Sec. 599).

Application of other provisions of the Companies Act: The provisions of Section 124 to 145 relating to the registration of charges will apply to foreign companies in respect of charges on property created in India, The provisions of Section 118 relating to the rights of members and debenture – holders to have a copy of the ‘trust deed’ for securing any issue of debentures of the company will also apply to foreign companies to the extent of requiring them to keep at their principle place of business in India the books of account with respect to moneys received and expended, sales and purchases made, and assets and liabilities in relation to their business in India. (Sec. 600).

The Companies (Amendment) Act, 1974 has made several other Sections of Act applicable to foreign companies. Accordingly:

- (i) The provisions of Section 159 relating to the filing of Annual Returns with the Registrar shall, subject to such modifications or adaptations as may be made therein by the rules made under this Act, apply to a foreign company [Sec. 600 (3) (b) (i)].
- (ii) The provisions of Section 209A (inspection of books of account, etc.), Section 233A (power of Central Government to direct special audit in certain cases), Section 234 to 246 (power of Registrar to call for information or explanation and investigation of affairs of company by Central Government) Shall, so far as may be, apply only to a company incorporated in India [Sec. 600 (3) (b) (ii) and (iii)] In respect of foreign companies, in which fifty per cent or more of the paid – up share capital (whether equity or preference or partly equity and partly preference) is held by Indian citizens and/or companies incorporated in India, such other provisions of the Act as may be notified by the Central Government with regard to business carried on by them in India, will become applicable to such foreign companies as they apply to a company incorporated in India. [Sec. 591 (2)].

It may be inferred from the above mentioned provisions that the Companies (Amendment) Act, 1974 intends to bring foreign companies into the ambit of the provisions applicable to Indian companies.

4. Government Company

A Government company is defined in Section 617 as “any company in which not less than 51 per cent of paid-up share capital is held by the Central Government or partly by the Central Government and partly by one or more State governments and includes a company which is subsidiary of a Government company as thus defined”.

The special provisions of the Companies Act relating to Government companies are as follows:

(1) Audit: (a) The auditor of a Government company shall be appointed or reappointed by the Central Government on the advice of the comptroller and Auditor General of India, provided that the auditor so appointed or reappointed does not hold appointment as the auditor in more than twenty companies, of which not more than ten could be companies with paid – up share capital of Rs.25 lakhs or more. In the case of an audit firm so appointed the ceiling of twenty companies shall be per partner of the firm who is not in full – time employment elsewhere. The Auditor General will have the power to direct the company’s auditor relating to the manner of audit and the performance of his duties. He shall also have the power to conduct a supplementary test audit of the company’s accounts by persons appointed by him; and (b) The auditor is required to submit a copy of his audit report to the comptroller and Auditor General, who shall have the right to comment upon the report. Any such comments shall be placed before the annual general meeting of the company along with the audit report (Sec. 619). Thus, it may be seen that the general provisions contained in Sections 224 to 233 of the Act relating to audit and appointment of auditors do not apply to a Government company.

(2) Annual report: (a) Where the Central Government is a member of a Government company; the Central Government shall prepare an annual report on the working and affairs of the company within three months of its annual general meeting before which the audit report is placed. The annual report is to be laid before both Houses of Parliament together with a copy of the audit report and any comments thereupon, made by the Comptroller and Auditor General of India.

(b) Where in addition to the Central Government, any State Government is also a member of Government company, that State Government shall place a copy of the annual report (prepared by Central Government) together with a copy of the audit report and the comments (referred to earlier) before the House or both Houses of the State Legislature.

(c) Where the Central Government is not a member of Government company, every State Government which is a member shall cause an annual report on the working and affairs of the company to be prepared within the same time (as referred to above), and then soon after lay it before the House or both Houses of the State Legislature with a copy of the audit report and comments thereupon.

(3) Application of the Companies Act: A Government company is to be registered under the Companies Act. It may be incorporated as a 'public' or 'private' company. The Central Government may, however, by notification in the Official Gazette, direct that any of the provisions of this Act shall not apply to any Government company or shall apply only with such exceptions, modifications shall be effective to the extent to which it is approved by Parliament (Sec. 620). Subject to such notification, such companies are governed by the Companies Act like any other limited company without any discrimination. The Central Government has issued notifications (published in the Gazette of India, dated 11 February and 4 March 1978) granting certain exemptions from complying with the provisions of Sections 198, 259, 268, 269, 309, 310, 311, 387 and 388 relating to the appointment of them. Similarly, Section 255, 256 and 257 pertaining to appointment and retirement of directors, and Section 370 relating to making of loans, etc., to companies under the same management shall not apply to such Government companies which are wholly owned by the Central or/and State Government(s).

In a bid to streamline the functioning of Government companies and to cut down delays, the Central Government has again issued five notifications (published in the Gazette of India, dated 16-7-85) granting exemption to Government companies from the application of the following Sections of the Companies Act:

- (i) Section 165, 187D, 294, 294AA(2) and (3).
- (ii) Section 108 in respect of shares held by nominees of government,

it has further been notified that Sections 43A, 149 (2A), 205A, 205B, 263, 264, 265, 266, 307, 308, 316, 317 and 386 of the Companies Act shall not apply to Government companies wholly owned by Central or/and State Government(s).

A Government company, no doubt, has certain special features but it should not be placed on the same footing as a State or Government, it basically remains a company in the ordinary sense, having a legal entity of its own, separate from that of its shareholders whoever they may be. It makes no difference whether the entirety of the capital is subscribed by the Government or the Government holds only 51 per cent of the share capital. In no case a Government company is identified with the State and its employees do not become Government servants, holders of civil posts under the Union or State Governments.

5. Investment Companies

An investment company is a company, the main business of which consists in acquiring, holding and dealing in shares and securities. However, legal opinions as well as statutory definitions differ as to the exact meaning and scope of the term, “Investment company, While one view is that an investment company acquires and holds shares and securities only for earning an income there from by holding them, the other view is that it is one which acquires and holds shares and securities both for earning an income for dealing in them for making a profit.

With regard to statutory definition, the provision to Sec. 372(10) of the Companies Act 1956 defines an investment company as, “a company whose principal business is the acquisition of shares, stocks, debentures or other securities. Section 2(10A) of the insurance Act 1938 also defines an investment company similarly. However, Section 109(ii) of the Income tax Act 1961, has defined an investment company as one whose business consists wholly or mainly in dealing in or holding of securities. As a general rule it can be said that an investment company should acquire shares and securities etc. and hold them for a considerable period of time with the intention of making profits there from.

6. Finance Companies

The Companies Act, 1956 does not define a ‘Finance Company’ although it does not preclude the formation and registration of a company under the Act with the object of carrying on the business of financing. However, the Companies (Acceptance of Deposits) Rules 1975 define a financial company. Accordingly a ‘financial company’ is defined as a

non-banking company which is a financial institution under the provisions of the RBI Act. In other words, financial institution means any non-banking institution which carries on as its business or part of its business any of the following:

- (i) Financing business whether by way of making loans or advances or otherwise.
- (ii) The purchase of shares, stock, bonds, debentures or securities issued by a Government or local authority.
- (iii) The letting of goods on hire under a hire-purchase agreement.
- (iv) The carrying on of any type of insurance business.
- (v) Managing or conducting or supervising or in any other capacity, of chits or kuries.
- (vi) Collecting monies in lump sum or otherwise, by ways of subscription or by sale of units or other instruments or in any other manner and awarding prizes, gifts, whether in cash or in kind or disbursing money in any other way to persons from whom monies are collected.

Public Companies and Private Companies

Companies limited by shares or guarantee may be divided into two categories, depending upon the interest of the general public in the companies; (i) Public Companies and (ii) Private Companies.

Private Company

According to Sec. 3(1)(iii) of the Companies Act, a private company one which by its Articles of Association

- (a) restricts the right to transfer its shares.
- (b) limits the maximum number of its members to fifty (excluding the present and / past employee members of the company), and
- (c) Prohibits any invitation to the public to subscribe for any shares or debentures of the company. It is further provided that where two or more persons hold one or more shares in a company jointly; they shall for the purpose of this definition be treated as a single member. A private company must include the words ‘Private Limited or abbreviations like ‘Pvt. Ltd.’ as the last words of its name. Private companies may again be (i) independent private companies (ii) private companies which are subsidiaries of Public companies.

Public Company

As per Sec. 3(1) (iv) a Public company means a company which is not a private company. Thus the maximum number of members in the public company is unlimited, the shares of such companies are freely transferable and they can issue invitation to the

general public to subscribe to their share capital. As the public is substantially interested in the affairs of such companies they are also subject to a somewhat strict legal control.

Difference between Private and Public Companies:

1. The minimum number of members to form a public company is seven. It is two in case of a private company.
2. The maximum number of members cannot exceed fifty in case of a private Company, but there is no restriction on maximum number of members for a public company.
3. There should be atleast three directors for a public company. A private company must have two directors.
4. For taking up directorship of a public company a director has to file a consent to act as such to the Registrar. Whereas, the directors of a private company need not do so.
5. Subscribe for the shares and debentures: A private company cannot make invitation to the public.
6. Members of a public company can transfer their shares freely, whereas the members of a private company cannot transfer their shares.
7. The quorum for meeting of the members is five in case of public company and two in case of a private company.
8. Total managerial remuneration in a public company cannot exceed 11% of the net profits. No such restriction applies to a private company.

Special Privileges of a Private Company:

A Private Company enjoys some special privileges which may be discussed under two heads:

1. Exemptions available to all Private Companies

1. A Private Company may have only two members.
2. It can allot shares before the minimum subscription is paid.
3. A Private company may allot shares without issuing a prospectus or delivering a copy of statement in lieu of prospectus.
4. When a public company issues new shares, it has first to offer these shares to the existing equity shareholders pro rata, unless the members in general meeting decide otherwise. There is no such provision in case of private companies.

5. A private company may issue share capital of such kinds, in such forms, and with such voting rights, as it may think fit.
6. It can commence business immediately on incorporation.
7. A private company need not keep and index of members.
8. It need not hold statutory meeting or file statutory report with the Registrar.
9. If the members personally present do not exceed seven, even one member can demand poll, and if the members personally present exceed seven two members can demand poll.
10. Managerial remuneration paid by a private company can exceed 11% of net profits of the company.
11. Two directors are enough for a private company
12. The directors of a private company enjoy more rights when compared to the directors of a public company.
 - a. Consent of a director to act as such need not be filed with the Registrar.
 - b. A director is not required to hold qualification shares.
 - c. An interested director can vote on a contract.

2. Exemptions and privileges available to an independent private company (i.e. one which is not a subsidiary of a public company)

1. An independent private company may give financial assistance for purchase of or subscription for shares in the company itself (Sec.77 (2)).
2. It can offer new shares to any person as it may think fit.
3. The provisions as to kinds of share capital (Sec.85), new issues of share capital (Sec.86), voting rights (Sec.87), issues of shares with disproportionately excessive
4. Rights (Sec.89) do not apply to an independent private company. An appeal cannot be made before the Company Law Board against refusal by the
5. Company to register a transfer of its shares (Sec.111 (3)). Provisions relating to general meeting are not applicable to an independent private company.
6. An independent private company is not governed by the restrictions imposed by Sec. 204 as regards appointment of a firm or body corporate to an office or place or profit.
7. The members of such companies are entitled to inspect the profit and loss account of the company filed with the Registrar.

8. The restriction as to the number of Companies of which a person may be appointed managing director and prohibition of such appointment for more than five years at a time do not apply to it.
9. It can make any amount of loan to other companies.
10. Under Sec. 372, it can subscribe for shares or debentures of other companies in the same group.
11. The Company Law Board cannot prevent the change in the Board of directors even if it is prejudicial to the interest of the Company (Sec. 409).
12. The provisions not applicable in the relation to director are:
 - a) It need not have more than two directors.
 - b) The directors need not retire by rotation.
 - c) Without Central Government approval, such companies can raise their number of directors beyond the limit fixed by Articles.
 - d) The provision requiring the giving of fourteen days notice by new candidates seeking election as directors is not applicable.
 - e) The provisions relating to the manner of filling up casual vacancies among directors, and the requirements that the appointment of directors should be voted on individually and that the consent of each director should be filed with Registrar, do not apply to it.
 - f) The directors need not hold the qualification shares.
 - h) It may provide special disqualification and ground for vacation of office of a director.
 - i) An interested director may participate in Board's proceedings and vote.

When does a private company become a public company?

1. Conversion by default (Sec. 43): Where a private company permits free transfer of its shares, or invites the public for subscription to its shares or the number of members exceed fifty, then that private company will be deemed to be a public company. The Company Law Board may relieve the company, if it is of opinion that the non-compliance was accidental or due to inadvertence or other sufficient cause.

2. Conversion by operation of law: A private becomes a public company:

- a. Where not less than 25 per cent of its paid-up share capital is held by one or more bodies corporate.

- b. Where its annual turnover at any time is not less than Rs.10 crores for three consecutive financial years.
- c. Where it holds not less than 25 per cent of the paid-up share capital of a public company, having a share capital.
- d. Where it invites, accepts or renews deposits from the public, Acceptance of deposits by a private company from its members, directors, or their relatives is excluded from the purview of this provision.

Privilege to Companies deemed to be public: The Articles of Association of a private company, which has become public by virtue of Sec. 43-A, may continue to have the essential requirements (viz., restriction on transfer of shares, limitation of the number of members to fifty and prohibition to the public to buy shares or debentures) which make it a private company.

A private company which becomes a public company by virtue of Sec. 43-A continues to be a public company until it has with the approval of the Central Government again become a private company.

3. *Conversion by Choice (Sec.44):* A private company may deliberately choose to become a public company. The requirement of Section 3(1)(iii) may be deleted by passing a special resolution within 30 days of its becoming a public company, it shall file with the Registrar a prospectus of a statement in lieu of prospectus along with a copy of the special resolution.

Conversion of public company into a private company

A public company may be converted into a private company without resorting to winding up of the company. There is no statutory bar on the conversion of a public company into a private company. According to Sec. 31 of the Companies Act, no alteration made in the Articles which has the effect of converting a public company into a private company shall have effect unless such alteration has been approved by the Central Government. The company must amend its articles by a special resolution so as to include therein the necessary restrictions and file with the Registrar within thirty days.

Illegal Associations

The term “illegal association” means an association which is not formed according to the provisions of any law and wherein the maximum number of members exceeds the statutory limit. According to Sec 11, no company, association or partnership consisting of more than 20 persons (10 in the case of banking business) can be formed to carry on any business for profit unless it is registered under the Companies Act, 1956. However, Sec.11 does not apply to foreign Companies, members of chit fund, charitable associations etc., It should be noted that once an association becomes illegal, it remains illegal until it is registered under the Companies Act, or formed under some other law. This Section does not apply to a HUF even though the number of adult members may be more than twenty. But if two or more joint families carry on business with more than 20 adults, it will be illegal.

Illegal Association – Consequences:

- (i) It cannot enter into any contract.
- (ii) The liability of the members becomes unlimited.
- (iii) The law does not recognize such existence.
- (iv) Every member shall be liable to fine upto Rs.1000.
- (v) It cannot sue any of the members / outsiders.
- (vi) It cannot be wound up under the provisions of the Companies Act, 1956

Holding company and Subsidiary company

On the basis of control, companies may be classified into:

- (i) Holding companies, and
- (ii) Subsidiary companies

Where one company controls the management of another company the former is called the ‘Holding Company’ and the latter over which the control is exercised is termed as a ‘Subsidiary Company’. The Act defines these terms as follows:

Holding company: “A company shall be deemed to be the holding company of another, if that other is its subsidiary” [Sec. 4(4)].

Subsidiary company: A company shall be deemed to be a subsidiary of another [Sec. 4(1)].

- (a) If that other company controls the majority composition of its Board of Directors with the sole object of controlling its management; or
- (b) If that other company holds more than half in nominal value of its equity share capital; or

(c) In the case of private company in respect whereof the preference shareholders and equity similar voting rights, if that other company is itself an independent private company and holds more than half of its total voting power; or

(d) Where a company is subsidiary of another company, which is itself subsidiary of the controlling company, the former becomes the subsidiary of the controlling company.

Thus a subsidiary company is one whose composition of Board of Directors is controlled by another company by another company or whose more than half of the nominal value of the equity capital is held by another company.

Questions

1. Explain the classification of Companies.
2. Define a 'private company' and 'public company'.
3. Distinguish between a private company and public company.
4. Define a company limited by guarantee.
5. How can private company be converted into a public company?
6. Write short notes on:
(a) Holding company (b) Unlimited liability (c) Deemed public company
7. What is an illegal association?
8. What are the privileges of a private company?
9. Enumerate the exemptions available to an independent private company?
10. When does a private company become a public company?
11. What is a foreign company? How far is it governed by the Companies Act 1956?
12. Define a government company. Explain the special provisions of the Companies Act relating to Government companies.

LESSON – 6.3 COMPANY INCORPORATION

A Company is said to have been formed when it has been registered under the Companies Act. However, there are several stages in the formation of a company. The various stages in the formation of a company are:

- (i) Promotion
- (ii) Incorporation or Registration
- (iii) Capital subscription
- (iv) Commencement of Business

While a private company can commence company business as soon as it is registered or incorporated, a public company cannot commence its business unless it has obtained a Certificate of Commencement of Business. The Various stages of formation of a company are dealt under the following paragraphs:

PROMOTION

Promotion is the first stage in the formation of a company, According to Gestemberg, “promotion refers to the discovery of business opportunities and the subsequent organization of funds properly managerial ability into-business concern for the purpose of making profits there forms”. A promoter may be an individual, a firm or association of persons or even a company. In simple words, a promoter is a person with expertise in the line of developing of a business proposition and carries out all the preliminary work for the formation of a company to run the business. According to C. Cockburn, C.J in *Twycorss vs Grant*, a promoter is one who undertakes to form a company with reference to a given project and to set it going project and to set it going, and who takes the necessary steps to accomplish that purpose . However, everyone who is connected with the formation of a company may not be a promoter. For instance, under the companies Act, persons acting in a professional capacity to assist persons engaged in procuring the / formation of a company (solicitors, values, chartered Accountants) are not liable as promoters under the companies Act.

Promoter – functions

The functions of a promoter may be divided into four stages:

- (i) Discovery
- (ii) Investigation
- (iii) Assembly
- (iv) Incorporation.

The promoter after conceiving an idea of starting a business and having carried out a detailed investigation as to the possibility and profitability of formation of a company will do the following functions:

- (i) Instructs and directs the solicitors to draft the Memorandum, Articles and other documents necessary for the registration of the company.
- (ii) Arrange for the printing and filing of these documents with the Registrar of Companies.
- (iv) decides about the name, location of its registered office, the bankers, auditors, legal advisers, brokers etc and arranges for minimum subscription to be raised (in case of public company) and obtains the certificate of commencement of business.

Promoter – Legal position

The promoter's legal position is that he is neither an agent nor a trustee of the company he promotes, as he functions as a promoter are preformed at a time when the company has not yet come into existence and there is neither a principal nor a fiduciary trust. However, the Companies Act, impose on him certain obligations which are fiduciary in nature. Fiduciary position indicates a position full of trust and confidence. However, it must be noted that although the fiduciary relation of the promoter begins only when the company is actually formed, the fiduciary obligation of the promoter begins as soon as he sets out to act as a promoter of that company. To conclude, a promoter is not entitled to retain any profit made directly or indirectly out of the promotion, whether made at the expense of the company or otherwise, unless the company consents after full disclosure of all the facts.

Duties of Promoter

1. To disclose secret profits: Being in a fiduciary position, the promoter must not make any secret profit at the expense of the company he promotes. If he has made any secret profit, it is his duty to disclose all the money secretly obtained by way of profit. If he fails to do so, the company may recover such profits from him.

A promoter is not forbidden to make profit but to make secret profit. In *Gluckstein V. Barnes*, the 'Old Olympia Co', was in difficulties and the debentures were worth very little. A Syndicate of persons was formed to purchase it for 1, 80,000. The Syndicate first bought the debentures of the old Olympia Company at a discount. Then they bought the company itself for 1, 40,000. Out of this money provided by themselves the debentures were repaid in full and a profit of 20,000 made thereon. They promoted a new company and sold Olympia to it for 1, 80,000. The profit of 40,000 was revealed in the prospectus

but not the profit of 20,000. It was held that 20,000 was a secret profit and since there was no sufficient disclosure, the promoters were bound to pay it to the company.

2. ***To disclose all material facts:*** The promoter should make full disclosure of all the material facts regarding the formation of a company. The promoter is not allowed to derive a profit from the sale of his own property to the company unless all material facts are disclosed. If a promoter contracts to sell to the company, a property without making a full disclosure, and the property was acquired by him at a time when he stood in a fiduciary position towards the company, the company may either rescind it or affirm the contract and then recover the secret profits from the promoter. The material fact may be disclosed to an independent and competent board of director or to the whole body of shareholders.

3. ***To make good profits obtained as trustee:*** The promoter must make good to the company what he has obtained as a trustee. A promoter stands in a fiduciary position towards the company. It is the duty of the promoter to make good to the company what he has obtained as trustee and not what he may get at any time.

4. ***Must not make an unfair use of his position:*** The promoter must make a fair and reasonable use of his power and position. He must act honestly.

5. ***To act diligently:*** The promoter is under an obligation to discharge his duties diligently right from the point of the conception of the idea to the stage when the company receives the certificate to commence business. He must disclose all the private arrangements resulting in profit by the formation of the company.

Liabilities of Promoters

A promoter has the following liabilities:

1. ***Liability to account for the profits:*** The promoter stands in a fiduciary position to the company. He is liable to the company for all secret profits made by him. When he does not make full disclosure to the company, the company may either

- (a) Rescind the contract and recover the purchase price where he sold his own property to the company, or
- (b) Sue the promoter for the amount of profit and recover the same with interest, or

(c) Claim damages for breach of fiduciary duties. The measure of damages will be the difference between the market value of the property and the contract price.

2. **Liability for mis-statements in the prospectus:** Promoter is liable to the original allottees of shares for the untrue statements in the prospectus. Thus, it is clear that his liability does not extend to subsequent allottees. The allottees may sue him for compensation for loss or damage suffered by them. The promoter may also be punished with fine up to Rs.5,000 for such untrue statement in the prospectus.

3. **Personal liability:** The promoter is personally liable for all preliminary contracts made by him for the company made by him for the company after its incorporation, adopts these contracts by entering into new contracts containing the same term as in the original contracts. The death of a promoter does not relieve him from liabilities. The property of the deceased promoter shall be liable in an action by a company for fraud or breach of trust. Where there are more than one promoter, they are jointly and severally liable in any action against one of them.

4. **Liability in course of winding up:** In the course of winding up of the company, on an application made by the official liquidator, the court may make a promoter liable for misfeasance or breach of trust. Further, where fraud has been alleged by the liquidator against the promoter, the court may order for his public examination.

5 **Curbs on promoters:** Where a promoter is convicted of any offence in connection with the promotion of the company, or if in the course of winding up of the company, it is found that he is guilty of misfeasance or breach of trust, the court may debar him from being a director or forbid him from taking part in the promotion, formation or management of a company for a period not exceeding five years without the sanction of the court.

Remuneration to Promoters

The promoters have to incur various expenses in connection with the formation of a company; therefore, it is quite reasonable that they should get suitable remuneration for their services. But it is interesting to note that the promoters cannot claim any remuneration from the company as a matter of right. They are entitled to remuneration for their services only if there is a contract to that effect. In *Re. National Motor Mail Coach*

Co. it has been held that, in the absence of an agreement. a company is not bound to reimburse a promoter in respect of registration fees and stamp duty paid by him.

In the absence of any agreement with the company after its incorporation, a promoter cannot sue the company for the recovery of his remuneration and preliminary expenses. However, the Articles of Association of the company generally empower the directors to pay a specified amount to the promoters for their services but this does not give the promoters any contractual right to sue the company. This is simply an authority vested in the directors of the company.

However, the promoters usually become the directors, so that in practice, the promoters are paid their remuneration.

The remuneration may be paid in any of the following ways:

- (i) A commission on the purchase price of the business or property taken over by the company through him.
- (ii) The promoter may be paid a certain lump sum.
- (iii) He may be given fully or partly paid shares in consideration of his services rendered.
- (iv) He may be given a commission at a fixed rate on the shares sold.
- (v) He may sell his own property to the company at a higher price and make profits. However, he must make full disclosure of this fact.
- (vi) He may be given an option to buy the shares of the company at par when their market price is higher.
- (vii) He may be appointed as chairman of the Board of Directors of the company.

Whatever be the nature of remuneration, it must be disclosed in the prospectus if it is paid within the preceding two years from the date of the prospectus. This is to enable prospective members to know about all such payments.

Pre-Incorporation Contracts

Contracts which are made by promoters with parties to acquire some property or right for and on behalf of a company yet to be formed are termed as 'pre-incorporation' or 'preliminary' contracts. Such contracts are not legally binding on the company even after its incorporation, because two consenting parties are necessary to a contract whereas the

company is a non-entity before its incorporation. The company has no legal existence until it is incorporated. Thus, a company cannot sue or be sued for pre-incorporation contracts.

Effects of Pre-incorporation Contracts

1. Not binding on company: A company, when registered, is not bound by pre-incorporation contracts, the reason being that at the time of making the contract the company was not in existence. This is so even if the company has taken some benefit from the contract. In *Re. English and Colonial Produce Co. Ltd.* a solicitor prepared the Memorandum and Articles of Association and paid the necessary registration fees on the instructions of persons who later became directors. He claimed his fees and expenses on the liquidation of the company. It was held, that the company was not liable to pay the solicitor's costs though it had taken the benefit of his work.

2. Cannot ratify the agreement: A company when registered cannot ratify or adopt the pre-incorporation agreements, because a contract can be ratified only when it is made by an agent for a principal who is in existence and is competent to contract at the time when the contract is made. Since company was not in existence, therefore, ratification is not possible. However, after incorporation a company may enter into a new contract to carry into effect the contract made by the promoters before incorporation

3. Promoters' personal liability: If the promoters undertook any liability under the agreement, they would be personally liable notwithstanding that they are described in the agreement as agent. In *Kelner V. Baxter*, an agreement was made between K and B; B was acting on behalf of the proposed hotel company. Wine supplied under the contract was used by the company which had ratified the agreement after incorporation. The company went into liquidation before paying the debt. It was held that B was personally liable and no ratification could release him from his liability.

4. Company cannot sue: The Company is also not entitled to enforce the preliminary agreements. In *Natal Lan ci & Colortisation Co. Pauline Colliery Syndicate*, it was held that a company cannot benefit from a contract purporting to have been made on its behalf before the company came into existence. Thus, a company is neither bound by, nor can have the benefit of pre-Incorporation contracts.

5. Position under Specific Relief Act: Until the passing of the Specific Relief Act 1963, the promoters found it very difficult to carry out the work of incorporation. Since contracts prior to incorporation were void and also could not be ratified, people hesitated to either supply any goods or work for the cause of incorporation. Promoters also felt shy of accepting personal responsibility. The Specific Relief Act, 1963 came as a big sigh of relief to the promoters of a company who have, before its incorporation, entered into contracts for the purposes of the company and such contracts are warranted by terms of incorporation. The contract may be specifically enforced by or against the company, if the company has accepted the contract and communicated such acceptance to the other party to the contract

Section 19 of the Specific Relief Act provides that the other party can also enforce the contract if the company has adopted it after incorporation and the contract is within the terms of incorporation.

INCORPORATION OF COMPANY

Incorporation of a company is the second stage of the company formation. It is effected by registration with the Registrar of Companies. The promoters will choose a few appropriate names and apply to the ROC to ascertain as to which of the names is available for adoption. In the meantime, they will also have to decide the objects which the company is to carry out, the place where the business is to be carried on, the extent of the responsibility of each member for losses and the amount of funds considered necessary to carry on the business properly. They will embody their decisions on these matters in a document called the Memorandum of Association. The rules and regulations for the company's internal management will be embodied in Articles of Association.

The formalities to be gone through in registering a new company under the Act are enumerated below:

1. An application in the prescribed form (Form IA) is to be made to the Registrar of Companies of the State in which the registered office of the proposed company is to be situated for information as to whether the intended name is available for adoption. A fee of Rs.500 is payable with the application [Rule 4A of the Companies Act (Central Government's General Rules and Forms 1956)].

2. Arrangement must be made for the preparation and printing of the Memorandum. and Articles of Association and for having them stamped according to the Indian Stamp Act.

3. The Memorandum and Articles are to be signed by at least 7 or 2 subscribers depending upon the nature of the company and each subscriber should add his address, description and occupation and the number of shares subscribed for; the documents should also be dated.

4. The promoters of the company should make arrangements for filing the following documents with the Registrar of Companies and paying the necessary fees for the incorporation of the company.

(a) Memorandum of Association

(b) Articles of Association

(c) Agreement if any, which the company proposes to enter into with any individual for appointment as its managing or whole time director or manager.

(d) Name availability letter received from the Registrar

(e) In case the name of first directors are given in the Articles or in the Prospectus, then the written consent of the directors to act as such in Form No. 29. Such persons shall have to give a written undertaking to take up and pay for their qualification shares.

(f) A statutory declaration that all the requirements of the Act and the rules thereunder in respect of registration have been complied with. The declaration may be signed by any of the following:

(i) An advocate of the Supreme Court or of a High Court

(ii) An attorney or pleader entitled to appear before a High Court

(iii) A chartered Accountant in whole time practice in India

(iv) A company secretary in whole time practice in India

(v) A person named in the Articles as a director, managing director, manager or Secretary of the Company.

This declaration should be on a non-Judicial stamp paper of appropriate value.

(g) The prescribed fee should be paid along with application. The amount of fees depends on the nominal capital of the company to be incorporated. The fee can be

paid to the Registrar of Companies in cash or by postal order or by money order or by demand draft or by cheque.

Once the required documents have been delivered and the prescribed fees paid, the Registrar will scrutinise the documents and if satisfied that all the formalities have been duly complied with, he will issue a certificate of incorporation. On receiving the certificate, the company becomes a body corporate with perpetual succession and a common seal. The address of the registered office of the company has to be filed In form no.18 within 30 days after the date of incorporation.

Certificate of Incorporation: If the Registrar is satisfied with the contents of the documents, he will register them and issue a certificate of incorporation, and under Section 34 the company becomes a body corporate. with perpetual succession and a common seal, from the date on the certificate, even if that is not in fact the date when it was issued.

Effect of certificate of incorporation: Section 35 provides that a certificate of incorporation given by the Registrar In respect of any association shall be conclusive evidence that all the requirements of the Act have been complied with in respect of registration and matters precedent and incidental thereto, and that the association is a company authorised to be registered under the Act. If there has been any procedural irritation in the incorporation of the company, it is immaterial and will not invalidate the registration of the Company.

A company comes into existence as a legal person upon the issue of the date of incorporation. Sec. 34(2) provides that from the date of incorporation, such of the subscribers of the Memorandum and other persons be the members of the company. The company shall be a body corporate by the name contained in the Memorandum, capable forthwith of exercising all the functions of an incorporated company.

According to Section 36 of the Act, on registration of the Company, the memorandum and articles of the company bind the company and its members to the same extent as if they respectively had been signed by the company and by the members and the contained covenants on its and their part to observe all the provisions contained in the Memorandum and Articles of Association.

INVITING SUBSCRIPTIONS

According to Sec. 69(1) of the Companies Act, no allotment shall be made of any share capital of a company offered to the public for subscription, unless the amount stated in the prospectus as the minimum subscription has been raised by the issue of share capital in order to provide for the matters specified in clause 5 of Schedule II has been 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. The amount so stated in the prospectus shall be reckoned exclusively of any amount payable otherwise than in money and it is known as minimum subscription. Besides the amount, payable on each share shall not be less than 5% of the nominal amount of the share. According to SEBI's Guidelines on disclosure and investors' protection, if the company fails to receive 90% of issued amount from public subscription plus accepted devolvement from underwriters within 120 days from the date of opening of the issue, the company shall refund the amount of subscription.

COMMENCEMENT OF' BUSINESS

A private company may commence its business immediately on incorporation but a public company cannot commence business immediately after incorporation unless it has obtained a certificate of commencement of business from the Registrar.

If the company has a share capital and has issued a prospectus inviting the public to subscribe to its shares or debentures, It cannot commence business until:

- a. Shares payable in cash have been allotted to the extent of the minimum subscriptions:
- b. Every director has paid in cash the application and allotment money on the shares taken by him.
- c. No money is liable to be repaid to the applicants for failure to apply or obtain permission for the shares or debentures to be dealt in on any recognised stock exchange.
- d. A statutory declaration duly verified by one of the directors or the secretary or where the company has not appointed a secretary, a secretary engaged in whole

time practice in the prescribed form that the above conditions have been complied with has been filed with the Registrar [Section 149 (1)].

If the company has a share capital but has not issued a prospectus to the public, it shall not commence the business unless:

- a. Statement in lieu of prospectus has been filed with the Registrar.
- b. Every director has paid in cash the application and allotment money on the shares taken by him.
- c. A statutory declaration duly verified by one of the directors or the secretary or where the company has not appointed a secretary, a secretary in whole time practice in the prescribed form that the above conditions have been complied with has been filed with the Registrar (Section 149(2)).

On the above requirements being duly fulfilled, the Registrar, shall certify that the company is entitled to commence business. The certificate is a conclusive evidence that the company is so entitled (Section 149(3)).

The Companies Amendment Act, 1965, has introduced certain new conditions for the commencement of business by a company. It had added two new Sub-Sections to Section 149. These conditions are mentioned below:

1. If a company (formed after the commencement of the Amendment Act 1965) having a share capital, whether or not it has issued a prospectus inviting the public to subscribe for Its shares, wants to start a business included in the 'other objects' it shall have to obtain the authority of a special resolution of its shareholders.
2. If an existing company (i.e. a company in existence before the commencement of the Amendment Act, 1965) wants to commence any business connected with the objects stated in its memorandum, it shall have to obtain the authority of a special resolution.
3. In both the above cases a declaration has to be filed by one director or the secretary or, where the company has not appointed a secretary, a secretary in whole time practice, with the Registrar that the requirement as to resolution has been complied with.

4. Where in cases (1) and (2) referred above, a special resolution has not been passed but the votes cast in favour of the resolution exceed the votes cast against it, the Central Government may, on an application by the board of directors allow the company to commence such business. In this case also, declaration has to be filed with the Registrar (Section 149 (2B)).
5. If a company commences business in contravention of Section 149 (2A), every person who is responsible for the contravention is liable to a fine which may extend to Rs.500/- for every day during which the contravention continues. Any contract made by the company before it has obtained the certificate of commencement is provisional only and does not become binding on the company until it has become entitled to commence business.

Where for any reason, the company cannot obtain the certificate of commencement and is not entitled to commence its business, the contract entered into after incorporation cannot be enforced against the directors or the company.

A company is bound to commence business within a year of its incorporation or else it is liable to be wound up by the court.

Where a company commences business or exercises borrowing powers in contravention of Section 149, every person who is responsible for contravention is liable to a fine upto Rs. 5000 for every day during which the contravention continues. This is in addition to any other liability (Section 149 (6)).

The provisions of Section 149 do not apply to a private company even if it is a subsidiary of a public company.

Questions

1. What are the documents to be filed with the Registrar prior to incorporation?
2. “A promoter stands in a fiduciary relation towards the company”— Explain.
3. State the duties and liabilities of a promoter.
4. How is a company formed under the Companies Act, 1956?
5. Explain the legal effect of the certificate of incorporation.
6. Bring out the conditions to be fulfilled for issuing a certificate of commencement of business.
7. Enumerate the steps to be taken before a company is entitled to commence business
8. Write notes on:
 - (1) certificate of incorporation
 - (2) certificate of commencement of business
9. Explain briefly what particular steps, as a promoter, you would take for the formation of a public company.
10. “A certificate of incorporation is conclusive evidence that all the requirements of the Companies Act, 1956 have been complied with” - Discuss.
11. Explain how promoters are to be remunerated?

UNIT – VII

Unit Structure:

Lesson – 7.1 Memorandum of Association

Lesson – 7.2 Articles of Association

Lesson – 7.3 Prospectus

LESSON – 7.1 MEMORANDUM OF ASSOCIATION

Introduction

In law, the word ‘Memorandum’ means “document recording terms of contract, agreement, establishment of company, etc.”. Every company must have a memorandum of association. A company’s memorandum of association is its most important document because it is the memorandum that determines the powers of the company. The memorandum may be described as the company’s charter, defining and limiting its powers and thereby helping to govern its relations with the outside world. The memorandum and other documents filed with the Registrar of companies are available for examination by any member of the public and indeed it will be seen that since the facility is available, persons contemplating dealings with the company may be expected to avail themselves of it. It would appear reasonable that members, debenture holders, creditors having invested in or entrusted to the company their hard earned capital, have the right to be assured of the activities to be pursued and be able to rely on that assurance.

MEMORANDUM OF ASSOCIATION

Definition: Section 2(28) of the Companies Act defines a memorandum as, “The memorandum of association of a company as originally framed or as altered from time to time in pursuance of any previous Company Laws or of this Act”. Lord Cairns in *Ashbury Carriage Company Vs. Riche* observed that the Memorandum of association of a company is its charter and defines the limitations of the powers of a company.

Form of Memorandum

According to Section 14 of the Companies Act, the memorandum of association should be in any one of the forms specified in Table B,C,D and E of schedule I to the Companies Act, 1956, as may be applicable to it, or in a form as near thereto as the circumstances permit. The forms specified in Table B,C,D and E are applicable to different types of companies, viz., Table B for companies limited by shares, Table C for companies limited by guarantee and not changing a share capital, and so forth . The company may either adopt any of these Tables applicable to it or may devise a form of its own which is as near to the appropriate Table as the circumstances permit.

The memorandum of Association must be (a) printed, (b) divided into paragraphs, numbered consecutively, and (c) signed by each subscriber who shall add his address, description and occupation in the presence of at least one witness who shall attest the signature and likewise add his address, description and occupation (Sec.15).

Contents of Memorandum

The memorandum of association of every company shall contain the following clauses:

1. Name clause
2. Situation clause
3. Objects clause
4. Liability clause
5. Capital clause, and
6. Association or Subscription clause

Each of these clauses is analysed below.

1. Name clause: Under this clause the corporate name- of the company is mentioned. Any suitable name can be chosen by a company, subject, however, to the following restrictions:

(a) In the case of companies limited by shares or limited by•’ guarantee, the word “Limited” or “Private Limited” must be the last word in the name of every public or private company respectively. There is, however, one exception to this rule as provided in Section 25 of the Act, which permits “charitable companies” formed to promote

commerce, art, science, religion, etc., (prohibiting the payment of dividends and applying all the profits to the promotion of their objects) under a licence granted by the Central Government to register with limited liability, but without the word “limited” as part of Its name. In the case of unlimited companies, only the name is to be given. It should be noted that the inclusion of the word “company” is not essential.

(b) As per Section 20 the name chosen must not be undesirable, in the opinion of the Central Government. The Act does not state what names shall be considered undesirable and as such gives very wide discretion to the Central Government. Ordinarily a name is considered undesirable and therefore not allowed if it is either:

- (i) too identical or similar to the name of another existing company or firm (whether registered or unregistered) so as to lead to confusion or
- (ii) misleading.

However, if through inadvertence or otherwise, a company is registered by an almost identical name, the court will grant an injunction restraining it from using that name (*Ewing Vs. Buttercup Margarine Co. Ltd.*). The Central Government may also direct a company within 12 months of its registration. to rectify the name if It is identical with or too nearly resembles the name of an existing company. The company must act according to the direction within 3 months of the direction.

2. *Situation clause:* Every company shall have a registered office from the day on which it begins to carry on business, or as from thirtieth day after the date of its incorporation whichever is earlier. All communications and notices are to be addressed to that registered • office. Notice of the situation of the registered office and every change shall be given to the Registrar within thirty days after the date of incorporation of the company or after the date of change. If default is made in complying with these requirements the company and every officer who is in default shall be punishable with fine which may extend to Rs. 50 for every day during which the default continues.

3. **Objects clause:** Of all the clauses in the memorandum the object clause is the most important. It should specify in unambiguous language the objects for which the company is formed. Great care should be taken in drawing up this clause, as the company will not be allowed to do any business which is not specifically mentioned here. As it is difficult to alter the objects clause later, it is necessary that promoters should include in this clause all possible types of business in which a company may engage in the future. Although it is best to state all powers in addition to the objects clause, yet if the company does anything which is incidental to and consequential upon the powers specified, such an act will not be illegal. Thus a trading company under its implied - power, though not mentioned in the objects clause, can borrow, draw and accept bills in the ordinary course of business.

According to the amendment to the Companies Act made in 1965, the objects clause of a company formed after the commencement of the Amendment Act must contain:

- (i) Main Objects of the company and objects incidental or ancillary to the attainment of these main objects;
- (ii) Other objects of the company not included above.

A statement of the objects in the Memorandum has two fold operation: It states affirmatively the ambit and extent of vitality and power which by law are given to the corporation, and it states, if it is necessary so to state, negatively that nothing shall be done beyond that ambit, and that no attempt shall be made to use the corporate life for any other purpose than that which is so specified. A company which has a main object together with a number of subsidiary objects cannot continue to pursue the subsidiary object after the main object has come.

4. **Liability clause:** This clause has to state the nature of liability that members incur. In the case of a company limited by shares, the members are liable only up to the amount paid on the shares taken by them. In the case of a company limited by guarantee, the members are liable to the amount undertaken to be contributed by them to the assets of the company in the event of its being wound up.

The liability clause is omitted from the memorandum of association of unlimited companies. Any alteration in the memorandum compelling a member to take up more shares, or which increases his liability would be null and void. According to Section 45 of the Act, if a company carries on business for more than six months while the number of members is less than, in the case of public company and less than in case of a private company, each member aware of this fact, is liable for all the debts contracted by the company after the period of six months has elapsed.

5. **Capital clause:** The memorandum of a company limited by shares must state the authorised or nominal share capital, the different kinds of shares and the nominal value of each share. The capital of a company may be divided into shares of two different classes, namely preference and equity shares.. The power to issue capital in shares of different classes may be taken in the capital clause of memorandum or it may be taken in the articles. A company u/s 95 of the Act, may alter the conditions of its memorandum with respect to its share capital by ordinary resolution if authorised by the articles. According to Sec. 100 a company limited by shares or a company limited by guarantee and having a share capital may reduce its share capital by special resolution if authorised by the Articles and confirmed by the Court.

6. **Subscription clause:** Subscribers to the Memorandum express their assent to form a company and signify their agreement to associate for that purpose. The memorandum has to be signed by each subscriber in the presence of at least one witness who must attest the signatures. Under this clause we have the declaration of association which is made by the signatories of the memorandum under their signature duly attested by witnesses, that they desire to be formed into a company and that they agree to the purchase of qualification shares. There must be at least 7 signatories in the case of a public company and at least two in respect of a private company. The subscribers usually act as first directors of the company. In respect of a company which is limited by guarantee or is having unlimited liability and which has no share capital, the legal provision regarding purchase of at least one share by each subscriber does not apply.

ALTERATION OF MEMORANDUM

Section 16 provides that the company cannot alter the conditions contained in memorandum except in the cases and in the mixes and to the extent for which express provision has been made in the Act.

Alteration of Name Clause

A company may, by passing a special resolution and with the approval of the Central Government signified in writing, change its name. But no such approval is required in cases of addition or deletion of the word 'Private' consequent on the conversion of a public company into a private company and vice versa.

If, through inadvertence or otherwise, a company has been registered with a name which is identical with or which too closely resembles the name of an existing company, the company may change the name by passing an ordinary resolution and by obtaining the approval of the Central Government in writing.

The change of name must be communicated to the Registrar of companies within 30 days of the change. The Registrar shall then enter the new name on the register in the place of the old name and shall issue a fresh certificate of incorporation with necessary 'alterations [Sec. 23(1)]. The Registrar shall also make the necessary alterations in the 'Memorandum of Association' of the Company [Sec. 23(2)]. The change of name becomes effective on the issue of fresh certificate of incorporation.

However it should be noted that the change of name shall not affect any rights or obligations of the company or render defective any legal proceedings by or against it.

Change of Registered Office

This may involve:

- (a) Change of registered office from one place to another place in the same city, town or village.
- (b) Change of registered office from one town to another town in the same state.
- (c) Change of registered office from one state to another state.

In case (a), notice is to be given within thirty days after the date of the change to the Registrar who shall record the same [Sec. 146(2)].

In case (b), special resolution is required to be passed at a general meeting of the shareholders and a copy of it is to be filed with the Registrar within thirty days. Then within thirty days of the removal of the office, a notice has to be given to the Registrar of the new location of the office.

Change of Registered Office from one State to another [Sec. 17]

A company may, by special resolution, alter the provisions of its Memorandum so as to change the place of its registered office from one state to another for certain purposes referred to in Sec. 17(1). The alteration shall take effect only when it is confirmed by the Company Law Board. (Procedure is similar to alteration of objects). The Board shall consider the objections of persons whose interests will, in the opinion of the Board, be affected by the alteration (Sec. 17(3)).

Where the alteration involves a transfer of the registered office from one state to another state, a certified copy of the order confirming the alteration shall be filed by the company with the Registrar of each of the states and Registrar of each state shall register the same. All the records of the company shall then be transferred to the Registrar of the state in which the registered office of the company is transferred [Sec. 18 (3)].

Alteration of Objects clause

Section 17 empowers a company by a special resolution duly confirmed by the Company Law Board (CLB) to alter the objects (or to change the places of its registered office from one state to another) if the alteration is required to enable the company

1. to carry on its business more economically and more efficiently.
2. to attain its main purpose by new or improved means.
3. to enlarge or change the local area of its operation.
4. to carry on some business which under existing circumstance may be conveniently or advantageously combined with the business of the company.
5. to sell or dispose of the whole, or any part of the undertaking, or
6. to restrict or abandon any of the objects specified in the memorandum.
7. to amalgamate with any other company or body of persons.

A printed or a typewritten copy of the special resolution is required to be filed with the Registrar of companies within thirty days of the passing thereof. Also a petition is to be filed to the CLB for confirmation of the special resolution. The CLB, being satisfied that the notice of the resolution was given to all persons whose interests are likely to be affected. By the alteration, including the Registrar of companies and the State Government, and having heard them, may confirm the alteration either wholly or in part.

A certified copy of the CLB's order together with a printed copy of the altered memorandum must be filed within three months of the date of the order, with the Registrar. The Registrar will register the documents and issue, within one month, a certificate which will be conclusive evidence that everything required has been done (Section 18).

Change in Liability clause

According to Sec. 38 of the Act, a company limited by shares or guarantee cannot change its memorandum as to impose any additional liability on the members or to compel them to buy additional shares of the company unless all the members agree in writing to such change either before or after the change.

Alteration of Capital

A company may alter its memorandum to increase the share capital (authorised capital) provided it is authorised by the Articles of Association. If the Articles do not authorize such alteration, the Articles must first be altered to that effect by passing a special resolution. A company may also alter its share capital by consolidation or subdivision of shares, conversion of shares into stock and vice-versa and by cancellation of un-issued capital. Consolidation is the process of combining of specified number of shares into one new share having a nominal value equal to the aggregate of the shares so consolidated. Subdivision of the shares is the process of subdividing shares or sum of them into shares of smaller amount than provided in the memorandum, viz., subdivision of one Rs. 100 share into 10 shares of Rs. 10. Fully paid-up shares are converted into "stock" for the purpose of its division into fractions of any denomination. Such stock can be reconverted into shares as and when found necessary. V. A company may also diminish the amount of its nominal share capital by cancelling the shares which remain unissued at the date such decision is taken.

Alteration of share capital can be effected by the company by passing an ordinary or special resolution in general meeting, as provided in the Articles of Association. If it is a special resolution, a copy of the resolution along with the explanatory statement must be filed within 30 days of the passing of the resolution. A notice of the alteration must then be filed with the Registrar within 30 days specifying the nature of the alteration. Thereupon, the Registrar records the notice and makes necessary changes in the Memorandum and Articles of Association.

DOCTRINE OF ULTRA-VIRES

The term 'ultra' means 'beyond' and the term, 'vires' means 'powers'. Thus, ultra vires means 'doing an act beyond the powers. Any activity done contrary to or in excess of the scope of activity of directors, Articles, Memorandum or Companies Act will be ultra-vires. These activities can be categorised as follows:

- (i) an act ultra-vires the directors
- (ii) an act ultra-vires the Articles of Association
- (iii) an act ultra-vires the Memorandum of Association
- (iv) an act ultra-vires the Companies Act

If an act is ultra vires the directors, it is not altogether void, because this act can be ratified by the general body of shareholders, and on such ratification the act becomes binding on the company. However, acts which are ultra vires the Articles of Association are altogether void. In respect of Memorandum of Association when the company does any act which is contrary to the objects clause of memorandum it shall be termed as ultra vires the memorandum and it shall be wholly void or inoperative. Such ultra vires activities cannot 'be subsequently ratified or validated even by a unanimous resolution of all the shareholders. The doctrine of ultra-vires was first applied in the case of *Ashbury Railway Carriage Co. Vs Riche*. The court held that the whole body of shareholders cannot ratify an ultra vires transaction. An ultra vires contract can never be made binding on the company. It cannot become intra vires by reasons of estoppel, lapse of time, ratification

etc. (The decision in *Attorney General Vs the Great Eastern Railways Company*.)

Consequences or effects of ultra vires transactions

1. ***Personal liability of directors:*** It is the duty of directors to see that the funds of the company are used only for legitimate business of the company. If directors make an ultra vires payment, then they can be compelled to make good the funds used.

2. ***Act null and void:*** A contract which is ultra vires the company is wholly void ab *initio* and of no legal effect. It cannot even be ratified by the whole body of shareholders.

3. ***Ultra vires acquired property:*** If company's funds were used in acquiring some ultra vires property, the company has the right to hold the property and protect it against damage by other persons.

4. ***Injunction:*** A company is bound strictly by the terms of its incorporation i.e. the memorandum. Hence, whenever a company goes beyond the scope of the objects clause, any of its members can get an injunction from the court to restrain the company from undertaking the ultra vires act.

5. ***Ultra vires torts:*** A company shall not be liable for torts committed outside its objects. The company can be made liable for torts or crimes of its employees if (a) the tort was committed in the course of an activity which is in the purview of company's memorandum and (b) it was committed by the employee within the course of his employment.

Questions

1. What is meant by memorandum of association? What is its purpose?
2. Explain the various clauses that are contained in memorandum of association.
3. Explain the necessity of setting out clearly the objects in the memorandum.
4. State the procedure for alteration of memorandum of association.
5. Enumerate the procedure for changing the situation of the registered office of a company from state to state.
6. Define the doctrine of ultra vires.
7. How can a company changes its name?
8. What is the relation of memorandum of association with-articles of association?
9. A memorandum of association is a fundamental document of a company - Why?
10. “A Company’s objects clause is of fundamental importance not only to members but also to non-members” — Explain.

LESSON-7.2 ARTICLES OF ASSOCIATION

Definition

Section 2(2), of the Companies Act defines the ‘articles’ as, “the articles of association of a company as originally framed or as altered from time to time in pursuance of any previous company law or of this Act including, so far as they apply to the company, the regulations contained in Table A in schedule-I of this Act”. The articles of association of a company and its by-laws are regulations which govern the management of its internal affairs and the conduct of its business. They define the duties, rights, powers and authority of the shareholders and the directors in their respective capacities and of the company. And the mode and form in which the business of the company is to be carried out. The Articles of association of a company have a contractual force between the company and its members as also between the members’ interest in relation to their rights as such members.

REGISTRATION OF ARTICLES OF ASSOCIATION

According to Sec. 26, a public company limited by shares may register the articles of association signed by the subscribers to the memorandum. If however, it does not register its own articles then the articles given in Table A of schedule I becomes applicable. Further, even if it does register articles of its own, Table A will apply automatically unless it has been excluded or modified. The articles of a company must be: (i) printed (ii) divided into paragraphs numbered consecutively (iii) signed by subscribers to the memorandum in the presence of at least one witness who shall attest the signatures. The articles are to be stamped with requisite stamp and be filed along with the memorandum.

Contents of Articles

The articles of a company usually deal with the following matters:

- (1) The business of the company, the amount of capital issued and the classes of shares into which the capital is divided; the increase and reduction of share capital.

- (2) The rights of each class of shareholders and the procedure for variation of their rights.
- (3) The execution or adoption of a preliminary agreement.
- (4) The allotment of shares, calls and forfeiture of shares for non payment of calls.
- (5) Transfer and transmission of shares
- (6) Company's lien on shares
- (7) Exercise of borrowing power
- (8) General meetings, notices, quorum, proxy, poll, voting, minutes.
- (9) Number appointment and powers of directors.
- (10) Dividends,
- (11) Accounts and audit
- (12) Keeping of books both statutory and others.

In addition to the foregoing regulations many companies include other matters like

1. giving the company power to adopt contracts entered into by promoters.
2. setting out how capital is to be divided into shares of two classes.
3. giving the directors power to appoint one or more of their body to the office of managing director and whole time director.

Restrictions on Contents of Articles

The Articles of association shall not contain anything which (1) contravenes any of the provisions of the Act or (ii) alters or extends the terms of the memorandum.

Alteration of Articles

Subject to the provisions of the Act and to the conditions contained in its memorandum, a company may, by special resolution, alter its articles. The term alter includes additions and omissions. A copy of the alteration must be filed with the Registrar within 30 days of passing the said resolution. The alteration will be effective from the date of registration by the Registrar. However, the company cannot in any manner deprive itself of the statutory power to alter its own Articles. The Articles may be altered in such a way as to have effect retrospectively. This flexibility of the company to alter its articles is however, subject to certain limitations.

Limitations to Alteration in Articles

1. The alteration must not be inconsistent with the provisions of the Companies Act or any other statute.
2. The alteration must not be inconsistent with the conditions contained in the memorandum.
3. The alteration must not deprive any person of his rights under a contract.
4. The alteration must not contain anything which is illegal or against public policy.
5. The alteration must be bonafide for the benefit of the company as a whole.

Distinction between Memorandum and Articles of Association

1. The Memorandum is the charter of the company which defines its objects and powers. The Articles are by-laws of the company for the internal management of the affairs for achieving the objects set out in the Memorandum.
2. The Memorandum is the supreme document of the company, while the Articles are subordinate to the Memorandum. If there is any conflict between the Memorandum and Articles, the memorandum shall prevail.
3. Memorandum of Association should not contain any provisions contrary to the Companies Act. Articles must not include any provisions contrary to Companies Act as well as Memorandum of Association.
4. Every company must have its own Memorandum. But a public Company limited by shares may or may not have its own Articles. It may adopt Table A of Schedule I of the Act.
5. The Memorandum defines the relationship between the company and the outsiders, while the Articles define the relationship between the company and its members and among members themselves.
6. A new company must prepare its Memorandum and file it with the Registrar before the registration of the company is effected. But Articles are not required to be filed for the purpose of registration. A company can adopt Table 'A' if it does not prepare its own Articles.
7. Any act of the company which is ultra vires the Memorandum is wholly void and cannot be ratified even by the whole body of shareholders. But any act which is ultra vires the Memorandum can be ratified by shareholders by passing a special resolution.
8. The Memorandum cannot be altered easily. The procedure laid down in the Act must be followed for altering the various clauses of the Memorandum. In some cases the

approval of the Company Law Board is required. But, alteration of Articles is not difficult. Articles can be altered by passing a special resolution and the approval of the Company Law Board is not necessary.

LEGAL EFFECTS OF MEMORANDUM AND ARTICLES

According to Section 36(1) of the Companies Act, the Memorandum and Articles of a company, when registered, bind the company and its members as if they respectively had been signed by the company and each member, and contained covenants on its and their part to observe all the provisions of the Memorandum and of the Articles. The Memorandum and Articles of Association constitute a binding contract between the company and its each member.

This means that the Articles bind the company to its members and members to the company and members to each other, but do not bind the company or its members to outsiders. The effect and Implication of this Section may be better understood by considering how far they- do bind: (1) the members to the company; (2) the company to the e members; (3) the members inter se; and (4) the company to the outsiders.

1. Members to the company: Every member of the company is bound to observe the provisions of the Memorandum and the Articles as if each member had signed the same (*Hanuman Prasad Gta Vs. Hiralal*). A company can sue its members for the enforcement of these provisions and- the members may also be restrained by court from committing the breach of provisions of these documents.

In *Boreland Trustees Vs. Steel Brothers & Co. Ltd.*, the Articles of the company provided that the shares of any member who became bankrupt should be sold to some other persons at a price to be fixed by directors. B became bankrupt and his trustee in bankruptcy claimed that he was not bound by the Articles of Association and could not claim the shares against the company.

In *Boreland Banking Company Vs. Briggs*, the Articles provided that the company shall have a first charge on the shares for debts due to the company by the shareholders. One of the shareholders owing money to the company borrowed money from a bank on

the security of the shares. The bank gave a notice of deposit of shares to the company. It was held that the shares deposited with the bank were bound by articles and the company will have priority because of this provision in the articles of the company.

Each member is not only bound by the covenants of Memorandum and Articles as originally framed but as altered from time to time in accordance with the provisions of the Companies Act.

Shareholders cannot among themselves enter into an agreement which is contrary to or inconsistent with the Articles of Association of the company.

2. *Company to the members:* The Company is also bound to Its members by the provisions of the Articles of Association. Any member is entitled to sue the company or obtain an injunction restraining the company from committing any breach of the Articles or from doing an illegal act. The company is bound to each member in respect of their rights as members. Where a right is conferred by the Articles on a shareholder to record his vote at a company meeting, the chairman of the meeting cannot deprive him of this right.

In *Hohnson Vs. Lyttle's Iron Agency*, a forfeiture of shares, irregularly effected by a company, was set aside at the instance of the aggrieved member as the company did not comply with the provisions of the Articles.

In *Wood Vs. Odessa Water Works Company*, the Articles of Association empowered the company at general meeting. Instead of paying the dividend in cash, a resolution was passed whereby the dividend was to be paid by issue of debenture bonds. A member filed a suit restraining the company from acting on the resolution. The court granted an injunction restraining the company from acting on the resolution.

It must be noted that these documents bind the company to members and vice versa in respect of their membership rights and not contractual rights of other kinds.

3. *The members inter se:* As between the members themselves, they are bound by the provisions of the Articles. The Memorandum and Articles of Association do not constitute express agreement among the members of the company, but each member is bound by these documents on the basis of the implied contract. The articles regulate their rights *inter*

se. But such rights can be enforced only through the company. Lord Herschel in *Welton Vs. Saffrey* observed, 'It is quite clear that the articles constitute a contract between each member and the company and there is no contract in clear terms between the individual members of the company, but the Articles regulate their rights inter se. Such rights can only be enforced by or against a member through the company or through the liquidator representing the company'.

4. Company to outsiders: The Articles of Association create no contract between the company and outsiders, even though outsiders are named in the Articles in some capacity other than of a member. An outsider cannot take advantage of the provisions of the Articles because he is not a party to the contract and, therefore, he cannot sue the company. An outsider is not entitled to enforce the Articles against the company for any breach of right that is conferred on him by the Articles. In *Browne Vs. La Trinidad*, the Articles provided that B was to be appointed as director till 1888. But he was removed earlier. The court held that Articles do not constitute a contract between the company and outsider and therefore B was not entitled to bring any action against the company. Similarly, where the Articles provided for remuneration to be paid to promoters, it was held that the promoters had no right of action against the company. Even a member cannot enforce provisions of Articles in some capacity other than a member.

DOCTRINE OF CONSTRUCTIVE NOTICE

The Memorandum and Articles of Association of every company are required to be registered with the Registrar of Companies. Section 610 provides that on registration, these documents become public documents. These documents are available for public inspection either in the office of the company or in the office of the Registrar of Companies on payment of one rupee for each inspection. Every person who deals with the company whether shareholder or an outsider is presumed to have read these documents and understood them in their true perspective. This is known as 'Doctrine of Constructive Notice'. Even if the party dealing with the company does not have actual notice of the contents, it is presumed that he has constructive notice of them.

Every person dealing with the company must inspect these documents and make sure that his contract is in conformity with their provisions. Whether he actually reads

them or not, he is presumed to have read and understood them. A party, subsequently, cannot plead ignorance of the contents of these documents and seek exemption from being liable. In *Kortal Vertkatswamy Vs. Ram MurthL* the Articles provided that all deeds, etc. were to be signed by the managing director, secretary and a working director. A deed signed by the working director and secretary was held to be inoperative and the party was not allowed to seek exemption on the plea that he had not read the Articles.

Lord Hatherley observed in *Mahoney Vs. East Holyford Mining Co.*, “Every joint stock company has its Memorandum and Articles of Association open to all who are minded to have by dealings whatsoever with the company and those who so deal with them must be affected with notice of all that is contained in these two documents”.

Accordingly, if a person deals with a company and the transaction turns out to be beyond the powers of the company or its officers as contained in these documents, he cannot enforce it against the company and he shall be personally liable to bear the consequences of such dealings.

However, the above doctrine of constructive notice is subject to one exception, that is, so far as the internal proceedings of the company are concerned, outsiders dealing with the company can safely assume that everything has been regularly done. This rule is known as the “doctrine of indoor management” which is explained below:

DOCTRINE OF INDOOR MANAGEMENT

Memorandum and Articles of Association, when registered with the Registrar of Companies, assume the character of ‘public documents’ under Section 610 of the Act and every person dealing with the company is deemed to be covered by the doctrine of constructive notice.

The doctrine of indoor management is an exception to the rule of constructive notice. The doctrine of indoor management imposes an important limitation on the doctrine of constructive notice. Persons dealing with the company should read these documents and satisfy themselves that the company has the power to enter into the contract, and they are required to do no more. He is not required to examine whether the internal proceedings have been complied with or not. The details of internal procedure are not open to public inspection as the Memorandum and Articles are. Thus, every person

dealing with the company is entitled to assume that everything has been done regularly so far as the internal proceedings of the company are concerned. In other words, outsiders can safely assume that provisions of the Articles have been complied with by the company in its internal working. This doctrine seeks to protect the outsiders against the company.

If the Articles of the company give powers to borrow with the sanction of an ordinary resolution in a general meeting, a lender need not enquire whether the general meeting was convened on proper notice, or whether a proper quorum was present at the meeting, or whether the necessary resolution was properly passed. He is entitled to assume that what has been done has been done regularly and can hold the company liable even if internal formalities are found not to have been complied with, the contract shall be binding on the company and it shall be liable to outsiders. This rule is known as the doctrine of indoor management

The rule was first laid down in *The Royal British Bank v. Turquand*. In this case, the directors of a company issued a bond to T. They had the power to issue such bonds but only subject to the resolution passed at a general meeting of the company. In this case no such resolution had been passed. It was held that T could recover the amount of the bond from the company on the ground that he was entitled to assume that the resolution had been passed. Lord Hatherly observed ' "Outsiders are bound to know the external position of the company, but are not bound to know its indoor management" '.

The doctrine of indoor management is of great practical value. This rule is based on business convenience and justice. First, no business could possibly be carried on if a person before dealing with the company was required to find out whether all the internal rules and regulations have been duly complied with. Secondly, an outsider dealing with the company is presumed to know the constitution of the company, but not what may or may not have taken place within the doors that are closed to him.

In *Premier Industrial Bank Ltd Vs. Corlton Mfg. Co. Ltd.*, the doctrine of indoor management was summed up as under: "If the directors have power and authority to bind the company, but certain preliminaries are required to be gone through on the part of the company before that power can be duly exercised, then the person contracting with the directors is not bound to see that all these preliminaries have been observed. He is entitled to presume that the directors are acting lawfully in what they do".

Exceptions to the Doctrine

The doctrine of indoor management is subject to the following limitations:

1. **Knowledge of irregularity:** The protection under the rule of indoor management cannot be claimed by a person who has the knowledge of the irregularity or constructive notice of irregularity [*Narayandas Somani Vs. Sangli Bank Ltd.*]. In *Howard Vs. Patent Ivory Manufacturing Co.*, the directors had the power under the Articles to borrow on behalf of the company up to 11,000. And for any amount exceeding this sum, the sanction of the shareholders in the general meeting was required. The directors themselves lent 3,500 to the company without the sanction of the shareholders in the general meeting. It was held that the company was liable for 1,000 only.

2. **Negligence on the part of the outsider:** Where the circumstances are of a suspicious nature as to invite further inquiry and the person has failed to enquire into it, he shall not be entitled to protection under this rule. Where a director deposited cheques drawn in favour of the company in his own account, the bank was held liable because the act of the director was of an unusual nature, which should have put the bank on alert.

Similarly, where the transaction is of an unusual nature, the outsider must make detailed inquiries. In *Anand Bihari Lcd, Vs. Dinshaw & Co.* the plaintiff accepted a transfer of the company's property from its accountant; the transfer was held void. The plaintiff should have seen the power of attorney executed in favour of the accountant by the company.

3. **Forgery:** The protection under this doctrine shall not be available where the outsiders have relied upon a forged document, because forgery is a nullity. A company is not liable for forgeries committed by its officer. In *Ruben Vs. Great Fingall Ltd.*, the secretary of the company issued a share certificate by forging the signature of two directors under the seal of the company. The holder of that share certificate claimed to be a registered member of the company, but the company refused to accept him as a member of the company. Ruben claimed damages relying on the Turquand rule. It was held that he could not do so because the rule did not apply where the document was forged.

4. **No Knowledge of the Articles:** The doctrine of indoor management cannot be invoked in favour of a person who had no knowledge of the Articles of association of the company.

The Turquand's rule is based on the principle of estopped and, therefore, it cannot be applied in favour of a person who did not in fact consult the Memorandum and Articles of the company and consequently did not act on relying on these documents.

In *Rama Corporation Ltd. Vs. Proved Tin and General Investments Ltd.*, T was a director in the investment company. He proposing to act on behalf of the company entered into a contract with the Rama Corporation and took a cheque from the latter. The Articles of the company did contain a clause that the directors could delegate their powers to one of them. But Rama Corporation never read the Articles. Later it was found that the directors of the company did not delegate their power to T. Plaintiff relied on the rule of indoor management. It was held that a person who at the time of entering into a contract with a company has no knowledge of company's Articles, he cannot rely on those Articles.

5. Acts outside apparent authority: An outsider will not be protected by the rule laid down in Turquand's case if the act of an officer of a company is one which would not ordinarily be within his powers simply because under the Articles power to do the act could have been delegated to him. In *Kreditbank Cassel Vs. Schenkers Ltd.*, the branch manager of the bank drew and endorsed some bills of exchange on behalf of the company without having received any authority from the company. It was held that the company was not liable on these bills of exchange.

Questions

1. What is meant by 'Articles of association' of a company?
2. Which companies must have their own articles? What is Table A?
3. How can the articles of a company be altered?
4. Explain the principle laid down in *Royal British Bank Vs. Turquand*. What are the exceptions to it?
5. State the contents of articles of association.
6. Explain the doctrine of indoor management. State exceptions if any.
7. Differentiate Memorandum from Articles of association.
8. What is meant by constructive notice of memorandum and articles?
9. Discuss the effect of memorandum and articles on their registration with the ROC.
10. The Articles constitute a contract between the company and its members and also members' interest' - Examine the statement.

LESSON -7.3 PROSPECTUS

Definition

A prospectus as per Section 2(36) and along with Sec. 58A means any document described (or) issued as prospectus and includes any notice, circular, advertisement or other document inviting deposits from the public or inviting offers from the public for the subscription or purchase of any shares in, or debentures of, a body corporate.

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

1. It invites subscriptions to shares or debentures or invites deposits; and
2. The aforesaid invitation is made to the public.

Section 67 lays down two-way criteria as to what shall constitute an invitation to the public:

1. An invitation to the public shall include an invitation to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner. However, a document by way of Invitation to existing members or debenture holders to subscribe to shares, or debentures by way of right is not prospectus [Sec.56(5)].

2. An invitation shall not be an invitation to the public if it cannot be calculated to result directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the invitation. Thus, it will not be an invitation to public where B, a friend of A who receives the invitation, also desires to subscribe, but his offer shall be refused because he was not invited to make the same. On the other hand it will become an invitation to public where his (B's) offer shall also be accepted.

Any document to be construed as prospectus should have the following essentials:

- (a) There must be an invitation offering to the public,
- (b) The invitation must be made by or on behalf of the company or in relation to an intended company;

- (c) The invitation must be to subscribe or purchase;
- (d) The invitation must relate to shares or debentures.

A prospectus is required to meet the following legal requirements:

1. Issue after Incorporation

A prospectus is generally issued after incorporation of the company. However, *Section 55* permits the issue of a prospectus In relation to an intended company.

2. Dating of Prospectus

[Sec. 55]: A prospectus must be dated and that date, unless the contrary is proved, shall be taken as the date of publication of the prospectus.

3. Registration of Prospectus

Section 60 provides that no prospectus shall be issued by or on behalf of a company or In relation to an intended company unless on or before the date of its publication, there had been delivered to the Registrar for registration, a copy thereof. The copy of the prospectus so delivered must be signed by every person who is named therein as a director or proposed director of the company or by his agent authorised in writing.

The copy of the prospectus should be accompanied by the following documents:

1. Consent of the expert to the issue, if a statement made by him is to be published.
2. Written consent of all those persons whose names are mentioned in the prospectus as auditors, legal advisers, solicitors, bankers, brokers etc.
3. A copy of every contract appointing or facing remuneration of a managing director or manager.
4. A copy of every other material contract not being a contract entered into in the ordinary course of the business carried on or intended to be carried on by the company or a contract entered into more than 2.years before the date of the prospectus.
5. A written statement by the persons making any report required by part II of schedule II relating to the adjustments, if any, as regards the figures by any profits or losses or assets and liabilities dealt with by the report set out in the prospectus in pursuance of part II of schedule II, giving reasons therefore..
6. Consent of Director under Sec. 266 to act in that capacity. It is relevant in case of new directors only.
7. A copy of the underwriting agreement, if any.
8. Where a prospectus is issued in more than one language, a copy of it as issued in each language should be delivered to Registrar of companies.

9. The prospectus must be issued within 90 days after the date on which a copy thereof has been delivered for registration. If a prospectus is issued subsequently after the expiry of this period, it shall be deemed to be a prospectus, and if a copy of which has not been delivered to the Registrar and the company, as well as every person who is knowingly a party to such an issue of prospectus shall be liable to a fine which may extend to Rs.5,000 [Sec. 60].
10. Expert to be unconnected with the information or management of the company [Sec. 57]: A prospectus must not include a statement purporting to be made by an expert. Unless the expert is a person who is not, and hasn't been, engaged or interested in the formation or in the management, of the company.
11. Terms of contract mentioned in prospectus not to be varied with the legal act. A company cannot vary the terms of a contract referred to in the prospectus except subject to the approval of, or except on authority given by, the company in general meeting.

CONTENTS OF A PROSPECTUS

Section 56 of the companies Act lays down that the matters and reports stated in Schedule II to the Companies Act must be included in a prospectus. The format of schedule II was revised by the Government vide its notification dated 3.10.1990. The revised format of prospectus requires the prospectus to be divided into three parts.

In the first part particulars are to be given about matters detailed below:

Part I of Schedule II

1. General information: Under this head, information is given about

1. Name and address of registered office of the company.
2. Name(s) of stock exchange(s) where application for listing is made.
3. Declaration about refund of the issue if minimum subscription is not received, within 90 days from closure of the issue..
4. Declaration about the issue of allotment letters/refund within a period of 10 weeks and interest in case of any default in refund at the prescribed rate under Sec.73.
5. Date of opening of the issue.
6. Date of closing of the issue.
7. Name and address of auditors and lead managers.

8. Whether rating from CRISIL or any rating agency has been obtained for the proposed debentures /preference shares issue. If no rating has been obtained this should be answered as 'No'.

9. Names and addresses of the underwriters and the amount underwritten by them.

2. Capital Structure of the company:

1. Authorised, issued, subscribed and paid-up capital.

2. Size of the present issue, giving separately reservation for preferential allotment to promoters and others.

3. Terms of the present issue

1. Terms of payment.

2. How to apply

3. Any special tax benefits

4. Particulars of the issue

1. Objects

2. Project cost

3. Means of Financing (Including contribution of Promoters)

5. Company management and project

1. History and main objects and present business of the company

2. Promoters and their background

3. Location of the project

4. Collaborations, if any

5. Nature of the product(s), export possibilities.

6. Future prospects

7. Stock market data.

6. Certain prescribed particulars in regard to the company and other listed companies under the same management which made any capital issue during the last 3 years.

7. Outstanding litigations relating to financial matters or criminal proceedings against the company or directors under Schedule XIII.

8. Management perception of risk factors (e.g. sensitivity to foreign exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost/time over-run etc.)

Part II of Schedule II

Requires the company to give detailed information. This part Is further sub-divided into three parts, viz., General information, financial information and statutory and other information.

General Information shall include information on matters like

1. Consent of directors, auditors, solicitors, managers to the issue, Registrars to the issue, Bankers of the company, Bankers to the issue and experts.

2. Change, if any in directors and auditors during the last 3 years and reasons there for.

3. Procedure and time schedule for allotment and issue of certificates.

4. Names and addresses of company secretary, legal advisor, lead managers, co-managers, Auditors, Bankers to the issue and Brokers to the issue.

Financial information includes

1. Reports of the auditors of the company with respect to its profits and losses and assets and liabilities and the dividends paid during the five financial years immediately preceding the issue of prospectus.

2. Report by the accountants on the profits or losses for the preceding five financial years and on the assets and liabilities on a date which must not be more than 120 days before the date of the issue of the prospectus.

Statutory and other information includes information about

1. Minimum subscription

2. Expenses of the issue

3. Underwriting commission and brokerage.

4. Previous public or rights issue giving particulars about date of allotment, refunds, premium/discount etc.

5. Issue of shares otherwise than for cash.

6. Particulars about purchase of property, if any.

7. Revaluation of assets, if any.

8. Material contracts and time and place where such documents may be inspected.

Part III of the Schedule Gives explanation of certain terms and expressions used under Part - I and Part — II of the schedule.

Is the Issue of Prospectus Compulsory?

No. Issue of prospectus by a company is not compulsory in the following cases:

1. A private company is not required to Issue a prospectus.
2. Even a public company need not Issue a prospectus if the promoters or directors feel that they can mobilise resources through personal relationship and contacts. In such cases the company is required to file a statement called “statement in lieu of prospectus’ with the Registrar of companies.
3. As per the Amendment Act, 1988 a company may issue any form of application for shares or debentures of a company accompanied by a memorandum containing the prescribed salient features of a prospectus (instead of a prospectus). However, in such a case, a copy of the prospectus must be made available to any person on request [Sec. 56(3)].
4. Where the application form is issued in connection with .a bonafide invitation to a person to enter into an underwriting agreement with respect to the shares or debentures [Sec. 56(3)]
5. Where the application form is issued in relation to shares or debentures not offered to the public [Sec. 56(3)].
6. Where the shares or debentures are offered to existing holders of shares or debentures (i.e. rights issue) with or without the right of remuneration in favour of other persons [Sec. 56(5)].
7. Where the issue relates to shares or debentures which are to be uniform in all respects with shares or debentures previously issued and dealt in or quoted on a recognised stock exchange [Sec. 56(5)].
8. Where invitation to the public for subscription to the shares or debentures of a company is made in the form of an advertisement ordinarily called as ‘prospectus announcement’ [Sec. 66].

Abridged Prospectus

The Central Government had vide SR No.6 14 (E) dated October 3, 1991 prescribed the memorandum containing the salient features of abridged prospectus by adding Form 2A to the Companies (Central Government’s) General Rules and Forms 1956. The Department of Companies Affairs has vide F.No. 1/6188 - CCV, circular No 1/92 dated January 9, 1992 notified that share application forms should be a part of abridged prospectus being attached to it along a perforated line. The prospective investors

are guided, as it provides an opportunity to study the contents of the abridged prospectus before submission to the designated bankers/same company. The particulars that are required to be furnished in the prescribed format Form 2A according to rule 4CC of Companies (Central Government) General Rules & Forms 1956, are enumerated below;

1. General information; (2) capital structure of the company; (3) Terms of the present issue; (4) particulars of the issue; (5) company management and projects; (6) schedule of implementation of the project, (7) products to be manufactured, future prospects etc., (8) payment! refunds. (9) particulars of companies under the same management; (10) Managements perception of risk factors.

Refusal Goods for Registration of Prospectus

The Registrar is empowered to refuse registration of the prospectus under the following grounds: (I) if the prospectus is not dated; (ii) if the prospectus contains a statement purported to be made by an expert without a statement that he has given and has not withdrawn his consent; (iii) if it does not contain consent in writing of directors; (iv) if a copy of the documents mentioned u/s 60(1) has not been filed.

Voluntary Disclosure

The prospectus is the window through which an investor can look into the soundness of the company's venture. The prospective buyer of shares is entitled to all true disclosures in the prospectus. It should not conceal any matter which ought to be revealed. In a nutshell the prospectus shall tell the truth, the whole truth and nothing but the truth. This ruling is called 'the golden rule' for framing a prospectus. This ruling was laid down by V.C. Kindersley in *New Brunswick and Canada Railway and Land company Vs. Muggeridge (1860)*

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Deemed Prospectus

According to Sec. 64, an offer for sale is a prospectus and it is deemed to have been issued by the company. Sec. 64 provides that where a company allots or agrees to allot any shares or debentures of the company with a view to allot any of those being offered for sale to the public, the document by which the offer of sale to the public is made shall for

purposes be deemed to be a prospectus issued by the company. Unless the contrary is proved, it is evidence that an allotment of, or an agreement to allot shares/debentures was made with a view to, allot the shares/debentures being offered for sale to the public, if it is shown.

(a) that an offer for sale was made within 6 months of allotment or agreement for allotments, OR

(b) that at the date of the offer for sale, the company had not received the whole consideration for the shares/debentures.

The document containing the offer for sale must contain the following particulars;

(i) the net amount of the consideration received or to be received by the company in respect of the shares/debentures offered for sale.

(ii) The place and time at which the relevant contracts may be inspected. The persons making the offer for sale to the public are to be deemed directors of the company for the purpose of registration of the prospectus.

Statement in Lieu of Prospectus (Section 70)

If a public company makes a private arrangement for raising its capital, then it must file a statement in Lieu of Prospectus with the Registrar at least three days before any allotment of shares or debentures can be made.

Schedule III contains a model form of a statement in lieu of prospectus in pursuance of Section 70; Schedule IV contains a model form of a statement in lieu of prospectus when a private company is converted into a public company in pursuance of Section 44. If allotment of shares or debentures is made without filing the document, the allottee may avoid it within two months after the statutory meetings or where no such meeting is to be held, within two months of the allotment. Contravention also renders the company and every director liable to a fine up to Rs. 1,000.

MIS-STATEMENT IN PROSPECTUS

According to Sec 62(3), the offer for sale must set out all the details required to be inserted in a prospectus. It should also specify the net amount of consideration received by the company on the shares or debentures to which the offer relates, and specify the place and time at which the relevant contracts may be Inspected. As all the provisions which apply to prospectus issued by a company apply to such a document, it must disclose everything truthfully. When a prospectus contains false/fraudulent statement of facts, it can be termed as mis-statement In prospectus. According to Section 65 of the Act, a statement Included in a prospectus shall be deemed to be untrue, If the statement is misleading in the form and content in which it is included. It also provides that where the omission from a prospectus of any matter is calculated to mislead, the prospectus shall be deemed, in respect of such omission to be a prospectus in which an untrue statement is included.

Liability for mis-statement in Prospectus

A person who makes the offer will be liable for any mis-statement in that document in the same manner as persons who authorise the Issue of a false prospectus. When there is mis-statement of material fact in a prospectus, there may arise

(1) Civil Liability (ii) Criminal Liability: Every person who Is a director of the company at the time of the issue of the prospectus, every promoter of the company and every person including an expert, who has authorised the issue of a prospectus shall be liable.

For any untrue statement or mis-statement in the prospectus, a person who has subscribed for any shares or debentures on the faith of the prospectus and has sustained any loss or damage may sue for compensation all or any of the following:

(i) the company (ii) every director (iii) every person whose name appeared in the prospectus as a proposed director (iv) every promoter (v) V every person who has authorised the issue of the prospectus.

The Golden Rule

It is the duty of those who issue the prospectus to be truthful in all respects. This Golden Rule was enunciated by Kindersley, V.C. in *New Brunswick, etc., co Vs. Muggeridge* and has come to be known as the golden legacy.

The burden of proof in a suit by an allottee that he has been misled by the mis-statement in the prospectus lies on the allottee. He must prove the following:

- (i) the mis-representation was a fact
- (ii) it was in respect of a material fact.
- (iii) he acted on the misrepresentation and
- (iv) he has suffered damages in consequence.

Civil Liability

A person who has been induced to subscribe on the faith of an untrue statement in the prospectus has remedies against the (i) Company (ii) the directors and promoters and experts.

Remedies for mis-representation in prospectus: A company is responsible for a statement in prospectus only if it is shown that the prospectus was issued by the company. The company is liable if though the prospectus is issued by the promoters, the Board ratifies and adopts the issue, for the prospectus is the basis of the contract for shares.

Remedies against the company

(i) Rescission of the contract: Where a prospectus contains mis-statement whether innocent or fraudulent, the agreement to take up shares is voidable at the option of the aggrieved shareholder. He may apply to the court for the contract to be set aside, and his name to be struck off from the Register of members. He may also claim his money

(ii) Action for damages: The allottee may recover damages from the company for any loss he may have suffered if the invitation to buy the shares is emanating from the company and the persons making it on behalf of the company have fraudulently misrepresented material facts. Damages are generally claimed from the directors, promoters and other persons who authorised the issue of the prospectus.

Remedies against Directors, Promoters and Experts

(i) Damages for misrepresentation: According to Section 62, every director, promoter or any other person who authorised the issue of the prospectus is liable to compensate any misled allottee of shares for any loss sustained by him because of the untrue statement in the prospectus. However, the directors will not be liable for damages for mis-statement if they believed them to be true.

(ii) Liability for omission: An omission from a prospectus of a matter required to be stated under Section 56 may give rise to an action for damages at the instance of a subscriber for shares, despite the omission does not make the prospectus misleading. However, a director or other person sued u/s. 56 may defend himself by proving

- (i) that he had no knowledge of the matter not disclosed, or
- (ii) that the contravention arose out of an honest mistake of fact.

Liability under the General Law

Persons who authorise a false or misleading prospectus can also be held liable in action for deceit under general law as provided in the Contract Act. The aggrieved subscriber can claim full compensation for the loss sustained by him but he should prove the points mentioned below:

- (i) There was a fraudulent mis-statement.
- (ii) The representation related to material fact.
- (iii) The aggrieved party i.e. the original allottee actually relied on the mis-statement and was actually deceived.

However civil liability can be avoided under the following circumstances as specified u/s 62(2) of the Companies Act, if he proves:

- (a) that having consented to become a director, he withdrew his consent before the issue of prospectus and it was issued without his consent.
- (b) that the prospectus was issued without his knowledge or

consent and on becoming aware of its issue he immediately gave reasonable public notice of that fact.

- (c) He withdrew his consent after the issue of the prospectus but before allotment and public notice was given.
- (d) He had reasonable ground to believe that the statements were true and believed them to be true.

Criminal Liability for mis-statement in Prospectus

According to Section 63 of the Companies Act, where a prospectus includes any untrue statement, every person who has authorised the issue of the prospectus shall be punishable with (a) imprisonment for a term which may extend to 2 years or (b) fine up to Rs. 5,000 or both, But he can escape from the liability if he can prove that the statement was immaterial or that he had reasonable ground for believing that it was true.

Penalty for fraudulently inducing to invest money: According to Section 68, any person guilty of fraudulently inducing persons to invest money in a company shall be punishable with imprisonment up to 5 years or fine up to Rs. 10,000 or both.

Prohibition of allotment of shares in fictitious names: Section 68A makes the following acts punishable with imprisonment for a term extending to 5 years:

- (a) making an application to a company for acquiring or subscribing for any shares therein under fictitious name or (b) inducing a company to allot or register any transfer of shares therein to him or any other person in a fictitious name.

It is obligatory for every company to prominently display the above provisions in every issue of a prospectus as well as in the forms of application for shares.

SEBI now authorised to institute prosecution: The Department of Company Affairs has by its two notifications issued on November 24, 1993 and February 15, 1994 authorised the Securities and Exchange Board of India (SEBI) to institute prosecutions in respect of certain offences under Sections 56, 57 and 58 of the Companies Act, 1956.

SECURITY LISTING

Security listing or listing of securities means inclusion of securities in the official list of Stock Exchange for the purpose of trading. In other words, it implies that securities of these companies have been listed by the Stock Exchange concerned. The Companies (Amendment) Act, 1988 has provided that every company, intending to offer shares or debentures to the public for subscription by the issue of a prospectus shall before such issue, make an application for permission for the shares or debentures intending to be so offered to be dealt with in the stock exchange.

Listing imparts liquidity to shares, bonds and debentures by providing for free marketability, enforces timely disclosure and dissemination of corporate information as well as proper supervision and control of dealings in the listed securities.

Companies may enlist their securities in as many Stock Exchanges as they like in addition to the Regional Stock Exchange (RSE). However, companies having paid up capital of Rs.5crores or more are required to get their shares listed on atleast one stock exchange other than the regional stock exchange. Companies desirous of getting their securities listed are required to apply to the stock exchange and enter into a listing agreement with them. Subject to certain conditions, the stock exchange may grant permission. The company is required to adhere to all the covenants of the listing agreement.

Refusal of listing by a Stock Exchange

A stock exchange may refuse permission to listing of securities when

- (a) the eligibility criteria as to minimum issued capital and minimum public offer is not followed:
- (b) the company has not conformed to the requirements as to reservation out of public offer for employees of the company and shareholders of the promoter companies as applicable:
- (c) the company has not followed the prescribed guidelines with respect to cost of public issues, opening and closing of subscription list etc.,
- (d) the prospectus of the company making the public offer does not conform to the conditions in regard to public issues.

Right of appeal against refusal of stock exchange to list securities of public companies:

Where a recognised stock exchange refuses to list the securities of any public company, the company shall be entitled to demand the reasons for such refusal. On receipt of the reasons for such refusal, the company may, within 15 days, appeal to the Central Government against such refusal. The Central Government may thereupon (after giving the stock exchange an opportunity of being heard) vary or set aside, the decision of the stock exchange. On decision being varied or set aside, the recognised stock exchange shall act in conformity with the orders of the Central Government.

Where the stock exchange has omitted or failed to dispose of within Sec. 73(1) of the Act, the stock exchange must grant or refuse permission before the expiry of 10 weeks from the date of closing of subscription list, the application for permission for the shares or debentures to be dealt with on the stock exchange. The company may within 15 days from the date of the specified time or within such further period not exceeding one month as the Central Government may on sufficient cause being shown, allow, appeal to the Central Government against such omission or failure. Thereafter, the Central Government may, after giving the stock exchange an opportunity of being heard, grant or refuse the permission.

Advantages of listing of securities

Security listing provides valuable benefits to the company, the investor and the public at large:

(a) *Benefits to the company:*

(i) The securities when listed receive intensive advertisement as the name of the company is carried in the daily official list of the stock exchange and transactions in securities are reported in the news papers/TV. Thus, listing adds to the prestige and Importance of listed companies.

(ii) An official quotation on the floor of the recognised stock exchange is an economic barometer of the health of the company. It facilitates raising of finances from the financial institutions and the investing public for modernisation, expansion, diversification or for setting up of new projects.

(iii) Listing encourages institutional and other under—writers to participate in the issue of shares.

(b) Benefits to the Investor:

(i) Listing ensures liquidity by providing for free marketability and transferability of listing securities.

(ii) The regular and latest reports on listed companies help the investing public in assessing securities of the listed companies.

(iii) Purchase and sale of securities of a listed company can be effected at a fair price.

(iv) The official quotation of the prices of shares of recognised stock exchanges are taken as standard for income tax and wealth tax purposes.

(c) Benefits to the Public:

(i) Transparency in corporate details and their timely disclosure encourage prospective investors to know more about the corporate sector, for investment.

(ii) The dissemination of corporate information, when stored systematically in a scientific manner, serves as valuable corporate data at the disposal of the society.

Questions

1. Define a prospectus. Is the issue of a prospectus compulsory on the part of a company?
2. What is a prospectus? Explain its contents.
3. What is a deemed prospectus?
4. When should a statement in lieu of prospectus be issued?
5. "Prospectus is the window through which company is displayed without distortion" - Comment.
6. Distinguish a prospectus from statement in lieu of prospectus.
7. Explain the legal provisions relating to issue and registration of a prospectus.
8. Who are liable for mis-statement in a prospectus? Explain the extent of civil and criminal liability for such mis-statement.
9. What amounts to a mis-statement in a prospectus? Explain the remedies available to a subscriber who has taken shares on the basis of a mis-statement *in* a prospectus.
10. Write short notes on:
 - (a) Golden rule of prospectus
 - (b) Registration of a prospectus
 - (c) Deemed prospectus
 - (d) Prospectus by implication
 - (e) Mis-statement/untrue statement in prospectus.
11. What is listing of shares? Is security listing compulsory?
12. Can a stock exchange refuse listing of shares?
13. State the remedies available to a company against stock exchange refuse listing of shares?
14. Enumerate the advantages of listing of securities on a stock exchange.

UNIT- VIII
LESSON - 8 DIVIDENDS, BONUS AND INTEREST

DIVIDENDS

The profits of a company, which can be legally distributed among its shareholders, are called dividends. Dividends are that portion of profits of the company to be distributed to shareholders in proportion to their shares held by them. The term 'dividend' is not defined in the Companies Act, 1956. Out of the profits of the Company, the divisible profits are determined subject to the provisions of the Companies Act and the Articles of Association. The law does not give the meaning of profit. It also does not state that only true profits can be distributed. However, Sec. 205 (2A) of the Companies Act, provides that no dividend should be declared or paid out of the profits of the company arrived at without providing for depreciation. The depreciation should be provided as per the requirement of sub sec. (1) of Sec. 205 of the Companies Act and as per the Sec. 350. Dividend can be declared by a company for any financial year only after the transfer to the reserves of the company of such percentage as prescribed by the Central Govt. Rules 1975, [Sec. 205(2A)]. But the transfer of profits to the reserves of the company should not exceed 10%. However, it can transfer higher percentage of profit also. Payment of dividend depends primarily upon a company's profits of the current year or of the undistributed profits of the previous years, dividends can also be declared out of the funds, provided for the purpose of declaring dividends by the Central or State Governments in pursuance of the guarantee given by such governments.

Dividend to be declared at the annual general meeting

The companies Act does not grant any specific power to the companies registered there under to declare and pay any dividend. The Articles of Association generally regulate the method in which dividends are to be declared. Generally the dividend is recommended by the directors as per the articles of association [Sec. 173(1)(a)]. It is approved and declared in the annual general meeting by the shareholders [Reghunadan Newtia V. Swadeshi, cloth dealers Ltd. (1964), 34.com. cos. 574(cal)] only when there is adequate divisible profit, and the financial position of the company is sound [Kantilal Manilal V. Commr. of Income Tax (1957)26. com. cas. 57(Bom)].

The declaration of dividend is the internal matter of the company. It is subject to certain legal requirements and the provisions of the Articles of Association of the company. Even the court does not have power to interfere with the authority of the directors and shareholders [Burland V. Arle.(1902) A.C. 831. But dividend shall not be paid out of capital.

When the profit of the company is inadequate the dividend can be declared out of the accumulated profits of the company and transferred to its Reserve Account, under Sec. 205A(3). This declaration should be made as per the rules, prescribed for the purpose by the government. The same procedure can be adopted for the declaration in the case of absence of profits by the company in any year.

Declaration of Dividend on Preference and Equity Shares

(i) Dividend on preference shares: The dividend can be declared on the preference shares according to the provision of the Companies Act, the Rules, articles of association and the terms and conditions of the issue. The preference shareholders shall have preferential right for the payment of dividend over the equity shareholders. The preferential right in respect of dividend may be either for a fixed amount or fixed rate as agreed upon. When no dividend is declared in any year these holders have to go without any dividend. But the cumulative preference shareholders have the right to demand even the unpaid dividend of any year, during the subsequent years or in any year at which profits are available for distribution.

(ii) Dividend on equity shares: The equity shareholders do not have the right for fixed amount or fixed rate of dividend for their shares as the preference shareholders. The directors have discretion to recommend declaration of any dividend, which they think reasonable under Section 217(1)(c). Sometimes they may refuse to declare any dividend to the equity shareholders. In such case, the shareholders cannot insist on the payment of dividend [Board V. Barrow Haematite Steel Co. (1902)(1)ch.3531. A company which fails to comply with the provisions of 80A i.e have not redeemed the redeemable preference shares, should pay dividend till the default continues for equity shares.

Once the dividend is declared it becomes a debt payable by the company to the shareholders [Batcha F. Guzdar V. Commr. of Income Tax, Bombay, (1955,1.SCR.876:AIR.1955. Sec. 74 (1955) 25 com. cos 1]. The shareholders have the right to recover the declared dividend within three years from the date of declaration when any company has declared dividend in respect of any year at its annual general meeting. No further dividend, for the same year can be declared by the company IBiswanath Prasad Khaitan V. New Central Jute Mills (co) Ltd. (1961) 31 comp. cas. 1251. A company which could not declare dividend at any annual general meeting can do so at the subsequent general meeting.

Special provisions have been made for the payment of dividends under Sections 93 and 205 to 207 for the payment of dividends. The Act provides that the dividend shall be paid only in cash. The Central Government may if it thinks necessary to do so, in the public interest allow the company to declare and pay dividend for any financial year or any previous financial years without providing depreciation.

Sec. 205A and 205B are the two new provisions relating to the payment of dividend introduced in the Companies Act 1974 through Amendment. Sec. 205A deals with the transfer of unpaid dividends within 7 days of the expiring of 42 days from the date of declaration of the dividend to a special account with a scheduled Bank under the name 'Unpaid Dividend Account of Co. Ltd/Co. Private Ltd. If the company fails to transfer the amount of unpaid dividends within the given time, it has to pay an interest at the rate of 12 percent per annum. Any such amount transferred to the Unpaid Dividend Account and which remains unpaid or unclaimed for a period of three years from the date of such transfer shall be transferred to the "General Reserve Account". All the claims must then be made to the Central Government. After this transfer the central government will settle such claims.

On failure of complying with any of the above requirements, the company or any officer who is at fault is punishable with a fine up to Rs. 500 for every day of which the default continues.

Liabilities of Directors In case of Payment out of capital

When the company has wrongly paid the dividend out of capital, It may reduce the capital. The directors who are responsible for such payment are jointly and severally liable to repay the amount to the company with interest. However the directors are entitled to recover the amount from the shareholders who received the dividend.

Payment of Dividend to Registered holders

Dividend can be paid only to the registered shareholder or to his order or to his bankers or to the producers of coupons in respect of share warrants. The declared dividend is to be paid by the company, within 42 days from the date of declaration to the shareholders. If there is any default, the director, who has knowingly failed to pay, is liable for Imprisonment upto 7 days and with a fine, under Sec. 207.

The following are some of the important provisions regarding dividends:

1. Dividends can be paid for any financial year only out of the profits of the current year or previous year.
2. Dividends can be paid only in cash, but during the capitalisation of profits or reserves, the bonus share can be issued as fully paid up.
3. The capital profits can be distributed by way of dividend when: (i) the assets are revalue, (ii) the capital profits remain after the revaluation of all the assets; and (iii) the distribution of a dividend of such profits is allowed by the Article of the company.
4. The company must transfer certain percentage of profit not exceeding 10 percent or as may be prescribed by the Central Govt. to the reserves of the company before the declaration and payment of dividend. However they may also transfer an higher percentage of profits voluntarily to the reserves (Sec. 205). If the proposed dividend is less than 10% no transfer is necessary.
5. The company must provide for depreciation, including for arrears before declaring dividend [Sec. 205(3)].
6. A company which fails to redeem the irredeemable preference shares cannot declare dividend till the redemption [Sec. 80A] .

7. In case of absence of or inadequacy of profits in any year, the dividend can be declared out of the accumulated profits and reserves in accordance with Rules framed by the Central Govt.
8. The shareholders declare the dividend in the annual general meeting, which is recommended by the board of directors.
9. The payment of dividends should be made or the dividend warrants are to be posted to shareholders within 42 days from the date of declaration (Sec. 207).
10. The directors are empowered under its articles to declare Interim dividends with the consultation of the auditors.
11. According to company law only the registered shareholders of a company are eligible to receive dividend and offers for rights or bonus shares. In the case of transfer of shares the transferor should take - a mandate to the transfer as per the Companies (Amendment) Act, e, 1988 of Sec. 206A. In the absence of such mandate, it is obligatory on the part of the company to transfer the dividends accruing on such shares to the Unpaid Dividend Account. The right alone will be kept in abeyance till the title to the shares is decided.
12. Sec. 208 provides an exception to Sec. 205 which enables the company to declare dividend only out of profits. It provides that where shares are issued to raise money to defray the cost of works of building or plant which cannot be made profitable for a long period the company may pay at the rate of 4% interest on the amount of capital paid up in respect of such shares as per its articles and with sanction of Central Govt.
13. After the declaration of dividend by the company if it has not been paid or claimed before 42 days from the date of declaration the company has to transfer such dividend to a special account within 7 days from the date of expiry of the 42 days with any scheduled bank (Sec. 205A(1)). The amount can be claimed by the shareholders within a period of 3 years from the date of transfer.
14. In case of failure by the company for the transfer of the unclaimed dividend to the "Unpaid Dividend Account", the company shall pay interest at the rate of 12 percent per annum [Sec. 205A(4)].
15. On completion of three years from the date of transfer, which remains in the "Unpaid Dividend Account" shall be transferred to the general revenue account of the Central Govt. The person entitled for the dividend can claim from the Central Govt. [Sec. 205-B].

16. The company should give the following information in the statement. when it transfers to the general revenue account: a) the nature of the amount, b) the names and address of the persons entitled for the dividend, c) the entitlement of each person and d) the nature of his claim thereto and such other particulars as may be prescribed (Sec. 205-A(6)).
17. If the co. fails to follow any of the requirements of Sec. 205A, the company and every officer who is at fault shall be punishable with a fine up to Rs.500 for every day during which the failure continues [Sec. 205-A(8)].
18. The dividend shall be paid only to the registered shareholder, to his agent or to his banker. When share warrant has been issued the payment can be made to the bearer of such warrant or to his bankers [Sec. 206(1)].

Penalty for defaulting directors: When the directors of the company fail to pay the dividend or post the warrant within 42 days from the date of declaration, every director at default is liable for a punishment of simple imprisonment up to 7 days and with a fine [Sec. 207].

Generally the capital profit will not be distributed amongst shareholders, as dividend. The non-trading profits are capital profits. But in certain cases the capital profit can also be declared as dividend and paid to the shareholders of the company (Lubbock V. British Bank of South America (1892)).

BONUS

Every company may transfer part of its profits to a reserve account, every year. The Companies Amendment Act 1974 made it obligatory under Sec. 205(2A) to transfer certain percentage of profits as prescribed by the Central Government. As per the articles of association, a part of its accumulated reserve fund can be used to increase the share capital of the company by using either partly or fully paid-up shares, to its shareholders. Bonus share may be issued from the share premium Account, and capital Redemption Reserve Account (Sec. 80(5)). Bonus shares cannot be issued as gift. The shareholders get the bonus shares besides the dividend, which they may get from the company.

Conditions for the issue of Bonus Shares

A company can issue bonus shares under the following conditions:

- a. Articles of the company must permit the issue.
- b. The issue must be recommended by the Board of Directors and then be approved by the shareholders in the general meeting.
- c. The controller of Capital Issues should permit this issue without considering the amount involved.

Right to Bonus Shares

Only the registered shareholders are entitled to receive the bonus shares. A transferee of the shares, whose name has not been registered by the company, in its register of members, is not entitled for the bonus shares. Regarding the offer of bonus shares made by the company, pending registration of transfer, Sec. 206A(b), provides that the company shall keep such offer in abeyance. The offer of bonus shares shall be kept pending until the registration of transfer and the 'offer shall be made to the transferee of the shares, after his name is entered in the register of members of the company.

Restrictions on Issue of Bonus Shares

The Government of India has introduced the following restrictions on the issue of bonus shares, as per the orders issued in March, 1974.

1. No company will be allowed to issue more than two bonus shares over a period of five years.
2. A company can make bonus issue only from the free reserves create out of profits or share premium received in cash. But the company cannot declare bonus instead of dividend.
3. Though every company is made to get the approval of the Controller of Capital Issues, for the issue of bonus shares such issue should be authorised in the Articles Association of the company. Otherwise the company should pass a resolution in the general meeting to this effect.
4. The subscribed capital may be increased after the Issue of bonus shares. Then a resolution will be passed in the general meeting increasing the authorised capital.
5. Any reserve created for fixed asset will not be allowed to be capitalised.

6. The development rebate is taken as a free reserve while calculating the residual reserve test. It is allowed to be capitalised.
7. The residual reserve, after the proposed capitalisation should be at least 33½ percent of the increase in the paid up capital.
8. The company will not take the capital redemption reserve, if any, for computing the minimum reserves of 33½ percent.
9. While calculating the minimum residues of 33½ percent all the contingent liabilities disclosed in the audited accounts which have influence on the net profit shall be included.
10. A company will be allowed to issue bonus shares only if 30 percent of the average profits before tax of the company for the previous three years yield a rate of dividend on the expanded capital base of the company at 9 percent.

INTEREST

Interest is the consideration payable to the creditor by the debtor for the use of the borrowed money. The payment of interest is a charge on the profit and loss account of the borrowing concern. It is to be paid compulsorily irrespective of the profit of the company, as per the terms and conditions, on the agreed percentage. Directors have no discretions in the payment of interest. Interest on accrual becomes a debt. Generally interest is payable, once in 6 months to the debenture holders on the dates mentioned on such terms and conditions, stated in the debentures. In the case of bearer debentures, the interest is paid through the coupons, enclosed with them. To the registered debenture holders it is paid, on the production of interest warrants. The interest is paid in the same manner as the payment of dividend.

Payment of interest out of capital [Sec. 208]

Sec. 208 of the Companies Act 1956 states the circumstance at which the payment of interest can be made on capital out of capital. Sometimes the company may raise money by issue of shares for the purpose of meeting the expenses of creating any work, building or plant which cannot make profit for a long period. In such circumstances the company may pay interest on the share capital and charge the same to the capital account as part of the cost of construction.

The company should fulfil the following conditions to make such payments:

1. The company's articles of association should permit the payment of interest.
2. Prior sanction of the central government is necessary.
3. The government may appoint an officer to make an enquiry into the expenses of the company.
4. The period of sanction for the payment of interest should not go beyond the close of the half year next, after the half year during which, the work has been completed.
5. The rate of interest should not exceed 4 percent. The above payment of interest should not reduce the capital of the company [Sec. 208(7)].

INTERIM DIVIDEND

Dividend which is paid on shares before the time of declaring the final dividend is called the interim dividend. It is paid between two annual general meetings of the company. The Act does not contain any provisions with regard to interim dividend. Regulation 86 of Table-A provides that the Board may from time to time pay to the shareholders such Interim dividends as appear to it to be justified by the profits of the company (Lucas V. Fitzgerald (1903) 20.T.L.R. 16.18].

Before the declaration of interim dividend, the directors must satisfy members that there are profits available for distribution, and such declaration is authorised in the articles of the company. After having declared the interim dividend, if the directors have discovered that the dividend is to be paid out of capital or the available profit is inadequate for declaration and distribution of dividend, they may reconsider or refuse the payment of such dividend [Lagunas Nitrate co. *Ltd.* V. Henry Schroeder & Co. & Schmidt (1901),25,L.T.22J In J. Dalmia V. Commissioner of Income Tax (1964)34, comp. cas. 668, the supreme court held that the interim dividend is not a debt and cannot be enforceable obligation.

Procedure for declaration and payment of dividend

1. The Board of directors should make sure before considering the declaration that it has been empowered by the articles of the company to declare interim dividend. Further they should also satisfy themselves that they have adequate profits to provide for depreciation under Sec.:. 205 for the financial year;

2. To ascertain the available profits for the declaration of interim dividend a proforma account is to be prepared.
3. When the shares of the company are listed in the stock exchanges, the stock exchanges are to be informed regarding the date of Board Meetings where this subject is to be discussed.
4. After having considered the proforma accounts they have to consider (i) the available profit after allowing depreciation, (ii) entitlement for interim dividend (iii) closure of Register of members & Transfer Books or fixing record date (iv) the date of posting interim dividend warrants (v) opening of a separate bank account.
5. If the shares are listed in more than one stock exchange those stock exchanges, are to be informed regarding the closure of Register of members.
6. A notice is to be published in the news papers before 7 days of closing the register of members fixing the record date.
7. Arrange for the printing of the warrants and get duly signed as per the direction of the Board.
8. Though Sec. 207 is not applicable for the interim dividend the dividend warrants can be posted before 42 days from the date of Board resolution.
9. For non Resident shareholders the dividend warrant should be posted after getting permission from Reserve Bank of India as per the provisions of Foreign Exchange Maintenance Act,1999.
10. The interim dividend should be confirmed in the next annual meeting along with a resolution.

Dividend Warrants

Dividend warrant is an instrument containing an order by the company to its banker to pay the amount specified therein to or to the order of the shareholder named therein who is entitled to claim dividend. The warrant is drawn with Payee's account only. The dividend warrant is of two parts. The *first* part is a notice of the dividend to the shareholder and a certificate of deduction of Income Tax. The other part is the dividend warrant.

CAPITALISATION OF PROFIT

Any company having accumulated reserves may convert part of the reserves into fully paid shares and issue them to the existing shareholders, with the recommendation of the Board and subject to the Articles of the company. Articles 96 and 97 of Table A deal with the capitalisation of profits. If the articles of the company does not provide authority to capitalise profits, the shareholders can demand the payment in cash. The shareholders become the owners of the company from the date of resolution itself [Shri Gopal Paper Mills V. I.T. Commr., Calcutta., (1970) 2. Sec. 80: AIR. 1970. sc.1750].

Questions:

1. Briefly explain the procedure to be adopted for the declaration and payment of dividend by a company
2. When and under what circumstances can a company pay interest out of capital? What shall be the maximum rate of interest in such cases?
3. Enumerate the procedures to be followed for the issue of bonus shares by a company.